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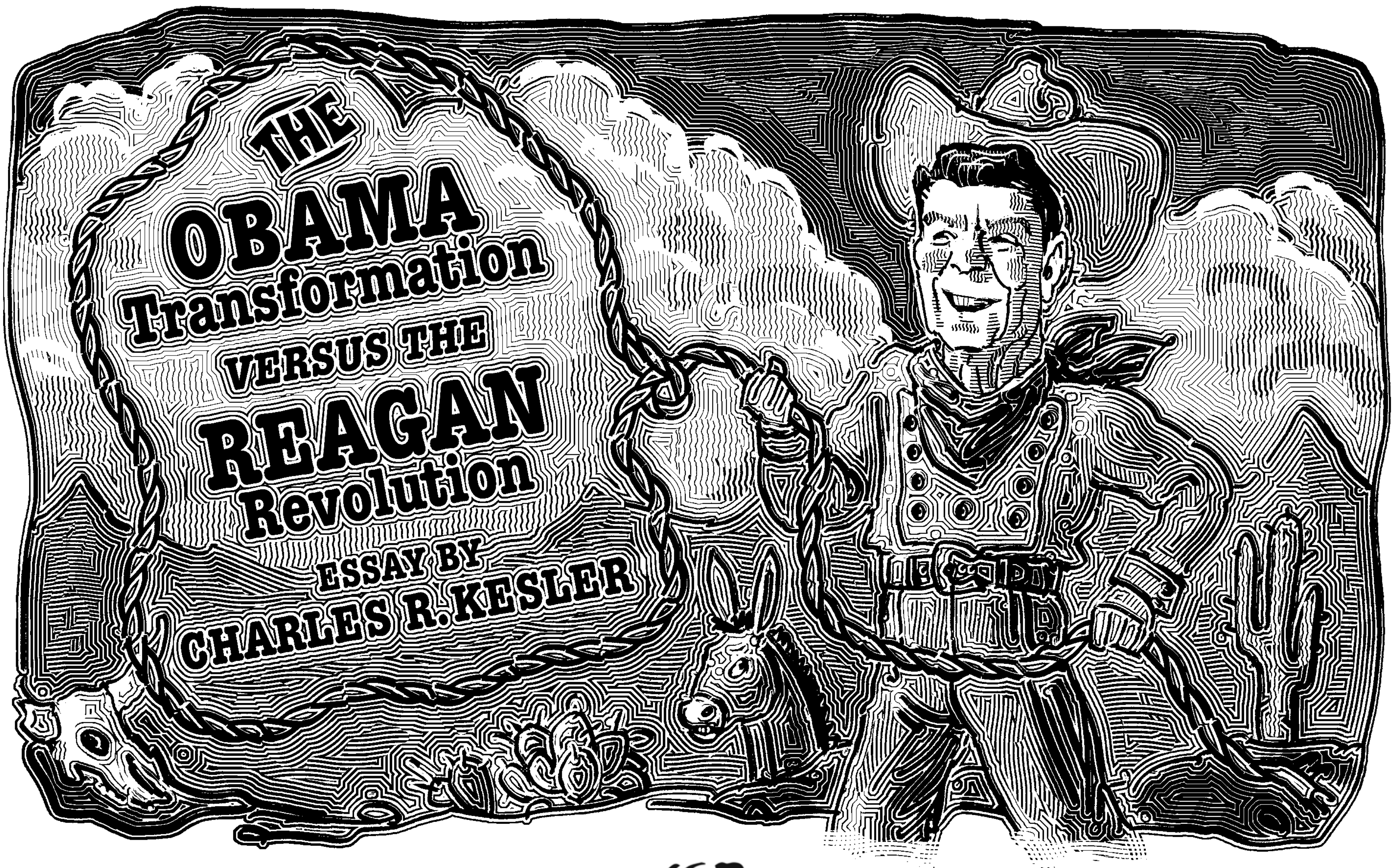

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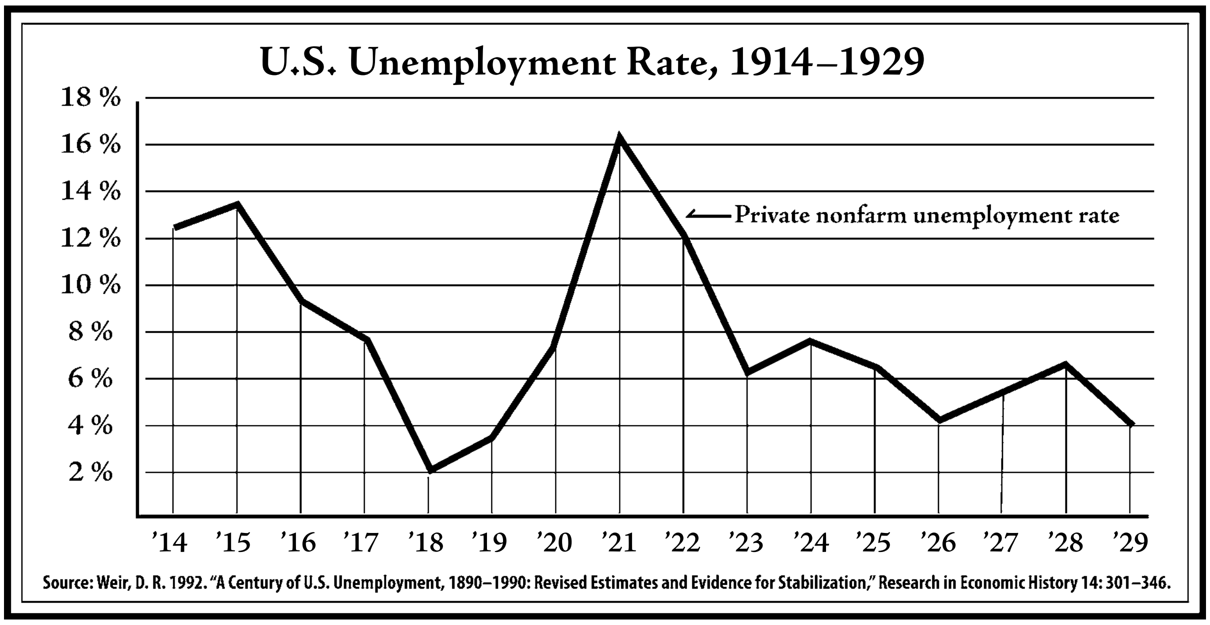
Book Review by Allan H. Meltzer

Don't Just Do Something

The Forgotten Depression: 1921, the Crash that Cured Itself, by James Grant.
Simon & Schuster, 272 pages, $28



James Grant's *The Forgotten Depression* is about the U.S. economy's deep recession beginning in 1920—when prices and wages fell rapidly, wiping out the post-World War I inflation—and its robust recovery two years later without any government intervention. In the final chapter, Grant compares "the crash that cured itself" to the Great Depression that began in 1929 and lasted through a decade's worth of attempted government cures.

Although there is no precise definition to distinguish a depression from a recession, in the 1920-22 downturn, real GNP fell 6.8% and the Standard and Poor's stock index fell 9.0% from peak to trough, whereas for the 1929 decline, the comparable reductions were 38% and 70%. The earlier crash may not loom as large in the public mind as the Great Depression, but there are several economic histories that do cover the recession and recovery—including Milton Friedman and Anna Schwartz's magnificent *A Monetary History of the United States, 1867–1960* (1963) and my own *History of the Federal Reserve* (2003, 2010)—so Grant's title is a little misleading.

The founder and publisher of the bimonthly journal *Grant's Interest Rate Observer*, he argues that the main difference between the two downturns was that in the earlier one, real wages fell sharply, whereas in the later one, they rose by 10%. Unlike President Herbert Hoover's policy of shifting "the burden of economic suffering to capital from labor," price deflation in the earlier recession lowered the price level of real wages.

Although he is right to highlight this difference, Grant neglects to mention that in both recessions, or depressions, the country was on some form of the gold standard. As in any fixed exchange rate system—like the current euro—adjustment during recessions requires a decline in unit labor costs, most likely achieved by reductions in real wages. That's the message that Ireland, Spain, and, to a lesser extent, Portugal have recently accepted. France and Italy continue to languish because, like Hoover, they hinder and even prevent real wage reductions.

I'm not sure Grant recognizes this point. He has long been known as an advocate of the gold standard, calling it "not the least imperfect monetary system ever to function in human society." Countries mainly choose flexible exchange rates in order to lower unit labor costs by devaluing currency. Our government abandoned the gold standard in 1933 because it preferred currency depreciation to real wage deflation. Unfortunately, several members of the euro system do not want to act on the unavoidable truth that their system requires real wage adjustment.

Although he recognizes that the massive 1920-21 deflation was extremely painful for people at the time, Grant maintains that "[i]n comparison to what was to follow, it was…a triumph." He doesn't go beyond this conclusion either to claim or to suggest that a less painful adjustment might have been found. Fortunately, Hoover's successor, Franklin Roosevelt, chose devaluation.

The Forgotten Depression is as much a pleasure to read for its deft sketches of life in the 1920s and of the political players of the time, as for its vivid account of the collapse of stock prices, the fall in General Motors shares, and the DuPont Company's near bankruptcy. When the downturn began in 1920, at the end of Woodrow Wilson's second term, the president said, "I am perfectly sure that the state has got to control everything that everybody needs and uses." In the 1912 presidential campaign, he had promised to reduce tariffs and restore federal revenue by taxing "the rich." In the White House, he blamed "greed" and "gouging businessmen," not expansive wartime policies, for the postwar inflation. Progressives, too, decried "the injustice in the distribution of income." Some things never change.

William McAdoo—Wilson's son-in-law, treasury secretary, and ex officio head of the Federal Reserve part of the time—wanted (along with his successors) to keep interest rates low in order to finance the wartime debt. The Republicans' victory in the 1920 election put Andrew Mellon in at the Treasury, which, despite the recession, maintained a 7% discount rate. The discount rate would not again exceed 6% until the inflation of the late 1960s and '70s.

Grant recognizes that the sharp boost in interest rates ended the economic expansion and later ended the inflation. It also attracted gold inflows from abroad that reversed the decline in money and credit, supporting the expansion in 1922-23 that continued until the 1929 collapse.

He fails to mention, however, that in addition to the 7% discount rate, some regional reserve banks charged very high rates on relatively small bank borrowings. These very high rates caught the eye of members of Congress, and subsequent hearings chastened the Federal Reserve. As a result, the Federal Reserve Board, in a political move, rejected discount rate increases in 1928-29 that reserve banks, especially in New York, had requested as a means of controlling borrowing.

When grant at last discusses the deep recession and the response, he repeats that the central feature was wage deflation accompanied by Secretary Mellon's efforts to balance the budget, reduce the debt, and lower tax rates. The proposed budget surpluses gave investors confidence that tax rates and government spending would decline over time, stimulating investment and growth. And they did. Mellon's budget surpluses averaged 20% of tax receipts from 1921 to 1929, and the Treasury Department retired almost 30% of the debt outstanding in 1921. Mellon reduced income tax rates in 1922, 1923, 1924, 1925, and 1928.

Grant cites three reasons for the strong recovery in 1922: (1) inventory rebuilding after sharp liquidation, (2) lower interest rates brought about by the gold inflow and Federal Reserve policy, and (3) the deflation that lowered prices and increased purchasing power. He doesn't mention tax rates and deficit reduction, reduced regulation, or the key support given to these policies by Secretary Mellon and President Harding. Grant should have reemphasized the decline in real wages that made costs of production competitive, though he does refer later in the book to real wage reduction.

At the time, Grant notes, "28 percent of the American workforce were engaged in agriculture." By the second half of 1920 the average price of ten leading crops had fallen 57%, with the price of raw cotton falling 75%. "By November 1921, [the average price] had sunk below 1913." Faced with the financial ruin of a large group of voters, the Harding Administration did what governments almost always do: it serviced its constituency; in this case, aiding farmers by passing the Agricultural Credits Act of 1923, which used the Federal Farm Credit Banks to lend to farmers. These government lenders survive to the present.

Harding and the Republicans of that era were protectionists who favored a high tariff to protect American industry while, at the same time, opposing government regulation of industry. By contrast, Herbert Hoover was more amenable to federal action to relieve distress. As secretary of commerce under Harding and Calvin Coolidge, Hoover managed to get a public works program adopted to help unemployed workers through the 1921 winter. The states and cities paid for the programs and ran them. Later, Congress and the administration approved a $76 million highway bill intended to create 150,000 jobs. The bill became law after the recovery had begun.

The years before the great depression are one of the best periods of economic growth and low inflation in the past 100 years. It is curious that, outside of a few footnotes, Grant doesn't refer to Friedman and Schwartz's *A Monetary History of the United States*, or rely on its data on reserves, money, and purchasing power parity. Instead, Grant uses early data produced by the Commerce Department. Nathan Balke and Robert J. Gordon provided more reliable historical data on prices and GNP for the National Bureau of Economic Research.

Nor does Grant discuss whether the conditions that permitted a severe deflation followed by rapid recovery were exceptional. He remarks in a few places that both political parties accepted that the gold standard required deflation and real wage reduction from wartime peaks. Labor unions existed, but they had little political influence prior to the New Deal. Devaluation against gold was unthinkable at the time. In fact, the Federal Reserve's Benjamin Strong and the Bank of England's Montague Norman agreed that both countries had to deflate to restore the prewar parity.

Since then, strong Republican presidents, including Dwight Eisenhower and Ronald Reagan, chose not to run balanced budgets during recessions as Harding had done. Economic policy is now made in a political system in which voters expect government to do something when faced with high unemployment, even if it involves deficit spending. Eisenhower was more determined to balance the budget than most postwar presidents, but he accepted a large deficit in the 1958 recession. In the postwar United States, only Ike and Bill Clinton had back-to-back budget surpluses.

Despite its flaws, I recommend *The Forgotten Depression*. Its lively history and analysis of Republican economic prescriptions in the 1920s provide a tantalizing contrast to the record of President Obama's failed stimulus. Above all, James Grant reminds us that, in the long term, America cannot recover its economic health without a recovery of its economic principles.

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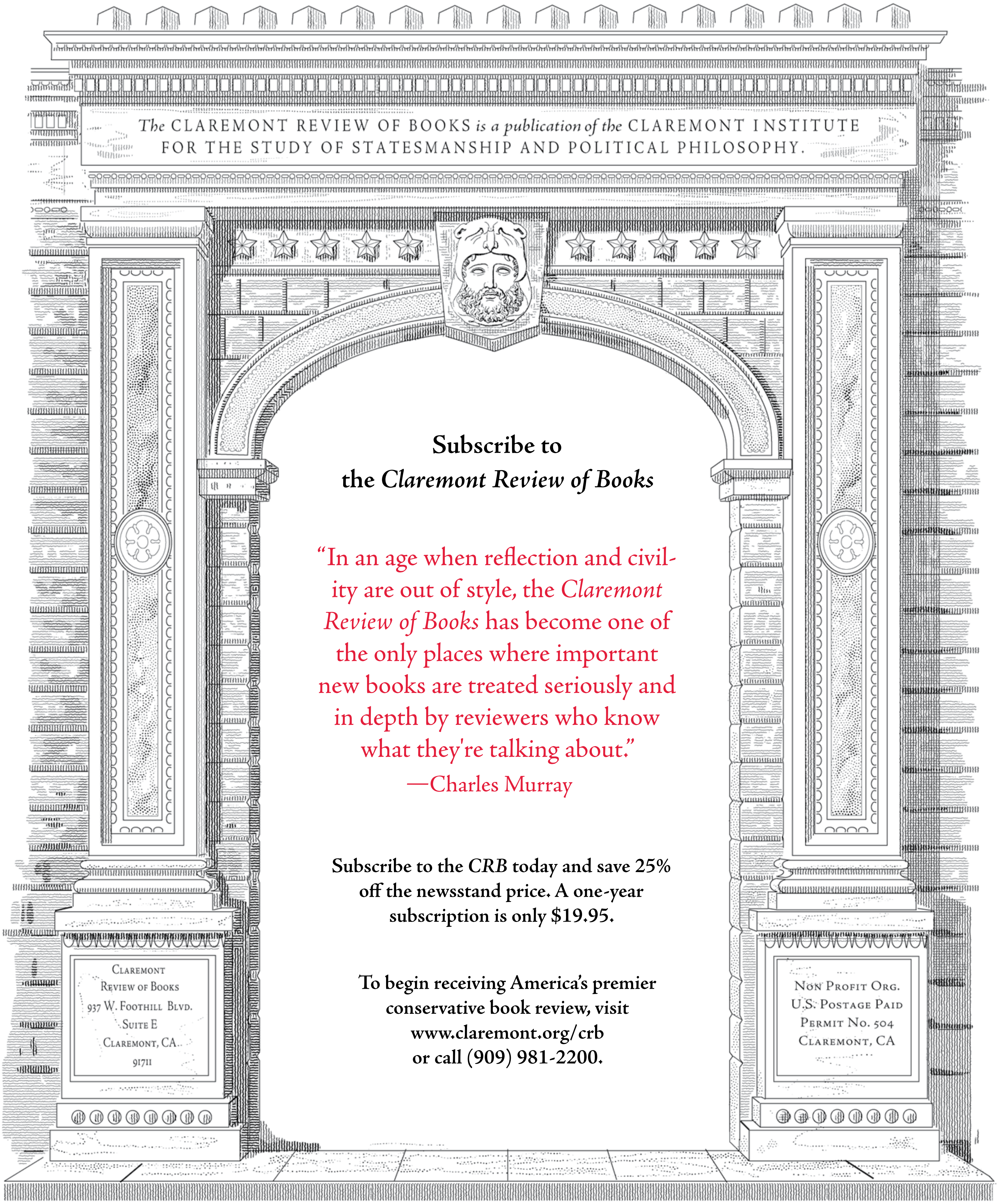

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