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Hayek for download

The editor of *Grant's*, whose "The Forgotten Depression: 1921, the Crash that Cured Itself," won the 2015 Hayek Prize, delivered the associated Hayek Prize Lecture on June 2 in New York. The text of his remarks follow.

2015 Hayek Lecture The Forgotten Depression

This is the thing that generally happens in heaven. I thank the Manhattan Institute and the Hayek Prize jurors. I thank George Selgin, who graciously wrote a letter to place the book in nomination. And I thank Tom Smith, the Hayek Prize financier. My book and I couldn't be happier.

Once upon a time in the early 20th century, there was a deflationary depression. Unemployment reached the double digits, farm incomes collapsed, industrial production plunged and the Dow Jones Industrial Average was nearly sawed in half. From peak to trough, America's last governmentally unmedicated business-cycle downturn spanned 18 months.

The question before the house is why it ever ended. The fiscal response to the crisis was a balanced budget. The monetary response was high interest rates—punishingly high even in nominal terms. Yet, as I say, the depression ended. It was Hayek's price mechanism—Adam Smith's invisible hand—that performed the economic healing.

My mission this evening is, first, to describe what happened during the final year of Woodrow Wilson's administration and the opening months of Warren G. Harding's, and, second, to relate those long-ago occurrences to the present day. Conscientious historians are at pains to separate present and past—to block out the attitudes and prejudices of the moment from their perception of yesteryear's events. I confess that I undertook this project in response to contemporary events. In 2008, the Great Depression of the 1930s monopolized the market in historical analogy. Policymakers constantly invoked the 1930s with reference to the crisis of the mangled mortgages and combusting banks. No intervention was too great to forestall a repeat of that calamity, they said. Thus, the drive to "stimulate"—to print money and to spend it. We are still being stimulated seven years after the trouble started.

As far as I know, not one senior policymaker invoked the 1920-21 affair on the other side of the stimulus argument. You may say—many have said—that 1921 was a long time ago. So was 1931. And you may observe that the world has changed since 1921—as it has since 1931. I submit that, in respect of the study of economic history, the 1920s are just as deserving as the decade that followed them. As Amity Shlaes reminds us, the 1930s did no honor to American public policy. Monetary manipulation, heavy taxation, punitive regulation, public works spending and persistently low interest rates failed to restore the Harding-Coolidge prosperity. So I turned my attention to the decade that roared.

They say that the past is a foreign country. In monetary, banking and regulatory arrangements, the 1920s seem especially alien. Ninety-five years ago, the dollar was defined as a weight of gold and the shareholders of a nationally-chartered bank were responsible for the solvency of the institution in which they owned a fractional interest—which is to say, if the bank failed they got a capital call. This sword of Damocles was called double liability. Patterns of thought and speech were likewise different from today's. The abstraction that we moderns call "the economy" had not yet been conceived. People spoke of good times and bad, of boom and bust, but not yet of a macroeconomic whole to be observed, much less to be managed.

In the 1960s, John Cowperthwaite, British governor of Hong Kong, refused to allow the collection of economic statistics lest the bureaucrats misappropriate that information in the service of governmental macroeconomic manipulation (the very word "statistics" derives from "the state"). Wilson and Harding had precious few statistics at their disposal, even if they were inclined to implement the cyclcial policies that were yet uninvented. So ill lit was the economic landscape that the Republican Party seemed unaware that a depression was in progress when it convened in June 1920 to nominate Warren G. Harding as its presidential candidate. At least, the platform writers neglected to mention "the economy" in their list of charges against the incumbent Wilson administration. "Economy in government" was the only context in which the GOP chose to employ the "e" word. Business activity had peaked five months earlier, in January 1920.

By the time the depression ran its official course in July 1921, industrial production had plunged by 31% and commodity prices by 40%. Maximum joblessness ranged between two million and six million out of a nonfarm labor force of 31.5 million—that was the range of estimates presented at the national conference on unemployment at which Herbert Hoover presided in September 1921, just as recovery was beginning. Notable bankrupts included the CEO of General Motors, Billy Durant, and a Kansas City haberdasher named Harry S. Truman.

Some today, including the historian Christina Romer, argue that the 1920-21 downturn was little more than a recessionary bump in the road. A contemporary congressional inquest concluded, with respect to commodity prices that "the debacle of 1920-21 was without parallel." The bitterly sardonic lyrics of the 1921 hit tune, "Ain't We Got Fun?" would also seem to attest to the seriousness of the situation. You've probably heard this line: "There's nothing surer, the rich get rich and the poor get children."

Booms not only precede busts, the Austrian school of economics teaches; they also cause them. So it was in 1920. The combatants of the Great War had fought on the cuff. They spent more than they raised in taxes, and they borrowed or printed the difference. They abandoned the gold standard almost as soon as the shooting started. The result was an inflation that distorted both prices and judgment.

Inflation ravaged America, too, though this country entered the war 2 ½ years after the first shots were fired and the Wilson administration never abandoned the letter of the gold standard. Consumer prices rose by 11% in 1916, by 17% in 1917 and by 18.6% in 1918.

History taught that peace would bring deflation. Such had been the experience of Britain after the Napoleonic wars and the United States after the Civil War. When governments stopped printing money for the very purpose of destroying life and property, prices would certainly tumble.

They did not tumble. The long-thwarted American consumer celebrated the end of wartime stingency by making the cash registers ring. By the fall of 1919, plants were operating at full tilt, raw materials were unobtainable except at markups to quoted prices and delivery dates were being pushed way out into the future. A sensible pair of shoes had cost $3 before the war. Now they sold for $10 or $12. Wages couldn't seem to keep up with prices nor prices with costs.

Responding to flyaway prices, producers and consumers took actions they would presently come to regret. General Motors built itself the world's biggest office building. National City Bank—today's Citibank, even then accident-prone—lent not wisely but too well against the inflated collateral of Cuban sugar. Farmers borrowed to purchase marginal acres of cropland, which they planted from fencepost to fencepost.

The inflationary music didn't stop all at once but decrescendoed in the fall of 1919. On Nov. 3, the Federal Reserve Bank of New York lifted its discount rate to 4 ¾% from 4%; over the next three weeks, the Dow gave up 12.8% of its value. In January 1920, the Fed tightened once more, this time all the way to 6%. Commodity prices started to soften in March, the Japanese silk market being an early deflationary bellwether.

The price declines were immediate and, in many cases, steep, though they failed to seize the national attention. Certainly, they made no deep impression on the still wet-behind-the-ears Federal Reserve. "There are already indications that the transition period is nearing a halt and than an improvement in the general situation is in sight," the governors ventured at the end of August 1920. They were a year early.

Benjamin Strong, head of the Federal Reserve Bank of New York, was a year prescient. In a letter to the monetary economist Edwin W. Kemmerer, early in 1919, he predicted exactly how deflationary events would unfold. Interest rates would be going up, as the Fed extricated itself from the untenable position of suppressing the cost of the Treasury's wartime borrowing. Prices would be falling and business activity contracting.

"I believe," Strong prophesied, "that this period will be accompanied by a considerable degree of unemployment, but not for very long, and that after a year or two of discomfort, some losses, some disorders caused by unemployment, we will emerge with an almost invincible banking position, with prices more nearly at competitive levels with other nations, and be able to exercise a wide and important influence in restoring the world to normal and livable conditions. One must have a theory of these things to work on, and at least the courage to practice and state it."

Implicit in Strong's theory was faith in the self-correcting nature of markets and in the strength and resilience of American finance. He believed that the depression he foresaw was a necessary evil. Wages, like prices, were too high and had to come down. They would fall to sustainable levels sooner or later. If the Federal Reserve could give them a helpful push, so much the better for the timely return to sustainable prosperity.

There was no mistaking this American zeitgeist for the Era of Good Feelings. 1919 brought race riots, a wave of strikes in the heavily unionized labor force, a Red scare and an influenza pandemic. In 1920 came Prohibition and the unmasking of a swindler named Ponzi. On Sept. 16, 1920, a terrorist explosion on Wall Street killed 38 and wounded 300. Later that month, a grand jury heard evidence into the Chicago White Sox's alleged fixing of the 1919 World Series. By 1921, according to the contemporary reckoning of the English economist T.E. Gregory, the world was "nearer collapse than at any time since the downfall of the Roman Empire."

Still, the successive administrations of Woodrow Wilson and Warren G. Harding hewed to policies of economic nonintervention. With Wilson, it was a case of laissez-faire by accident. In the war, his administration had rationed, commandeered and regimented without ideological compunction. After the war, it had attacked inflation by the ancient quack remedy of villifying the producers who charged the objectionable prices. "I am perfectly sure that the state has got to control everything that everybody needs and uses" the president was quoted as saying in the summer of 1919. Nobody knows what Wilson might have done if he had kept his health. The stroke he suffered in September 1919 incapacitated both him and his administration. It presently seemed to the journalist Ray Stannard Baker as if "our Government has gone out of business."

Not so the Federal Reserve, which continued to turn the screws. In June 1920, it imposed a 7% discount rate. Adjusted for the deflation of prices and wages, that 7% felt more like 15%. The chairman of the Federal Reserve Board, W.P.G. Harding, gave speech after speech proclaiming that better times were at hand. This was not despite falling prices but because of them. The Boston Fed, in a cheerful March 1921 comment, echoed Harding: "[W]e have been witnessing two important conditions precedent to the laying of enduring foundations for the future stability of business, namely, liquidation and deflation. . . . "

To many people, those particular foundations seemed neither necessary nor stable. Critics included, broadly, the political left; Sen. Robert L. Owen, Democrat of Oklahoma, who had shepherded the Federal Reserve Bill through the upper house of Congress; the economists Irving Fisher, Gustav Cassel and John Maynard Keynes; and the comptroller of the currency, John Skelton Williams, who, as an ex-officio governor of the Federal Reserve, bitterly criticized the high interest rates for which he himself had voted.

Tucked away in Williams's archives is a newspaper cartoon which the comptroller did not draw but might well have inspired. The scene is an operating room out of the blood-bucket era of orthopedic medicine. An unanesthetized patient, labeled "Business," stares bug-eyed as the doctor, ticketed "Federal Reserve," begins to amputate his right leg. It is more than concerning to Business that the doctor is oblivious to the ingrown toenail, designated "Speculation and High Prices," for which the patient had evidently sought treatment. "Gosh Doc," implores Business, "couldn't you cut it off down a little nearer to the toe?"

In a speech to the United States Chamber of Commerce in May 1930, President Herbert Hoover made bold to claim that, "for the first time in the history of great slumps, we have had no substantial reduction in wages." In a later totting up of data compiled by the Bureau of Labor Statistics, the A.F.of L. found truth in that assertion:Whereas 92% of reporting firms had reduced wages in 1921, only 7% did so in 1930. The result, according to new research by the UCLA economist Lee Ohanian, was a rise in real manufacturing wages—and a disastrous drop in manufacturing hours worked.

Just how paradoxically enlightened were the supposedly primitive ideas of 1920 and 1921 did not become evident till after the 1930s had run their course. Downwardly mobile wage rates were one such constructive feature of the forgotten depression. It helps to recall that the gold value of the dollar was fixed. It was not within the Federal Reserve's power to raise up prices and/or wages by conjuring new dollar bills, even if it had wanted to. Prices and wages were expected to do the adjusting, if adjustment was called for. As prices were deflating, so should wages fall, reasoned the business and financial community.

Wages would not and should not fall, Samuel Gompers, president of the American Federation of Labor, countered. Working people had not yet regained the purchasing power they had lost in the war. The fact is that wage rates did drop in the early 1920s, though by exactly how much is unknown. The decline was steep enough to prevent the evisceration of business profits that would otherwise have occurred and that, in the 1930s, did occur, along with its complement, mass unemployment. The restoration of profits at lower levels of prices and wages made a signal contribution to the blooming recovery of the early 1920s.

Harding won the 1920 presidential election on a promise of "less government in business and more business in government." Like his secretary of the Treasury, Andrew Mellon, Harding favored sound money, low taxes and the free play of wages and prices. "We must face a condition of grim reality, charge off our losses and start afresh," said the cheerful ex-newspaperman in his inaugural address. "It is the oldest lesson of civilization."

The depression was 15 months old when Harding moved into the White House. Mellon—banker, industrialist and a director of no fewer than 60 corporations—knew full well how hard were the times. He subsequently described the crisis of 1921 as among the most severe in American history. To President Harding and him, it was the very gravity of the situation that demanded reduced federal spending and lower tax rates—and in Mellon's personal view, lower interest rates, too. In none of the 12 years leading up to 1912 had the federal government spent as much as $700 million. Now it laid out that much and more in annual debt service.

To staunch the gushing red ink, Harding personally went to the Senate to make his case against a pending bill to pay a multi-billion-dollar soldiers' bonus. Mellon pushed for elimination of the wartime excess profits tax and a halving in the top income-tax rate on personal incomes, to 32%.

Uncounted millions of unemployed people were pleading for work; tax cuts and spending reductions were the means to providing it: Such was the bedrock of the Harding-Mellon economic plan. "Stabilized finance and well established confidence are both essential to restored industry and commerce," the president told the senators who yearned to pass the legislation that would cause the Treasury to mail government checks to millions of their demobilized constituents. Harding prevailed.

Though the phrase "new normal" was unspoken in 1921, people did wonder if the world had lost its bearings. "The stockholders of this company are anxious to know whether this represents a new era of reduced business or whether the depression will quickly pass," was how the president of E.I. duPont de Nemours & Co., posed the question in his 1921 annual letter. Earnings per share had plunged to $2.35 in 1921 from $17 in 1920. Inventories and the payroll had both been chopped in half.

DuPont's chief executive blamed not some new era but an old-fashioned inventory cycle. As duPont had liquidated its inventories, so had its customers and suppliers reduced theirs. It stood to reason that restocking would prove a potent stimulant—which, indeed, it did.

Mellon did not immediately get the tax cut he wanted, but the Federal Reserve, beginning in the spring of 1921, did begin to implement the interest-rate reductions for which he had quietly lobbied. To objections that a ½ of 1% reduction in the 7% discount rate would incite speculation, Mellon replied that the country could use a little speculation.

By the time the stock market scraped bottom late in the summer of 1921, "scores" of companies were valued at less than their working capital, according to The Wall Street Journal. The shares of "large numbers" of industrial companies were selling at "one-third of their intrinsic values."

Coca-Cola, in which punters had earlier speculated as a play on the new Prohibition law, was one such comely bargain. At $19 a share—500,000 shares were outstanding, providing a stock-market capitalization of just $9.5 million—the company was valued at what would prove to be 1.7 times 1922 earnings and 2.5 times

1923 earnings; the shares provided a dividend yield of 5 ¼%. Gillette Safety Razor Co., which was selling as many razors and blades in 1921 as it had in 1920, was quoted at little more than five times forward earnings and yielded 9 ¼%. Radio Corporation of America, not yet revealed as one of the great growth stocks of the 1920s, could be purchased in the market for about as much as the company would earn in 1923: $1.50 a share.

The springtime thaw in Federal Reserve interest-rate policy was by no means the only, or most important, source of monetary stimulus. Sky-high real American interest rates and rock-bottom American asset values pulled in gold from abroad. Between January and July 1920, foreign bullion augmented the American gold stock by some $400 million, to a grand total of $3 billion. Optimists hoped for $500 million more before the great importation ran its course. By the close of 1923, another $1 billion had landed. President Harding had aimed to restore business confidence. Foreigners expressed their confidence by sending money.

Over and done with in 18 months, the depression of 1920-21 was the beau ideal of a deflationary slump, I judge. The banking system survived without a single major failure, even if certain eminent New York institutions wobbled and hundreds of country banks closed. Though painful, the depression was hardly pointless. It rebalanced costs and prices and corrected the investment errors of the inflationary boom. A powerful, job-filled recovery followed: In 1922, industrial production leapt by 26%, domestic auto and truck production by 63%. "From practically all angles," judged the Wall Street Journal in a New Year's Day 1923 retrospective, "1922 can be recorded as the renaissance of prosperity."

Contemporaries mainly withheld their applause. The virtue of downward flexibility in wage rates was so obvious to the many whose wages had declined (there was, of course, no federal safety net). Then, too, a year-and-a-half's worth of business contraction seemed unnecessarily protracted—there was, as yet, no Great Depression against which to draw a favorable comparison. "It is a pity," regretted the September 1921 economic review of the National City Bank, i.e., Citibank, "the agony must be so long drawn out, a pity the inevitable adjustments cannot be quickly made, with intelligent comprehension and a cooperative spirit."

Stability became the public-policy watchword of the mid and late 1920s. Irving Fisher talked up the virtues of active monetary management. By buying and selling the correct volumes of government securities, a central bank might keep prices on an even keel, or so he proposed. "The need of our time is stabilization," declared the famous Yale economist.

In the final quarter of the 19th century, average prices had fallen in response to the rise of labor-saving technology. The world had advanced in economic understanding since then, the stabilizationists insisted. The price level (if one could could acurately calculate such a thing) must be made to stand still, whatever the underlying decline in the cost of production.

And when the 1920s stopped roaring, the Fed and the Hoover administration applied what they took to be the lessons of 1920-21. The Fed lowered interest rates—it didn't raise them—and President Hoover rallied employers against wage reductions. "It seems manifest," judged Fisher in May 1930, "that thus far the difference between the present comparatively mild business recession and the severe depression of 1920-21 is like that between a thunder-shower and a tornado."

Seven years after this colossal misjudgment came one of the wisest of the contemporary postmortems of the Hoover policies. The authors of "Banking and the Business Cycle," published in 1937, identified the essential flaw of Fisher's argument. By propping up a price level that, owing to cheapening production costs, would otherwise have fallen, the Fed had implemented a kind of invisible inflation. So doing, it had disturbed the economic architecture in ways that led to a bust. "[T]he end result of what was probably the greatest price-stabilization experiment in history proved to be, simply, the greatest and worst depression," the critics judged—correctly, I think.

In 1923, Keynes told a British audience that "an individualist society left to itself does not work well, or even tolerably. . . . The more troublous the times, the worse does a laissez-faire system work." The story of the forgotten depression disproves that contention.

Mistaken though he was in his reading of the American record, Keynes—and Fisher, too—won the battle of public policy. Today, in place of the gold standard, the world has adopted the Ph.D. standard—discretionary monetary management by formerly tenured academic economists. Prices and wages must always rise, never fall, contemporary doctrine has it, which policy takes the curious name "price stability." At the desired 2% per annum rate of rise, the consumer prices would quintuple over the course of a healthy lifespan.

Not much remains the same in America nearly a century after the events of 1920-21. The former gold dollar is today weightless, undefined. Double liability no longer attaches to the common equity of a commercial bank—with Dodd-Frank, it's not too much to say that the biggest such institutions have been functionally nationalized. "The economy," the abstraction of which the contemporaries of Wilson and Harding knew nothing, came to life in the 1930s and has subsequently come to seem almost tangible. We speak of it as if we could see it, touch it, smell it and, of course, manage it.

The people have changed and so has their government. Empathy has infused American public policy. In a 1921 speech on unemployment, Harding related that, in the best of times, a million and a half members of the American working population were unemployed. And he added, "The figures are astounding only because we are a hundred millions, and this parasite percentage will always be with us." Not only would a 21st century American president not utter the word "parasite," he or she would not even think it. (Mitt Romney came close but then he isn't the president.) It would not be a matter of not daring to think it. It would simply not occur to the chief executive to form the thought. In 2013, a Cato Institute report found that welfare paid more than a minimum wage job in 35 states and that in 13 states it paid more than $15 an hour. Wage flexibility, which contributed more than a little to the brisk work of the 1920-21 slump, is not the outstanding feature of 21st century American economic life.

The price mechanism, the hero of 1920-21, is thriving in the digital world—witness eBay and Uber—but hardly in the financial world. The 21st century Fed, freed from all gold standard constraints, has taken to sponsoring bull markets. By raising up asset prices—stocks, bonds, real estate—the central bankers hope to infuse Main Street with the riches of Wall Street. It seems not to occur to them that, by lifting (or attempting to lift) aggregate demand, they are likewise lifting aggregate supply. The rise and fall of the American energy business could serve as Exhibit "A" in this regard. Easy money financed a gush of American production; the resulting crack in the price of oil sent up cries of "deflation," to which the central bankers responded with pledges of continued low interest rates.

Hayek criticized the pretensions of economic science in his brilliant 1974 Nobel Prize lecture. He would likely have no high opinion of the econometric models that, in 2005, 2006 and 2007, failed to detect the biggest cyclical event in the professional lives of the model builders. On this score, you may recall the New York City blizzard that wasn't. Late in January this year, the meteorologists had forecast the biggest snowstorm since the Dutch landed on Manhattan island—which forecast missed. How, then, can the macroeconomists hope to succeed? Snowflakes are inanimate. They don't change their minds on account of something they read while surfing the Web or because a neighboring snowflake is getting rich by mortgaging its house. I think of the weathermen's foibles when I hear the Fed trying to rationalize a course of policy action because an inflation forecast for the five years beginning in the year 2020 has begun to sag—which the Fed actually does. Tell us, Chair Yellen, will the sun shine next Tuesday?

So, no, the policies of Wilson and Harding seem not especially to the liking of 21st century America. That alone does not render them obsolete. Something like "austerity" well served the Baltic states of Estonia, Latvia and Lithuania in the wake of the Great Recession. In telling contrast to Greece, observes John Dizard in a recent Financial Times column, the Baltics chose sound money and fiscal balance as the cure for what ailed them. Having suffered under Soviet rule, Dizard pointed out, "their people had no intention of moving any distance back to the past or away from orthodox market economics. They lacked faith in state-directed investment or in policies to maintain demand through accommodative monetary policy and fiscal stimulus." Today, on account of these Harding-esque initiatives, the three enlightened countries confront the problem of upward wage pressure stemming from tight labor markets—a high-grade problem, as Dizard observes.

If I were asked—and I have been asked—what America can learn from the experience of the early 1920s, I would reply: principles. Principle No. 1 is the primacy of the price mechanism. In Harding's time, the definition of money was inflexible—it was defined as a weight of gold—while prices and wages were, to a greater or lesser degree, flexible. Today, money is famously undefined, while the average of prices, and the average of wages, are—to a greater or lesser degree—inflexible. When imbalances arise, we fiddle with interest rates and exchange rates as opposed to addressing the relevant microeconomic dislocations—too much mortgage debt against too many houses being a recent example.

Principle No. 2 is that individuals should bear the responsibility for financial outcomes. Too-big-to-fail and Dodd-Frank would have been incomprehensible to Andrew Mellon. In the capitalism he knew, the stockholders who earned the dividends also bore the losses.

Principle No. 3 is that too much knowledge can be a dangerous thing. I wonder if one of our aspiring Republican presidential candidates wouldn't consider taking up the call for a trial blackout of government-issued macroeconomic data? Harding in American and Cowperthwaite in Hong Kong worked wonders in the statistical darkness.

Guido Majno wrote a history of medicine entitled "The Healing Hand: Man and Wound in the Ancient World." It's a chronicle of the cycles of insight and ignorance concerning medical practices in ancient Mesopotamia, China, India, Egypt, Greece and Rome. Peter Fisher, whose high level career has included stops at the Federal Reserve and the Treasury, once heard Majno summarize his findings. "You know," Peter quotes the historian as musing, "it was not really until the last year of the Second World War, with the widespread dissemination of penicillin, that if you suffered an open flesh wound you would have been advised to let someone touch you rather than let nature take its course."

In the decades since the forgotten depression and subsequent roaring recovery, doctors of economics have prescribed more and heavier interventions. Wholesale money printing, doing business under the clinical term "quantitative easing," has come to seem almost orthodox.

The triumph of sound money and of market-determined prices in the not so distant American past invites the suggestion that we, today, allow economic nature take its course.

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