Book Review: *The Forgotten Depression—1921: The Crash That Cured Itself*

By Lawrence H. White

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You might think that a book about a business cycle couldn't be a page-turner, but think again. James Grant, of the long-running biweekly Grant's Interest Rate Observer (and before that, a Barron's columnist), turns "America's last governmentally unmedicated depression" of 1920-21 into a riveting and instructive tale.

Grant crafts a drama that features major players in business and government on a stage built from the solid timbers of economic theory and statistics. But as he reveals in the preface, "The hero of my narrative is the price mechanism, Adam Smith's invisible hand."

Although not quite the forgotten downturn of the author's title, the depression of 1920-21 has not received the scrutiny it deserves. The instructive lesson of the story is that the federal government "met the downturn by seeming to ignore it—or by implementing policies that an average 21st century economist would judge disastrous"—and the hands-off approach actually worked.

Prices were allowed to fall rapidly—14% a year by one measure—between June 1920 and December 1921, faster than they would at the start of the Great Depression. Yet, real output contracted much less in the earlier downturn, followed by a "powerful, job-filled recovery."

That belies the common view, practically a mantra for former Fed Chairman Ben Bernanke, that falling prices are a source of trouble. It supports instead a less-fashionable perspective, long advanced by the economist Leland Yeager, that once aggregate demand has fallen, faster downward price adjustment reduces the loss of real output. In other words, falling prices are not a calamity, but a cure.

As Grant explains, economic policy in 1920 became “laissez faire by accident.” President Woodrow Wilson did not order federal anti-recession measures because he had been felled by a stroke. Benjamin Strong, the influential head of the Federal Reserve Bank of New York, believed that tightened monetary policy was needed to put the economy back on a sound footing after the orgy of finance to underwrite the Great War that had ended two years before.

Warren G. Harding, who followed Wilson as president in March 1921, was committed to a “return to normalcy” after unprecedented wartime inflation and borrowing. As Grant observes, Harding was a “candidate of disposition rather than ideas. Conciliatory, handsome, humble, tranquil, evidently ordinary—above all, ‘normal’—he was the antidote to the larger-than-life figures who had recently filled the White House to overflowing.” The stage was thus set for a “weighty and wonderful event.” The “malignity we call deflation” was allowed to operate.

“Stickiness” of prices and wages is a given in Fed Chair Janet Yellen’s world of New Keynesian models. The only timely remedy for a deflationary recession in that world is to pump up aggregate demand. In the economy of 1920-21, Grant shows us, things worked differently. The Federal Reserve did not slash interest rates and blow up the money supply. The fiscal authorities, Harding and his Treasury Secretary Andrew Mellon, cut federal spending nearly by half, reduced tax revenue, and doubled the federal budget surplus between 1920 and 1922. After 18 months of adjustments and liquidations, prices and wages had fallen to levels that better cleared the markets for goods and labor. The economy recovered vigorously.

At the book’s end, the author contrasts the passive handling of the 1920-21 depression with the activist handling of the Great Depression that began in 1929 and persisted through the 1930s. Because the Fed had kept the price level nearly constant from 1922 to 1929, the initial deflation came as a surprise. President Herbert Hoover, who has an undeserved reputation in the popular mythology for being like Harding in his economic policies, acted vigorously.

As the author writes, “Hoover moved now to stop a threatened business depression before it could start. ‘Words are not of any great importance in times of economic disturbance,’ the president declared in the wake of the 1929 crash. ‘It is action that counts.’ ” Through jaw-boning and arm-twisting, Hoover was determined to prop up wages in a time of falling prices. Unfortunately, high nominal wages priced workers out of jobs, bringing mass unemployment.

Grant calls his story the “triumph of the invisible hand.” Once read, The Forgotten Recession will be hard to forget.

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