



Episode 418: The Truth About One of Those Pre-Fed Depressions

Guest: Patrick Newman

WOODS: You have performed a very, very important service here by writing this journal article on the depression of the 1870s, because I've often said that from the point of view of economic history, one thing that we need quite a bit of is an examination of the various panics and economic downturns in U.S. history, particularly those that occurred before the Federal Reserve, because they'll claim that these are pieces of evidence that we needed a Federal Reserve; that a central bank could in fact smooth the business cycle, so to speak; that it could improve economic conditions. And there really isn't a whole lot of work done on that from an Austrian perspective. We do have the Rothbard book, a collection of his chapters and articles that takes you through the 19th century – in fact, I think today on today's show notes page, I will link to that – his *A History of Money and Banking in the United States*. So that'll be on TomWoods.com/418. What made you focus on the 1870s in particular?

NEWMAN: So, as you said, in terms of Austrians, there hasn't really been a lot of research done on the panics before the Federal Reserve. The biggest ones have been on the Great Depression – we have Rothbard's *America's Great Depression*. Then next in line has been the Depression of 1920-21, and so there's been various works, sometimes papers critiquing the Austrians on this. But there hasn't really been a lot, as you said, on the panics before the Federal Reserve.

So I wanted to do one that was after the Civil War, because a lot of times with the older panics – you know, the Panic of 1819, we also had Rothbard, who did his dissertation on that; 1837, 1857, some of the data can be very spotty, and a lot of people say that the economy was primarily agrarian; it was agricultural, so it wouldn't even provide very good lessons. I wanted to try and get one where we had a roughly growing, industrial economy.

And in particular, I chose the 1870s one, one, because it's listed as the longest contraction by the NBER business cycle dating. So it's from 1873 to 1879, which is six years. It's longer than the 1929 to 1933 contraction. And in particular, there are also some other interesting features. The money supply was declining during this time; there's a gradual decline in the money supply. It's sort of regarded as this long depression. I think it was called the Great Depression before the original, the real depression of the 1930s. And yeah, you have this six-year recession, and you sort of

want to say, okay, what went on during that time? Was it as bad as it was really thought to have been?

WOODS: Now in doing this, what you're doing is showing first the applicability of Austrian business cycle theory to particular historical episodes, but that, secondly, you have to explain – because Austrian business cycle theory can talk to you about the boom period, and then the fact that there's going to be a bust. But then the actual day-to-day operations and working out of that bust are going to be based on historical contingencies of one type or another, and the length of the bust period can be accounted for sometimes by government policy.

But in the 1870s, people would want to know, well, what would be that government policy? Is there any way that you can say that either the government encouraged money creation and credit expansion and interfered in the economy to delay the recovery? These are the sorts of things most people wouldn't know about, but I think they would assume that these things are minimal; that government involvement was so minimal, that it would really be a reach for Austrians to explain this episode, with reference to either government encouragement of an increase in the money supply or government hindrance to recovery.

So let's take both of those, then, and look at the boom phase. On the show notes page, TomWoods.com/418, I'll link to an episode we did on Austrian business cycle theory. So if you want to give a one-minute overview of that, rest assured, I have a full episode going into all the details. But start with that, and then let's see how this actually fits into the Austrian story.

NEWMAN: Yeah, so the Austrian business cycle theory basically says that through government action, or the overexpansion of banks, usually through a central bank – in this case, it was actually through new legislation, called the National Banking Acts – you have credit expansion, and this artificially lowers the interest rates in the economy. And this sort of incentivizes entrepreneurs to expand in long-term production processes. But in reality, time preferences haven't lowered, so the interest rate misleads entrepreneurs.

And what happens is, as this new money filters throughout the economy, the public spends it according to their old time preferences, and this sort of reveals the malinvestments. And you have sort of a tug of war as new money is pumped in. And eventually, through a combination of tightening money or entrepreneurs just realizing that their businesses are unprofitable, there are these malinvestments, through increasing costs and decreasing revenue – so decreased profitability – they have to liquidate them; there's the bust; and then you have the contraction.

So I liked how you also said you have the boom – the business cycle explains the boom and the immediate bust, but in a sense – you also have this idea of how do you explain – what actually occurs during the bust? So this is something that a lot of people find is controversial with Austrian business cycle theory, because in a sense, it sort of calls for a policy of laissez-faire during the bust. The resources have to be

reallocated from the malinvestments to where they're relatively more profitable, and where they can more efficiently satisfy consumer desires. And consequently, the traditional government management tools – you know, expansionary fiscal/monetary policy, Austrians would say that this would only hamper their recovery. So the fiscal policy – you know, the increased government spending – would simply prolong to distort resources; it wouldn't allow them to flow into their most valued uses. And the increased monetary expansion wouldn't allow for the proper liquidation to ensue, and for interest rates to fully reflect the public's time preference.

So during this period, as you said, there isn't a lot of government intervention. So fiscal policy after the Civil War: the Treasury is running surpluses; tax receipts are declining; spending was declining even more. So during this period, there wasn't really expansionary fiscal policy. Even more so, you can't find accurate yearly data on state and local governments, which you need to fully gauge total government spending. And in terms of monetary influence, there was some expansionary monetary policy during what I would consider the actual bust, the recession period of 1873 to 1875 – we can go into that a little bit more later if we want. But aside from minor government contraction of the money supply from 1875 to 1879, there wasn't the traditional expansionary monetary policy that we usually associate with the government trying to combat a recession.

WOODS: All right, so talk to us about the period from 1870 to 1873. This is the period that you identify in the paper as the boom period. Where was the boom? Where would we find in the economy this particular boom? We can easily see the boom taking effect in the bust that we had in 2008; we see the housing sector, in particular. What do we see in the 1870s?

NEWMAN: The main malinvestment, I guess, the big sort of hot investment going on at this time was railroads. So through a lot of government intervention – during the Civil War, a lot of land subsidies – both monetary and also land subsidies were granted out to various railroads. You had the Union Pacific and the Central Pacific, and then you had the Northern Pacific. And consequently, there are all sorts of railroads that branched off these main lines, and other sorts of state grants.

So railroads completely – it was a huge booming time for them, especially in the early 1870s, a lot – I think I say in the paper, railroads, they were a significant long-term investment. I think they constituted about 15 to 20% of investment at the time. They were also financed by foreigners and through credit expansion, so you had a lot of businesses, a lot of entrepreneurs embarking on new railroads. It was just sort of the demand; the country was seeming to be expanding westward, and it needed these, you could say, very capital intensive, long-term production processes to expand the production structure, and to improve the country's output capacity.

But what happened was – before the panic of 1873, a lot of railroads there started to experience a rising cost of production – so in terms of labor, raw materials, building track, locomotives, etc. And they also started to see decreased revenue, so they weren't really getting as much money as they thought they were.

And this is something that the Austrian business cycle theory says will happen. Entrepreneurs will realize that these projects weren't profitable. They were misled into embarking upon them, and instead they're facing resource constraints, rising costs – particularly because these resources are being more urgently demanded elsewhere.

So I try and show this – because I wanted to make my analysis to be as unbiased as possible – through the Davis industrial production index, and in particular, the machinery component, which had a large component of locomotives, which are shown through – obviously it's what railroads use. So I tried to show that during this time, there's a boom, significant rise in prices of production, of, you could say, mining, chemical and drugs, machinery. There's also a building boom; there's a building boom in Chicago at the time. So these are the sorts of industries that we would expect there would be a boom from the Austrian business cycle theory analysis.

WOODS: All right, so then of course, we have a bust. Now there have been all different discussions of the scope of that bust, and how bad it was, and we can talk about that in a minute. But I guess in order to understand the bust, we also need to know, not just about the sectors of the boom, but we also need to know something about the monetary system at that time, because I think it's kind of complicated. So what can you tell us about that?

NEWMAN: Okay, so in terms of the financial system, there obviously wasn't a Federal Reserve at this time; there wasn't a central bank. So during the Civil War, the government for various finance reasons, in order to fund the Civil War, they issued a large amount of greenbacks. So they took the country off the gold standard. And they also tried to create a quasi central banking system. It was originally called the National Currency Acts; it's later known as the National Banking Acts.

And this created a multi-tiered financial system, banking system where banks could pyramid off of other banks' deposits. So what you would imagine you would see in a free banking system – you know, this is something Mises always emphasized – is that competing banks, there would be a strong tendency to prevent overexpansion, because if one bank expanded too much through the adverse clearing mechanism, that bank's notes and deposits would be returned to the bank, and it would face a specie outflow.

But in this system, banks were allowed to pay interest reserve; they were allowed to hold a certain amount of the reserves at other banks. So at other banks – particularly you had central reserve banks; you had city reserve banks; then you had country banks. And the country banks were allowed to pyramid off the city reserve and the central reserve banks, and the city reserve banks were allowed to pyramid off the central reserve banks. So banks were incentivized to do this, because they could earn interest on these deposits and also through various branch banking restrictions. They wanted to diversify their investments. And this allowed for credit expansion to grow much more rapidly than what you would expect under a free market. And the other thing was that state banks – banks who weren't in the national banking system – there

were a lot of state bank laws that allowed them to pyramid off of national bank notes. So you really had a four-tiered system.

And what happened was, after the Civil War, there wasn't that much expansion. Really the money supply was only increasing by about 2%, from like 1867 to 1870 – 2% a year. But then afterwards, you had an enormous spike up, up to rates of 10% per annum. So this is an enormous change. And this was due to, one, there was an increase in the national bank notes, which state banks could use to expand credit off of, and also, just the banking system was able to shed reserves that could flow into the state banks so that they could expand credit. So really, after the Civil War, there's a little bit of time to get the system going. And then starting around the 1870s, there's an enormous increase in the money supply, and I marked that as the beginning of the boom for this period, so roughly a four-year period for the boom.

WOODS: All right, so that – okay, that's good, that's good. Is there a precipitating factor that leads to the bust? Is there – it happens in 1873, and – what does 1873 look like, in other words?

NEWMAN: So, at the end of the 1872 and 1873, there were a lot of troubles with the railroads. The railroads as I said before, they decrease profitability. They weren't making as much money as they thought they would, and their costs were higher than what they thought they would be.

And in particular you had Jay Cooke – he's the Philadelphia banker of Cooke & Co., which is sort of the prominent banking house. His failure eventually – it was overtaken by J.P. Morgan, but he was the big investment banker of the time. And his company sort of took upon underwriting the bonds for the Northern Pacific, which was the last transcontinental railroad in the Civil War grants that were given in, I think it was, 1864.

And so he was having trouble due to the decreased profitability of railroads, and the interest rates were slightly rising – railroads were having to borrow on the short term, and this was giving a cost squeeze. During the summer he was having trouble obtaining – he had all these bonds; he was having trouble selling them. And then Cooke & Co. went bankrupt, and this was sort of seen as like a big – it was this prominent investment bank, and it sort of sparked – it was one of the reasons that created the financial panic, because people started to realize, oh, are the other banks safe? And there was a run on brokerage houses and some commercial banks. But yeah, the Cook & Co. – the decreased profitability of the railroads in 1873 and the failure of Jay Cooke's company, I would argue – is what I have uncovered – as sort of the catalysts for the panic.

WOODS: Now tell us something about the depth of the bust. How bad were things? What's the traditional story? What did you find?

NEWMAN: The traditional story is that it was atrocious; it was terrible; it was this long depression. You either have analysis that will say, okay, the output decline wasn't as

much as the Great Depression, but it was still so protracted; so you still had this six-year decline in output. You look at the contemporary records; they say there's massive unemployment. And when you look at the modern output records, you say, okay; you could see there being a severe recession from 1873 to 1875 – even though some of the output statistics, they don't even go to contraction; they just show a slowdown in growth.

But really from 1875 to 1878/1879, there's a rebound in growth. So you have to imagine, okay, what's going on? How are you getting these output statistics that say one thing, and then you have these contemporary reports that say another? So through the historical record, I was able to find that a lot of contemporary reports, they were misled by the decline in prices, and just sort of the general lack of economic statistics and information. Businesses would see that there's this continuous fall in prices – you know, prices, wages, stock prices, etc. – they're all falling. And they think this is a decline in real value. So they say it's this terrible depression, when in reality, they were misled by the fact that prices overall were falling. So it was really a nominal illusion.

And at the same time, you also had businessmen in various newspapers, who are giving wildly inaccurate statistics. They're saying unemployment – there was one newspaper that said unemployment in, like, the construction industry was larger than, in reality – later statistics found out – than the total amount of construction workers in the country as a whole, and that unemployment relief agencies were miscalculating unemployment.

So in a sense, you have to take it – the everyday businessman, the everyday worker, he hears this information; it's not like he can go online and calculate prices. He doesn't have the information that we have now. And he hears that prices are falling; he's just always reminded of this continuing depression. The money supply's falling too. So you just assume, okay, we're just in this depression. Even though output rebounded after 1875. So this is sort of conflicting with the facts. You can't really have a protracted depression if output is increasing 3, 4% per annum. It just doesn't make sense.

WOODS: Well, then, tell us about the recovery. How long does the recovery really take? Not according to anecdotal statistics in newspapers, but according to your own study – how long does the recovery take, and is there anything that might be slowing the recovery down?

NEWMAN: The recovery during this time – I said the recovery took from 1875 to 1878. I sort of tried to cut off 1879, because that was the resumption of the specie – the U.S. went back on the gold standard, and there's a large increase in the money supply then. So traditionally, business – modern economics – would say that was the beginning of the recovery. You had this big boom; prices were rising again; money supply was increasing; this large jump in economic activity – that's usually, as I said, the traditional explanation, the beginning of the recovery. So the depression continued all the way through 1879. However, I tried to argue that, by 1875, the recession was really over. And I'm not alone in this. Joseph Davis, he created the

industrial production index, which I used in my paper; it was one of the indexes that I used in my paper. He also concluded that, really, the recession rose from 1873 to 1875, and that there was the beginning of – you know, an increase in growth – from 1875 to 1878.

So one of the things I would actually argue prolonged the depression was that from 1873 to 1875, there was an increase in the money supply – which, you know, if it was spent by businesses, would sort of prop up prices and production and prevent them from being liquidated. And I tried to argue that, in fact, the contraction in the money supply during the bust – there's explanations that argue that it could help the recovery, which provides some various theories. I tried to show that – from Rothbard and Mises, they argue this – there's various ways that monetary contraction can be beneficial.

But yeah, so during this time you had the reallocation of resources. Particularly railroads were declining during this time. This isn't something that's really – this isn't a bad thing, as predicted by the Austrians. These businesses over expanded; they need to liquidate, allow the resources to be used elsewhere. But you had a rebound in the other sectors of the economy, which as I tried to show, even during the bust – 1873 to 1875 – and during the recovery, there was all different movements in relative prices and production. So the bust hit the higher order industries the hardest, which is sort of what the Austrians would say.

And during the recovery, there was sort of a recovery in these industries in general. And it's not just simply like aggregate production shocks, where the economy is hit evenly, and the main cause of the recession is like an aggregate demand failure. I tried to show it was relative prices and production, which is how the Austrians explain the recession and the reallocation of resources during a bust and recovery.

WOODS: All right, well looking at the whole story, then, you've basically given a completely revisionist account, right? Now, it's not like nobody has every chipped away at this story before; I mean, Rothbard was certainly groping toward the correct answer in his work. But you've – wouldn't you characterize that as what you've done?

NEWMAN: Yeah, I'd like to imagine that's what I did. I tried to use Rothbard's *America's Great Depression* as a model for my work, and in a sense, I tried to provide a revisionist account, just as Rothbard did. So the traditional account is, the Great Depression was caused by laissez-faire, and Herbert Hoover did nothing. And Rothbard tried to show that the Great Depression was caused by expansionary government monetary policy, and that it was exacerbated by government intervention.

At the same time, I tried to show that this wasn't just a recession that came from the instability of the free market; there was government intervention that caused it. And at the same time, the recession is actually an example of how an economy can recover from laissez-faire policies, and that it wasn't this protracted depression, but in reality, during the mid to later part of the decade, there was strong growth. So yeah, in a sense, I tried to provide a revisionist perspective of this period that, hopefully, at the

least will provide some incentive for people to stop using the NBER dating method of saying it's a recession from 1873 to 1879, which is simply way too long, and it's based off of faulty statistics.

WOODS: And of course, once in a while, you get people who support the Fed pointing to this historical episode, and saying, oh, thank goodness we got the Federal Reserve, so we don't get episodes like this anymore. So that goes to show how important it is to get the history right, because if you get the history wrong, you're going to get the current events wrong; you're going to get the policy wrong. So what you're doing resonates in the present. What you're doing is not just an episode in historical analysis, as important as that is. But it reverberates all the way up to the present.

Well, I'm going to link to the paper – it's an article in the *Quarterly Journal of Austrian Economics* – so people can read it, on today's show notes page, TomWoods.com/418. I'll also have related episodes here. I did an episode on cycles before the Fed in general, that people might find interesting. Oddly enough, it's one of the most listened-to episodes of this show. Says something about my audience: one of the most listened-to episodes is about business cycles before the Federal Reserve. I just love you guys, what can I say? Patrick Newman, thanks for your time today.

NEWMAN: All right, you're welcome. Thanks for having me on.