**Episode 804: Revisiting the Depression You've Never Heard Of**

**Guest: Patrick Newman**

**WOODS:** All right, look, I'm going to link to your paper, of course, on the show notes page, TomWoods.com/804, that we're going to be talking about today. It's really great. It's really important. There are a lot of good people who've been doing what I might call revisionist work on this. Jeff Herbener has a paper on it. I don't know when it's going to see the light of day. But yours is really, really excellent. I can't say enough how happy I am with it. I want to talk about the whole controversy.

Let's do two things to set the stage here, and I'll tell you both of them right away so you can pace yourself. The first thing is when we talk about the so-called Depression of 1920-21, what are some of the features of it in terms of numbers to give people a sense of the depth of it? And secondly, give us the layman's really brief guide to the Austrian theory of the business cycle. I haven't discussed that on the show in a long time, and I've had a lot of new listeners come on so they should get some kind of overview of that. So let's start with those two things.

**NEWMAN:** Sure. So the Depression of 1920-1921, it's a post-World War I depression. World War I ended in November of 1918. It's generally seen as a very severe but brief depression. So the depression started in January 1920, and things got really bad around June 1920 for about half a year. During this time period, prices fell by over 40%, which is a significant drop. Unemployment went up to over 11%, a significant rise. Depending on the industrial production index you use, output fell by over a third, which is very severe. There's a very sharp increase in bankruptcies. Interest rates were very high. This is a very severe depression, and it got really bad, and then it quickly recovered from it. The economy quickly recovered from it.

So that's the general analysis of the Depression of 1920-1921, and it's usually compared with the Great Depression about ten years later, 1929 to 1933, or at least the Great Contraction. In one, the economy quickly recovered and in the other, the economy — well, we all know what happened after that.

So I try and explain this depression. In order to explain how things got so bad, why things were so bad, you have to look at, okay, what exactly caused them. So there's sort of a — you have to talk about resources being reallocated during this depression, you want to first look at why they were misallocated. And to answer that question, I use Austrian business cycle theory, which is basically the theory of the unsustainable boom and the inevitable bust.

So Austrian business cycle theory argues that when the central bank engages in expansionary monetary policy — which is what happened. The Federal Reserve engaged in expansionary monetary policy after World War I. So it artificially lowers interest rates, increases credit expansion beyond what would have occurred had they not intervened. And the interest rate coordinates production across time.

So when the interest rate signal is tampered with, this tampers the entrepreneurial calculations of various businessmen, and they embark on projects that appear to look profitable. They look profitable, but they're not actually profitable. So they're incentivized to embark on these projects, particularly long-term investments. Those are the most sensitive to changes in the interest rate. And they borrow on the producer's loan market. They embark on these various projects. In this particular period, it was in long-term investment related to agriculture, steel. You had a building boom. You also had — there was automobile production.

But what happens is that savings actually increased. The time preferences aren't actually low enough in order to sustain these projects. So what happens is the public reasserts their time preferences, and in doing so, by increasing consumption spending, they reveal that these investments were bad. They were malinvestments. They were losing ventures. So what this basically means is that either the central bank needs to engage in accelerating credit expansion, which would if taken to its logical conclusion inevitably lead to very high rates of inflation if not hyperinflation, or they tighten credit expansion and this reveals unprofitability of the various investments. So now you need to have a liquidation. You need to have a reallocation of resources from these higher order malinvestments back to the lower orders, back to industries that can be sustained given consumers' time preferences.

So that's the general theory I use to explain the depression. You had a boom created by the Federal Reserve, and then afterwards, you had this massive reallocation period. And because it wasn't really interfered with, you had a swift recovery.

**WOODS:** Okay, very, very good. Now, you spend a fair amount of time in the paper dealing with objections from other people, or one person in particular, probably. And I don't want to spend a lot of time on the show dealing with it because you go through it in great detail in the paper: the issue of how do we demonstrate that the characteristics of the Austrian business cycle are present in this downturn — for instance, showing that the higher order stages were multiplied beyond what was reasonable and that they were hit the worst. You do manage to try to reconstruct that, admitting that it's actually difficult given the statistics that we have. I think that's well done, but let's stipulate that the features of the Austrian business cycle are indeed present from 1919 through 1921. Let's now think about, given the analysis you just gave of business cycles, what would follow from that analysis in terms of what government ought to do.

**NEWMAN:** Sure. So during this depression phase — so first you have the boom, then you have sort of the crisis phase, and then the next phase is sort of the recovery, liquidation phase. So during this period, resources need to be reallocated from these long-term investments to short-term investments, or from the higher orders to the lower orders. The structure of production needs to readjust.

And in order for that to happen, the government should really practice a hands-off policy, a laissez-faire policy. So they shouldn't engage in expansionary monetary policy that sort of props up prices and production in the higher orders and could sort of reignite another boom — so sort of kicking the can down the road, not really allowing the economy to recover — or expansionary fiscal policy. In the increased government spending — you can think of the deficit spending. That sort of diverts or siphons resources away from the profit-and-loss private sector to the government, and the government sort of has a natural handicap because they can't calculate according to profits and loss and continues to waste resources.

So during this depression phase, which is controversial for many macro economists, but the Austrians are sort of alone in arguing you need to have a total hands-off policy. In fact, possibly engage in contractionary monetary and contractionary fiscal policy in the form of cutting government expenditures.

**WOODS:** So given that that's what we would recommend and that that is pretty much the opposite of what Keynesians would recommend — really almost anybody in the mainstream, it's something like the opposite of what they'd recommend — it becomes important to look at historical episodes, because for most people, that's where things get proven. Now, we can argue the legitimacy of that and the methodological questions, but if people say, Look, we had the worst downturn in American history in the Great Depression of the 1930s, and look, we had New Deal spending and it made it better, that's going to stick in people's minds a lot more than an abstract demonstration. That's just a fact. So it is important to address historical episodes like this and see which approach seems to account for the observed events better.

Now, in the case of the 1920-21 depression, what seems to have happened is that the Fed was largely not active and we had a severe cut in federal spending. And so it seems like that fits directly into our thesis, that here the government stayed out, the Fed stayed out, and the thing recovered. You didn't have anything like what you saw in the 1930s. But there has been a response to this on the other side, and part of that response has been the Fed did intervene and the Fed's intervention does seem to account for why we had a recovery. I'm interested in how you handled that objection in particular.

**NEWMAN:** Sure. So one of the most common sort of counterattacks and rebuttals to the Austrian position, as you mentioned, for this depression is that, Well, okay, recovery began in the beginning of 1921, mid 1921, but around this time, the Federal Reserve, as gauged by, by then, the most prominent policy tool, the discount rate — the rate the Fed charges banks to borrow from them — that started to fall and the money supply started to increase after. So okay, this is just a normal period of expansionary monetary policy. So yes, it's true that during the depression, the government engaged in a contractionary monetary policy, but after that, then they put their foot on the accelerator and that's why it recovered. So there's nothing out of the ordinary for this explanation. The Austrians, their timing's a little off, etc.

So to that, I sort of have a multifaceted argument to that. The first is, well, the recovery began before the Federal Reserve engaged in monetary easing. Recovery began in March 1921 and expansionary fiscal policy really only started to occur in about May, June 1921. More importantly, the money supply didn't even start to increase until about September 1921. So during several months, the money supply was actually falling or it actually remained constant during this time when recovery was occurring, so when output started to rise.

In addition — and I think this is quite significant. So what matters is not necessarily the money supply but total spending, at least in terms of the traditional aggregate demand argument. So that aggregate demand, that total spending can be measured by what's known as nominal GDP. But if you look at nominal GDP, the change in nominal GDP from 1921 to 1922, it really was flat. It didn't change at all. So nominal spending didn't increase at all.

So this monetary easing, yes, it did occur, but it occurred sort of too little too late. The recovery really began from market forces, in particular, wage cuts. So this expansionary monetary policy occurred, it started to really affect the economy well after the economy was recovering.

**WOODS:** Now how about the fiscal side of things? What has been the critics' argument there? Is there one?

**NEWMAN:** So the fiscal argument is that — Well, the main argument the Austrians brought up is, so after World War I, there was a massive decline in government spending. If you imagine, we know longer need this massive military buildup. So critics would usually argue that in particular there was a massive — that the large decline in government spending occurred before the depression, so it really started in 1919, and that sort of the timing of the Austrians is wrong, so to speak.

To that, I argue that yes, it is true that fiscal policy started turning contractionary before the recession began, but in addition, it also was contractionary and it continued to fall, although not by as much, during the depression. So yes, government spending started to be contractionary before, but it continued to be contractionary. So it wasn't as if you had contractionary fiscal policy, then expansionary fiscal policy. During the whole time, government expenditures were falling.

**WOODS:** All right, so therefore your paper — and by the way, your paper is just ridiculous in terms of the numbers and the charts and everything. I mean, this seems like it was a lot of work. Can I just ask that question?

**NEWMAN:** Yeah, it was a good amount of work, yeah.

**WOODS:** Oh my gosh, wow. As I was going through it, I thought, Okay, this is not just he went through some secondary sources, summarized them, and slapped it together as a paper. This is really, really helpful raw data that you've got in there as well. So let's recap then. The long and the short of it is you have a severe downturn — I mean, certainly by modern standards, it's more severe than most of us have experienced, at least according to some metrics, that is. And nevertheless, without knowing about or following any of what are called the modern, sophisticated means of lifting an economy out of the depression, well the economy got out of the depression. And attempts to say that, Well, in fact, the Fed did it — just, the timing doesn't work and the magnitudes don't work. It just doesn't make sense. The only story that makes sense in this case, regardless of all the objections of Krugman, Brad DeLong and whoever else, only our story really fits the facts as we know them.

**NEWMAN:** Yes, exactly. That's the main point I was trying to drive home, that this is — the title of the paper is "The Depression of 1920-1921: A Credit-Induced Boom and a Market-Based Recovery?" And I try and answer yes, it was a credit-induced boom and it was a market-based recovery. Those are the only theories consistent with the data.

**WOODS:** All right, now I want to ask you a totally unrelated thing, but as you'll see, it's not totally unrelated. I got to know you when you were a summer fellow at the Mises Institute and you worked closely with Joe Salerno. And now you're teaching at Florida Gulf Coast University, you've written a number of, I think, important papers in American economic history. You're doing real work. There are — I don't want to mention names, but it's possible to find in the Austrian world people who get a degree in economics who then write either metaeconomics or they write case studies about people who lived 500 years ago or whatever, that really are not — I wouldn't really classify as economics. Whereas you're actually doing economics. How about that? A young person in Austrian economics doing economics. It's a tremendous thing.

Can you say something about your experiences as a summer fellow? Because I know I have some young folks listening and I think that program for graduate students and for advanced undergrads in some cases is something they should seriously consider.

**NEWMAN:** I had an absolutely fantastic time the two years I was a summer fellow. I first went to Mises University the year before in 2011, and I said, Wow, this would be really great to be a summer fellow. You spend the whole summer here researching right at the Mises Institute; you're around all these great faculty members; you're surrounded by Rothbard's books, Rothbard's archives, etc. I was a summer fellow 2012, 2013. One of the greatest times of my life. I had a tremendous — I was able to get a tremendous amount of work done, a lot of work related to some of the economic history I talked about, including this paper. Some of the groundwork for that. Made great connections with various other fellows, such as Matt McCaffrey. I was also able to become very close with Joe Salerno. I highly recommend trying to apply for that, especially if you're interested in grad school. It's a great experience. It's very helpful, and certainly you get a taste of what it's like to be an academic and to do serious research. I highly recommend it.

**WOODS:** And tell me a bit just about your position at Florida Gulf Coast University. Is this a tenure track job?

**NEWMAN:** So right now I am a visiting assistant professor. So there's a permanent position I'm applying to, as well as other positions, and I'm sort of hoping to stay here. But right now it's a great position with the faculty and everyone else. It's a great school that I'm at. I really enjoy it. The faculty's great. I was able to teach the classes I was interested in. This semester I taught macroeconomics, money and banking. I also taught a class in Austrian economics, which I felt was very good, had great students in that. So right now I'm sort of starting out with the university and hope to continue there.

**WOODS:** Well, that's really great. You're still quite a young guy. And it's good also that you're there with another Austrian I know, Chris Westley. I've got to think of a reason to get him on. I've got to find out what he's writing about these days and get him on. It's over 800 episodes and I haven't talked to Chris Westley. I've got to make sure and do that. Well, anyway, I'm glad things are going well for you. This paper helps us all out. In fact, just in my private Facebook group the other day, somebody was griping about I guess the Wikipedia entry on the Depression of '20-21 and saying, Oh, what are we going to do? Don't we have any replies to this? And I linked to your paper and it was like fireworks were going off and confetti was everywhere. They were so delighted to have your paper. So I thought, Okay, that means — when the fireworks and the confetti come out, that means it's time for an episode. So I'm glad you were able to join me. We'll get people to read your paper at TomWoods.com/804, and best of luck. Thanks again.

**NEWMAN:** Thank you so much for having me on.