Jim Grant on the Forgotten Depression
Guest: Jim Grant
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James Grant, publisher of* Grant's Interest Rate Observer*, is the author, most recently, of* The Forgotten Depression: 1921—The Crash That Cured Itself*.

WOODS: It's a real pleasure to have you on. It's a great coincidence that I was planning to invite you anyway, and then I discovered you have this book to be released tomorrow: *The Forgotten Depression—1921: The Crash That Cured Itself.* I wrote an article on this for a journal called the *Intercollegiate Review* several years ago, and I had people saying I should convert it into a book, but I can say in all sincerity that this is vastly superior to anything I could have produced. So I am so glad you did it.

GRANT: How gracious. Thank you, Tom.

WOODS: Let's start with one quick current events question. I am sure you've commented on this in the financial press and media, but what are your thoughts on the conclusion of QE?

GRANT: Well, I am unaware that it has really concluded, and I say that because the precedent of massive, radical, monetary action of this extraordinary intervention by the Fed is now firmly established, and the next time the American economy trips or steps in front of a bus, we can be certain that the feds will be back with the printing press geared up and interest rates set to plummet. So I think that these big interventions are certainly going to be suspended for now, but I think they'll be with us again on form in a much bigger way. If you look back to the succession of financial difficulties and/or crises since the early 1990s, the Federal Reserve has come in with a much heavier hand event by event. The federal funds rate, which is the Fed's basic policy-making interest rate, was pushed into 3% and subsequently down to 2 and 1% and then subsequently, as of five and a half years ago, down to zero. And in Europe already interest rates are pegged at less than zero, and trillions upon trillions of dollars of digital paper currency have been emitted into the world by central banks all around the globe. So this precedent is with us, and it's coming back again.

WOODS: Well, no doubt we'll have to have you on sometime in the future to talk about when it does and what's going on these days, but I want to talk about this very illustrative case of 1921.

Let me read you a great quotation from Joseph Schumpeter, who was not himself an Austrian School economist, but maybe a fellow traveler and a very interesting and smart guy. He says that "the case of 1920-21 also shows better than any theory could how the system pulls itself out of troughs under its own steam and how it succeeds in doing so while the price level is falling." So he seems to be drawing the same conclusion that you do. Give me the 60-second overview of what happened in 1920-21, and then we'll get into the weeds.

GRANT: Okay, big inflation came after World War I. That inflation turned into a deflationary collapse in 1920. The feds met this disaster of employment and of production. They met it by seeming to do nothing. They balanced the budget. The Federal Reserve actually raised interest rates, and lo and behold 18 months after it began this catastrophe ended, and the '20s proverbially roared.

WOODS: Wow! That's fantastic. I think that was like 25 seconds. Excellent! Great! We can make use of the remaining—

GRANT: I have been practicing, Tom.

WOODS: No doubt. You are ready for your media tour starting tomorrow. All right, tell us—on this show though you can be a little bit more technical than maybe you can be in other venues. Tell us about the inflation. What were the causes of it? In other words, what were the motivations behind the inflation?

GRANT: The world went to war, of course, as we all now know, and I am reminded in this anniversary here the world went to war in 1914. America entered this conflict in 1917, and to finance America's prosecution the war, the Treasury borrowed, and the Federal Reserve that's still wet behind the ears—it was only in business since 1914—printed a great deal of money and suppressed interest rates as it was destined to do in World War II, and as it has recently been doing. So the price level is then measured. It was up double digits in 1916, '17, and '18. I am talking about inflation rates of 12 and 15%. What was surprising to people was the persistence of inflation after the armistice. After the Napoleonic wars, after the Civil War in this country, prices had fallen. Wartime inflation ended, and prices resumed their fall because the world was getting more productive, and as it cost less to make things, so it cost less to buy them. That was the reform after major wars. But in 1919, prices did not decline, but rather kept going up. And people thought, aha, we are embarked on a new age, and they adjusted their affairs accordingly. In Kansas City, Missouri, an entrepreneur named Harry Truman gets back from the war with a partner of this business to sell menswear. They opened a haberdashery. In Detroit the General Motors Corporation—even then one of the American industrial behemoths—built a headquarters building suitable for, well, a behemoth. It was a vast—the biggest office building, I think, in the world at that time. Farmers planted fence row to fence row and mechanized, borrowing the money often with which to buy land and equipment.

So the world capitalized for the expectation of continued rising prices, and then came the great crash of 1920. Prices did not resume—did not continue their upswing, but rather precipitously declined. They declined beginning not in America, but with the Tokyo silk market. So people were confounded, and having prepared for the wrong outcome, they had to make adjustments for what they now saw in front of them.

WOODS: It's surprising to me how many people whether—I don't know if we would call it the financial press at that time—or even people who were associated with the Federal Reserve, you can find some people in those days who thought it was not a preposterous idea to suggest that prices had been deformed under the pressure of these unusual circumstances, and now it's necessary for prices to adjust to the circumstances of today, instead of panicking about deflation.

GRANT: Well, deflation was actually the goal for some of these Federal Reserve people, including the man who headed the Federal Reserve Bank of New York, who was effectively the Janet Yellen of his day. That was Benjamin Strong.

WOODS: Yeah, this surprised me. All I knew about Strong was his policies leading up to 1929. I hadn't known his views here. This was interesting.

GRANT: He was very much a markets guy. He was in favor of what we now call price discovery, which is the invisible hand at work. He was very much a free-market advocate and a practitioner, and he was by no means a cruel man. He believed that deflation was necessary and furthermore was salutary, would benefit this country because it would readjust prices and wages and incomes and profits. He felt that if you artificially attempted to prop up the price level through credit creation, you were only postponing a very unhappy day of reckoning.

WOODS: Now, that leads to a question I would have under other circumstances, which is I wonder how his thinking evolves, or maybe there were other justifications he had for the inflation later in the '20s. But I want to stay focused on your book, so I will have indulge myself on that question another time. Tell us about how severe the downturn became in '20 and '21. What kind of figures do we see?

GRANT: Well, the statistical output of the government at that time was very meager—which is perhaps one source of American strength, if you believe as I do that we are now suffering from a kind of statistical hypochondria. But as then calculated, the depression or the recession—opinions vary, but I say depression—was quite severe. Unemployment was almost certainly in the double digits. Industrial production fell on the order of 30% top to bottom. Commodity prices, which could be measured, fell on the order of 40%. And the Dow Jones Industrial Average was down more than 45%. So it was very severe, and there was a great deal of suffering. People at the time thought that they'd never seen the likes of it, nor had they. Prices had never before in American history fallen so sharply, nor so quickly as they did between 1920 and '21. It took away the breath of the people watching all this unfold, and indeed, nothing like this happened even in 1929 and '30. For speed of collapse 1920, '21 is in a league of its own.

WOODS: Let me ask you about that figure involving industrial production falling 30%. Couldn't a Keynesian say that, look, today we never see a statistic like that. You never in postwar America, post-World War II that is, you would never see industrial production falling 30%, and that's because we've got built-in automatic stabilizers, or this or that, but obviously that does show that we've gotten better at fine-tuning the economy via the Fed and federal government. How else can you account for why we don't have outright collapses of that scale? How would you answer that?

GRANT: Well, there's something to that. The government, as we all know, is omnipresent. Scarcely a sparrow falls to earth without the Federal Reserve commenting on that fact. The feds are out there subsidizing incomes. There are programs by the scores to maintain incomes in the face of falling activity. So, yeah, there's something to that, but nothing is for free, and I think consciously or explicitly or otherwise we have exchanged dynamism for some measure of income security. But I think as the takeaway from the episode of 1920, '21 is not even so much how quickly it ended, but how dynamic was the recovery after it did.

WOODS: Yeah, now let's talk about that. Let's talk about, first of all, who the presidents were. A lot of this is actually taking place during the fiscal year in which we're still dealing with Woodrow Wilson. Now Woodrow Wilson was largely incapacitated by this time because of a series of strokes he had, and I wonder if that had perhaps something to do with the relative inaction in the face of these economic statistics?

GRANT: Tom, it was very much the case. Woodrow Wilson when he was active, perhaps all too active, had instituted a program of war socialism—1917, 1918. The government got involved in almost every aspect of American enterprise from the fixing, or at least the administration, of coal prices, to wage policy—you name it, the government's fingers were in it. But come the peace, Wilson was on record, at least informally, conversationally there as saying that the time had now come for the government to take a much more interventionist approach to economic policy in general. But then, as we all know, he was struck down while trying to sell his program for the League of Nations. He got in the train and went out West to make his speeches, and he was incapacitated, and then so was his administration. So what he had under Woodrow Wilson was a kind of a *laissez faire* by accident.

WOODS: Well, I had a friend who rather gruesomely calls it a stroke of good luck. I won't go that far, but that's what I've heard said.

But how about Warren Harding? What I love about Warren Harding is that he's despised by everyone, although John Dean wrote a somewhat rehabilitative biography of him recently. But everybody loves to hate Warren Harding because he smoked and he drank and he did all this and that, and he wasn't that smart, and he didn't go to Harvard. I think he went to the University of Alabama or something. Yet, he did have some basic common sense about what was going on. He even had some basic common sense about monetary policy. Can you tell us about Harding?

GRANT: Well, Harding, I think, was one terrific president if your criteria for leadership in this country is peace and prosperity. He's hardly been bested. One of the first things he did in office was to organize a disarmament conference. He was of the view that peace was what we humans ought to be engaged in and to do this he wanted the world's governments to get rid of their armies and navies to the greatest extent possible. So that was one achievement. The lasting achievement of the disarmament conference was all too transitory, but still, that was what Harding wanted. He wanted peace. As to prosperity, he set into motion policies to balance the federal budget and to withdraw the federal government from business, and in this he was successful. So with respect to peace and prosperity, I rate Harding's all-too-truncated administration a success more than a failure. He died before the scandals emerged. But he was a somewhat of a guileless fellow, and my favorite quotation about Harding is from one of his critics, and this critic was reflecting on Harding's magnanimity as embracing and benevolent face and personality and this fellow said of Harding—he said, "He gave out love." And I think that's what Harding did, and he was, I think, successful in very important ways.

WOODS: Of course, a big part of his program involved cuts in marginal income tax rates, and this was an idea that was pushed heavily by his Treasury secretary, Andrew Mellon, but these tax cuts didn't actually take effect until after the economy had really turned a corner. So although they may have prepared the roaring '20s, they are not in and of themselves the explanatory factor with regard to how the economy reverses itself out of 1921. What else was he doing that might have helped to contribute to that?

GRANT: Well, you mentioned Mellon. Mellon was one of the great American businessmen and financiers. He had interests in everything from aluminum to banking. And he had a practitioner's almost tactile sense of what made business work, and for that matter, not work. And when Mellon came in in early 1921, one of the first tasks he set for himself was to persuade his colleagues on the Federal Reserve Board—the Treasury secretary was then an *ex officio* member of the Board of Governors of the Fed—to reduce interest rates. They had been very high, and the Fed acceded to this, and the glimpse of lower interest rates was itself a great boon and elixir to a marketplace that had been quite discouraged and run down. So Mellon effected, or help to effect, this reduction in interest rates, and he set in motion an administration-wide determination to reduce outlays and to also synchronously reduce the burden of taxation, and I think the prospect of that was most helpful. Certainly I think it helped the stock market to recover.

WOODS: Now somebody could come along and say, aha: see, it goes to show that if the Federal Reserve lowers interest rates—and here I think we're talking about the discount rate—then this leads to these good outcomes, and this goes to show that we need the Fed's intervention. But I guess part of my response to that would be, it's not that low interest rates are never a good idea. It's that in a case like this, interest rates may have been high for a while because there were high inflation expectations. But now that the inflation expectations, in a deflationary environment, no longer exist, the justification for the higher interest rates no longer exists. Am I on the right track?

GRANT: I think you are. The Federal Reserve not only raised rates, but it raised them to the point of asphyxiation. Picture the scene of a major commodity index falling down the stairs to the extent of about 40% top to bottom—enormous, enormous dislocations in the prices that people received and paid. Farmers were absolutely devastated. Cotton prices, tobacco rises—just fell right out of it. So imagine in the face of these calamities a central bank coming in and raising—not lowering, mind you, but raising—the discount rate from 5% to 6% to 7, and not even stopping until it got to 8%. That's the number I think it was. So the economists talk about the real or the inflation-adjusted level of interest. In the case of 1921, the so-called real interest rate was positively punitive. I think what this did was to accelerate the processes by which America shrugged off the excesses and the misallocations of the inflationary era and readjusted itself to the prospect of something like stable prices in a postwar era. In any case, the vision of lower rates was a terrific relief.

WOODS: What did Herbert Hoover think President Harding ought to do about unemployment?

GRANT: Well, Hoover was a man of who it was said that he was the secretary of commerce and the assistant secretary of everything else. He was the prototypical bureaucratic busybody, and I should interrupt myself to say that he was also a truly excellent man. He was an accomplished mining engineer. He was a philanthropist *par excellence.* He was a patriot. He was a scholar. He and his wife, whose name was Lou, took it upon themselves to translate a medieval mining text she handling the Latin, he conducting experiments in the basement or the kitchen having to do with metallurgy. So this was a formidable man, Herbert Hoover. But he was a meddler, and he persuaded Harding to convene a President's Conference on Unemployment, which of course, I say, of course, in the scheme of things, seemingly inevitably came after the low ebb in American business fortunes in 1921. So it was somewhat academic. But it shows you where Hoover's heart was and where his mind was. He was all in favor of the government taking a more active interventionist approach, which as president he proceeded to do in 1929, 1930.

WOODS: Now on the other hand, what seems to have solved the unemployment problem—and we can compare 1920-21 with 1929 and thereafter on this—was wage flexibility.

GRANT: Ah, yes. This was, I think, the key to the situation. To us today, living as we do at a time when the Federal Reserve defines stable prices as actually rising prices, the idea of the Federal Reserve standing by and letting, indeed encouraging, wages to adjust downward, seems almost medieval. It seems barbarous, wantonly cruel. And yet, paradoxically, this was the key to success in the adjustment of the '20s and the failure of the adjustment in the early 1930s. Because prices fell, wages fell as well, not so much, not so fast. Wages did adjust downward, and in adjusting, they helped to restore profit margins. If the costs of things fall, that's good for a manufacturer. If costs fall, that's good. If prices fall, well, that's manageable. But if wages don't fall, what choice does the manufacturer have except to make do with less labor, meaning to lay off people, to fire people? And that's what happened in the 1930s. But in the '20s, falling wages allowed employers to increase production and to keep labor, and indeed, to hire more of it, and by late 1921 there were labor shortages appearing again in Detroit.

WOODS: One of the long-term outcomes of this episode as we look through the '20s and beyond seems to be the evolution of the Fed away from—I still don't support it—but away from its more modest mission at the beginning. The idea of relatively frequent intervention in the form of open-market operations begins to take shape. Is that right?

GRANT: Yes, it does. One might have supposed—certainly I am of a mind to have expected and hoped that the lessons in 1920, '21 would have been kind of absorbed and institutionalized. People might have said, well, that was not pleasant, but it was over and done with, and let us do more of the same next time. It seems to be a more than defensible approach to our difficulties to allow this wondrous thing called the price mechanism to do its work. But that was not the lesson. Other people—the policymakers, at least, took away under the influence of Herbert Hoover and others and John Maynard Keynes—the idea took hold that governments ought to be in the business of, for example, of stabilizing things, and especially of stabilizing a price level, and this idea came to dominate the counsel of the Fed. And as the '20s wear on, we see the Fed intervening with what they call open-market operations, meaning the buying and selling of government securities to influence market outcomes. We see the Fed in 1927 lowering its discount rate to help the Bank of England stabilize prices across the Atlantic. So by the time 1929 and '30 comes around, the idea of the stabilization of prices, which had been nascent before World War I, this idea now becomes rather in the mainstream. I'm not sure that was exactly progress, but it was a fact.

WOODS: Jim, before I let you go, I want you to tell people for just a minute about *Grant's Interest Rate Observer* that you have been publishing for I don't know how many years now.

GRANT: Nearly 31. It seems sometimes like 50, but it's 31 years. I got in the business in 1983, thinking the world did not have enough to read on the subject of finance. So that was—actually it was not the case in 1983. It's still less the case today. What we try to do is to make our readers look forward to the appearance of *Grant's* every two weeks by identifying what we hoped is the next thing in finance. We want to identify things that are overdone and things that are underdone—values and promotions. So we want to help our readers understand where they can find the very best that Wall Street has to offer, and where they are going to identify the very worst that is on offer. That is, extremes of value and the lack of value.

WOODS: And how can people find you online?

GRANT: They can Google *Grant's Interest Rate Observer* or James Grant, and I hope that Mr. Google will lead them right here.

WOODS: Absolutely. That's fantastic. Well, listen, I appreciate your time today. I am thrilled about this book. I want to urge people to check it out—*The Forgotten Depression—1921: the*

Crash That Cured Itself. It has the analysis of a great economist, but the bracing and elegant prose of a journalist of the old school, when journalists could still write. So, Jim Grant, thank for this book and for being with me today.

GRANT: Thank you, Tom. Thank you very much.