

WARREN HARDING AND THE FORGOTTEN DEPRESSION OF 1920

It is a cliché that if we do not study the past we are condemned to repeat it. Almost equally certain, however, is that if there are lessons to be learned from an historical episode, the political class will draw all the wrong ones—and often deliberately so. Far from viewing the past as a potential source of wisdom and insight, political regimes have a habit of employing history as an ideological weapon, to be distorted and manipulated in the service of present-day ambitions. That’s what Winston Churchill meant when he described the history of the Soviet Union as “unpredictable.”

For this reason, we should not be surprised that our political leaders have made such transparently ideological use of the past in the wake of the financial crisis that hit the United States in late 2007. According to the endlessly repeated conventional wisdom, the Great Depression of the 1930s was the result of capitalism run riot, and only the wise interventions of progressive politicians restored prosperity. Many of those who concede that the New Deal programs alone did not succeed in lifting the country out of depression nevertheless go on to suggest that the massive government spending during World War II is what did it.¹ (Even some nominal free-marketeters make the latter claim, which

hands the entire theoretical argument to supporters of fiscal stimulus.)

The connection between this version of history and the events of today is obvious enough: once again, it is claimed, wildcat capitalism has created a terrific mess, and once again, only a combination of fiscal and monetary stimulus can save us.

In order to make sure that this version of events sticks, little, if any, public mention is ever made of the depression of 1920–21. And no wonder: that historical experience deflates the ambitions of those who promise us political solutions to the real imbalances at the heart of economic busts. The conventional wisdom holds that in the absence of government countercyclical policy, whether fiscal or monetary (or both), we cannot expect economic recovery—at least, not without an intolerably long delay. Yet the very opposite policies were followed during the depression of 1920–21, and recovery was in fact not long in coming.

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The economic situation in 1920 was grim. By that year unemployment had jumped from 4 percent to nearly 12 percent, and GNP declined 17 percent. No wonder, then, that Secretary of Commerce Herbert Hoover—falsely characterized as a supporter of *laissez-faire* economics—urged President Harding to consider an array of interventions to turn the economy around. Hoover was ignored.

Instead of “fiscal stimulus,” Harding cut the government’s budget nearly in half between 1920 and 1922. The rest of Harding’s approach was equally *laissez-faire*. Tax rates were slashed for all income groups. The national debt was reduced by one-third. The Federal Reserve’s activity, moreover, was hardly noticeable. As one economic historian puts it, “Despite the severity of the contraction, the Fed did not move to use its powers to turn the money supply around and fight the contraction.”² By the late summer of 1921, signs of recovery were already visible. The following year, unemployment was back down to 6.7 percent and was only 2.4 percent by 1923.

It is instructive to compare the American response in this period to that of Japan. In 1920, the Japanese government introduced the fundamentals of a planned economy, with the aim of keeping prices artificially high. According to economist Benjamin Anderson, “The great banks, the concentrated industries, and the government got together, destroyed the freedom of the markets, arrested the decline in commodity prices, and held the Japanese price level high above the receding world level for seven years. During these years Japan endured chronic industrial stagnation and at the end, in 1927, she had a banking crisis of such severity that many great branch bank systems went down, as well as many industries. It was a stupid policy. In the effort to avert losses on

inventory representing one year’s production, Japan lost seven years.”³

The U.S., by contrast, allowed its economy to readjust. “In 1920–21,” writes Anderson, “we took our losses, we readjusted our financial structure, we endured our depression, and in August 1921 we started up again. . . . The rally in business production and employment that started in August 1921 was soundly based on a drastic cleaning up of credit weakness, a drastic reduction in the costs of production, and on the free play of private enterprise. It was not based on governmental policy designed to make business good.” The federal government did *not* do what Keynesian economists ever since have urged it to do: run unbalanced budgets and prime the pump through increased expenditures. Rather, there prevailed the old-fashioned view that government should keep spending and taxation low and reduce the public debt.⁴

Those were the economic themes of Warren Harding’s presidency. Few presidents have been subjected to the degree of outright ridicule that Warren Harding endured during his lifetime and continues to receive long after his death. But the conventional wisdom about Harding is wrong to the point of absurdity: even the alleged “corruption” of his administration was laughably minor compared to the presidential transgressions we have since come to take for granted.

In his 1920 speech accepting the Republican presidential nomination, Harding declared:

We will attempt intelligent and courageous deflation, and strike at government borrowing which enlarges the evil, and we will attack high cost of government with every energy and facility which attend

Republican capacity. We promise that relief which will attend the halting of waste and extravagance, and the renewal of the practice of public economy, not alone because it will relieve tax burdens but because it will be an example to stimulate thrift and economy in private life.

Let us call to all the people for thrift and economy, for denial and sacrifice if need be, for a nationwide drive against extravagance and luxury, to a recommittal to simplicity of living, to that prudent and normal plan of life which is the health of the republic. There hasn't been a recovery from the waste and abnormalities of war since the story of mankind was first written, except through work and saving, through industry and denial, while needless spending and heedless extravagance have marked every decay in the history of nations.

It is hardly necessary to point out that Harding's counsel—delivered in the context of a speech to a political convention, no less—is the *opposite* of what the alleged experts urge upon us today. Inflation, increased government spending, and assaults on private savings combined with calls for consumer profligacy: such is the program for “recovery” in the twenty-first century.

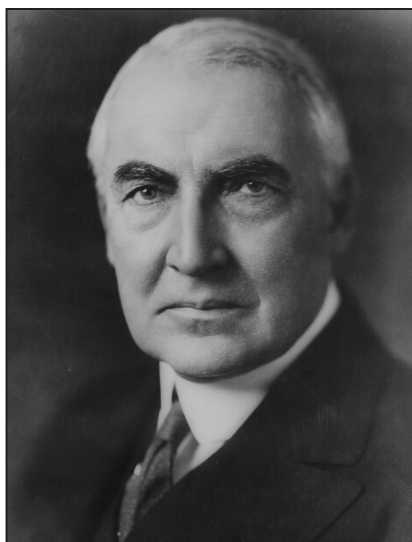
Not surprisingly, many modern economists who have studied the depression of 1920–21 have been unable to explain how the recovery could have been so swift and sweeping even though the federal government and the Federal Reserve refrained from employing any of the macroeconomic tools—public works spending, government deficits, inflationary monetary policy—that conventional wisdom now recommends as the solution

to economic slowdowns. The Keynesian economist Robert A. Gordon admitted that “government policy to moderate the depression and speed recovery was minimal. The Federal Reserve authorities were largely passive. . . . Despite the absence of a stimulative government policy, however, recovery was not long delayed.”⁵ Another economic historian briskly conceded that “the economy rebounded quickly from the 1920–21 depression and entered a period of quite vigorous growth” but chose not to comment further on this development.⁶ “This was 1921,” writes the condescending Kenneth Weiher, “long before the concept of countercyclical policy was accepted or even understood.”⁷ They may not have “understood” countercyclical policy, but recovery came anyway—and quickly.

One of the most perverse treatments of the subject comes at the hands of two historians of the Harding presidency, who urge that without government confiscation of much of the income of the wealthiest Americans, the American economy will never be stable:

The tax cuts, along with the emphasis on repayment of the national debt and reduced federal expenditures, combined to favor the rich. Many economists came to agree that one of the chief causes of the Great Depression of 1929 was the unequal distribution of wealth, which appeared to accelerate during the 1920s, and which was a result of the return to normalcy. Five percent of the population had more than 33 percent of the nation's wealth by 1929. This group failed to use its wealth responsibly. . . . Instead, they fueled unhealthy speculation on the stock market as well as uneven economic growth.⁸

If this absurd attempt at a theory were correct, the world would be in a constant state of depression. There was nothing at all unusual about the pattern of American wealth in the 1920s. Far greater disparities have existed in countless times and places without any resulting disruption. In fact, the Great Depression actually came in the midst of a dramatic *upward* trend in the share of national income devoted to wages and salaries in the United States—and a



President Harding—a champion of laissez-faire

downward trend in the share going to interest, dividends, and entrepreneurial income.⁹ We do not in fact need the violent expropriation of any American in order to achieve prosperity, thank goodness.

It is not enough, however, to demonstrate that prosperity happened to follow upon the absence of fiscal or monetary stimulus. We need to understand why this outcome is to be expected—in other words, why the restoration of prosperity in the absence of the remedies urged upon us in more recent times was not an inconsequential curiosity or the result of mere happenstance.

First, we need to consider why the market economy is afflicted by the boom-bust cycle in the first place. The British economist Lionel Robbins asked in his 1934 book *The Great Depression* why there should be a sudden “cluster of error” among entrepreneurs. Given that the market, via the profit-and-loss system, weeds out the least competent entrepreneurs, why should the relatively more skilled ones that the market has rewarded with profits and control over additional resources suddenly commit grave errors—and all in the same direction? Could something outside the market economy, rather than anything that inheres in it, account for this phenomenon?

Ludwig von Mises and F. A. Hayek both pointed to artificial credit expansion, normally at the hands of a government-established central bank, as the non-market culprit. (Hayek won the Nobel Prize in 1974 for his work on what is known as Austrian business cycle theory.) When the central bank expands the money supply—for instance, when it buys government securities—it creates the money to do so out of thin air. This money either goes directly to commercial banks or, if the securities were purchased from an investment bank, very quickly makes its way to the commercial banks when the investment banks deposit the Fed’s checks. In the same way that the price of any good tends to decline with an increase in supply, the influx of new money leads to lower interest rates, since the banks have experienced an increase in loanable funds.

The lower interest rates stimulate investment in long-term projects, which are more interest-rate sensitive than shorter-term ones. (Compare the monthly interest paid on a thirty-year mortgage with the interest paid on a two-year mortgage—a tiny drop in interest rates will have a substantial impact on the former but a negligible impact on the latter.) Additional invest-

ment in, say, research and development (R&D), which can take many years to bear fruit, will suddenly seem profitable, whereas it would not have been profitable without the lower financing costs brought about by the lower interest rates.

We describe R&D as belonging to a “higher-order” stage of production than a retail establishment selling hats, for example, since the hats are immediately available to consumers while the commercial results of R&D will not be available for a relatively long time. The closer a stage of production is to the finished consumer good to which it contributes, the *lower* a stage we describe it as occupying.

On the free market, interest rates coordinate production across time. They ensure that the production structure is configured in a way that conforms to consumer preferences. If consumers want more of existing goods right now, the lower-order stages of production expand. If, on the other hand, they are willing to postpone consumption in the present, interest rates encourage entrepreneurs to use this opportunity to devote factors of production to projects not geared toward satisfying immediate consumer wants, but which, once they come to fruition, will yield a greater supply of consumer goods in the future.

Had the lower interest rates in our example been the result of voluntary saving by the public instead of central-bank intervention, the relative decrease in consumption spending that is a correlate of such saving would have released resources for use in the higher-order stages of production. In other words, in the case of genuine saving, demand for consumer goods undergoes a relative decline; people are saving more and spending less than they used to. Consumer-goods industries, in turn, undergo a relative contraction in response to the decrease in demand for

consumer goods. Factors of production that these industries once used—trucking services, for instance—are now released for use in more remote stages of the structure of production. Likewise for labor, steel, and other nonspecific inputs.

When the market’s freely established structure of interest rates is tampered with, this coordinating function is disrupted. Increased investment in higher-order stages of production is undertaken at a time when demand for consumer goods has not slackened. The time structure of production is distorted such that it no longer corresponds to the time pattern of consumer demand. Consumers are demanding goods in the *present* at a time when investment in *future* production is being disproportionately undertaken.

Thus, when lower interest rates are the result of central bank policy rather than genuine saving, no letup in consumer demand has taken place. (If anything, the lower rates make people even more likely to spend than before.) In this case, resources have *not* been released for use in the higher-order stages. The economy instead finds itself in a tug-of-war over resources between the higher- and lower-order stages of production. With resources unexpectedly scarce, the resulting rise in costs threatens the profitability of the higher-order projects. The central bank can artificially expand credit still further in order to bolster the higher-order stages’ position in the tug of war, but it merely postpones the inevitable. If the public’s freely expressed pattern of saving and consumption will not support the diversion of resources to the higher-order stages, but, in fact, pulls those resources back to those firms dealing directly in finished consumer goods, then the central bank is in a war against reality. It will eventually have to decide whether, in order to validate all the higher-order expansion, it is prepared

to expand credit at a galloping rate and risk destroying the currency altogether, or whether instead it must slow or abandon its expansion and let the economy adjust itself to real conditions.

It is important to notice that the problem is not a deficiency of consumption spending, as the popular view would have it. If anything, the trouble comes from too much consumption spending, and as a result too little channeling of funds to other kinds of spending—namely, the expansion of higher-order stages of production that cannot be profitably completed because the necessary resources are being pulled away precisely by the relatively (and unexpectedly) stronger demand for consumer goods. Stimulating consumption spending can only make things worse, by intensifying the strain on the already collapsing profitability of investment in higher-order stages.

Note also that the precipitating factor of the business cycle is not some phenomenon inherent in the free market. It is *intervention* into the market that brings about the cycle of unsustainable boom and inevitable bust.¹⁰ As business-cycle theorist Roger Garrison succinctly puts it, “Savings gets us genuine growth; credit expansion gets us boom and bust.”¹¹

This phenomenon has preceded all of the major booms and busts in American history, including the 2007 bust and the contraction in 1920–21. The years preceding 1920 were characterized by a massive increase in the supply of money via the banking system, with reserve requirements having been halved by the Federal Reserve Act of 1913 and then with considerable credit expansion by the banks themselves. Total bank deposits more than doubled between January 1914, when the Fed opened its doors, and January 1920. Such artificial credit creation sets the boom-bust cycle in motion. The Fed also

kept its discount rate (the rate at which it lends directly to banks) low throughout the First World War (1914–18) and for a brief period thereafter. The Fed began to tighten its stance in late 1919. Economist Gene Smiley, author of *The American Economy in the Twentieth Century*, observes that “the most common view is that the Fed’s monetary policy was the main determinant of the end of the expansion and inflation and the beginning of the subsequent contraction and severe deflation.”¹² Once credit began to tighten, market actors suddenly began to realize that the structure of production had to be rearranged and that lines of production dependent on easy credit had been erroneously begun and needed to be liquidated.

We are now in a position to evaluate such perennially fashionable proposals as “fiscal stimulus” and its various cousins. Think about the condition of the economy following an artificial boom. It is saddled with *imbalances*. Too many resources have been employed in higher-order stages of production and too few in lower-order stages. These imbalances must be corrected by entrepreneurs who, enticed by higher rates of profit in the lower-order stages, bid resources away from stages that have expanded too much and allocate them toward lower-order stages where they are more in demand. The absolute freedom of prices and wages to fluctuate is essential to the accomplishment of this task, since wages and prices are indispensable ingredients of entrepreneurial appraisal.

In light of this description of the post-boom economy, we can see how unhelpful, even irrelevant, are efforts at fiscal stimulus. The government’s mere act of spending money on arbitrarily chosen projects does nothing to rectify the imbalances that led to the crisis. It is not a decline in “spending” per se that has caused the problem. It

is the mismatch between the kind of production the capital structure has been misled into undertaking on the one hand, and the pattern of consumer demand, which cannot sustain the structure of production as it is, on the other.

And it is not unfair to refer to the recipients of fiscal stimulus as arbitrary projects. Since government lacks a profit-and-loss mechanism and can acquire additional resources through outright expropriation of the public, it has no way of knowing whether it is actually satisfying consumer demand (if it is concerned about this at all) or whether its use of resources is grotesquely wasteful. Popular rhetoric notwithstanding, government *cannot* be run like a business.¹³

Monetary stimulus is no help either. To the contrary, it only intensifies the problem. In *Human Action*, Mises compared an economy under the influence of artificial credit expansion to a master builder commissioned to construct a house that (unbeknownst to him) he lacks sufficient bricks to complete. The sooner he discovers his error the better. The longer he persists in this unsustainable project, the more resources and labor time he will irretrievably squander. Monetary stimulus merely encourages entrepreneurs to continue along their unsustainable production trajectories; it is as if, instead of alerting the master builder to his error, we merely intoxicated him in order to delay his discovery of the truth. But such measures make the eventual bust no less inevitable—merely more painful.

If the Austrian view is correct—and I believe the theoretical and empirical evidence strongly indicates that it is—then the best approach to recovery would be close to the opposite of these Keynesian strategies. The government budget should be cut, not increased, thereby releasing resources that private actors can use to

realign the capital structure. The money supply should not be increased. Bailouts merely freeze entrepreneurial error in place, instead of allowing the redistribution of resources into the hands of parties better able to provide for consumer demands in light of entrepreneurs' new understanding of real conditions. Emergency lending to troubled firms perpetuates the misallocation of resources and extends favoritism to firms engaged in unsustainable activities at the expense of sound firms prepared to put those resources to more appropriate use.

This recipe of government austerity is precisely what Harding called for in his 1921 inaugural address:

We must face the grim necessity, with full knowledge that the task is to be solved, and we must proceed with a full realization that no statute enacted by man can repeal the inexorable laws of nature. Our most dangerous tendency is to expect too much of government, and at the same time do for it too little. We contemplate the immediate task of putting our public household in order. We need a rigid and yet sane economy, combined with fiscal justice, and it must be attended by individual prudence and thrift, which are so essential to this trying hour and reassuring for the future. . . .

The economic mechanism is intricate and its parts interdependent, and has suffered the shocks and jars incident to abnormal demands, credit inflations, and price upheavals. The normal balances have been impaired, the channels of distribution have been clogged, the relations of labor and management have been strained. We must seek the readjustment with care and

courage. . . . All the penalties will not be light, nor evenly distributed. There is no way of making them so. There is no instant step from disorder to order. We must face a condition of grim reality, charge off our losses and start afresh. It is the oldest lesson of civilization. I would like government to do all it can to mitigate; then, in understanding, in mutuality of interest, in concern for the common good, our tasks will be solved. No altered system will work a miracle. Any wild experiment will only add to the confusion. Our best assurance lies in efficient administration of our proven system.

Harding's inchoate understanding of what was happening to the economy and why grandiose interventionist plans would only delay recovery is an extreme rarity among twentieth-century American presidents. That he has been the subject of ceaseless ridicule at the hands of historians, to the point that anyone speaking a word in his favor would be dismissed out of hand, speaks volumes about our historians' capabilities outside of their own discipline.

The experience of 1920–21 reinforces the contention of genuine free-market economists that government intervention is a hindrance to economic recovery. It is not in spite of the absence of fiscal and monetary stimulus that the economy recovered from the 1920–21 depression. It is *because* those things were avoided that recovery came. The next time we are solemnly warned to recall the lessons of history lest our economy deteriorate still further, we ought to refer to this episode—and observe how hastily our interrogators try to change the subject.

- 1 On the fallacy of “wartime prosperity” during the Second World War, see Robert Higgs, *Depression, War, and Cold War* (New York: Oxford University Press, 2006).
- 2 Kenneth E. Weiher, *America's Search for Economic Stability: Monetary and Fiscal Policy Since 1913* (New York: Twayne, 1992), 35.
- 3 On Japan, see Benjamin M. Anderson, *Economics and the Public Welfare: A Financial and Economic History of the United States, 1914–1946* (Indianapolis: Liberty Press, 1979 [1949]), 88–89, 90.
- 4 *Ibid.*, 92.
- 5 Robert Aaron Gordon, *Economic Instability and Growth: The American Record* (New York: Harper and Row, 1974), 21–22, cited in Joseph T. Salerno, “An Austrian Taxonomy of Deflation—With Applications to the U. S.,” *Quarterly Journal of Austrian Economics* 6 (Winter 2003): 89.
- 6 Robert A. Degen, *The American Monetary System: A Concise Survey of Its Evolution Since 1896* (Lexington, MA: D. C. Heath, 1987), 41.
- 7 Weiher, *America's Search for Economic Stability*, 36.
- 8 Eugene P. Trani and David L. Wilson, *The Presidency of Warren G. Harding* (Lawrence, KS: University Press of Kansas, 1977), 72.
- 9 C. A. Phillips, T. F. McManus, and R. W. Nelson, *Banking and the Business Cycle: A Study of the Great Depression in the United States* (New York: Macmillan, 1937), 76.
- 10 The Austrian theory also applies to cases in which no central bank was present and artificial credit expansion took place by other means. Government intervention is at fault in these cases as well. See Jesús Huerta de Soto, *Money, Bank Credit, and Economic Cycles*, trans. Melinda A. Stroup (Auburn, AL: Ludwig von Mises Institute, 2006).
- 11 Roger W. Garrison, “The Austrian Theory: A Summary,” in *The Austrian Theory of the Trade Cycle and Other Essays*, comp. Richard M. Ebeling (Auburn, AL: Ludwig von Mises Institute, 1996), 99.
- 12 Gene Smiley, “The U.S. Economy in the 1920s,” EH.Net Encyclopedia, ed. Robert Whaples, March 26, 2008; <http://eh.net/encyclopedia/article/Smiley.1920s.final>.
- 13 Ludwig von Mises, *Bureaucracy* (New Haven, CT: Yale University Press, 1944).