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REVIEW ESSAY

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Reflections on  
Reflections  
*A Consensus about  
the Great Depression?*

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ROGER W. GARRISON

In *Reflections on the Great Depression* (2002), leading economists who lived through and wrote about the Great Depression are invited to reflect on that horrific and still-puzzling episode. Randall E. Parker of East Carolina University (Greenville, North Carolina) conducted eleven interviews in 1997 and 1998, his questions sometimes provoking answers that will amuse and inform a wide variety of readers. The interviewees, five now deceased (indicated by an asterisk), were born during the first two decades of the twentieth century: Paul Samuelson, Milton Friedman, Moses Abramowitz\*, Albert Hart\*, Charles Kindleberger, Anna Schwartz, James Tobin\*, Wassily Leontief\*, Morris Adelman, Herbert Stein\*, and Victor Zarnowitz.

“What do you think of monocausal explanations of the Great Depression?” “What was the initial impetus for the Great Depression, and what accounts for its depth?” “What ended the Great Depression?” “Could it happen again?” “Should the Federal Reserve be an arbiter of security prices?” These questions and others—about John Maynard Keynes’s influence, the role of government, and the distribution of

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income—create a common denominator among the varied discussions of the world between the wars.

To put the questions and answers into perspective, Parker mentions in the preface his own empirical investigations (Fackler and Parker 1994), in which he put several monocausal explanations to the test. To pass the test, the hypothesized cause must explain (using 95 percent confidence bands) the depth and duration of the depression. Neither money nor debt nor gold flows could pass. It took a combination of causes to account for the actual movements in output over the course of the cycle. The explanations jointly deserving of our attention, as set out by Parker in an overview chapter, are Milton Friedman's monetary hypothesis, Ben Bernanke's debt-deflation hypothesis, and Barry Eichengreen's gold-standard hypothesis. Bernanke, now a governor of the Federal Reserve System, wrote the book's foreword.

The discriminating reader will detect an unconscious blurring of correlation, explanation, and causation. Suppose a careless smoker starts a grass fire. After burning an acre or two of grass, the fire ignites a large pile of discarded tires. The heat intensifies markedly. Then gusting winds send the blaze into a nearby forest. The whole episode comes to be known as the Great Conflagration. Years later, pyrometricians put the various monocausal explanations to the test (using 95 percent confidence bands). Neither the old-tire hypothesis nor the gusting-winds hypothesis nor any other single hypothesis passes. (They overlook the careless-smoker hypothesis, which would have been a pyrometric nonstarter in any case.) It takes a combination of causes to account for the actual intensity and duration of the fire.

Investigators less constrained by 95 percent confidence bands and more attuned to the distinction between correlation and causation would not hesitate to identify the careless smoker as the cause and to regard the old tires and the gusting winds as having enormously compounded the consequences. This verdict would stand even though the careless smoker by himself accounts for neither the intensity nor the duration of the fire.

When asked "What was the initial impetus for the Great Depression, and what accounts for its depth?" Morris Adelman offers a revealing answer: "I don't know what the initial impetus was, and I can't account for how deep it went except I would say that the second question is much more important than the first" (p. 162). In other words, never mind what got it all started; the important thing is what made the bad situation worse! Herbert Stein attributes a similar view to Friedman and Schwartz: "we were having an ordinary recession which was converted into the Great Depression by the mistakes of monetary policy" (p. 174). The very use of the term *ordinary recession* signals that no cause need be identified. An ordinary recession is so, well, ordinary that the question of what caused it usually doesn't even arise. Some modern macroeconomists, Barry Eichengreen among them, use the term *garden-variety recession* to similar effect. The reader is led to believe that the ordinary or garden-variety recession itself has no particular claim on our attention and serves only as background for discussing the descent into deep depression.

Friedman, who doesn't share Adelman's agnosticism, gives his view of the issue: "monetary developments [in the early 1930s] were the major explanation for the depth and the length of the contraction. As I've said over and over again, I'm not saying that that caused the initial recession. . . . And I don't doubt for a moment that the collapse of the stock market in 1929 played a role in the initial recession" (p. 49). So, was the stock market run-up indicative of the final throes of an unsustainable boom? No. As Friedman makes clear later in the discussion, he's not at all suggesting that there was a boom-bust cycle:

PARKER: *Ben Bernanke has said that business cycle models should explain both the post-war and the interwar eras and that we shouldn't have two sets of models to explain them both.*

FRIEDMAN: I agree with that, but I go further. I don't believe there is such a thing as a business cycle [i.e., a boom-bust cycle]. I believe there are economic fluctuations [i.e., occasional lapses from full employment followed by recoveries].

PARKER: *Oh, the plucking model, OK.*

FRIEDMAN: That's right. That is a single model which fits both the interwar and post-war. (pp. 54–55)

In recent years, Bernanke (1983) has resurrected the old debt-deflation view of the Great Depression. Investors who are seriously in debt when a price deflation occurs are in big trouble. If there are enough such people and they all have to tighten their belts, then spending falls precipitously, and the whole economy is in big trouble—especially the banks. In the face of bad loans and hard times, banks become more conservative. They build up their reserves, which intensifies the deflationary pressures. The big trouble gets bigger. This kind of self-aggravating process can turn a 1930 into a 1933. Parker describes the depression-inducing dynamics of debt cum deflation as the "Nonmonetary/Financial hypothesis" (p. 14). He recognizes, however, that this hypothesis is built on Friedman and Schwartz's monetary hypothesis. Clearly, the monetary aspect is crucial because otherwise there would be no accounting for the initial deflation. The debt, accumulated in the 1920s with little or no regard for the deflation that lay ahead, just helps to explain how a change in a nominal magnitude (the money supply) can have real consequences (reduced spending all around and hence reduced employment and output levels).

Recent contributions to the debt-deflation literature (Fackler and Parker 2001) are aimed at answering the question: Did borrowers in the 1920s actually fail to anticipate the deflation in the 1930s? Yes, they actually did—otherwise, they would not have agreed to borrow long term at positive nominal interest rates. The monetarists believe, however, that their own hypothesis can survive well with or without the debt-deflation flourish. Parker asks Anna Schwartz about the role of debt and deflation, referring to Irving Fisher's original 1933 article. Here, Schwartz, who sees the Fisher-

Bernanke perspective as “overblown” (p. 116), takes the opportunity to give us a little eyes-open history of economic thought:

SCHWARTZ: I’m not impressed with Fisher’s contribution as an intellectual contribution. I think he was just explaining his own life (laughter). I mean here’s this guy who’s a million dollars in debt to his sister-in-law because he had played the stock market. . . . I don’t blame him for expecting that the stock market would just continue in the direction in which it had been moving because he didn’t really know what the Federal Reserve was going to do. But then when he got stuck with this enormous debt that he couldn’t repay his sister-in-law, I think this seemed to him the explanation of why the Depression had happened. (p. 121)

It’s pretty clear what Schwartz thinks of Fisher, but what does she think of Friedman? Friedman believes that the collapse of the stock market in 1929 was what started the difficulties and that the Federal Reserve then made matters worse by allowing the money supply to collapse; Schwartz believes that the soaring stock market would have continued to soar if only the Federal Reserve hadn’t cut the good times short with its untimely monetary stringency.

Putting the stock market crash into proper perspective poses a problem for most business-cycle theorists. To “explain” the origins of the depression by pointing to the crash leaves them with a great deal of explaining to do. But to deny that the stock market played any causal role also requires some explaining. Were security prices in mid-1929 consistent with the fundamentals? If so, how had those fundamentals changed so dramatically since, say, 1925? And what then changed them again in the opposite direction? Were security prices dramatically out of line with the fundamentals in mid-1929? If so, what were the policies or market malfunctions that gave rise to overvalued equity shares? Was the stock market bubble just a symptom of a problem rather than the problem itself? If so, just what was the problem?

Parker’s *Reflections* cries out for more attention to the “initial impetus” question. The careless-smoker hypothesis advanced by the Austrian school focuses attention on a period well before Fisher’s sister-in-law began making bad loans. Beginning in the early 1920s and with renewed resolve in 1927 and 1928, the Federal Reserve set itself the task of “fostering” economic growth. As things turned out, it fostered a little more growth than honest-to-God saving could sustain. Further, unduly favorable credit conditions throughout the decade account for both the increased indebtedness that Fisher and Bernanke are concerned about and the stock market run-up that Friedman and Schwartz are at odds about.

In 1923, when F. A. Hayek first visited the United States, he saw a direct application of the theory of the business cycle spelled out in Ludwig von Mises’s 1912 book *The Theory of Money and Credit* (reissued in 1953). The Austrian theory answers

the “initial impetus” question by showing how a credit-driven boom ends in a bust. The theory explains the “ordinary recession”—though this particular recession was a bit on the extraordinary side owing to the historical setting. The relatively new and hence not well understood Federal Reserve was able to keep the boom going for a good many years. The theory does not purport to explain the actual depth and duration of the Great Depression, but it is consistent with the understanding that in the wake of the downturn all manner of policy blunders (monetary, fiscal, and regulatory) caused the depression to be much deeper and much longer than it otherwise would have been. Nor does the theory deny that some of the growth during the 1920s was real. In fact, the increases in real output offset in large part the inflationary pressures of easy money, keeping the general price level nearly constant and giving the illusion of macroeconomic health. (The careless-smoker analogy is not intended to suggest that carelessness was what underlay the Fed’s pro-growth policies in the 1920s; it suggests only that the difference between Fed-fostered growth and otherwise healthy growth is difficult for econometricians to detect and, although crucial to our understanding of the whole episode, bears little on the issues of the depth and duration of the subsequent depression.)

The Austrian theory does provide a sound analytical basis for answering Parker’s oft-asked question, “Should the Federal Reserve be an arbiter of security prices?” Of course it should not. Under circumstances in which it has its own house in order, it need not and should not pass judgment on either relative or overall movements in security prices. But when those movements seem to be wholly unanchored in reality and to take on the features of an orgy or when they appear to be based on “irrational exuberance,” then the Federal Reserve should reevaluate its own role as a supplier of investment funds. To continue to fuel a speculative boom ignited by easy money is to have a “tiger by the tail,” an aspect of the Austrian theory explored by Sudha Shenoy (Hayek 1978).

Did Parker or any of the interviewees have any inkling about the Austrian theory? Although that theory does not qualify as a “modern explanation” in Parker’s book, his overview chapter contains a short section that identifies “contemporary explanations” of the Great Depression. One explanation is based on “Say’s law and the belief in the self-equilibrating powers of the market.” The other is the Austrian explanation. Parker sets out the Austrian view, but without mentioning Mises or Hayek or any other Austrian economist:

The Austrian school of thought argued that the Depression was the inevitable result of overinvestment during the 1920s. The best remedy for the situation was to let the Depression run its course so that the economy could be purified from negative effects of the false expansion. Government intervention was viewed by the Austrian school as a mechanism that would simply prolong the agony and make any subsequent depression worse than it would ordinarily be. (pp. 9–10)

Note that there is no hint here that the Austrians identify government intervention—in the form of artificially low interest rates maintained by the Federal Reserve—as the cause of the overinvestment. Also, as the Austrians always emphasized, it is not just overinvestment, but “malinvestment” (an intertemporal allocation of capital at odds with actual saving behavior) that characterizes the artificial boom and leads to a bust. Parker does not see the Austrians as offering an analytical framework (as laid out, for example, in Garrison 2001) for showing how interest-rate falsification has undesirable consequences. Instead, he sees their views as raw ethical judgments that underlie their moralizing about overly aggressive investment behavior and that support their reactionary political stance. Parker identifies the political counterpart to the Austrian theorists as the “liquidationists”:

These individuals [the liquidationists] basically believed that economic agents should be forced to re-arrange their spending proclivities and alter their alleged profligate use of resources. If it took mass bankruptcies to produce this result and wipe the slate clean so that everyone could have a fresh start, then so be it. The liquidationists viewed the events of the Depression as an economic penance for the speculative excesses of the 1920s. Thus, the Depression was the price that was being paid for the misdeeds of the previous decade. (p. 9)

Drawing from President Hoover’s *Memoirs* (1952), Parker allows Treasury secretary Andrew Mellon to express the Austrian/liquidationist sentiments. The unbuttoned Mellon advises Hoover to “[l]iquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. . . . [The depression] will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people” (p. 9). When an interviewee even hints at the Austrian view of the problems in 1929, Parker responds with the question, “Purge the rottenness out of the system?” The words *penance* and *purge*, as used to denigrate the Austrian view, have the same flavor and intent as the word *hangover* in the dismissive treatment penned by Paul Krugman (1998). The contra-Austrian message is clear: they don’t teach; they preach.

Friedman contrasts the theories taught at the University of Chicago with those taught at the London School of Economics (LSE, where Hayek presented and defended the Austrian theory), explaining why the LSE graduates were more receptive to Keynesian thinking: Abba Lerner (at the LSE) “had been given a picture of incredible darkness,” but Friedman (at Chicago) “had been given a picture that we had things that we could do.” Hence, “Keynes had a message to bring [to Lerner and the Austrians], he had no message to bring [to Friedman and the Chicago economists]” (p. 44). To Parker’s suggestion that the Austrians wanted to “purge the rottenness,” Friedman, to his credit, responds, “Well, I don’t think Hayek or Lionel Robbins would have used that phrase” (p. 43).

Parker, following Eichengreen (1992), recognizes that the gold standard provided a critical international link and that sterilization policies adopted by the United States kept gold flows from serving as an international equilibrating mechanism (pp. 16–19). Charles Kindleberger has always emphasized the international aspects of the forces that converted recession into depression, but he also claims to be “a debt-deflation man” (p.96). Like so many of the others, however, he is eclectic on the issue of the initial impetus, mentioning cryptically a “series of bubbles: They go way up and something, I don’t know what, pushes them back down” (p. 97). For Kindleberger, the impetus to downward-moving bubbles was probably interest rates and the Hatry crisis. (English financier Clarence Hatry was disgraced and ruined in September 1929 when some of his loan collateral was revealed to be forged securities.) There is no hint in the discussion that the Federal Reserve with its easy-money/growth-fostering policies was the bubble blower.

Kindleberger’s one gratuitous mention of Mises epitomizes the modern attitude toward the Austrian school. In 1939, Kindleberger went to Switzerland for a three-year stint at the Bank for International Settlements, but when France fell to Hitler in 1940, he decided he needed to go home. The Kindlebergers left Geneva on July 3 on the first leg of their journey, traveling by bus through the unoccupied part of France to Barcelona. While bussing across France and into Spain, they encountered an Austrian:

KINDLEBERGER: . . . [W]hen we got to the border, I realized [that] behind me on the bus was Ludwig von Mises. He was feeling very badly and his wife wanted to have the window beside me closed. I wanted, because of my wife being pregnant, to have it open. I didn’t realize who he was until we got to the border going into Spain. He was not my favorite economist. It wouldn’t have done me any good to know who he was, I wouldn’t change my attitude about the window. (p. 90)

Kindleberger’s sympathy for Mises is matched by the sympathy that modern macroeconomists have for the Austrian theory of boom and bust. It wouldn’t do them any good to know what that theory actually is; they wouldn’t change their attitudes about “ordinary” recessions and the Great Depression.

Most of the interviewees suggest that it was the mobilization for entry into World War II—or the money creation that financed that mobilization—that eventually got the economy out of depression. Most hedge their answers about the possibility of another Great Depression. The monetarists believe or hope that at least the Federal Reserve had learned not to allow the money supply to collapse. These beliefs and hopes, however, are not accompanied by warnings against the Federal Reserve’s fostering more economic growth than actual savings can sustain.

In his brief concluding remarks, Parker points to the unfinished task of achieving a full understanding of the interwar experience. He imagines that the torch has been passed from the interviewees to Bernanke, Eichengreen, and a few other like-minded

researchers, and, on the basis of modern advances, he sees the profession as much closer than ever before to “a consensus on the causes of the impetus, depth, protracted length, and worldwide spread” (p. 201) of the Great Depression. Of course, he cannot expect modern Austrian macroeconomists to share in this assessment.

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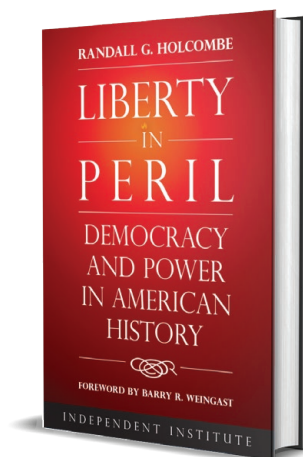
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