Business Economics

The Midas Paradox: Financial Markets, Government Policy Shocks, and the Great Depression

By Scott Sumner. 2015. Oakland, California: The Independent Institute, Pp. 507. $36.05 hardcover.
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By John C. Goodman

First we had the paradox of thrift. Now Scott Sumner brings us the Midas paradox. In this book, Sumner reopens the discussion of the Great Depression—why it occurred and why it lasted so long. The book is the culmination of 30 years of work and it draws on previously unpublished data to give us a fresh look at the most important economic event in the history of the American Republic. Economists who read it won't be disappointed.

In contrast to the classic work of Milton Friedman and Anna Schwartz, which targets Federal Reserve failure as a large, perhaps even the main, contributor to both the 1929–33 and the 1936–38 declines, he focuses instead on the international market for gold.

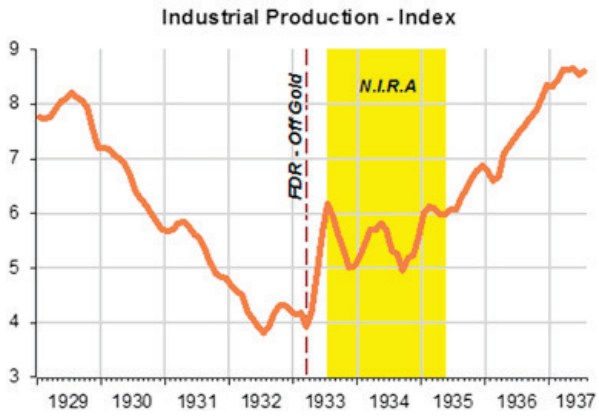
Sumner takes the Keynesian idea that while thrift is good for individuals, massive increases in thrift on a national scale spell disaster (at least in the short run) and applies it to monetary theory. Private increases in gold holdings may be a good thing; but for countries on a gold standard, an attempt by everyone to hoard more gold decreases aggregate demand. In turn, if prices (and especially wages) are sticky, this will lead to a decrease in output. Moreover, the timing of the gold demand increases during the Depression years could not have been worse. The combination of gold hoarding and bad government policies, in Sumner's view, dominate the effect of misguided central bank errors.

The times were bleak. Between 1929 and 1933, national income was cut in half as prices and output both fell by 30 percent. One-fourth of the labor force was out of work. The newly elected president, Franklin Roosevelt, acted quickly to implement a demand-side policy change that in Sumner's view would have ended the Depression in short order were it not completely undermined by a supply-side change that kept the economy depressed until as late as 1940.

"The year 1933 saw the two most dramatic macroeconomic policy experiments ever undertaken by the U.S. Government," he writes. "The first experiment was the severing of the dollar from gold. Even though conservative Wall Street types generally revered the gold standard, between April 19th (the day the dollar was floated) and July 3 the Dow jumped by 65 percent." Almost 90 percent of that increase, Sumner tells us, "occurred on 10 days when there were important monetary events related to that action. Business responded by expanding output at the fastest rate in history."

Take a look at Figure 1. It shows a 57 percent increase in industrial production between March and July of 1933. Roughly one-half of the ground lost in the previous four years was made up in just four months. Had that trend continued, the Depression would have been completely over by year end! Even on more modest growth assumptions, Sumner argues that the Depression should have been over by the end of 1934.

Figure 1. Index of Industrial Production



*FDR—Off Gold Standard.
Source: Marcus Nunes

Yet all that was nipped in the bud by a second experiment—a national policy of artificially raising wages, beginning with the National Industrial Recovery Act. Until the Act was declared unconstitutional by the Supreme

Court, the American economy was organized as a series of cartels, patterned after a similar experiment in Italy. Every industry and every trade was encouraged to set prices and wages collectively. That policy didn't do much for prices, but in mid-1933 the nominal wage astonishingly rose by 22.3 percent in just two months. That and subsequent policies, says Sumner, prolonged the Depression by 6-7 years. Modern economists expect to find no relation between the real wage and industrial output or maybe even a procyclical relationship. But during the Depression years, the relationship was countercyclical. In fact, Sumner regards this as the most important finding of his book. During the 1930s there were four major wage shocks, each of which tended to abort otherwise promising recoveries in industrial production. These wage shocks tended to make real wages more countercyclical—higher wages led to lower output. (The shocks are listed below.)

Wage Shock	Production Before (%)	Production After (%)
July 1933	+57.4	–18.8
May 1934	+11.9	–15.0
Nov 1938	+15.8	+2.5
Nov 1939	+16.0	–6.5

Sumner's book is very much in the tradition of *A Monetary History of the United States*. But unlike Friedman and Schwartz, Sumner models the demand side of the economy based on the supply and demand for gold. "The price of gold is the proper indicator of monetary policy in 1933, not the money supply or interest rates," he writes. For example, the catalyst for the Depression was a worldwide increase in the demand for gold—in response to numerous factors—leading to public and private gold hoarding. That led to a worldwide decrease in aggregate demand.

He gives short shrift to other explanations of the Depression. Hoover's policies of high tariffs, high taxes, and high wages weren't helpful, any more than Roosevelt's refusal to cooperate with Hoover on economic policy prior to taking office. But none of these actions were powerful enough to create the damage that was done.

In the 1920s, the common view of economists was that the business cycle was the "dance of the dollar." The Depression gave rise to an alternative (Keynesian) view that deemphasized the role of money. Sumner, who is often called the father of "market monetarism," in many ways revives a classical way of looking at the world. There is not much here that would surprise Alfred Marshall. Or even David Hume.

This is first-rate scholarly work and it deserves our attention, especially as much of it applies to the recent Great Recession.

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