

Tight Money, High Wages: a review of Scott Sumner's *The Midas Paradox: Financial Markets, Government Policy Shocks, and the Great Depression* (Independent Institute, 2015)

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Scott Sumner's new book, *The Midas Paradox*, uses a "gold market approach" to understand the causes and persistence of the depression of the 1930s. By wide agreement, the roots of the 1929-1932 depression lay in a shortfall of aggregate demand – which was a consequence of systemic monetary constraint. Sumner uses the world's quantity of monetary gold and the ratio of gold-to-money to determine the stance of monetary policy and to identify lost opportunities. The more usual indicators of interest rates and the quantity of money turn out to be misleading under a gold standard.

He then moves beyond the roots of the downturn to the reasons for persistence of weak economic conditions for years after the underlying monetary problem was solved. He develops the unexpected view that the US in particular saw a supply-side depression that began in 1933, one driven in large part by New-Deal-driven interferences in labor markets.

Monetary Origins of Depression

Sumner credits what he calls the Mundell-Johnson hypothesis, according to which the roots of the depression were in the post-WWI undervaluation of gold, as a precursor to his study.¹ As the junior placeholder on that hypothesis, I recap my understanding of it here. The purchasing power of an ounce of gold changed little from the middle of the seventeenth century to the middle of the twentieth. Gold constraints were typically relaxed during wars to facilitate official spending and borrowing – and allowing price inflation. But English deflation restored prewar price levels in the years after the Puritan wars of the seventeenth century and the Napoleonic wars of the nineteenth. A similar deflation was likely to occur after the First World War as major economies of Germany, Britain, and France would return to gold convertibility at the prewar value of \$20.67/ ounce during the 1920s. The low postwar gold value affected monetary reserves in two ways: 1) it depressed the value of outstanding stocks; and 2) it reduced the price incentive for new gold production. In France, the US, and Germany, which had traditionally had large gold coin circulations, gold was mostly taken out of circulation during and after the war, which lessened confidence in convertible paper money. Economist Gustav Cassel drew attention to the "gold standard paradox," by which a gold-based monetary system would require ever-increasing gold production to accommodate economic growth while maintaining reserve ratios. Yet world gold production during the 1920s was below what it had been in the decade before the war; and given the postwar decline in gold's purchasing power, the real value of new gold produced in the mid-1920s was just over 50 percent of what it had been in 1914.

Ralph Hawtrey and Keynes in the early 1920s thought it would be possible to avoid deflation by supplementing gold with foreign exchange – sterling and dollars – as a monetary reserve; other economists, including Cassel and Charles Rist, doubted that a "gold exchange" standard would be viable.

¹ Robert A. Mundell, Nobel Lecture, 2000; and H. Clark Johnson, *Gold, France, and the Great Depression, 1919-1932* (Yale, 1997).

The doubters turned out to be correct. The viability of the gold standard was tied to its mystique; it provided a cultural and emotional link to the prewar *status quo*.

In proposing a hypothetical increase in the gold price, perhaps at the time of the Genoa Conference in 1922, Mundell and Johnson intended a counterfactual through which subsequent deflation might have been prevented. Almost no one suggested changing the gold price at the time – in my research the only advocacy I found for a price increase came from a gold producers' association. In 1934, of course, the US raised the price it would pay for gold – which removed weak systemic demand as a cause of the international depression.

Sumner raises the objection that increasing the price of gold in the early 1920s would have risked significant inflation unless central banks raised their demand for gold in the short run. I believe he overstates the threat of inflation. For one thing (as Sumner acknowledges in his theoretical chapter), prewar gold reserve ratios fluctuated considerably; central banks did not generally act as though bound to monetize new gold to satisfy “rules of the game” – nor did central banks of the US, France, or Germany show much inclination to monetize excess reserves a few years later. Also, only the US among major economies was on a gold standard during the early 1920s, so there would have been no central bank coordination requirement had the price then been raised.

Sumner argues that what mattered for monetary policy was the world's gold reserve ratio, not the amount of flow of gold from one central bank to another. This is a distinction without much difference: as conditions tightened in the late 1920s, gold tended to flow away from countries seeking expansion – for example, the sterling area – to gold bloc countries, including France, or at times to the US, where the gold-to-money ratio was already relatively higher. The consequence of such gold movements, especially during 1928-1932, was hence to sterilize gold inflows and thereby to raise the world's gold reserve ratio. The potentially expansionary (or contractionary) systemic impact of gold flows was diagnosed by Henry Thornton in the early 19th century.

The economists most concerned about the inadequate supply of gold reserves were the first to notice pressure from central banks' stepped-up accumulation. Cassel and Hawtrey were early critics of the Bank of France. Movement of gold to Paris accelerated with adoption of the French Monetary Law in June 1928, which stabilized the franc, required that all French reserves be held as gold, and (significantly) prohibited addition to its substantial stock of foreign exchange. Robert Mundell made nearly the same observation about French monetary policy in his 2000 Nobel lecture.

Sumner suggests that the Depression started with the stock market crash in October 1929, rather than with French gold conversions in 1928, and intensified in 1930. The rise in liquidity preference following the Wall Street market crash reflected the tightening of gold ratios in 1930. The key policy error, he writes, was “the failure to accommodate Britain's need to rebuild gold reserves in 1930, as it had in 1927.” Sumner's timing is right. The US money supply did not collapse in 1930, and the banking sector was stable until late in the year -- yet US prices and real GDP fell sharply. Post-Benjamin Strong leadership at the Federal Reserve deserves criticism for re-asserting the pro-cyclical real bills doctrine, and for not making expansionary use of the large US stock of gold reserves. Also, the Smoot-Hawley tariff, signed in June 1930, made it harder for the rest of the world to balance accounts with the US.

The world, however, had changed since 1927. At the earlier date, French Prime Minister Raymond Poincare still intended for the franc to appreciate – which would have slowed or ended the gold inflow to France. But the revalorizers lost, the franc was formally stabilized in June 1928 at the deliberately undervalued level of one-fifth of prewar parity, and the movement of capital and reserves to France became a flood. While the world's monetary gold stock rose from \$9.2 B to \$11.3 B from December

1926 to June 1932, for a \$2.1 B increase, the Bank of France's gold holdings rose by \$2.5 B over the same period. Other gold bloc countries Belgium, the Netherlands, and Switzerland, all of which followed Paris' lead on monetary matters, added an additional \$900 M to their reserves during the same period. The world outside of the gold bloc thus had a net loss of \$1.3 B in gold. The share of the world's gold reserves held by these gold bloc countries, including France, rose from 11 ½ to a staggering 38 ½ percent, over this critical 5 ½ year period. From December 1929 to December 1930 alone, roughly the period Sumner highlights, the share of the world's total held by France and the other three gold bloc countries rose by 5.5 percent, while the US share rose by only a smaller 1.0 percent. France also held \$1.4 B in foreign exchange, more than half of it in sterling; Bank of France officials made clear repeatedly in 1927 and 1928 that they considered the use of sterling as a reserve to be inflationary; and Bank Governor Emile Moreau wrote in his diary in May 1927 that he could force an end to sterling convertibility – and an end to the gold exchange standard -- at any time. Even without actual withdrawal of gold, French pressure made the use of sterling as a reserve untenable well before 1930. Had the US attempted to inflate in 1930 (and it would have been worth an effort), much outgoing US gold would have gone to France rather than to the Bank of England.

Looking forward, Sumner accepts such reasoning, as he indicates the likelihood that continued US efforts to inflate in 1932 would have led to an outflow of gold to France or other gold bloc countries, where most of it would have been sterilized. Sumner observes that the Federal Reserve's open market purchases (OMPs) in the spring of that year did little to boost the US economy, in large part because expansion led to fears of dollar devaluation. Coincident private gold hoarding reduced central bank reserves, hence offsetting any expansionary effect from the OMPs. Sumner concludes that, far from demonstrating the US was in a "liquidity trap" (where additional liquidity would hoarded rather than spent) in 1932, the failure of expansion efforts illustrated the constraint of the international gold standard.

Evidence from these years suggests the advantages of using gold quantities and reserve ratios rather than changes in money stock or interest rates as evidence of the stance of monetary policy. Sumner comments that even Friedman and Schwartz understated the downturn by looking at money supply data rather than at rising gold reserve ratios. In the 21st century, gold ratios are no longer relevant – but money, interest rate, and even inflation indicators have often provided misleading signals. (US monetary authorities nevertheless continue to target interest rates and, to a lesser extent, to target inflation.) Market monetarists, led by Sumner, have embraced nominal GDP (NGDP) targeting as a kind of updated Chicago School monetarism. The object in setting monetary policy should be for each central bank to target, and thereby stabilize, expectations, Mundell, who usually focuses on systemic monetary conditions, prefers to look at movements in exchange rates to determine when a particular central bank has become too contractionary or expansionary. Unlike most data indicators, exchange rates automatically incorporate expectations about growth and inflation.

Keynes and Other Economists

Sumner also uses the 1932 evidence to consider what Keynes meant, or what exactly he contributed to understanding the macroeconomics of depression. He notes that John Hicks and Milton Friedman emphasized the role of a liquidity trap as the pivotal concept in understanding the *General Theory*. Sumner is not quite convinced, but agrees that the concept of "monetary policy ineffectiveness... occupied a central position in the Keynesian revolution." I suggest that is too simple, as the liquidity trap, and even monetary policy effectiveness, compete with other concepts for center stage in Keynes' most prominent book. One of these is the instability of the investment function, the topic of Chapter 12 on

“long-term expectations.” Another was concern about stagnation and a declining rate of profit, a frequent topic in later chapters of the book. In my effort to identify cases where Keynes thought monetary policy could not work, not one of them had zero-bound interest rates.² Writing in 1929, Keynes advocated public works, not because monetary policy could not have worked, but because existence of the gold standard made it impractical to try. Then and during the next few years, Keynes frequently recommended public works spending to boost demand, in part because of constraints on national monetary policy in a deflation-bound international system. But with the *General Theory* in 1936, Keynes had mostly ceased discussion of public works and moved instead to the need to stabilizing the broader volume of investment. By this time, his analysis often assumed a closed economy framework, in which gold standard constraints were no longer an issue.

Keynes’ analysis of monetary policy has more dimensions than most “Keynesians” understand, and more than anti-Keynesians acknowledge. It is misleading shorthand to imagine that interest rate targeting comprised the whole of Keynes’ intended policy instruments. Drawing on his earlier writings, Keynes in the *General Theory* advanced a quasi-Wicksellian analysis setting the schedule of marginal efficiencies of capital (MEC) against the market interest rate – and both are suitable targets for monetary policy. Keynes frequently noted that changes in prices and in the quantity of money could affect MEC directly, rather than working through interest rates. In his chapter on the “marginal efficiency of capital,” Keynes notes that a rise in prices can raise the investment-demand schedule. In the same chapter, he comments that an expected *fall* in the rate of interest – if it presages a decline in future investment prospects -- can *reduce* present investment outlays.³ This amounts to a penetrating critique of reliance on interest rate targeting, “Keynesian” or otherwise, as an instrument of monetary policy. In “the theory of prices,” he notes that an increase in the quantity of money can affect expectations of future prices, which then affect MEC. In his discussion of saving and investment, Keynes touts the “fundamental proposition of monetary theory,” according to which the relationship between the supply and demand for money determines national income and securities prices. An economist persuaded of the ineffectiveness of monetary policy would not write this way about using money or prices to boost investment!

Keynes’ deeper concern in the *General Theory*, much more than in his earlier writings, was with what he saw as the tendency of “present day capitalist individualism” to lead into stagnation. He put forth such concepts as that of an “average marginal efficiency of capital” falling to zero, and the “euthanasia of the rentier, of the functionless investor.” Such conclusions are only incidentally related to Keynes’ understanding of monetary economics. As we read this kind of thing in the *General Theory*, we should keep in mind that he was writing in the 1930s, an era of depression, fascism, socialism, and wide popularity of Marxism among intellectuals – and he was searching for an alternative, relatively liberal vision for a larger future state. Sumner doubts that much of that is very helpful for understanding how the depression happened, or why it persisted.

Whatever his skills as a monetary economist, Keynes set back understanding in two ways. First, in the *General Theory*, and specifically in his discussion of Say’s Law, Keynes almost deliberately misrepresented “classical” understanding of monetary policy. In a sentence, and against Keynes’ description of their view, Jean-Baptiste Say and other classical economists believed “supply would generate its own demand” *only if* the quantity of money was sufficient to maintain price levels. Sumner writes of what is now “the growing awareness of the sophistication of pre-Keynesian business cycle models.” Second, Keynes’ frequent emphasis during the 1930s on the role of fiscal policy diverted attention from the monetary dynamics that led to the depression. It is hard to avoid the conclusion that

² <https://marketmonetarist.files.wordpress.com/2012/06/keynes-evidence-for-fiscal-stimulus-23-june-12.pdf>

³ J.M. Keynes, *General Theory* (1936), p. 143.

Keynes and the prominence of Keynesian literature delayed by years, if not by decades, understanding of both classical monetary models and of the monetary roots of the depression.

A Supply-Side Depression?

Sumner's largest contribution is in explaining why and how the depression persisted – or, as he sees it, why we had a second, supply-side depression beginning in 1933. The great depression should have ended with Roosevelt's decision to float the dollar in March 1933 and then to establish a new gold price at \$35/ounce in February 1934. *The Midas Paradox* traces daily and weekly press reports on market reactions to monetary and exchange developments, and isolates data to show an explosive, one-off 57 percent increase in industrial production during March-July 1933, immediately after Roosevelt took office. A few conclusions from that event:

1. The heart of the depression was deflation; when deflationary expectations were decisively countered, aggregate demand and economic activity quickly recovered.
2. Inflation injected into a deflationary environment boosts economic activity despite the existence of large-scale unemployment; inflation need not be a consequence of full employment of resources. (This contradicts much modern business cycle theory.)
3. As Sumner observes, the level of interest rates and changes in the money supply were irrelevant to this process; what mattered were expectations of future activity. Expectation of higher prices affected activity immediately, without a time lag.
4. The fact that the monetary depression was compounded from late 1930 by a banking crisis did not prevent recovery, or even force a slow, drawn-out recovery.

The devaluation of the dollar against gold comprised Roosevelt's best chapter in economic policy. Unfortunately, it was soon followed by New Deal "supply" shocks that offset much of the benefit from the devaluation. Sumner's most dramatic evidence is for the impact of labor market policies in five times aborting recovery in the US during 1933-1940. The first of these was in the National Industrial Recovery Act (NIRA) of 1933, which led to average wage increases of over 20 percent during July-September 1933 and to a rapid fall-off industrial production. NIRA was ruled unconstitutional in 1935, which gave stock prices a boost; but passage of the Wagner Act the same year encouraged formation of labor unions. The American Federation of Labor and the Congress of Industrial Organizations led successful unionization drives in 1936 and 1937, and minimum wages were increased sharply in 1938 and 1939. Each of these events generated expectations of rising production costs that were reflected almost immediately in stock market declines. (If this seems a conclusion that would please a GoP advisor, consider that evidence of an inverse link between wages and expected profits would also reinforce convictions of the most doctrinaire Marxist.) Keynes' commented on NIRA in the same vein in January 1934:

...rising prices caused by deliberately increasing prime costs or by restricting output have a vastly inferior value to rising prices which are the natural result of an increase in the nation's purchasing power... [It is] "hard to detect any material aid to recovery in the National Industrial Recovery Act."⁴

Keynes wanted increased demand, which would have raised MEC -- not higher production costs, which would lower it. Sumner's narrative conclusion is reinforced by short-interval data plotting that show a close inverse relationship between real wages and industrial production. The data also reflect a crucial before-and-after distinction. Before mid-1933, real wages rose when prices declined – making wage

⁴ Keynes, "Mr. Roosevelt's Experiments," *London Times*, 02 Jan 1934.

trends statistically dependent upon, or endogenous to, ongoing monetary contraction. After that date, higher real wages rose to reflect public policy initiatives – so that wage increases became an exogenous driver of slow economic conditions. US unemployment stayed in double-digits well into 1940.

What of recovery outside of the US? Britain and Germany, seeking to save reserves, had moved toward autarky as early as 1931 – Britain by concentrating on trade within the sterling bloc, Germany by advancing barter deals, usually in eastern Europe. France remained an active international trader, and should have benefited from devaluation and the surge in international gold supplies; but, as Sumner reports, this advantage was largely offset by Popular Front redistributionist measures that constrained growth, much as New Deal changes had in the US.

Sumner deploys both the gold market and the labor market arguments to explain the 1937-1938 downturn, during which US real GDP fell by 11 percent and industrial production by 30 percent, and which is often described as the second worst depression of the twentieth century. First, he cites a rise in the world's gold ratio, caused by both official sterilization in the US and – what he emphasized more -- a sharp increase in private gold hoarding. Second, wages rose rapidly in early 1937 in response to unionization drives and also, perhaps, in response to expectations raised by Roosevelt's landslide victory in the 1936 election. Uncertainty was heightened by frequent union-related violence.

Sumner does not cite Doug Irwin's paper on gold sterilization during 1937 and 1938, which appeared after the *Midas Paradox* text was completed. In what now counts as a serious policy mistake, Irwin notes that the Treasury responded to rising wholesale prices in 1936 by deliberately sterilizing new gold inflows from December 1936 until February 1938, most of it by August of 1937 when the heavy pace of gold inflows slowed. In this process, dollars issued against new gold were drained by sales of other central bank assets. At least 10 percent of what would have been the new monetary base was cancelled by the sterilization. A money supply measure (M2) that increased by 12 percent annually during 1934 -1936, turned flat and even slightly negative from about January 1937 through July 1938.⁵ The monetary evidence suggests that 1937 saw a true-to-form deflationary squeeze – differing from that of 1932 mainly because national reserves were so abundant by the later date that the US faced no gold standard constraint.

Private gold movements, as Sumner describes them, were baffling and somewhat contradictory – first driven by fear of a revaluation of the dollar gold dishoarding, then by fear of a devaluation and gold hoarding. The second makes little sense: with new gold piling up at the Fed, and no deflationary pressure coming from abroad, why would US monetary authorities have wished to devalue in 1937? Trends in the volume of private gold hoarding nevertheless mattered because they can provide a window into expectations. Sumner has elsewhere formalized this insight with the argument that central banks should use futures markets to obtain growth forecasts, and then “target the forecast.”

Industrial production rose by about 40 percent from the pre-NIRA-shock peak in July 1933 to the pre-crash peak in July 1937 – at which time it was higher than it had been at its peak in 1929.⁶ This was a disappointing rate of growth for a period shortly after the worst depression in US history, but growth it was; it is not convincing to roll this four-year period into a longer “supply-side depression.” A real depression (mercifully short) struck again after July 1937; it was made worse by ongoing unionization efforts that pushed wages up while aggregate demand was already falling. But what made it a

⁵ Doug Irwin, *Gold Sterilization and the Recession of 1937-1938*, NBER Working Paper No. 17595, Nov 2011.

⁶ <https://research.stlouisfed.org/fred2/series/INDPRO>

“depression” was not rising wages but the burst of reserve sterilization, and the sharp braking of monetary expansion. It is still correct to say that depressions are usually monetary.

Conclusions and a Caution

Sumner’s discussion of the causes of the 1929-1932 depression reinforces that there was an important difference between that downturn and the 2007-2009 “great recession.” The earlier depression was monetary in origin; bank failures and financial crisis did not kick in until at least late in 1930, when they amplified demands for money and for gold relative to supplies. The 2007 downturn, in contrast, as Sumner observes, began with a financial crisis, the heart of which was widespread and often hidden exposure to low-quality mortgage debt. US monetary policy was not an initial trigger, and probably did not become contractionary until the dollar started to rise sharply in July 2008, at which point the recession entered a harsh, and unnecessary, new phase. Understanding of the more recent events has been delayed by the pattern of economists (and others) tending to focus either on the financial sector collapse or on the monetary contraction, without adequately integrating the two.

If high wages did not exactly cause a New Deal depression, they certainly hindered recovery and contributed to creating a milieu of economic stagnation. Indeed, we have surprising agreement across the ideological spectrum, that capitalist growth works best with flat or no more than constrained growth in unit wages – and we have robust evidence that exogenous influences pushed up wage growth, kept unemployment high, and slowed recovery from 1933. Sumner’s data may discomfit many economists, although they will be hard-pressed to deny his conclusions. His evidence will contribute to arguments over the distributional consequences of recovery and growth in the 1930s, and perhaps more generally.

Sumner’s discussion of monetary and labor market factors suggests caution for prospects in 2016 and forward. Assuming economic lessons from the 1930s are transferable, economic growth requires a combination of monetary expansion and unit wage restraint (that is, salary increases should be linked to improved productivity.) The Federal Reserve in 2016 appears ready to put some brake on monetary expansion, despite NGDP growth since 2008 that continues to fall farther below pre-2008 trend, ongoing economic weakness in Europe and Japan, and a slowdown in China. The post-recession recovery in the US since 2009 has added lots of jobs – 14 million, according to President Obama – but by most measures, wages and salaries have remained nearly flat, hence income inequality has become a potent political issue. Paul Krugman has argued that the recovery of profits and stock prices since 2009 owes much to wage compression. – if he is correct, it is the opposite of the pattern Sumner describes post-1933. It is reasonable to expect that an incoming US administration in 2017 might want to use administrative measures to boost compensation – possibly through a higher minimum wage, mandatory home leave provisions, or obligatory profit sharing. If monetary expansion slows while wages and salaries grow faster, the recovery will face an uncertain future, and perhaps a short one.