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Scott B. Sumner, *The Midas Paradox: Financial Markets, Government Policy Shocks, and the Great Depression*, Independent Institute, 2015, 560 pp, \$36, Hardcover

By Clark JOHNSON[†]

Abstract. In a study with detailed evidence and technical economics, Scott Sumner seeks to explain both the monetary origins of the Great Depression (1929-1932) and its persistence due to government-driven wage shocks (1933-1941). He credits the Mundell-Johnson hypothesis, based on the post WWI undervaluation and shortage of gold, with identifying the deflationary pressure that led to monetary distress. Sumner concludes that interest rates, money supply, and price changes provide inadequate measures of the stance of monetary policy. Sumner's most important evidence supports his arguments that, first, raising the price of gold in 1933 facilitated price inflation and rapid recovery after years of deflation; and second, that several Roosevelt-era recoveries were stopped in their tracks by New Deal-driven real wage increases. The 1937-38 depression was caused by Treasury sterilization of gold inflows, but aggravated by unionization drives and wage increases. Reviewer considers Sumner's critique of Keynesian economics, and adds overview to identify two areas where Keynes' "revolution" set back understanding. He then moves to some intra-New Deal dynamics and to some recent political economy parallels.

Keywords. Great Depression, New Deal, Wages, Monetary History, Financial Markets, Keynesian Macroeconomics.

JEL. B22, E24, E52, F33, N12.

1. Introduction

Scott Sumner's *The Midas Paradox*, seeks to understand the Great Depression through combining economic history, macroeconomics, and the history of economic thought into a "seamless" whole. 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 ratio of gold-to-money (a "gold market approach") to determine the stance of monetary policy at different times and to identify lost opportunities. The more usual indicators of interest rates and the quantity of money turn out to be misleading.

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

[†] Recently with the US Department Of Defense

☎ . 1-413-626-4819

✉ . hcj8588@yahoo.com

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conclusions contribute much to understanding what succeeded and failed during the Roosevelt Administration— which was, as concerns economic results, perhaps the most consequential US Administration during the twentieth century.

Sumner is best known for his advocacy of nominal GDP (NGDP) targeting as an approach to monetary management, and especially for his blog the money illusion.com. *The Midas Paradox* text was completed in 2011, but reflects development of his monetary frame work over a period of a decade or more.

2. Monetary Origins of the Great 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 (Mundell, 2000).² As its junior placeholder, I recap that hypothesis here. According to British data, the purchasing power of an ounce of gold changed little from the middle of the seventeenth century to the middle of the twentieth. Gold convertibility was typically relaxed during wars to facilitate military spending and borrowing – and thereby allowing inflation of paper currencies. But English deflation restored prewar price levels as convertibility was restored in the years after the Puritan wars of the seventeenth century and again after the Napoleonic wars of the nineteenth; a similar deflation occurred after the 1861-1865 Civil War in the US. Another deflation was likely after the 1914-1918 World War, as major economies of Britain, France, and Germany expected to deflate in order to restore gold convertibility during the 1920s.

The low postwar real (commodity exchange) value of gold affected monetary reserves in two ways: 1) it depressed the value of outstanding gold stocks; and 2) it reduced the price incentive for new gold production. In the US, France, 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 previously co-circulating 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 John Maynard Keynes hoped in the early 1920s to avoid deflation by supplementing gold with foreign exchange – sterling and dollars – as monetary reserves; other economists, including Cassel and Charles Rist, doubted that a “gold exchange” standard would be viable. 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 was able to find for a price increase came from a gold producers’ association. In 1934 the US raised the price it would pay for gold from the prewar level of \$20.67/oz. to \$35/ oz. – which removed the gold standard as a cause of weak systemic demand.

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

² Robert A. Mundell, Nobel Lecture, 2000; and H. Clark Johnson, *Gold, France, and the Great Depression, 1919-1932* (Yale, 1997).

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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 increased.

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 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 as the Bank of France converted a portion of sterling reserves to gold during 1927. Movement of gold to Paris accelerated with adoption of the French Monetary Law in June 1928, which stabilized the franc, required that all French required 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 and the Monetary Law 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 crash mirrored 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 [under NY Fed President Benjamin Strong] in 1927.” Sumner notes that the US money supply did not collapse in 1930, and that the banking sector was stable until late in the year -- yet US prices and real GDP fell considerably. Post-Strong leadership at the Federal Reserve (Strong died in October 1928) 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, which President Hoover signed in June 1930, made it harder for the rest of the world to balance accounts with the US.

Although liquidity preference rose in the US only after the October 1929 stock market crash, it is a reasonable inference that deflationary signals coming from France, as well as from tightened Federal Reserve policy in the US beginning in 1928, played a role in chilling sentiment that led to the crash itself.

In any event, the world had changed between 1927 and 1930. At the earlier date, French Prime Minister Raymond Poincare still intended for the franc to appreciate toward its prewar exchange value – which would have slowed or ended the gold inflow to France. But the strong-franc faction 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 alone 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

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matters, added an additional \$900 M to their reserves during the same period. The world outside the gold bloc thus saw 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 in 1928 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 at any time – and hence an end to the gold exchange standard. Even without actual withdrawal of gold, French pressure made the use of British pounds as a reserve untenable. 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 be 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 gold reserve ratios rather than interest rates or changes in money stock 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 in 2016 nevertheless continue to target interest rates and, to a lesser extent, inflation.) Market monetarists, led by Sumner, have embraced nominal GDP (NGDP) targeting as a kind of Chicago School monetarism updated to incorporate expectations. The object in setting monetary policy should be for each central bank to target, and thereby stabilize, expectations in NGDP growth. Mundell, who usually focuses on international monetary conditions, prefers to look at movements in exchange rates to indicate when a particular central bank has become too expansionary or contractionary. Unlike most monetary indicators, exchange rates automatically incorporate expectations about growth and inflation.

3. A Supply-Side Depression?

Sumner's largest contribution in *The Midas Paradox* is in explaining why and how the depression persisted – or, as he sees it, why the US 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. Sumner 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

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from March to 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 (in this case via devaluation) 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. (Sumner comments that this evidence 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. Anticipation 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 do much to slow it down.

5. Fiscal stimulus, or deliberate deficit financing of government-directed projects, appears to have made at best a minor contribution to the demand boost during the four month period. Roosevelt came into office calling for a balanced budget, and took immediate steps to reduce government salaries. His Administration soon after introduced the job-creating Civilian Conservation Corps, distributed \$550 M to the states for relief, and funded various public works. Total federal spending rose from \$5.1 B (nominal) in Hoover's fiscal year 1933 to \$5.9 B in Roosevelt's FY 1934, while the fiscal deficit rose from \$1.8 B in FY 1933 to \$2.1 B in FY 1934 budget.³ These numbers could explain the March-July 1933 recovery only if we were to posit extraordinary spending "multipliers"! Also, as we will see in a moment, much of the early gains in output were forfeited later in 1933, despite continued fiscal stimulus.

The revaluation of gold comprised Roosevelt's best chapter in economic policy. Its lead advocate was Professor George Warren, an agricultural economist who had long observed correlations between value of gold and the price of agricultural commodities – but who tends to get little respect in historical accounts of the New Deal. Sumner gives Warren his due as a macroeconomist; both Keynes as a contemporary and Friedman and Schwartz in their historical account underestimated the impact that a higher gold price could have on expectations, and hence its immediate impact in boosting demand. Support for reflation came from many in Congress, especially from members representing farmers, but also from such New York bankers as J.P. Morgan and Russell Leffingwell. The decision to go off gold, implemented through the US Treasury, deliberately circumvented conservative orthodoxy at the Federal Reserve and in much of the financial community.⁴

Unfortunately, devaluation was soon followed by New Deal-driven negative supply shocks that offset much of its benefit. 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 adopting the National Industrial Recovery Act (NIRA), which led to average wage increases of over 20 percent during July-September 1933 and in turn to a fall-off in industrial production that wiped out roughly half of the gains of the previous four months. NIRA was ruled

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http://www.usgovernmentdebt.us/spending_chart_1930_2016USb_13s1li0111cn_H0t%3Cbr%20/incl ude/federal_budget_actual

⁴ Jean Edward Smith, *FDR* (Random House, 2007); pp. 328-330.

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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 then 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. 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.⁵

Keynes returned to labor costs in his Chapter 19 on "money-wages" in the *General Theory*, where he noted the inter-changeability of nominal wage decreases (increases) and money supply increases (reductions) in influencing aggregate demand.⁶ Sumner reduces the Great Depression to two types of shocks: 1) gold market shocks, which influenced nominal aggregate demand; and 2) wage shocks, which impacted the way nominal changes would be separated into changes of real output and of price. To underline the role of wage shocks, he continues:

Can we simplify any further? Surprisingly, the answer is yes. As we saw in Figure 1.2, the seventeen high frequency output fluctuations [during 1929-1939] discussed in Chapter 1 can be explained with a single variable, real wage rates. (p. 418)

The data also reveal a crucial before-and-after distinction. Before mid-1933, real wages rose when prices declined – making wage 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 dampened economic growth. (If this seems a conclusion that would please a GoP advisor, consider that evidence of an inverse link between wage levels and expected profits would also reinforce convictions of the most doctrinaire Marxist.) The US unemployment rate stayed in double-digits well into 1940.

Sumner's account undermines a frequent view during the New Deal years, including that of Keynes in parts of the *General Theory*, as well as that of many populists and "socialists" of various stripes even today, that the Depression was a consequence of unregulated financial capitalism. According to that view, recovery from the Depression required public-private partnerships, top-down coordination, and stepped-up regulatory oversight, especially of the financial sector. Historian James MacGregor Burns, for example, attributed the sharp increase in industrial production during March-July 1933 to NIRA and job-creation programs – which, as we saw above, gets it backward.⁷ But it would be a mistake to interpret the New Deal as conceptually cohesive. Demand for top-down partnership, welfare and jobs relief, and for labor organization, often came from populist factions in the Democratic Congress. Roosevelt himself led not by policy blueprint but by balancing competing demands. Burns noted that Roosevelt "hated abstractions," and described his "intellectual habits" as "staccato." He liked to punch holes in other people's theories.⁸

⁵ John Maynard Keynes, "Mr. Roosevelt's Experiments," *London Times*, 02 Jan 1934.

⁶ Keynes, *The General Theory of Employment, Interest, and Money* (1936), p. 267.

⁷ James MacGregor Burns, *Roosevelt: the Lion and the Fox* (Harcourt, Brace and World, 1956); pp. 181-182.

⁸ Burns (1956), p. 334.

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What of recovery outside of the US? Britain and Germany, seeking to maintain 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 in 1936 and the surge in international gold supplies; but, as Sumner reports, this advantage was largely offset by Popular Front redistributionist measures that constrained recovery of demand, 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 depression, during which US real GDP fell by 11 percent and industrial production by 30 percent, and which is often described as the second worst American depression of the twentieth century. First, he cites a rise in the world's gold-to-money 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, to expectations raised by Roosevelt's landslide re-election victory in 1936. Uncertainty was heightened by frequent union-related violence.

As in 1933, many New Dealers in 1937 incorrectly thought wage increases should provide a boost to output. When economic indicators turned downward, Roosevelt's advisers were divided between those who wanted "more New Deal," including more farm and labor legislation and more spending, and those, including Treasury Secretary Henry Morgenthau, Jr., who wanted less. Roosevelt chose items from each side, attacking "trusts," but calling for a balanced budget. Then Keynes himself wrote to Roosevelt in February 1938 urging a sharp boost in public spending to rekindle demand;⁹ Federal Reserve Chairman Marriner Eccles similarly encouraged spending, but like Keynes was oddly passive about what the central bank could accomplish with monetary policy. The President resisted the advice to bust the budget. New Dealers seem not to have understood the central role that devaluing the dollar had in boosting production four years earlier, and neither Keynes nor Eccles called it to their attention. Apparently the President did not ask advice of Warren this time around – who anyway died in 1938. Roosevelt was discouraged, and felt his economic policy had failed;¹⁰ in his defense, his advisers deserve a share of the blame.

Sumner does not cite Doug Irwin's 2012 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. Where Treasury had championed price inflation and circumventing the Fed in 1933, by 1937, under Morgenthau's direction, it had become deflationist. 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 1938.¹¹ 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. Irwin credits Roosevelt with the

⁹ Keynes (1989), Vol. 21, pp. 434-39.

¹⁰ Burns (1956); pp. 335-336.

¹¹ Doug Irwin, *Gold Sterilization and the Recession of 1937-1938*, NBER Working Paper No. 17595, Nov 2011.

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official decision to end sterilization in April 1938, and economic growth resumed by that summer.

Private gold movements, as Sumner describes them, were baffling and somewhat contradictory – first driven by fear of a revaluation of the dollar and 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 provide a window into expectations. Sumner has elsewhere formalized this insight with the argument that central banks should introduce NGDP futures markets to obtain growth forecasts, and then intervene through money and capital market operations to adjust the forecast to match the policy goal. In short, “target the forecast.”

Industrial production rose by about 40 percent from the post-devaluation, 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 1929.¹² This was a disappointing rate of growth for what should have been a rebound after the worst depression in US history, but growth it was; it is not convincing to roll this four-year period into a longer 1933-1940 “supply-side depression.” A monetary, demand-side depression (thankfully short) struck again after July 1937; it was made worse by the negative supply shock that occurred while aggregate demand was already falling. But what made it the 1937-1938 “depression” was not rising wages but the burst of reserve sterilization, and the sharp braking of monetary expansion. It remains correct to say that depressions usually have monetary causes.

4. Keynes and Other Economists

Sumner moves from the 1932 evidence to ask what Keynes 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 agree, provided we can extend the concept to include other themes from the Keynes’ most influential book. One of these was the instability of the investment function (essentially the instability of the schedule of marginal efficiencies of capital, or MEC), the topic of Chapter 12 on “long-term expectations.” Another was concern about stagnation and a declining rate of profit (that is, declining MEC), a frequent topic in later chapters of the book. In my past effort to collect historical instances in which Keynes thought monetary expansion could not be implemented, none of them derived from a liquidity trap – that is, zero-bound interest rates.¹³ In 1929 and during the next few years, Keynes frequently recommended public works spending to boost demand, in part because of constraints on monetary expansion in a deflation-bound international system. But with the *General Theory* in 1936, Keynes moved beyond public works to advocacy of stabilizing the broader volume of investment, which he argued would be necessary even in a closed economy (that is, even without the complication of international capital flows.)

Keynes’ analysis of monetary policy has more dimensions than most “Keynesians” understand, and more than anti-Keynesians acknowledge. It is

¹² <https://research.stlouisfed.org/fred2/series/INDPRO>

¹³ Johnson (2012), “Keynes; Evidence for Monetary Policy Ineffectiveness?”

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

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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 MEC against the market interest rate – and *both* are suitable objects for monetary policy. Keynes frequently noted that changes in prices and in the quantity of money could affect MEC directly, rather than work through interest rates. In his Chapter 11 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.¹⁴ This was a penetrating critique of interest rate targeting, “Keynesian” or otherwise, as an instrument of monetary policy. In his chapter on “the theory of prices,” he notes that an increase in the supply 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.¹⁵ An economist persuaded of the ineffectiveness of monetary policy would be unlikely to write this way about using money or prices to boost investment!

In his earlier *Treatise on Money*, Keynes recommended boosting prices as a mechanism for raising demand and investment, and hence for rapidly moving past a downturn. His caution on interest rate targeting suggests a critique of the more recent innovation of negative-interest rate policy. In at least some passages from the *General Theory*, Keynes would seem to advocate boosting money supply directly, rather than counting on ever-lower interest rates to re-start spending and investment.

Nevertheless, Keynes is better known for expressing doubts about monetary intervention – and he went on to develop two policy visions, both drawing on the premise of monetary policy ineffectiveness, that have had long-term resonance. The first is that fiscal pump priming (rather than monetary expansion) can best boost demand in a depressed economy, especially when interest rates approach zero. To this day, such lights in the economics profession as Paul Krugman and Larry Summers emphasize government borrowing and spending as the straightforward path to recovery under such circumstances. The Keynesian argument against monetary stimulus does not succeed – for reasons Keynes himself spelled out. The question remains as to whether fiscal expansion can also boost demand, or at minimum be part of a demand-boosting policy mix. Sumner's focus in *The Midas Paradox* is on monetary and wage policy, and he views demand-side fiscalism as an unnecessary distraction. But because of the prominence of the issue in literature on the New Deal, he would have done well to include more detail on efforts to expand or contract public spending during 1933-1941, and on whether or how they reinforced or contradicted monetary and wage policy efforts.

Almost in passing, Sumner observes (p. 341) that a major increase in US military spending from August 1940 through December 1941 generated economic recovery that had been elusive for over a decade. This conclusion appears to support the claims of fiscalists, and recalls what an older Keynesian once told me of that period: “We saw a miracle!” Sumner says he can explain all changes in industrial production during 1929-1939 by looking at gold market and real wage shocks; does the correlation break down when we get to 1940 and 1941?

A second policy vision developed in the *General Theory* concerned what Keynes saw as the tendency of “present day capitalist individualism” to lead into

¹⁴ Keynes (1936), p. 143.

¹⁵ Keynes (1936), pp. 84-85.

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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.” These concepts drew on the premise that monetary policy could not prevent the collapse of MEC; but more was at work. Keynes wrote in the 1930s, an era of depression, fascism, socialism, and wide popularity of Marxism among intellectuals. The New Deal’s NIRA was a fruit of a similar impulse, and led to comparisons with Mussolini’s Italy. The thrust of NIRA was to move past what was understood as the “aimlessness and wastefulness of free competition and rugged individualism” by building a “partnership” of industry, labor, farmers, and government.¹⁶ Keynes sought an alternative, relatively liberal vision for a larger future state. The world since the 1930s, however, has tended to move away from centralized economic control, and has embraced more “capitalism,” especially in Asian and other “emerging” markets. Keynes’ forecast of capitalist stagnation has proved off-target.

Monetary policy ineffectiveness proved a weak foundation for the revolution Keynes intended in economic theory and practice. By claiming more than the evidence could bear, Keynes and the prominence of Keynesian literature set back understanding in two ways, probably by decades. First, Keynes’ frequent emphasis during the 1930s on autonomous investment fluctuations and fiscal interventions diverted attention from the monetary dynamics that led to and aggravated the depression. Such “non-revolutionary” monetary economists as Cassel, Hawtrey, and Irving Fisher were more prescient at the time. Second, in the *General Theory*, and specifically in his discussion of Say’s Law, Keynes almost deliberately misrepresented “classical” understanding of monetary policy. 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 in this spirit of what is now “the growing awareness of the sophistication of pre-Keynesian business cycle models.”

5. Conclusions and a Caution

Sumner’s discussion of the causes of the 1929-1932 depression points to 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 late in 1930, when they amplified demands for money and for gold relative to supplies. The 2007 downturn, in contrast, 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 of the downturn, and probably did not become contractionary until the dollar started to rise sharply in July 2008; at that 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.

The Midas Paradox reinforces the conclusion within the economics profession that the Great Depression was caused by monetary contraction, and that the workings of the international gold standard prevented most national economies from reflating. Sumner illustrates that Roosevelt’s decision to revalue gold during 1933 led quickly to a recovery of prices and production. This should have meant the end of the Depression in the US and elsewhere. Even without the gold standard constraint, however, depression can be induced by inept monetary policy, including that of 1937-1938 in the US. Another depression has been caused more recently by

¹⁶ Burns (1956), pp. 153, 197, 198.

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the European Central Bank, which, according to Eurostat data, held NGDP growth in the Eurozone to less than half of one percent annually for a five-year period beginning from the second quarter of 2008.

If increasing unit-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 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 onward. Sumner's data may discomfit many economists, although they will be hard-pressed to deny his conclusions. His evidence should 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. Economic growth requires a combination of monetary expansion and labor cost increases in line with improvements in 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 growth 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, for which reason income inequality has become a potent political issue.

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 mirror-reverse of the pattern Sumner describes for the New Deal era, where wage expansion depressed profits and stock prices. 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 unit wages and salaries increase, the post-recession recovery will face an uncertain future, and perhaps a short one.



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