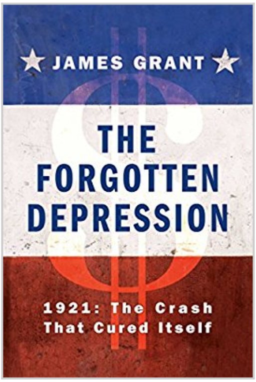

The Forgotten Depression: 1921: The Crash That Cured Itself

By James Grant

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By the publisher of the prestigious Grant's Interest Rate Observer, an account of the deep economic slump of 1920–21 that proposes, with respect to federal intervention, "less is more." This is a free-market rejoinder to the Keynesian stimulus applied by Bush and Obama to the 2007–09 recession, in whose aftereffects, Grant asserts, the nation still toils.

James Grant tells the story of America's last governmentally-untreated depression; relatively brief and self-correcting, it gave way to the Roaring Twenties. His book appears in the fifth year of a lackluster recovery from the overmedicated downturn of 2007–2009.

In 1920–21, Woodrow Wilson and Warren G. Harding met a deep economic slump by seeming to ignore it, implementing policies that most twenty-first century economists would call backward. Confronted with plunging prices, wages, and employment, the government balanced the budget and, through the Federal Reserve, raised interest rates. No "stimulus" was administered, and a powerful, job-filled recovery was under way by late in 1921.

In 1929, the economy once again slumped—and kept right on slumping as the Hoover administration adopted the very policies that Wilson and Harding had declined to put in place. Grant argues that well-intended federal intervention, notably the White House-led campaign to prop up industrial wages, helped to turn a bad recession into America's worst depression. He offers the experience of the earlier depression for lessons for today and the future. This is a powerful response to the prevailing notion of how to fight recession. The enterprise system is more resilient than even its friends give it credit for being, Grant demonstrates.

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Editorial Review

Review
"Mr. Grant is an excellent writer, and *The Forgotten Depression* is a carefully researched history of this dramatic episode. . . . Mr. Grant's chronicle makes difficult economic concepts easy to understand, and it deftly mixes major events with interesting vignettes. . . . People who believe in the inadequacy of the current macroeconomic orthodoxy will find him to be an articulate spokesman." (*The Wall Street Journal*)

“Learned, beautifully written, and timely.” (Llewellyn H. Rockwell, Jr., Chairman, the Mises Institute)

“Grant engagingly tells the tale of this extraordinary episode, which has been shoved down the memory hole because it doesn't comport with reigning economic orthodoxy.” (*Forbes*)

“The Forgotten Depression is a loving tribute to laissez-faire . . . Grant pens his tale with a wry humor reminiscent of John Kenneth Galbraith in The Great Crash. . . . a timely reminder that our forebears knew of other, more efficacious, remedies to cure financial hangovers than the hair of the dog.” (*Reuters*)

“A riveting and instructive tale. . . . the depression of 1920-21 has not received the scrutiny it deserves. The instructive lesson of the story is that the federal government “met the downturn by seeming to ignore it—or by implementing policies that an average 21st century economist would judge disastrous”—and the hands-off approach actually worked. . . . Once read, *The Forgotten Depression* will be hard to forget.” (*Barrons*)

“Grant unearths a forgotten depression to pose the iconoclastic argument that the government’s best response to economic turmoil is to keep its hands off. A veteran financial writer, Grant handles abstruse issues with a light touch and a sure hand, gleaning wisdom in such unexpected figures as Charles Dawes, first director of the federal budget, and Warren G. Harding.” (Charles Rappleye, author of Robert Morris and Herbert Hoover, a Biography (forthcoming))

“Are markets self-correcting? What, if any, role should government play when the Hidden Hand falters? Even as much of the world struggles through The Great Recession, James Grant offers a libertarian dissent from interventionist dogma. You don’t have to agree with Grant’s economics to admire the rigor of his thought, the grace of his prose, or the sweep of his argument contrasting what went right in the 1920s, and wrong in the 1930s. This is a true rarity, a first-rate work of history that is as relevant as the morning headlines.” (Richard Norton Smith, author of On His Own Terms: A Life of Nelson Rockefeller and An Uncommon Man: The Triumph of Herbert Hoover)

“Grant makes a strong case against federal intervention during economic downturns.” (*Pittsburgh Tribune Review*)

“It is a matter of libertarian faith that the Great Depression was prolonged rather than alleviated by Keynesian economic policy, and Grant's intent is clear: The invisible hand reigns supreme, the market knows what's good, and government meddling usually ends badly. . . . interesting reading indeed.” (*Kirkus Reviews*)

"[An] amusing economic history of the Progressive Era." (*Publishers Weekly*)

“Mr. Grant’s history lesson is one that all lawmakers could take to heart.” (*Washington Times*)

“Grant has written an elegant history of the 1920-1921 depression.” (Robert Samuelson *The Washington Post*)

About the Author
James Grant is the founder of *Grant’s Interest Rate Observer*, a leading journal on financial markets, which he has published since 1983. He is the author of seven books covering both financial history and biography. Grant’s journalism has been featured in *Financial Times*, *The Wall Street Journal*, and *Foreign* Affairs. He has appeared on *60 Minutes*, *Jim Lehrer’s News Hour*, and *CBS Evening News.*

The Forgotten Depression

1

THE GREAT INFLATION

The coda to the murderous Great War of 1914–18 was an influenza pandemic even more lethal than the war itself. But the wounded world of 1919 could count one saving grace, at least. The oft-predicted postwar depression had failed to materialize. Quite the contrary: Business was booming.

Here was a most pleasant anomaly. History taught that peace would bring depression. Such had been the experience of America after both the War of 1812 and the Civil War. The Great War was a world war. No doubt, many reasoned, a worldwide economic adjustment would prove even more disruptive than the slumps that had followed more isolated conflicts of the past.

No template for government action to resist depressions was yet in place. Long-established economic doctrine rather favored laissez-faire. As the natural seasons turned, so did the economic ones: summer and winter, boom and bust. Individuals might prepare for the inevitable lurches to the down side—a workman might save, a farmer might market his crops in anticipation of lower prices, a banker might call in loans to brace for a depositors’ run. But from the government, not much was expected but to balance its budget, maintain a sound currency and allow business to take its natural, improving course. “[T]hough the people support the government, the government should not support the people,” declared President Grover Cleveland in vetoing a $10,000 appropriation to pay for the distribution of seed grain to drought-stricken Texas farmers in 1887.[1]

It was the letter of the Cleveland doctrine rather than the spirit that still prevailed in some policy-making circles. Many voices now pressed the government to intervene. “Progressive,” the speakers styled themselves, though the progress to which they aspired concerned not the management of the business cycle but redressing the supposed injustice in the distribution of income. By 1892, the Populist Party was demanding inflation of the currency, a graduated income tax, strict limitations on corporate ownership of land and the nationalization of the railroads and telephone and telegraph companies.[2] By 1908, Eugene Debs was demanding a republic in which the working class governed the plutocracy, rather than the other way around. By 1910, Theodore Roosevelt, no avowed socialist, was demanding that “human welfare” be raised above “property.”[3]

“From the same prolific womb of governmental injustice we breed the two great classes—tramps and millionaires,” the Populists had alleged. Certainly, electrical illumination, the internal combustion engine and related marvels lightened the burden of labor and thereby liberated many from drudgery and want. But, equally, according to the composite Progressive indictment, the rich had never been richer, nor the gap between rich and poor provokingly wider.4

In the 1912 presidential election, Debs drew 6 percent of the popular vote on the Socialist ticket, the best showing by any left-wing candidate in any presidential contest before or since.5 He finished fourth.

William Howard Taft, the 300-odd-pound Republican incumbent, campaigning on the doctrine that "[a] National Government cannot create good times" (but could, through ill-advised policy, institute bad times), won a mere two states, Utah and Vermont.6 He came in third.

Theodore Roosevelt, who had bolted from the GOP to preach that government could, in fact, effect the very improvements that Taft resisted, pledged to "use the whole power of government" to resist "an unregulated and purely individualistic industrialism."7 He placed second.

Candidate Wilson vowed to tame the "trusts," rein in the big Wall Street banks, lower tariffs and—to compensate for lost revenue from reduced import duties—tax the rich. President Wilson, having beaten the divided GOP, proved as good as his word. By the close of his first year in office, the former president of Princeton University had presented the nation with an income tax and a central bank (in name, a kind of decentralized central bank). The federal government would never again lack the means of financing itself.

In 1916, at the end of his first term, Wilson sought a second. He was deserving on financial grounds alone, the Democratic Party platform asserted: "Our archaic banking and currency system, prolific of panic and disaster under Republican administrations—long the refuge of the money trust—has been supplanted by the Federal Reserve Act, a true democracy of credit under government control, already proved a bulwark in a world crisis, mobilizing our resources, placing abundant credit at the disposal of legitimate industry and making a currency panic impossible." Then, too, the Democrats commended themselves for "the splendid diplomatic victories of our great president, who has preserved the vital interests of our government and its citizens and kept us out of war."

New vistas of federal activism opened on April 6, 1917, when the president led the nation into war. As Washington drafted men, so it conscripted incomes. In House debate in 1913 over the proposed income tax, a seemingly wild-eyed Progressive had called for a schedule of rates culminating in 68 percent on incomes above $1 million. "The amendment was, of course, beaten," reported the New York Times, the paper seeming to roll its eyes at the very notion of so confiscatory a marginal rate of taxation.8 By 1918, the Treasury was taking 77 percent of incomes above $1 million.9 The Wilson administration took control of merchant shipping, the railroads and the telegraph and telephone companies. It rationed raw materials and set ceilings on prices and wages. It intervened in labor disputes. It allocated, requisitioned and commandeered private property. It liberalized the banking rules and thereby encouraged the expansion of credit: After June 1917, a New York bank could lend 38.8 percent more against every dollar of reserve it was required to hold than before the change was enacted.10 Woodrow Wilson delivered the activist government that America's populists and socialists had long demanded.11

So when Frank Morrison, secretary of the American Federation of Labor, warned in January 1919 that the government was the only instrument of postwar economic salvation—and that, barring federal intervention, there could be "bread lines in every industrial center before May 1"—his message had none of the shock value it would have had before the war.12 More conventionally familiar was the fatalistic voice of the Babson economic forecasting service, which predicted "a period of trouble and depression." There was no getting around it, said the founder, Roger W. Babson: "We can prepare for reaction and prevent it from being disastrous, but to stop it is impossible."

Right as rain did the bears initially appear to be. Within four weeks of the November 11, 1918, Armistice, the War Department had cancelled $2.5 billion of its then outstanding $6 billion in manufacturing contracts;[13] for perspective, $2.5 billion represented 3.3 percent of the 1918 gross national product.[14] In January 1919 commodity prices tumbled. Steel mills, which had hardly been able to keep up with war-induced demand, now operated at 60 percent to 65 percent of capacity. Order books dwindled, that of the United States Steel Corporation by 42 percent between the Armistice and May 1919. Not since the Panic of 1907 had the giant steel maker seen the likes of it.[15]

But the Morrisons and Babsons had failed to reckon with the long-thwarted American consumer. Purchases patriotically deferred during the year and a half of U.S. belligerency were now exuberantly rung up. War or not, Americans had continued to drive their Fords and Chevrolets and Buicks (gasoline sales never wavered during the ostensibly luxury-free duration of the conflict). Now, with the peace, the people demanded silk shirts, new cars and a little fun.

European consumers, too, were buying American, their spending power enhanced by loans funneled through their governments from the U.S. Treasury. In the five years prior to the outbreak of war in Europe in 1914, American exports had averaged $2.1 billion a year. They accelerated during the war and soared again with the peace. In 1919, they reached nearly $8 billion.[16]

Doomsayers could hardly believe their eyes. Surely, they reasoned, a postwar boom was a contradiction in terms. What was needed—and what was, on form, inevitable—was a bust. As with physical objects, so with prices: What goes up would have to come down. Consumer prices had risen by 11 percent in 1916, by 17 percent in 1917 and by 18.6 percent in 1918. They were on their way to rising by 13.8 percent in 1919.[17]

Flyaway prices were symptoms of wartime financial disorder. Immense public borrowing, and the easy money to accommodate it, may or may not have been a necessary evil, but the Armistice now rendered it unnecessary. When governments stopped printing money for the very purpose of destroying life and property—when production and orthodox banking made their welcome reappearance—come this happy day, the experts promised, prices would certainly tumble.

But prices resumed their rise as the experts reconsidered their forecasts. In early May, the Commercial and Financial Chronicle was prepared to admit to its Wall Street readership that "merchants are less timid about buying." Before very long, the merchants were buying boldly. By the fall of 1919, plants were operating at full capacity, raw materials were unobtainable except at exorbitant prices and delivery dates were being pushed out by as much as a year.[18] Come Christmas, the Chronicle's columns were reporting that "consumption plainly outruns production; in parts of the country what might be called a Saturnalia of buying prevails; the retail holiday business is said to be the largest on record."[19]

If Saturnalia it was, the inflationary boom of 1919 was a bitter and unhappy one. Wages couldn't seem to keep pace with prices, nor prices with costs. A pair of sensible shoes had cost $3 before the war. Now they sold for $10 or $12. Bankers scornfully spoke of the shrunken "fifty-cent dollar."[20] Pensioners, judges, professors—anyone on a fixed income—suffered a crippling loss in living standards. Class rose up against class and interest group against interest group.

Especially did the great inflation set labor against management, city dwellers against farmers, creditors against debtors and the Federal Reserve against a growing legion of monetary critics. The "high cost of living"—or the more headline-suitable acronym "H.C.L."—became the national hot button. And hovering in the background of these economic conflicts was the outbreak of revolution in Europe and the triumph of Communism in Russia. Was America next in line for a workers' revolt? "We are going to socialize the basic industries of the United States," vowed John Fitzpatrick, veteran president of the Chicago Federation of Labor, on September 18, 1919.21

Labor took out its anger on management, which not infrequently responded with allegations that the unions were stalking horses for the violent left. In 1919, one in five American workers was involved in a strike; it was an unprecedented figure at the time, and it has never been approached since.22 The United Mine Workers, the nation's biggest union, struck the coal mines, and a quarter million steelworkers walked out on U.S. Steel. There was a police strike in Boston. There were strikes by machinists, iron workers, upholsterers, butchers, paper makers, boot and shoe workers, raincoat makers, oilfield hands, longshoremen, puddlers, metal polishers, carmen, waiters, garment workers, die sinkers, grain handlers, livestock handlers, silk weavers, petticoat workers, silk operatives, drop-forge men, painters, glaziers, braziers, tool makers, cigar makers, subway workers, actors, carpenters and pressmen.23 In September 1919, President Wilson, setting off on his ill-fated cross-country trip to take his case for the League of Nations directly to the people, stopped in Columbus to deliver his first speech. The crowd was disappointingly small—it seemed that the Columbus trolleymen had struck.24

Many were the local and particular grievances that pushed workers and managements to break off negotiations and mount (or suffer) a strike. One common thread was the workers' loss of real income to sky-high prices. Another was radical politics.

The Bolshevik triumph in Russia in November 1917 electrified the American left. Here was the sign they had so long awaited. A general strike—the first in American history—shuttered Seattle for five days in January 1919. Yes, the Reds and anarchists and members of the Industrial Workers of the World—better known as Wobblies—were bound to admit, the reactionaries had cut short the people's uprising. But what an inspiring revolt it had been.25

Still inspired, the would-be vanguard of the socialist revolution marked May Day with the mailing of 30 letter bombs to members of the American Establishment. Lacking adequate postage, most of the bombs went undelivered. Reinspired, or refinanced, the revolutionaries tried again.26 Among their targets was Wilson's energetic and ambitious attorney general, A. Mitchell Palmer.

Late on the night of June 2, an assailant dropped a bomb near the front door of Palmer's Washington, D.C., home. The device blew the would-be executioner to bits—he seemed to have tripped before he reached his target—but left Mr. and Mrs. Palmer physically unharmed. "Class war is on and cannot cease but with a complete victory for the international proletariat" was an excerpt from the dozens of copies of the anarchist pamphlet "Plain Words" that the bomber had not had the chance to distribute.27

Such acts of domestic violence did nothing to sweeten the relations between management and labor. Angry and fearful men glowered on either side of the bargaining table. "It might be that before we got through we would bring some one before a firing squad," Warren S. Stone, grand chief of the Brotherhood of Locomotive Engineers, had testified before a House committee in August in consideration of a bill to nationalize the nation's railroads.28

In November, 400,000 unionized bituminous coal miners walked off the job in defiance of a federal court injunction. During the war the union, led by John L. Lewis, had submitted to such wages as the operators vouchsafed to pay. Now the miners demanded a 40 percent increase (their opening demand was 60 percent, along with the nationalization of the mines); since 1914, as the Department of Labor did the sums, the cost of living in the mining districts of Brazil, Indiana, and Pana, Illinois, had jumped by almost 80 percent. The typical mining family earmarked 37 percent of its budget for food, the cost of which was soaring.

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General Motors Corporation, founded in 1908 and already an American blue chip, registered sales of $270 million in 1918 and $510 million in 1919;29 it earned $15 million in 1918 and $60 million in 1919; it had 49,118 employees in 1918 and 85,980 in 1919.30 There was no doubting the boom in Detroit.

GM marked the first full year of peace with a burst of energy—prices, after all, were on the fly. It got into the tractor business, diversified into refrigerators, founded the General Motors Acceptance Corporation and purchased a controlling interest in the Fisher Body Corporation. And it was in 1919 that the GM executive committee approved construction of an imperial new headquarters. The Durant Building, named for the founder, Billy Durant, would have 15 stories, 4 wings, 1,700 offices and 30 acres of floor space. As the world's biggest office building at the time, it would cost a suitably imposing $20 million.

Anyone could see that the automotive field was still in its infancy. In July 1919 a motorized convoy of army vehicles set off from Washington, D.C., to San Francisco to demonstrate the need for more and better American highways. The troops—led by, among others, Captain Dwight D. Eisenhower—arrived in September. On good highways, the procession averaged almost 10 miles an hour.31

Taking the boom at face value, the GM front office accepted that raw materials were genuinely in short supply and that—contrary to experience, economic theory and even common sense—prices would rise more or less indefinitely. In such a state of mind, top management took to rubber-stamping the requests for investment funds that poured in from the heads of the company's various operating divisions. At one sitting of the executive committee, the GM chieftains approved $10,339,554 in unbudgeted spending. "The meeting was not unusual," relates Alfred P. Sloan Jr., who attended it. "Overruns on capital investment had become the rule."32

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Just back from the war, Harry Truman, a former army artillery captain, resolved to do three things. He would quit farming, marry Bess Wallace and open a men's furnishings store in Kansas City, Missouri. And each of these things he proceeded to do, the store in partnership with his wartime buddy Eddie Jacobson.

Truman & Jacobson opened for business late in November 1919, at the northeast corner of Twelfth and Baltimore Streets. The location was prime—opposite the city's biggest and newest hotel, the Muehlebach—and the capitalization seemingly ample. Truman contributed some $15,000 in equity, much of which he had realized from the sale of livestock and machinery at the Truman family farm in Grandview. Jacobson chipped in between $900 and $1,000. Bank loans financed the inventory.

As prices were rising and Federal Reserve credit was available to member banks at concessionary rates of interest, bankers were eager to lend. Nor did consumers need to be cajoled into borrowing or buying. Soaring prices meant that money was better spent than saved. Besides, wartime scrimping was over and done with: People demanded the best and were prepared to pay for it. The partners handed out blotters to which were affixed a snappy line attributed to Dr. A. Gloom Chaser: "It takes 65 muscles of the face to make a frown and 12 to make a smile—why work overtime?" And the pitch: "Buy your men's furnishings from us at new prices. You will smile at the great reductions. We will smile at the increased business. Then none of us will be overworked."

Truman and Jacobson set the name of their enterprise in colored tiles in the Twelfth Street entryway. The partners were there early and late, opening at 8 AM and closing at 9 PM, six days a week. They sold shirts, hats, leather gloves, belts, underwear, socks, collar pins, ties and detachable collars. It was a dull customer who couldn't guess where the principals had spent the year 1918. On prominent display was a four-foot loving cup engraved to "Captain Harry" from the boys of Company D, 129th Field Artillery.

This was the prosperous Kansas City of the "Twelfth Street Rag," and the boys dropped in to shop. Cash registers were ringing, including the one at Truman & Jacobson's, which would have rung more profitably if their first clerk hadn't turned out to be a thief. "Twelfth Street was in its heyday and our war buddies and the Twelfth Street boys and girls were our customers," Eddie Jacobson reminisced. "Silk underwear for men, and silk shirts, were the rage. We sold shirts at $16." Adjusted by changes in the Consumer Price Index, a $16 shirt in 1919 would translate into a $202 shirt at this writing. Well and truly, austerity was over.33

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Inflation fooled almost everyone, including—1,100 miles to the east—the once famously conservative National City Bank, forerunner of today's Citigroup. Safety had been City's stock in trade: It catered to "timid" people, a bemused federal examiner reported in 1891, "who feel that their money is a little safer in this bank than it would be in government bonds." This was at the very beginning of the James Stillman era. A master at the bankerly art of saying "no," Stillman could also prudently say "yes." By 1905, City was the nation's largest bank, with assets of more than $300 million, 27 percent more than the runner-up, National Bank of Commerce. It was hugely profitable besides.

It was not infallible. On the eve of the Bolshevik Revolution, it set about building Russian branches, gathering Russian deposits and investing in czarist bonds. "[O]f all the foreign countries," declared Stillman's protégé, Frank Vanderlip, in 1916, "there is none that offers a more promising outlook than Russia." Vanderlip, the second in command, lost his job when the victorious Communists dealt the bank its first lesson in sovereign political risk. Absent Vanderlip (Stillman had died in 1918),34 the bank sailed rudderless into the 1919 boom.

Soaring prices beguiled borrowers and lenders alike. To finance rising inventories, customers clamored for credit, and City profitably loaned. The Federal Reserve Bank of New York would lend to City at 4.75 percent, whereas City could lend to its customers at 5.6 percent. In the second half of 1919, City's book of business loans expanded by 30 percent.

Cuba seemed an especially promising theater of operations to the bank that made its offices at 55 Wall Street. The price of raw sugar, Cuba's top export, had vaulted to 22 cents a pound in the spring of 1920 from four cents a pound in the fall of 1918. American housewives, the Wilson administration and the National City Bank were now of one mind: Sugar prices were going to heaven.

City plunged into Cuba as Vanderlip had tried to commit to Russia. It built 22 branches in 1919 and loaned heavily to finance construction of sugar mills, railroads and other infrastructure that would presently assure much larger sugar production—and, ultimately, much lower sugar prices. (The enthusiasm was contagious: Chase National and Guaranty Trust, City's New York neighbors, also loaned in Cuba). By June 1920, exposure to Cuba and its one-crop economy came to total $79 million, or 80 percent of City's capital. "Management's bet on this single commodity had been imprudent to the point of folly," to quote City's own corporate history.35

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If this giant of Wall Street could be duped by the inflationary distortion of values, no less confused were the nation’s farmers. Never before had they sweated so little to earn so much. They had planted fence post to fence post during the war, and they retrenched not at all in the peace. Acreage planted to wheat in 1919 reached a record that stood until World War II. Tractor sales soared in tandem with crop prices. “Power farming” became the motto of a new personage on the American rural scene, the mechanized agricultural businessman.

In 1919, farm income from production reached a new high of $16.9 billion, no less than 152 percent above the prewar average of $6.7 billion. This record, too, would stand until the 1940s.36 Having money to spend, farmers bought breeding stock as well as tractors. In May 1919, “Rag Apple the Great,” a purebred Holstein-Friesian bull, fetched a heretofore unimaginable sale price of $125,000.37

The land on which the likes of Rag Apple regally grazed was by now in its own bull market. As crop prices were zooming, farmers and bankers reasoned, so should the capitalized value of the land on which the seeds were planted. In 1919, black Iowa corn ground fetched prices some 40 percent higher than the prewar average. In 1920, the premium was 70 percent.

Optimistic farmers borrowed to expand. “Most land purchases were made with at least a first mortgage,” recorded an agricultural historian of the period, “and sometimes even third mortgages, which looked far into the future for liquidation.” As levitating prices for land and crops and breeding stock were signs of the times, so, too, was the climb in agricultural mortgage debt. “People ask me,” said the president of the Iowa State Board of Agriculture in December 1919, “if I think this land will stay at that price [$200 to $500 per acre] and I say it certainly will. It may not go any higher for some time, but I do not think it will go back.”38

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