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Defending the Austrian Interpretation of the 1920–21 Depression: Reply to Borazan

Patrick Newman*

I welcome Ahmad A. Borazan's (2023) critique of my Austrian interpretation of the Depression of 1920–21. The episode has spurred intense discussion of laissez-faire policies' efficacy in economic downturns. In Newman (2016), I argued that the Federal Reserve's monetary expansion in 1919 generated an inflationary boom that forced it to raise interest rates, thereby precipitating a sharp contraction in 1920. Recovery began because businesses cut nominal wages, and this occurred before the Fed's 1921–22 easing reached the economy. In contrast, Borazan attributes the boom to government spending and speculative inventory investment, while he credits the recovery to, among other factors, an "administrative decree" about the return to expansionary monetary policy.

While Borazan discusses many other matters, given space constraints, I focus on the causes of the boom and recovery. First, I argue that Borazan's analysis ignores the role of the Fed's expansionary policy in causing the boom and the resultant inflation. Second,

* Patrick Newman (patrick.newm1@gmail.com) is an assistant teaching professor of economics at the University of Tampa. He is also a fellow of the Mises Institute.

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I show the irrelevance of Borazan's administrative decree and the importance of market-based wage cuts in generating the recovery.

WHAT CAUSED THE BOOM?

Austrian economists argue that recessions result from prior booms. According to Austrian business cycle theory (ABCT), when a central bank (or other government intervention) increases credit expansion, it artificially lowers interest rates. This encourages entrepreneurs to invest in long-term production processes that are infeasible given societal savings (Newman 2016, 389). Newman uses monetary, price, and production statistics to show the applicability of ABCT to the 1919 boom (390–400). In his alternative interpretation of 1919, Borazan (2023, 3–4, 6–8) omits monetary factors and the Federal Reserve's role.

According to Borazan, the boom resulted from "continued high levels of government spending" and "speculative inventory investment accumulation." The "1919 boomlet was characterized by high inflation," particularly a 15 percent rise in consumer prices. Inflation "had been high since 1917 due to the war economy and stayed high with the subsequent 1919 mini-boom as aggregate demand expansion was accompanied by rising wages demanded by an empowered labour movement." The boomlet then ended, partially "as a result of the Fed's contractionary monetary policy" (Borazan 2023, 3–4).

Borazan omits monetary figures and their relationship to inflation. As during World War I itself, monetary expansion caused consumer price inflation in 1919. The M2 money supply increased 17 percent that year, which in turn caused consumer, business, and government incomes to increase. This caused spending to increase, which caused aggregate demand to increase. Nominal spending, measured by nominal gross domestic product, increased 13 percent. As demand curves increased, prices rose (Newman 2016, 394–97).

Elevated government spending, inventory speculation, and unions demanding higher wages were not the primary causes of inflation, as Borazan argues. In each case, the money supply played a fundamental role. Government spending increased because the Treasury ordered the Fed to expand to keep borrowing costs low. Inventory speculation developed because easy money had previously caused prices to increase and led to inflationary expectations (Newman 2016, 396–97, 401–2). It is true that, as Newman documents, union strikes led to "adverse supply shocks [that] contributed to the rise in prices" (397); however, workers were striking for higher wages partially because new money was increasing the cost of living.

Borazan (2023, 4) mentions monetary policy when stating that the recession partially resulted from the Fed raising discount rates. This is true, but it is rather misleading in a paper criticizing the Austrian interpretation of the Depression of 1920–21 to mention the Fed's contraction in late 1919 and early 1920 and not discuss its previous easing.

Related to Borazan's neglect of monetary factors are the theoretical arguments he uses to dismiss ABCT's applicability. One key criticism posed is that in holding "the Federal Reserve *primarily* responsible for determining the supply of money," Newman incorrectly takes "an exogenous view of [the] money supply." Instead, "the economy's credit demand and bank lending decisions are central players in determining [the] money supply" (Borazan 2023, 8).

Borazan's (2023, 8) "endogenous" view of 1920s monetary policy is one-sided. It holds that the Fed could contract spending by decreasing bank reserves but was powerless to increase spending by increasing bank reserves. Banks did decide how much they lent, but the major factor shaping their decision was how many reserves they had, something the Fed could influence. In other words, if the Fed can take away the punch bowl, it can also spike it.

The Fed did in fact spike the punch bowl—it used the discount window to increase bank reserves by 14 percent. This contributed to the 17 percent increase in the money supply that prolonged artificially low interest rates after the war period. Low interest rates misled entrepreneurs into expanding long-term production. The central bank recognized its culpability, which is why, after receiving approval from the Treasury, it began raising the discount rate in November 1919 (Newman 2016, 396–400).

WHY DID THE ECONOMY RECOVER?

According to Austrian economists, a bust, or recession, occurs when entrepreneurs recognize the unprofitability of credit-induced investments. As a result, they enter bankruptcy and lay off workers, causing unemployment to rise. For the recovery phase to begin, entrepreneurs must reallocate these workers and other unemployed resources to shorter production processes. This involves cutting nominal wages and other input prices. Falling nominal wages decrease workers' adjusted real wages (the real wage divided by productivity), which restores profit margins and incentivizes the hiring of unemployed labor. The government should not interfere by using countercyclical policies—doing so only prolongs the structural distortions (Newman 2016, 389–90, 409).

Keynesian economists challenge the Austrian use of the 1920–21 Depression as a case study in economic recovery without fiscal and monetary stimulus. In that vein, Borazan posits that the recovery can instead be explained by John Maynard Keynes's own theory of expectations.

According to Borazan, Keynes believed that "a reduction of money wages could be stimulative . . . when people believe that the wage decline is coming to an end and wages are expected to increase" (Borazan 2023, 9). This change in expectations can only be accomplished by what Keynes calls an "administrative decree." Along these lines, Borazan argues that "the reversal of the contractionary monetary policy in May 1921 in a manner similar to an 'administrative decree,' generated positive expectations regarding the timing of the end of the contraction" (10).

Keynes uses the term "administrative decree" in a different context than Borazan. The full quote, which Borazan does not provide, is as follows: "When we enter on a period of weakening effective demand, *a sudden large reduction of money-wages to a level so low that no one believes in its indefinite continuance* would be the event most favourable to a strengthening of effective demand. But this *could only be accomplished by administrative decree* and is scarcely practical politics under a system of free wage-bargaining" (Keynes 1964, 265; emphasis added).

Rather than discussing changing expectations about the end of wage cuts, Keynes is referring to government-ordered wage reductions. He did not advocate wage cuts as an optimal policy but believed they could work if administered by the government. Keynes clarifies this when he subsequently states that "except in a socialised community where wage-policy is settled by decree, there is no means of securing uniform wage reductions for every class of labour," and "it is only in a highly authoritarian society, where sudden, substantial, all-round changes could be decreed that a flexible wage-policy could function with success" (Keynes 1964, 267, 269).

Even if we assume that Borazan's interpretation of Keynes's "administrative decree" is correct, he does not substantiate its application to Fed policy during the Depression of 1920–21. First, Borazan provides no contemporary evidence (e.g., newspaper articles, business memorandums, etc.) to show whether the Fed's policy reversal affected market expectations in the way he argues it did. Second, if the Fed did change market expectations, then the money supply, nominal spending, and nominal wages should have begun to increase after May 1921. But the money supply declined until September and remained at this level through January 1922. Quarterly changes in nominal spending are unavailable, but after collapsing 16 percent from 1920 to 1921, it flatlined at 0 percent from 1921 to 1922. This is hardly a return to expansionary conditions. Wage reductions occurred throughout the year. For example, U.S. Steel slashed nominal wages by 20 percent in May 1921, 10 percent in July, and 20 percent in August, for a total fall of 40 percent. International Harvester cut wages by 20 percent in April and 12.5 percent in November, for a total decline of 30 percent. If entrepreneurs had believed in May that monetary easing was forthcoming, they would have been unlikely to continue cutting wages throughout the year (Newman 2016, 398, 401, 407–10).

The evidence of the period is far more consistent with an Austrian interpretation. While monetary and spending conditions continued to languish, businesses cut nominal wages and reallocated labor and other resources. This, not the change in Fed policy, is the reason for the recovery.

CONCLUSION

The Depression of 1920–21 provides economists with insights into the efficacy of free-market adjustments to combat economic downturns. The Federal Reserve overheated the economy in

1919, and its subsequent monetary contraction caused a sharp yet necessary bust. The economy recovered as businesses cut wages and shifted resources away from unprofitable production processes. Borazan has challenged this Austrian interpretation, but his criticisms do not refute it. Monetary policy is key to understanding the boom, while wage cuts are imperative to understanding the recovery that followed the bust. It is important that economists and policymakers learn the causes of this business cycle so that we can avoid similar episodes in the future.

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