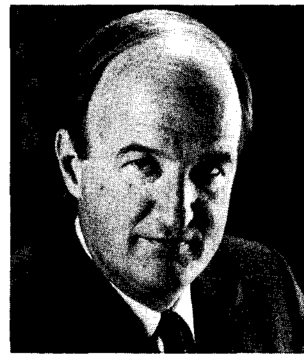
by Mark Skousen



Friedman vs. The Austrians, Part II: Was There an Inflationary Boom in the 1920s?

"I have no reason to suppose there was any over-investment boom . . . during the 1920s." —Milton Friedman

In my continuing exchange of letters with Professor Milton Friedman, the free-market economist challenged followers of the Austrian school to provide evidence of an overinvestment boom in the 1920s. He reiterated what he and Anna Schwartz concluded in *A Monetary History of the United States:* the 1920s was the "high tide" of Federal Reserve policy, inflation was virtually non-existent, and economic growth was reasonably rapid. Monetarists even deny that the stock market was overvalued in 1929! In short, "everything going on in the 1920s was fine."[1] The problem, according to Friedman, was not the 1920s, but the 1930s, when the Federal Reserve permitted the "Great Contraction" of the money supply and drove the economy into the worst depression in U.S. history.

In contrast to Friedman and the Monetarists, the Austrians argue that the Federal Reserve artificially cheapened credit during most of the 1920s and orchestrated an unsustainable inflationary boom. The stock market crash of 1929 and subsequent economic cataclysm were therefore inevitable.

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An interesting historical sidelight is the fact that Irving Fisher, the principal Monetarist of the 1920s, completely failed to anticipate the crash, while Austrian economists Ludwig von Mises and Friedrich Hayek predicted the economic crisis, although they did not pinpoint an exact date. Ever since then, Monetarists have argued that the 1929–33 debacle was unforecastable and have made every effort to show that there were few if any signs of trouble during the 1920s. The Austrians, in contrast, have attempted to confirm Mises-Hayek's view that the government created an inflationary boom that could not last, especially under an international gold standard.[2]

Was there an overinvestment boom in the 1920s? The answer depends on which statistics you examine. The "macro" data favors the Monetarists' thesis, while the "micro" data supports the Austrians' view.

In support of the Monetarists, the broad-based price indices show little if any inflation. Average wholesale and consumer prices hardly budged between 1921 and 1929. Most commodity prices actually fell. Friedman and Schwartz conclude, "Far from being an inflationary decade, the twenties were the reverse."[3]

However, other data support the Austrian view that the decade was aptly named the Roaring Twenties. The 1920s may not have been characterized by a "price" inflation, but there was, in the words of John Maynard Keynes, a "profit" inflation. After the 1920–21 depression, national output (GNP) grew rapidly at a 5.2 percent pace, substantially exceeding the national norm (3.0 percent). The Index of Manufacturing Production grew much more rapidly and virtually doubled between 1921 and 1929. So did capital investment and corporate profits.

Like the 1980s, there was also an "asset" inflation in the U.S. A nationwide real estate boom occurred in the mid-1920s, including a speculative bubble in Florida that collapsed in 1927. Manhattan, the world's financial center, also experienced a boom.

The asset bubble was most pronounced on Wall Street, both in stocks and bonds. The Dow Jones Industrial Average began its monstrous bull market in late 1921 at a cyclical low of 66, mounting a drive that carried it to a high of 300 by mid-1929, more than tripling in value. The Standard & Poor's Index of Common Stocks was just as dramatic—Industrials, up 321 percent, Railroads, up 129 percent, and Utilities, up an incredible 318 percent.

Astonishingly, the Monetarists go so far as to deny any stock market orgy. Anna Schwartz suggests, "Had high employment and economic growth continued, prices in the stock market could have been maintained."[4] It's as if they want to exonerate Irving Fisher's infamous blunder of declaring a week before the 1929 crash, "stock prices have reached what looks like a permanently high plateau." (Fisher's huge leveraged position in Remington Rand stock was wiped out by the crash.)

Schwartz's thesis is based on what appears to be reasonable price-earnings ratios for most stocks in 1929 (15.6 versus a norm of 13.6). However, P/E ratios can be a notoriously misleading indicator of speculative activity. While they do tend to rise during a bull market, they severely underestimate the degree of speculation because *both* prices and earnings tend to rise during a boom. However, when annual national output averages 5.2 percent during the 1920s, and the S&P Index of Common Stocks increases an average 18.6 percent a year, something has to give. In fact, during 1927–29, the economy grew only 6.3 percent, while common stocks gained an incredible 82.2 percent! As the old Wall Street saw goes, "Trees don't grow to the sky." A crash was inevitable.

The Austrians argue that the Federal Reserve's "cheap-credit" policy was to blame for the structural imbalances of the Twenties, while the Monetarists dispute any significant inflationary intent. The money stock (M2) grew 46 percent between 1921–29, less than 5 percent per annum, which Monetarists do not consider excessive.[5] Austrians, on the other hand, point to the deliberate efforts by the Fed to lower interest rates, especially in 1924 and 1927, thus generating an unjustifiable boom in assets and manufacturing. More importantly, the credit expansion in the United States far exceeded the increase in gold reserves, which would eventually spell disaster under the gold exchange standard.

In sum, was there an inflationary imbalance during the 1920s, sufficient to cause an economic crisis? The evidence is mixed, but on net balance, the Austrians have a case. In the minds of the Monetarists, the "easy credit" stimulus may not have been large, but given the fragile nature of the financial system under the international gold standard, small changes by the newly established central bank triggered a global earthquake of monstrous proportions.

In my next column, I will address a growing debate among economists: Did the gold standard make the 1929–33 crisis worse? □

1. Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867-1960* (Princeton, N.J.: Princeton University Press, 1963), pp. 240–98.

2. See my article, "Who Predicted the 1929 Crash?" in Jeffrey M. Herbener, ed., *The Meaning of Ludwig von Mises* (Norwell, Mass.: Kluwer Publishers, 1993), pp. 247–83. Interestingly, John Maynard Keynes also failed to predict 1929–32, and lost three-fourths of his net worth.

3. *Monetary History*, p. 298.

4. Anna J. Schwartz, "Understanding 1929-1933," in *Money in Historical Perspective* (Chicago: University of Chicago Press, 1987), p. 130.

5. Friedman criticizes Murray Rothbard's inclusion of cash-value from life insurance policies as "pure chicanery" in an effort to inflate monetary figures. By doing so, Rothbard increases the money supply, 1921–29, by 61.7 percent instead of Friedman's more traditional 46 percent figure. See Murray Rothbard, *America's Great Depression*, 4th ed. (New York: Richardson & Snyder, 1983 [1964]), p. 88 passim. I tend to side with Friedman on this issue.

BOOKS

Perpetuating Poverty: The World Bank, the IMF, and the Developing World

Edited by Doug Bandow and Ian Vásquez

Cato Institute • 1994 • 362 pages • $15.95 paperback

Reviewed by Ken Ewert

There is a biblical proverb that says: "the tender mercies of the wicked are cruel." I have often thought of this verse in relation to the misery that political policies such as rent control or minimum wages have caused people—especially the poorest of people. The "tender mercies" of governments—attempts to use the law as an instrument of compassion—often turn out to be cruel to the intended beneficiaries, the poor. With friends like most modern governments, the poor do not need any enemies.

Perpetuating Poverty demonstrates this to be true on an international scale. Fifty years and hundreds of billions of dollars of aid from Western governments—tunneled through the IMF, the World Bank, and a number of other multilateral aid agencies—have had an impact on world poverty: it has helped keep the Third World poor just that—poor.

Development economists have long held that the Third World is poor primarily because of its lack of capital. According to the conventional wisdom poor nations cannot, on their own, afford to save enough to break out of a subsistence-type economy. Their only hope is massive infusions of capital from the taxpayers of the West. They need Western wealth in order to "develop." Furthermore, according to the popular Marxist notion of Western guilt for the exploitation of the poor nations, the Third World has a right to Western wealth.

It now seems beyond question that the massive wealth transfers to Third World governments have not, in general, helped the poor. As the editors note in the introduction, "the multilaterals can point to few, if any, cases in which their efforts have led to improved living standards and sustained economic prosperity." Forty years of international aid transfers have left Latin America with a foreign debt of $430 billion, sub-Sahara Africa with per capita incomes lower today than they were in the 1970s, and India with an annual per capita income of around $300.

Why has aid failed? Primarily because most developmental institutions lend to governments, and not to individuals. The recipient governments are often—through their destructive economic policies—the very cause of the economic problems that the aid seeks to rectify. International aid is, in effect, a subsidy to bad economic policies and a bloated public sector. It succeeds, not in alleviating poverty, but in extending and prolonging bureaucratic control over the poor of the Third World. Governments who would have been forced to change or collapse have instead been kept afloat by loans from the World Bank or the IMF and allowed to continue their destructive policies. This is something like an international welfare program, not for the poor of the Third World, but for their governments. Much aid has been wasted in poorly planned, ill-administered projects of little benefit—such as crop-storage depots built where peasants never go, or funds allotted to buy a profitable private bus line in India and turn it into a money-losing public enterprise. Billions of dollars, collected from middle-class taxpayers of the West, have "aided" Third World elites to possess grand estates, private zoos, classic car collections, and Swiss bank accounts.

But this book does not merely look at the "bad cases"—it is a devastating critique of foreign aid in principle. Shyam Kamath, in his chapter on foreign aid and India's Leviathan State, shows how foreign aid has allowed India to create and sustain one of the "world's largest and most inefficient public sectors." Robert Salinas León dem-