PRICE-LEVEL "FLEXIBILITY" AND THE COMING OF THE NEW DEAL: REPLY TO SUMNER

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Sumner's crtique of our *American Economic Review* papers (De Long and Summers 1986, 1988) raises issues on the levels of economic policy and of economic history. We first discuss issues relating to the proper conduct of economic policy, and conclude that Sumner's critique does not alter our view. We then turn to the issues concerning the appropriate interpretation of the Great Depression, and conclude that Sumner's critique of our analysis of the National Industrial Recovery Act of 1933 (NIRA) has some force. If we were writing our 1986 paper over again, we would place stress on the general abandonment by Roosevelt of the previous deflationary policy regime, on the devaluation of the dollar and the passing of the NIRA as twin signals of this shift in regime, and not on the NIRA itself as a unique signal of the end of deflation.

Economic Policy

Sumner attempts to draw a distinction between price-level *stability* and price-level *inflexibility*. We do not find this distinction compelling. If—as Irving Fisher thought and as we think—the key to avoiding deep depressions lies in maintaining enough price-level stability to keep the self-reinforcing spiral of deflation and depression from gathering force, then anything that tends to make the price level *inflexible*—in the sense of making it unresponsive to macroeconomic shocks—is likely to decrease the likelihood of deep depressions.

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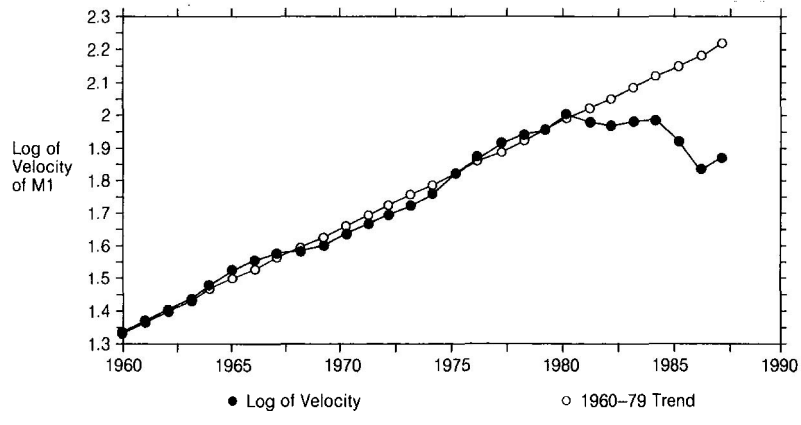
Price-level inflexibility could be generated by long-term labor contracts, by firms' desires to maintain consistent wage and salary schemes, by—as Sumner correctly notes Irving Fisher would have preferred—confidence that the central bank will move quickly to offset macroeconomic shocks, or by any of numerous other mechanisms. Different mechanisms will, of course, have different effects on the economy's *microeconomic* performance as it allocates scarce resources to alternative uses. But all mechanisms that create price-level inflexibility will decrease the likelihood of deep depressions as long as very large declines in real aggregate demand are driven not by large declines in the real money stock but by large declines in the velocity of money generated by households' perceptions of ongoing inflation.

Do these considerations have empirical as well as theoretical force? The only two major "natural experiments" that the United States has seen in the past century do suggest that changes in households' perceptions of the current ongoing rate of inflation or deflation have large effects on the velocity of money. One of these "experiments" was the Great Depression itself, during which the entire fall in real GNP could, in an accounting sense, be attributed to a decline in velocity; the Great Depression is the subject of the second half of this comment. The second more recent "experiment," considered here, is the similar collapse of monetary velocity during the Volcker depression of the early 1980s, as shown in Figure 1. William Poole (1988) has argued that such a decline in velocity is what one should have expected to see, given the decline in the rate of inflation (and

FIGURE 1

THE VELOCITY OF MONEY IN THE UNITED STATES, 1960–87



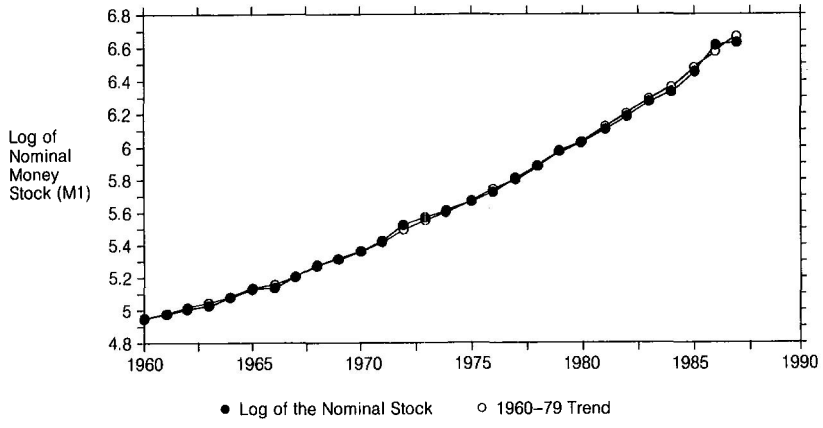
the concommitant decline in long-term interest rates) during the 1980s, and assuming that money demand is relatively sensitive to shifts in households' perceptions of the ongoing rate of inflation (or level of nominal interest rates).

Recognition of the key role played in deep depressions by collapses in velocity has implications for economic policy (in addition to the recognition that institutions which support price-level inflexibility may be useful) that Sumner fails to draw out. One kind of monetarism, which we associate with Irving Fisher and with Friedman and Schwartz's (1963) *Monetary History of the United States*, sees the key to monetary policy as the maintenance of a stable path for the price level and for the total level of nominal aggregate demand. Monetarism of a second kind, found in Friedman (1984b), for example, argues that the key to monetary policy is the maintenance of a stable path for a relatively restrictive monetary aggregate—in the case of Friedman (1984b), the nominal stock of high-powered money. Monetarism of the second kind shifts primacy from achieving a stable path for nominal demand and prices to achieving a stable path for some restrictive measure of the most liquid assets.

If the velocity of money really is, as we maintained in our *American Economic Review* articles, sensitive to perceptions of ongoing deflation, then policies recommended by this second tendency flirt with disaster. The Great Depression showed that a stable path for real balances or for the nominal stock of high-powered money was perfectly consistent with a deep deflation-driven depression. A similar lesson can be drawn from the Volcker depression. As Figure 2 shows,

FIGURE 2

GROWTH OF THE NOMINAL MONEY STOCK, 1960–87



the path of growth of the nominal money supply did not slow much in the 1980s. This fact led monetarists of the second kind (see, for example, Friedman 1984a) to call for additional monetary contraction. To the extent that such contraction would have further reduced perceived inflation and reinforced the collapse of velocity, it would have been a bad mistake to follow such advice—advice given because, as Poole (1988) puts it, monetarists "analyzing monetary policy . . . relied on a velocity time trend" instead of an economic theory of velocity.

Economic History

As Figure 3 shows, the Great Depression was an economic collapse of a magnitude that had never before been seen. Previous depressions had come to an end—the equilibrium-restoring forces at work in a market economy had swung into action—when slack and idle resources were between 5 and 10 percent of GNP more than average. On the basis of pre-1929 experience, in every year from 1930 on, it would have been reasonable (given the past pattern of cyclical volatility) to expect that prosperity was just around the corner. Yet the slide into the Great Depression went on and on, piling up more and more unused resources, until the inauguration of Roosevelt and the coming of the New Deal.

As Figure 4 shows, the slide into the Great Depression was not accounted for by declines in the money stock or in high-powered money: Both the velocity of money and the product of velocity and the money multiplier fell steeply during the Depression. Monetary policy was "expansionary" in the sense that the central bank kept both the real money stock and the nominal high-powered money stock approximately constant and kept nominal interest rates on government obligations low during the slide.

We see Roosevelt's announcement of a New Deal as the key factor that removed expectations of further deflation and so allowed the beginnings of recovery. We saw the NIRA as the centerpiece of the first stage of the New Deal, and attributed to it the shift in perceptions—the recognition that Roosevelt's inauguration marked a sharp break from the previous deflationary policy regime, and that henceforth deflation was not to be feared—that we see as the principal factor driving the recovery that began in 1933. We argued that the damaging *microeconomic* effects the National Recovery Act (NRA) may well have had on the economy's performance as a resource allocation mechanism would have been swamped, in the first stage at least, by the *macroeconomic* effects of the shift in expectations generated by the passage of the NIRA as a signal that the

FIGURE 3

THE U.S. BUSINESS CYCLE, 1890–1940

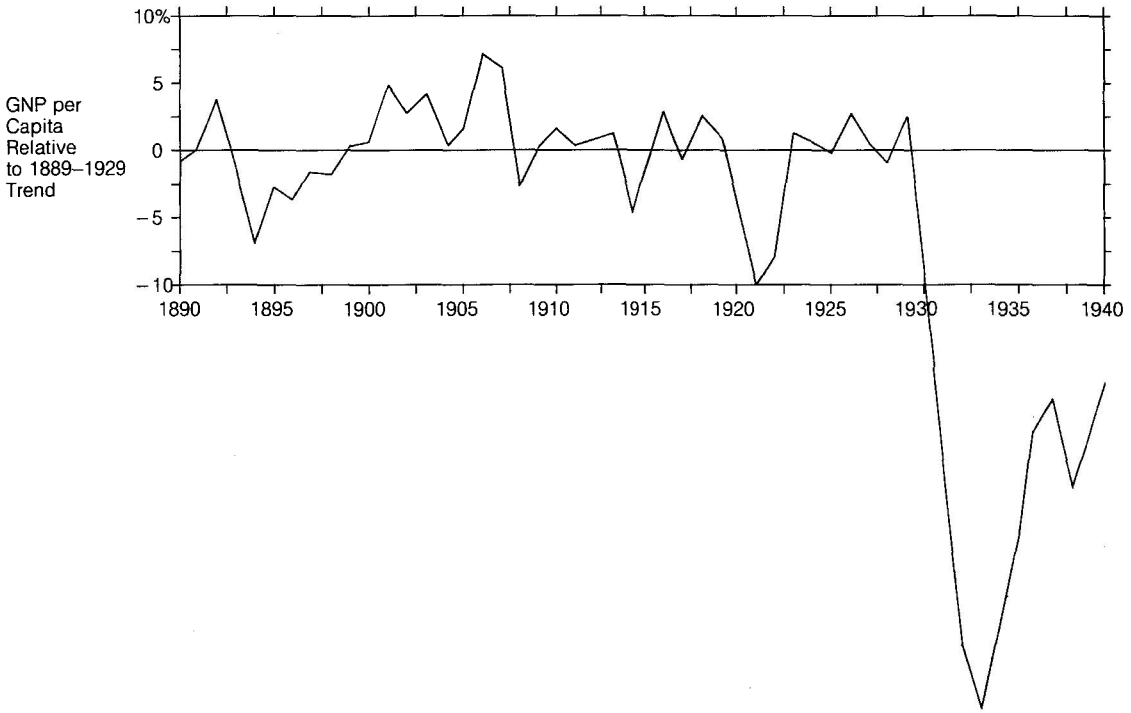
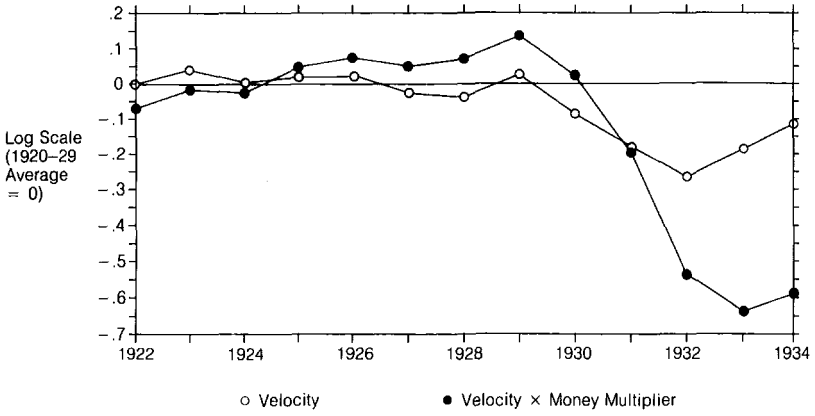


FIGURE 4

VELOCITY AND VELOCITY × MONEY MULTIPLIER IN THE DEPRESSION



regime of deflation had ended. We accepted Arthur Lewis's judgment that in the summer of 1933 "the [NRA] codes seemed to be making some contribution to recovery. . . . Their psychological effect was good; businessmen took heart from the prospect of rising prices, and began to give orders for goods. Unemployment fell a little" (Lewis 1949, p. 107). Lewis then went on to argue that once its initial effect on expectations had passed, the NRA's effects were largely negative.

Sumner points out that the NIRA was not the sole element of the first stage of the New Deal. Alongside Roosevelt's introduction of the NIRA came the abandonment of the gold standard and the adoption of a deliberate policy of forcing up the dollar price of gold—of devaluation. Sumner argues that such an abandonment of the gold standard was as clear a signal of the abandonment of the old deflationary regime as could be given, and that even in the absence of the NIRA the abandonment of the gold standard would have generated the same positive expectational effects. Peter Temin (1989) makes a similar argument that the key regime shift was the abandonment of the gold standard.

If we were rewriting our *American Economic Review* paper today, we would place less stress on the NIRA itself and more stress on the idea of the New Deal—encompassing both the NIRA and the abandonment of the gold standard—as the key to the shift away from deflationary expectations necessary to generate the beginnings of recovery. We thus think that Sumner's criticisms of our analysis of the NIRA have some force. But we remain somewhat skeptical that

abandonment of the gold standard all by itself would have been sufficient to generate all the positive expectational effects of the entire New Deal package. Temin (1989) argues that Great Britain's abandonment of the gold standard was not fully efficacious because it was seen as an isolated action taken out of weakness, rather than as the beginnings of a nondeflationary regime of economic policy.

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