The Midas Paradox: Financial Markets, Government Policy Shocks, and the Great Depression. By Scott Sumner. Oakland, CA: Independent Institute, 2015. Pp. xv, 507. $37.95, hardcover.
doi: 10.1017/S0022050717000213

What caused the Great Depression? Why did the Depression last so long? Economists often address these questions separately. And so much has been written on the subject that it is hard to make more than a marginal contribution to the literature. Scott Sumner's *The Midas Paradox* is refreshing because it provides an analysis of both questions and makes more than a marginal contribution. Sumner presents a new framework for thinking about the Great Depression, but one that is also capable of corroborating the results of previous work.

At the risk of oversimplification, much of the book is centered on identifying an explanation for countercyclical real wages observed during the Depression. To explain countercyclical real wages, Sumner employs a textbook aggregate supply-aggregate demand analysis in which nominal wages are sticky. Supply shocks emanated largely from New Deal policies, which increased nominal wages, but reduced output. Demand shocks tended to show up in the price level. Thus, an adverse demand shock would reduce the price level and output. As a result, real wages rise as output declines in response to both adverse supply and demand shocks.

The innovation in Sumner's approach is the use of the gold market to describe changes in aggregate demand. Other scholars have focused on either closed economy macroeconomic frameworks that emphasize the role of monetary aggregates or the constraints of the international gold standard. Sumner, however, argues that the proper way to understand fluctuations in the price level is through a supply and demand analysis of the gold market. The basic intuition is that fluctuations in the supply and demand for monetary gold will result in textbook changes in the real price of gold. However, since the price of gold is fixed under the gold standard, the necessary changes in the real price of gold will show up in the price level.

While this type of analysis seems straightforward, there are many moving parts that affect the gold price. The supply of gold refers to the supply of monetary gold. Thus, shifts from monetary to non-monetary gold result in a decline in supply of gold, which is deflationary. In addition, changes in the demand for gold can be thought of as the product of the demand for currency and the gold reserve ratio. Increases in the demand for gold are also deflationary.

To assess the importance of these factors, Sumner employs a variety of different techniques. Although he refers to this as a narrative approach, his analysis of the gold market mixes evidence from financial market data, newspaper accounts of market movements, a gold market accounting framework, and linear regressions. His evidence shows the importance of central bank gold hoarding (i.e., significant increases in the gold reserve ratio) and increases in the demand for currency from 1929–1933. Most importantly, however, Sumner's gold market approach is capable of explaining every significant fluctuation in the price level during the Great Depression, something that previous frameworks cannot claim.

What is especially useful about Sumner's framework is that it can also be applied to the world. Since the world as a whole is a closed economy, the gold market approach determines the world price level. It is therefore possible to use the gold market approach

https://doi.org/10.1017/S0022050717000213 Published online by Cambridge University Press

to discuss the effects of international cooperation (or lack thereof) among central banks as well as to examine the role of domestic monetary policy. Sumner's framework is able to compare and contrast his approach with the existing monetarist and international gold standard approaches. The fact that Sumner's framework can corroborate existing research while also explaining fluctuations that the previous literature could not suggests it is a more comprehensive approach.

The book also goes beyond monetary explanations. For example, Sumner also emphasizes that the role of New Deal policies had in increasing wages. These policy-induced higher wages represented an adverse supply shock thereby contributing to countercyclical real wages. But how does one know that these policies were actually driven by New Deal policies? Sumner's empirical approach is quite interesting. First, he estimates a regression of industrial production on its own lag and the real wage. The results show that real wages were countercyclical between 1920–1939 as well as within each individual decade. However, when he dichotimizes the real wage into nominal wages and the price level, the price level is procyclical during both decades (consistent with his gold market approach), but the nominal wage is only countercyclical during the 1930s. In fact, he points out that the nominal wage did not become countercyclical until 1933.

Perhaps important to recent discussions of monetary policy, Sumner uses his approach to analyze the devaluation that occurred when Franklin Roosevelt took office. The increase in the price of gold caused a significant increase in aggregate demand and the price level. The effect was immediate. Within the gold market approach, an increase in the price of gold will cause expectations of the future money supply to rise and therefore the price level will rise immediately. Further, even in the absence of an expected increase in the money supply, prices of domestically produced goods should rise based on arbitrage. Sumner emphasizes that the immediate response of the price level demonstrates the importance of the public's expectations.

The role of monetary policy expectations is central to the modern New Keynesian model. Forward guidance has been a tool of monetary policy in the aftermath of the Great Recession. The role of expectations following the increase in the price of gold would seem to provide some empirical support for both the model and the practice. However, hidden in Sumner's book is a cautionary tale about this type of policy. While it is true that the price level increased immediately following the increase in the price of gold, the gold standard has a built-in mechanism, namely international price arbitrage, which ensures that the price level would eventually rise. In a modern fiat regime there is no automatic mechanism capable of generating this outcome. The public's expectations in a fiat regime depend on the commitment of the central bank to do something in the future. This word of caution is important because a key and recurring empirical observation in Sumner's book is that fears of devaluation often led to private gold hoarding, which was deflationary (precisely the opposite effect of an actual devaluation). Sumner leaves the question of why expectations of devaluation and actual devaluation had precisely the opposite effect as a subject for future research. However, one possible hypothesis is that an actual devaluation had a built-in commitment mechanism. At the very least, this should give current policymakers some pause about forward guidance.

Overall, Sumner provides one of the most comprehensive treatments of the Great Depression within a single framework. The empirical analysis is eclectic and enlightening. Scholars of the Great Depression, and macroeconomists more generally, should have a copy of this book on their shelf.

Joshua R. Hendrickson, *University of Mississippi*

https://doi.org/10.1017/S0022050717000213 Published online by Cambridge University Press