

A THEORETICAL & HISTORICAL CRITIQUE OF THE MONETARIST HYPOTHESIS OF THE GREAT DEPRESSION

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1. Introduction

Milton Friedman is widely regarded by the conservative movement as a figurehead of free-market economics and his monetarist school of economic thought is considered by many a favorable alternative to Keynesianism. Unlike Keynes, who thought capitalist countries suffered from inherent instability, Friedman attributed business fluctuations to monetary shocks and blamed the Federal Reserve for failing to expand the money supply to stop the Great Depression. Milton Friedman and Anna J. Schwartz presented their monetarist hypothesis of the Great Depression in their seminal work, *A Monetary History of the United States, 1867-1960*. While Friedman was a brilliant economic thinker, his theory of business cycles leaves much to be desired. Upon examining Friedman and Schwartz's hypothesis and the accompanying literature many problems begin to emerge. Specifically, monetarism's lack of capital theory, misplaced fear of deflation, and failure to recognize the credit expansion of the 1920s led Friedman and Schwartz to draw erroneous conclusions about the causes of the Great Depression and recessions in general.

2. The Monetarist Hypothesis of the Great Depression

Friedman and the monetarists sought to establish a hypothesis of the Great Depression that would make the

government culpable for this economic catastrophe rather than the private sector. Skeptical of activist fiscal policy, monetarists believed that the economy was inherently stable apart from the influence of monetary shocks.¹ They thus advanced the notion that the Great Depression was primarily due to a massive monetary contraction. Friedman and his acolytes evidently thought this obviated the private sector of guilt for the Great Depression since the damage could have been stopped by the Federal Reserve reinflating the money supply.² As a general rule, monetarists thought that the primary factor explaining changes in money income was the money stock.³

Friedman and Schwartz apply this reasoning to the Great Depression, suggesting it began because of a monetary contraction. The contraction started out mild, with a handful of bank failures, however, a “contagion of fear” swept throughout the economy leading depositors to rush to convert their deposits into currency.⁴ In November of 1930, 256 banks failed with more than \$180 million of deposits. This was followed in December by another 352 bank failures with over \$370 million of deposits. The first

1 BRIAN SNOWDON & HOWARD R. VANE, *MODERN MACROECONOMICS: ITS ORIGINS, DEVELOPMENT AND CURRENT STATE* 193 (Edward Elgar Publishing Inc. 2005).

2 *Id.* at 79.

3 *Id.* at 173.

4 *Id.* at 170; MILTON FRIEDMAN, AND ANNA JACOBSON SCHWARTZ, *A MONETARY HISTORY OF THE UNITED STATES, 1867-1960*, 308 (Princeton University Press 1963).

of these bank runs, and subsequent bank failures, started in agricultural areas, but took a drastic turn for the worse when the contagion spread to New York and the Bank of the United States on December 11. The bank had over \$200 million in deposits making it the largest commercial bank to have failed in U.S. history. Additionally, the bank was esteemed in part due to its official-sounding name, which added further weight to its demise.⁵ In short, a multitude of factors exacerbated depositors' fears and deepened the liquidity crisis.

Monetarists allege that this bank failure, and many others that would follow, could have been prevented if the Fed had merely expanded the money supply and provided the banks with the liquidity they desperately needed.⁶ Despite extensive deliberation and planning, however, the Federal Reserve failed to act to save the Bank of the United States. This was in large part due to the Clearing House banks withdrawing their support from the measures advocated for by the Federal Reserve Bank of New York to save the Bank of the United States.⁷ The Federal Reserve's intended solution called for merging the Bank of the United States with several other banks and the provision of a guarantee fund to be supported by other banks. This would have assured the depositors of the Bank of the United States of the safety of their assets. Furthermore, Friedman and other

5 FRIEDMAN, *supra* note 4, at 309-311.

6 *Id.* at 301.

7 *Id.* at 311.

monetarists argue that the Federal Reserve continued to have a lackadaisical approach to further monetary expansion after this. If they had merely engaged in more extensive open market operations then the Depression would not have been nearly as severe as we experienced. To quote Friedman: "Prevention or moderation of the decline in the stock of money, let alone the substitution of monetary expansion, would have reduced the contraction's severity and almost as certainly its duration."⁸

A further element of the monetarist hypothesis was the Federal Reserve's so-called "sterilization of gold" that flowed into the U.S. economy. In short, the United States, according to Friedman, didn't allow the inflows of gold they were receiving from the United Kingdom and other countries to expand the money stock. Instead, banks held onto gold to improve their liquidity position. In short, when gold would flow into the United States from trade with the United Kingdom, U.S. banks would hold onto the gold rather than lend out more money on those gold reserves. From 1929 to 1931 the U.S. gold stock dramatically increased in size. As Friedman and Schwartz note, the money stock had been 10.6 times the gold stock in August of 1929, but the money stock fell to 8.3 times the gold stock by August of 1931.⁹ Friedman contends that the state of the economy could have been improved if these gold inflows

8 *Id.* at 301.

9 *Id.* at 360-361.

had been allowed to increase the amount of money available to businesses and individuals.

After this failure to allow the gold inflow to increase the money supply, the Federal Reserve had to confront another gold-related problem: the gold drain of 1931. The gold drain started in September of 1931 as a consequence of multiple European countries leaving the gold standard.¹⁰ This is because foreigners were concerned that the United States would follow Europe's lead and stop backing guaranteeing a specific amount of gold in return for their banknotes. Consequently, foreigners began redeeming their banknotes for gold. Friedman believes the Federal Reserve's response to this monetary crisis was also insufficient. Specifically, Friedman believes that the gold drain and the elevated discount rates the Reserve had imposed should have been offset by sufficient open market operations. This would have offset the external drain of gold and lessened the pressure being put on banks' reserves.¹¹

The above-mentioned bank failures, supposedly occasioned by the Fed's failure, led to a dramatic decline in the money stock, which Friedman pegs as the cause of all our woes. The statistics on the money stock decline are admittedly dramatic. Between 1929 and 1933 the United States' total money stock fell by over a third and commercial bank deposits dropped by more than 42 percent. In

10 *Id.* at 315-316.

11 *Id.* at 318.

absolute terms, this was a fall of \$18 billion.¹² In arguing that this deflation is so deleterious, Friedman claims that such changes in the money stock are closely associated with declines in economic activity and money incomes. As has already been alluded to, money stock changes are considered by monetarists to be the most important factor influencing monetary incomes (Friedman and Schwartz 1963, 676; Snowden and Vane 2005, 193). Throughout *A Monetary History*, one must search very hard to find theoretical explanations of why such deflation of the money stock is bad and why the market cannot sufficiently adjust its prices. In short, it is almost as if Friedman and Schwartz take the fact that deflation is bad as a given. Regardless of this ambiguity, it is this issue of deflation that is at the heart of the monetarist hypothesis of the Great Depression.

3. Monetarist's Lack of Methodology

While an exposition of the monetarist hypothesis is fairly straightforward, one issue that has drawn significant critique is Friedman and Schwartz's failure to articulate a clear methodology for their research and theorizing. In 1970 Friedman took up the task of explicating such a methodology in his paper "Theoretical Framework for Monetary Analysis." Far from presenting an elaborate new method of economic analysis, Friedman ended up presenting a framework akin in nature to the IS-LM model.¹³ This was

12 *Id.* at 352.

13 "The IS-LM model is a Keynesian macroeconomic model de-

far from being negative in the eyes of Friedman. Indeed, his goal in writing this framework was to prove that he was thoroughly conventional in his framework and the differences between him and those who disagreed were namely empirical.¹⁴ In the conclusion to this short exposition, Friedman explicitly states that the framework he presented is not unique to him and that most economists could agree with him. While different economists will stress different points or elaborate in different areas, the fundamentals remain unchanged. In short, Friedman argues that “the basic differences among economists are empirical, not theoretical.”¹⁵ As has been noted by Daniel J. Hammond, Friedman’s desire was for the attention of his colleagues not to be directed at any theoretical model, but rather at the summaries of evidence he presented, and the implications drawn from theoretical models.¹⁶

4. Deficient Understanding of Capital and Production

Moving beyond methodology, one of the conspicuous inadequacies of monetarist thought on business cycles

describing the interaction of the market for goods and the loanable funds market. The IS stands for “investment-saving” and the LM stands for “liquidity preference-money supply” (Investopedia 2023); INVESTOPEDIA, IS-LM MODEL: WHAT IT IS, IS AND LM CURVES, CHARACTERISTICS, LIMITATIONS INVESTOPEDIA (2023), <https://www.investopedia.com/terms/i/islmmodel.asp>.

14 SNOWDON, *supra* note 1, at 174.

15 FRIEDMAN, *supra* note 4, at 234.

16 DANIEL J. HAMMOND, THEORY AND MEASUREMENT: CAUSALITY ISSUES IN MILTON FRIEDMAN’S MONETARY ECONOMICS 154 (Cambridge University Press 1996).

is their lack of capital theory, or to be more precise, their distorted and limited conception of capital. In leveling this critique, it is important to note that the lack of capital theory is a defect of neoclassical economics more broadly which subsequently impacted the various schools of thought operating under this framework, including monetarism.¹⁷ This lack on the part of monetarists helps explain the many analytical travesties they commit. To begin, one must examine definitions of capital from neoclassical economists like John Bates Clark and Frank Knight. Clark believed that capital was a self-sustaining fund that produced a return automatically, ruling out the possibility that capital could be consumed via depreciation and needed to be maintained.¹⁸ Frank Knight similarly thought that capital was “a permanent fund which automatically and synchronously produces income.”¹⁹ Relatedly, Clark and Knight did not believe that production processes occurred in stages, rather it is simultaneous with consumption. This flows directly from a static Walrasian conception of general equilibrium and is present in contemporary circular flow diagrams which entirely rule out the role of time. The interest rate is simply lower if the “social fund” of capital is smaller, leaving no role for time preference.²⁰

17 JESÚS HUERTA DE SOTO, *MONEY, BANK CREDIT, AND ECONOMIC CYCLES* 512 (The Ludwig von Mises Institute 2006).

18 *Id.* at 514.

19 *Id.* at 517.

20 *Id.* at 514-515.

This neoclassical understanding of capital would seem silly to any businessman faced with the very real phenomenon of the depreciation of capital and with the decisions of production which occur within the time constraints of his production process. As Austrian economist Fritz Machlup notes, “There was and is always the choice between maintaining, increasing, or consuming capital.”²¹ While the notion of perpetual capital might make sense to an academic, this concept would appear to the businessman as pure lunacy. Moreover, it seems almost painfully obvious to note that the production process is just that, a process. Steps must be taken in sequential order for a finished product to be produced. All these critiques point to neoclassical economists’ clear divergence with a causal realist understanding of the economy on the issue of capital.

The lack of capital theory becomes problematical when monetarists’ acceptance of the mechanistic version of the quantity theory of money is considered. Monetarists believe that monetary inflation changes prices directly and proportionately. In other words, inflation affects all economic sectors equally, meaning there is no discoordination of the structure of production. Malinvestment is not a problem. This naïve view stems from the fact that monetarists’ conception of capital includes no time element and considers production to be simultaneous with consumption.

21 Fritz Machlup, *Professor Knight and the ‘Period of Production,’* 43 *JOURNAL OF POLITICAL ECONOMY* 577, 577 (1935).

It thus conceals the disrupting nature of credit inflation and leads monetarists to draw the wrong conclusions about the causes of economic recession.²² Indeed, Friedrich A. Hayek said that the Achilles heel of monetarist theory is that it focuses solely on general price levels and not on “the effects on the structure of relative prices.” This defect led economists to disregard the misallocation of resources across the production structure, which is the most damaging effect of inflation.²³ Due to monetarists’ deficient understanding of capital, they confuse the cause with the effect in economic cycles. They mistakenly state that depressions are caused by monetary contraction, whereas, in reality, economic crises are caused by malinvestment enabled by credit expansion. Later this results in monetary contraction and recession in the bust part of the boom-bust cycle, not the other way around. In other words, as malinvestments are liquidated and many of the banks’ previous loans are defaulted on, these banks will attempt to improve their liquidity position, and monetary contraction can occur. In other words, as defaults occur banks will feel pressure to improve their liquidity position and decrease their outstanding liabilities. As Jesús Huerta De Soto notes, “Attributing crises to a monetary contraction is like attributing measles to the fever and rash which accompany it.”²⁴ What is even

22 DE SOTO, *supra* note 17, at 523.

23 F. A. HAYEK, *NEW STUDIES IN PHILOSOPHY, POLITICS, ECONOMICS, AND THE HISTORY OF IDEAS* 215 (University of Chicago Press 1978).

24 DE SOTO, *supra* note 17, at 527.

more unfortunate is that this confusion led monetarists to advocate for policies that merely target symptoms, namely monetary contraction. Inhibiting the speed with which the market liquidates malinvestment, however, merely allows entrepreneurial error to continue and prolongs the recession.²⁵

5. Unwarranted Fear of Deflation

5.1 The Nature of Deflation and Its Supposed Danger

While the above analysis seems to suggest that the deflation experienced as part of the Great Depression was more likely a consequence than it was a cause of the downturn, monetarists' assumption that deflation is bad in general also warrants critique. While in the past the term deflation generally referred to a decrease in the stock of money, today it simply refers to a general fall in consumer prices.²⁶ Why is it that economists fear such deflation and even blame large-scale recessions on it? In answering this question, it must be noted that Friedman and Schwartz do not dedicate much of *A Monetary History* to a detailed exposition of how deflation impacts real economic processes. Instead, the focus of their analysis is empirical and traces the correlation between deflation and recession. With that disclaimer, we can outline the general reasoning

25 *Id.* at 534.

26 Joseph T. Salerno, *An Austrian Taxonomy of Deflation - With Applications to the US*, 6 THE QUARTERLY JOURNAL OF AUSTRIAN ECONOMICS 81, 82-83 (Winter 2003).

of economists as to why deflation may cause recessions. Such economists suggest that deflation causes output prices to fall, but if wages or other input prices remain rigid or sticky then the proper adjustment doesn't take place and companies' revenues fall. They will then reduce production and lay off workers. A similar line of reasoning is that consumers may delay spending because they expect prices to fall further, triggering analogous reductions in output and employment. Additionally, falling prices make the real value of debt more onerous for borrowers.²⁷ Such fears have led many economists to warn that if expansionary or "re-inflation" policy is not taken, then the economy will fall into a so-called deflationary spiral.²⁸ As an examination of the theoretical and historical evidence will show, these fears are overblown.

5.2 Theoretical Critique

On the theoretical level, there does not seem to be anything inherent to the nature of deflation that would cause recessions. As has been observed by many Austrian economists, any quantity of money will suffice to meet all the needs of the market.²⁹ In other words, the economy will merely adjust prices such that money continues to service all exchanges. The problem of stickiness is overestimated

27 Claudio Borio et al., *The Costs of Deflations: A Historical Perspective*, BIS QUARTERLY REVIEW 31, 31 (March 2015).

28 JÖRG GUIDO HÜLSMANN, DEFATION AND LIBERTY 7 (The Ludwig von Mises Institute 2008).

29 *Id.* at 24.

and largely due to the government in the first place. Deflation is a monetary phenomenon; thus, it does not affect the wealth of society as a whole. Massive price drops would not change our ability to meet our daily needs because, as Hülsmann elegantly articulates, “the disappearance of money is not paralleled by a disappearance of the physical structure of production.”³⁰ The key as far as wealth is concerned is the relative difference in prices, not their nominal level. The fact that deflation does not necessarily entail an aggregate decrease in wealth, however, should not be confused with money neutrality. Indeed, the main change brought about by deflation is not recession but rather a shift in the structure of ownership and redistribution of resources. This restructuring takes place based on how heavily different firms or households relied on debt. Firms that relied heavily on debt will go bankrupt because they will not be able to repay these debts as their revenue has been reduced by decreases in prices. The same will be true of private households with excessive debt. This isn’t inherently good or bad, this simply means that different people own companies or houses.³¹ So, while property ownership is shifted, there is not an aggregate reduction in wealth.

5.3 Evidentiary Critique

There are four types of deflation: growth, confiscatory, cash-building, and bank credit. The first three of these

30 *Id.* at 25.

31 *Id.* at 26-27.

are less relevant to the monetarist hypothesis but examining them still helps to illustrate that deflation is not inherently bad. Growth deflation is simply the deflation brought on by the increased competition from an increased supply of goods. The historical coexistence of economic growth and deflation has substantial evidentiary backing. This type of deflation was the norm throughout the nineteenth century in industrialized nations under the classical gold standard.³² Or consider the example of 1876-1879 from the post-Civil War United States. The money stock had fallen by roughly 8.6 percent and the prices fell by just shy of 4 percent. Despite this deflation, real output was growing at a clip of 5.20 percent per year, a rate that greatly outstripped the average for the period of 1876-1913.³³ In short, deflation hardly seems to be a death knell for economic growth. Confiscatory deflation deals with the direct confiscation of cash balances by the government and is rarely—if ever—witnessed.³⁴ Cash-building deflation refers to people increasing their cash balance held in physical currency. Stated another way, bank depositors could convert their deposits into physical cash and hold onto it for use in the future. It is a voluntary market process that consequently satisfies peoples' preferences. Specifically, it can help people improve their liquidity position as their expectations of the future become more pessimistic or uncertain. This form of deflation doesn't

32 SALERNO, *supra* note 26, at 84.

33 *Id.* at 95.

34 *Id.* at 96.

affect the real wage rate, but rather only nominal prices, leading to the conclusion that it is not a threat to economic welfare.³⁵

Finally, there is bank credit deflation, in other words, a contraction of the fractional-reserve bank credit. Such a contraction may be brought on either by bank runs or contractionary monetary policy. To take the first case, bank runs reflect depositors' lost faith in banks' ability to redeem notes and demand deposits. Since this is a voluntary process, it satisfies peoples' preferences. Banks that claim to be trustworthy guardians of depositors' wealth should be purged from the market if they fail to live up to these promises.³⁶ To be even more specific, if such institutions extend credit beyond real savings in ways that do not satisfy people's time preferences, then it is not in the interest of the market to allow such institutions to continue to operate. Not only is the elimination of such banks necessary to liquidate malinvestment and correct for the boom, but historically such periods of bank deflation had relatively mild effects on real output. Indeed, before the 1930s, Salerno notes that "bank credit deflations in the U.S. were swift and devoid of severe economic dislocations."³⁷ For example, in 1839 the money supply fell by a third as nearly a quarter of the nation's banks collapsed. Despite massive deflation, real consumption increased and only

35 *Id.* at 85-86.

36 *Id.* at 86-87.

37 *Id.* at 87.

investment decreased to correct the malinvestments of the boom. Today, government impositions like price controls and minimum wage requirements make prices stickier and hence make such adjustments more difficult.³⁸ We must note, however, that it is government intervention and not the deflation that is at fault in forestalling adjustment.

The second case of bank credit deflation caused by contractionary monetary policy has similar effects. Salerno notes that such deflation merely results in the destruction of “pseudo titles” and is thus no less damaging to economic well-being than eliminating counterfeit titles. Such monetary policy merely hastens the realization of the scam enabled by credit expansion.³⁹ Consider the case of the depression of 1920-21. In 1915-19 the Fed stimulated massive credit expansion and inflation to finance WWI. Recognizing this as a problem, the Fed raised discount rates in December 1919, January 1920, and June 1920. As a result, the money stock growth rate decreased to only 2.9 percent in 1920 and then fell further to -7.5 percent in 1921. The Depression was shockingly brief, however, lasting only 18 months. The market experienced intense deflation but recovered quickly.⁴⁰ This is consistent with the idea that the Fed merely accelerated the realization of the malinvestment of the boom.

38 *Id.*

39 *Id.* at 88.

40 *Id.* at 89.

Finally, recent empirical work seems to back up the argument that deflation does not cause recessions. Economists at the Federal Reserve Bank of Minneapolis have concluded that there is no link between deflation and depression. The only period for which they could find any such evidence was the Great Depression and even then, the evidence was far from overwhelming. Indeed, they found that 90 percent of episodes with deflation did not have depression associated with them.⁴¹ The basic conclusion of all this analysis seems is that the primary evil pointed to in the monetarist hypothesis of the Great Depression (i.e. deflation) is far from being universally bad.

6. Credit Expansion and Unsustainable Growth

The final defect of the monetarist hypothesis is the assumption that the growth of the roaring twenties was sustainable. Monetarists claim banks were engaging in perfectly normal behavior and there was nothing uniquely wrong. The historical account, however, does not align with this narrative. To begin with, the money stock dramatically increased during the period of the 1920s. According to Benjamin Anderson, there were two major episodes of monetary expansion in 1924 and 1927. The Fed purchased several hundred million dollars in government securities each of these years. Unsurprisingly the excess reserves this

41 Andrew Atkeson & Patrick J. Kehoe, *Deflation and Depression: Is There an Empirical Link?*, 94 AMERICAN ECONOMIC REVIEW 99, 100-101 (2004).

gave banks enabled billions of dollars of credit expansion by banks.⁴² Bank deposits increased by \$13.5 billion, and investments and loans rose by \$14.5 billion, numbers that dwarfed the credit expansion required to finance the United States' participation in WWI.⁴³ In defending Murray Rothbard's account of the inflation of the 1920s, Salerno offers similar statistics. Using Rothbardian definitions, the money stock increased by 61 percent from mid-1921 to 1928, resulting in an annual monetary inflation rate of 8.1 percent each year. Even using a restrictive definition, the money stock increased by 55 percent, an annual rate of 7.3 percent.⁴⁴ This credit expansion did not represent a decrease in people's actual time preferences and consequently was not representative of an increase in real savings. What is particularly interesting is that studies by mainstream economists have backed up the claim that bank failures were not merely due to irrational depositor fears resulting in a liquidity crisis. Rather, the wave of bank failures can be pointed to as resulting from changes in the fundamentals of bank health, including weaknesses in banks' portfolios and liability structures.⁴⁵ In short, rather than being a purely monetary liquidity crisis, the Great Depression and the

42 BENJAMIN ANDERSON, *ECONOMICS AND THE PUBLIC WELFARE: FINANCIAL AND ECONOMIC HISTORY OF THE UNITED STATES, 1914-1946*, 128 (D. Van Nostrand Company 1949).

43 *Id.* at 134.

44 SALERNO, *supra* note 26, at 428.

45 Charles W. Calomiris & Joseph R. Mason, *Fundamentals, Panics, and Bank Distress During the Depression*, 93 *AMERICAN ECONOMIC REVIEW* 1615, 1615 (December 2003).

monetary contraction that accompanied it seem to be traceable to worsening bank health which is a natural byproduct of extensive credit expansion.

7. Conclusion

In summation, monetarists believe that recessions like the Great Depression are the result of monetary contractions which result in significant deflation. The claims of Friedman and Schwartz are largely empirical, as evidenced by their lack of thorough methodology. Unfortunately, their hypothesis lacks the necessary understanding of capital and the production process to recognize many of the key features of the boom-bust cycles. Furthermore, monetarists' fear of deflation is not supported by solid theoretical reasoning or the corpus of historical evidence. Finally, monetarists ignore the evidence of significant credit expansion and the deterioration of bank health which point to malinvestment financed by the boom of the 1920s as the cause of the Great Depression. In short, while monetarists can be respected for their substantial contributions to economic thought, their theory of recession must be abandoned.