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Was Expansionary Monetary Policy Feasible during the Great Contraction? An Examination of the Gold Standard Constraint

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The recent consensus view that the gold standard was the leading cause of the worldwide Great Depression 1929–1933 stems from the two propositions: (1) Under the gold standard, deflationary shocks were transmitted between countries and, (2) for most countries, continued adherence to gold prevented monetary authorities from offsetting banking panics and blocked their recoveries. In this article we contend that the second proposition applies only to small open economies with limited gold reserves. This was not the case for the United States, the largest country in the world, holding massive gold reserves. The United States was not constrained from using expansionary policy to offset banking panics, deflation, and declining economic activity. Simulations, based on a model of a large open economy, indicate that expansionary open market operations by the Federal Reserve at two critical junctures (October 1930 to February 1931; September 1931 through January 1932) would have been successful in averting the banking panics that occurred, without endangering convertibility. Indeed had expansionary open market purchases been conducted in 1930, the contraction would not have led to the international crises that followed. © 2001 Elsevier Science

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1. INTRODUCTION

A much-debated hypothesis about the Great Depression is Friedman and Schwartz's (1963) contention that a severe but not unusual U.S. recession turned into the greatest contraction of all times because the Federal Reserve failed to undertake expansionary open-market operations. Controversy about the role of monetary factors in causing the Great Depression in the United States was a feature of the earlier literature, but the consensus of current literature is that monetary shocks (produced largely by a series of banking crises) played a major role in prolonging and deepening the Great Depression.[1]

International aspects of the Great Depression have also been the focus of attention in recent studies. Research on international experience shows conclusively that the countries that left the gold standard early suffered a less severe Depression than those that stayed on.[2] The international transmission of the Great Depression occurred for two key reasons. First, fixed exchange rates under the gold standard transmitted adverse shocks from one country to another. Second, commitment to the gold standard deterred countries from pursuing expansionary monetary policies to counteract these shocks.[3] This view of the transmission mechanism is supportive of the Friedman–Schwartz hypothesis insofar as it helps explain how banking panics in the United States could have produced a worldwide depression. However, this view also suggests that gold standard constraints might have prevented the Federal Reserve from increasing high-powered money sufficiently to offset decreases in the money stock induced by banking crises. A policy of expanding domestic credit to stabilize the stock of money might have aroused doubts about U.S. commitment to the gold standard and led to a loss of gold reserves. Eichengreen (1992) argues that the loss would have been sufficiently large to force the United States off the gold standard.

His argument points to the imperatives of the international gold standard rather than ineptness of the Federal Reserve as primarily responsible for not averting the Great Depression. For Friedman and Schwartz (1963), however, the Federal Reserve held so large a stock of gold that even had such a loss occurred, it would not have posed a serious threat to the U.S. commitment to the gold standard.

Although there is considerable interest in this issue, little empirical work exists on estimating the loss of gold reserves that might have resulted, had the Federal Reserve undertaken expansionary monetary policy to offset the banking panics

[1] For a recent review of the causes of the U.S. Depression, see Romer (1993).

[2] See, for example, Choudhri and Kochin (1980), Eichengreen and Sachs (1985), Bernanke and James (1991), and Bernanke (1995).

[3] Eichengreen (1992) documents the case of the central European countries (Austria, Germany, and Hungary), each of which in the summer of 1931 suffered banking crises. When the monetary authorities attempted to use expansionary policy to allay the banking crises, their currencies were subjected to speculative attacks, forcing them to abandon unrestricted convertibility to gold. Belgium in 1935 was forced off the gold standard under similar conditions.