KRUGMAN VERSUS FRIEDMAN: MONETARY POLICY, 1929–1933, A NOTE

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Abstract

In a retrospective on Milton Friedman, Paul Krugman is critical of Friedman's remarks on monetary base changes in the early years of the Great Depression. Krugman emphasizes that the monetary base did increase by about one billion dollars from 1929–1933, thereby implying the Fed was pursuing an expansionary policy. The purpose of this comment is to clarify monetary base analysis in this period. More specifically, two common misconceptions in regard to the monetary base are discussed: first, that changes in the base are a reliable indicator of the stance of Fed policy, and secondly that the Federal Reserve exercises absolute control over changes in the base.

Keywords: Monetary base, Monetary policy, Great Depression, Friedman and Schwartz, Bank failures

I. Introduction

In a recent retrospective on Milton Friedman in this journal, Ramrattan and Szenberg (2008, 27), refer to an issue raised by Paul Krugman (2007, 29) concerning the early years of the Great Depression. Krugman emphasizes that the monetary base increased by almost one billion dollars between 1929 and 1933. According to Krugman, such an apparent expansionary policy raises the question as to what level of blame can be assigned to the Federal Reserve for the huge decline in the M2 money supply in this period. Despite a convincing rebuttal to Krugman's analysis by Nelson and Schwartz (2008, 850–852), Krugman responded with the same simplistic monetary base analysis (2008, 857–858) that was in his original critique (2007).

II. Monetary Base Issues

There is often a lack of critical analysis concerning changes in the monetary base (MB). Use of the concept by many economists starts with the proposition that changes in the base are under the direct control of the Federal Reserve, and therefore are a good indication of the stance of monetary policy (Krugman, 2007, 28). Rarely is this simplistic approach reconciled with the fact that currency is the major component of the base, and its quantity is determined by customer demand. Krugman ignores the fact that the main reason for the MB increase in the 1930–1933 period is that cash demand increased as bank failures scared customers away from deposits. Such an MB increase is a sign of a banking system in crisis – not expansionary Fed policy.

Simplistic monetary base analysis can be very misleading unless several major qualifications are recognized. First and foremost, what really matters are the relative changes in the two components of the base.[1] Increases in currency demand (taken from bank deposits) have no effect on the money supply, assuming the associated reserve drain is neutralized by increases in Federal Reserve credit. On the other hand, changes in the reserve component of the base can have powerful multiplier effects on the money supply, estimated at a multiplier of about 15–18 for the early 1930's (Stauffer, 2000). Of course, during the bank panics of the early 30's, cash drain put severe pressure on reserve levels while Federal Reserve credit increases did not restore bank reserves.

A second major qualification involves the degree of control which the Fed has over the MB and its components. MB apostles often assume that the Fed's control over the MB is absolute, since

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open market operations can be relied upon to change the MB as desired. In reality, many factors can change the MB, or the composition of the MB, and the issue then becomes whether or not the Fed chooses to neutralize those influences. In addition to cash drain induced by bank failures, another good example of this is from the first year of the Great Depression (August 1929–September 1930): the MB fell by over $300 million due mainly to a decline in bank borrowing via discounted bills (F&S 1963, 340–341).

III. Krugman Versus Friedman

Paul Krugman's (2007, 29) criticism of Friedman is justifiable in a narrow sense. Friedman made what may appear to be a serious misstatement in his famous 1967 presidential address to the AEA; arguing that ". . . . . the Federal Reserve System forced or permitted a sharp reduction in the monetary base, because it failed to exercise the responsibilities assigned to it." This could be viewed as a half-truth; the MB did increase for the whole 1929–33 period, but it fell by 4.6% in the first year of the downturn. However, Friedman did not specify an exact time period in his AEA address, and according to Nelson and Schwartz (2008, 850) Friedman was referring to the time period from April 1928 to October 1930 when the MB did fall by about 5%. Krugman is perhaps a little too eager to indict Freidman for his inexact statement in order to further his agenda in his debate with Friedman concerning the general role of government. According to Krugman (2007, 29), this is an example of how "Friedman's assertions grew cruder". However, Krugman is the one who is very willing to limit his remarks solely to the issue of MB growth in this debate. This is a crude oversimplification of the reality of monetary events in this period.

As noted above, the MB did fall by 4.6% in the crucial first year of the downturn (August 1929–September 1930), before the first wave of bank panics. Bank reserves fell by $41 million, despite an inflow of currency as the public reduced its demand for cash by $285 million. The dominant contractionary force on the MB was a drop in bills discounted by larger banks, as cash inflows and deposit shifts from smaller banks lowered their demand for borrowed funds from the discount window. The Fed remained passive as total reserves fell and as the effective reserve requirement increased.[2] The result was a drop in M2 of $1.2 billion, helping to weaken smaller banks and setting the stage for the first wave of bank failures in September 1930. This M2 decline was the first step onto the slippery slope of monetary meltdown via widespread bank failures, yet Krugman dismisses the underlying MB decline as one of the ". . . episodes along the way in which the monetary base fell modestly for brief periods" (Krugman, 2007, 29).

The F&S indictment of passive Federal Reserve policy in the Great Depression will always be controversial because it involves "what if" or counterfactual arguments.[3] However, one issue is very clear: changes in the MB are just one piece of a very complex monetary puzzle. To emphasize aggregate MB changes, while ignoring its component changes or the reasons behind those changes is a disservice to critical analysis of monetary issues.

Notes

1. Nelson and Schwartz (2008, 852) provide an analysis of this issue in their rebuttal to Krugman. They emphasize that the Fed can always "expand its total balance sheet" to offset the drain on reserves created by increased currency demand.
2. Deposits and loans at larger member banks were increasing in this period, at the expense of deposits and loans at smaller (country) member banks and non-member banks – both of which had lower legal reserve requirements. To the extent the Fed was preoccupied with conditions at larger member banks, a perception of monetary ease would have resulted (Stauffer, 2000, 66).
3. It is interesting to note that the very first critique of F&S (1963) was the NBER's Director's comment by Albert J. Hettinger, Jr. which was an appendix to *A Monetary History. . . . .* (pp. 809–814). The topic he chose to emphasize was whether or not alternative Federal Reserve policies in the early years of the Great Depression could have prevented a collapse of the monetary system.

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