John H. Schnatter Institute for the Study of Free Enterprise

RESEARCH SUMMARY

Interwar Price Level Targeting

James S. Fackler, University of Kentucky
Randall E. Parker, East Carolina University

Fackler and Parker argue that the Great Depression may have been preventable with a formalized policy rule proposed by economist Irving Fisher. Policymakers have an ongoing debate about whether formalized policy rules are better than discretionary policy decisions for economic outcomes. The authors' analysis suggests that in the case of the Great Depression, if Fisher's policy rule had been adopted in 1930 the collapse of the economy would have been avoided.

In the 1920s Irving Fisher believed that the major cause of economic disruption was price variability, which could be fixed with price level targeting. As early as 1922, Congressman T. Alan Goldsborough had proposed a bill that would have made price level targeting a formal Federal Reserve policy. Fisher developed a policy by the early 1930s that would have:

- Quickly raise deflated prices,
- Maintain this price level within reason, and
- If needed, change the price of gold.

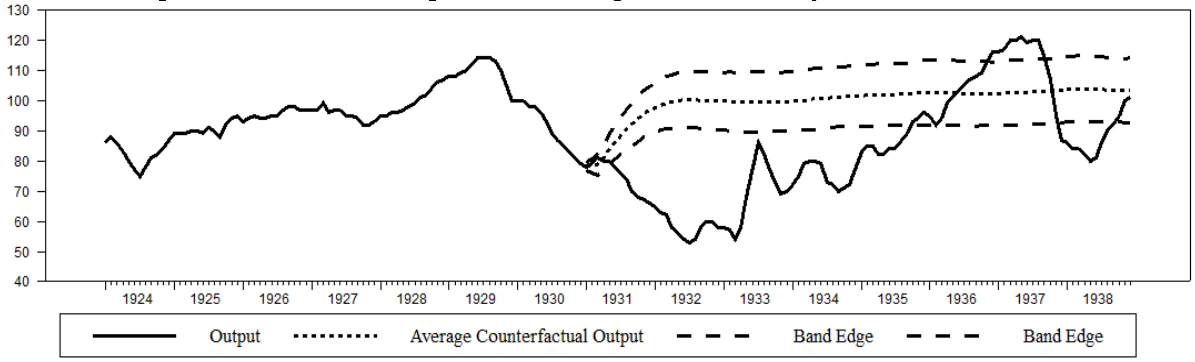
These policy changes could have been implemented by controlling the supply of money in the economy—increasing or decreasing the amount of currency in circulation. However, this legislation (after passing in the House 289-60 in 1932) died in the Senate under one of the main authors of the Federal Reserve Act.

Fackler and Parker use a selection of monetary data along with time series techniques to model the effect of Fisher's policy change before the Great Depression. While modern statistical techniques are used, the authors argue that Fisher's plan could have been implemented at the time using money supply (M2) to target a desired price level. If this had happened, the economy would likely have avoided the Great Depression—see the figure, which shows actual output, output as it would have evolved under the plan, and confidence bands around the estimated path of output.

For more information, contact:
Dr. James S. Fackler
Department of Economics
University of Kentucky
eco134@email.uky.edu

UKSchnatterInstitute@uky.edu, (859) 213-6604
Schnatter Institute at the University of Kentucky
334 Gatton College of Business and Economics
Lexington, KY 40506-0034
www.schnatterinstitute.org

Historical Output vs. Predicted Output from Irving Fisher's Policy Rule



Note: Output is the historical measure of industrial production.