University of Kentucky

Gatton College of Business and Economics

Institute for the Study of Free Enterprise

Interwar Price Level Targeting

- **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**

While the causes of the Great Depression have been hotly debated among economists for over three-quarters of a century, attention has turned recently to what was known about policy mistakes at the time. 2 For example, Tavlas (2011) presents evidence that contemporary economists predicted in advance that Federal Reserve policies had the potential to lead to the Depression. Here, we analyze the viewpoint, current in the period leading to the Depression and due in part to Knut Wicksell and Irving Fisher, that price level instability is the major cause of economic disruption and price level targeting is the cure. Specifically, we evaluate a policy proposal, due to Fisher, designed to reflate the Depression-era price level to the level that prevailed in the prior decade. To do so, we undertake a counterfactual econometric analysis of the monetary policy regime proposed by Fisher, a policy of price level targeting consistent with legislation introduced by Congressman T. Alan Goldsborough as early as 1922. Our results suggest that Fisher's proposed implementation of the key elements of the Goldsborough Bill would have likely prevented the Great Depression.

Counterfactual examinations of the evolution of the economy under alternative policies have been presented by McCallum (1990) and by Bordo, Choudhri, and Schwartz (1995). Using quarterly data, McCallum argues that a monetary base rule, and Bordo, Choudhri, and Schwartz that an M2 constant growth rate rule, would have produced GNP paths that would have largely or completely avoided the Depression. Fackler and Parker (1994) offer similar results using monthly data, including industrial production and M1.

The counterfactual analysis below contains several distinct differences from prior studies. First, our point of departure is the attention paid to price level targeting as a policy rule. Wicksell (1898) proposed such an approach, which was subsequently implemented in Sweden in the 1930s. In the United States, price level targets for monetary policy were also well known, as evidenced by literally dozens of bills introduced into Congress to charge the Federal Reserve with pursuing such targets. Second, as part of the Congressional Record, Fisher (US Government Printing Office 1932) described in detail how such a policy could be undertaken. We implement his methodology as closely as possible. Third, since national income accounting was in its infancy, the results of McCallum (1990) and Bordo, Choudhri, and Schwartz (1995) using GNP as the output variable, while suggestive in retrospect, could not have been used in the implementation of Fisher's scheme. However, since monthly data already existed for industrial production, we use this output metric rather than GNP. Our analysis, using our approximation to Fisher's explicit policy roadmap and data concepts available at the time, comes as close as we think possible to an examination of whether the alternative policy of targeting the price level would have produced an output path avoiding the Depression. Our results not only strengthen the Bordo, Choudhri, and Schwartz (1995) and McCallum (1990) conclusions, but also demonstrate that knowledge was available at the time that could have prevented the most cataclysmic period in US economic history.

The US economy experienced periods of substantial price instability during the interwar period, 1919–39. Deflations after World War I (WWI) and during 1929–33 were accompanied by substantial economic downturns. The deflation after WWI was a return to the antebellum price level after the wartime inflation, and many observers at the time saw the deflation of 1920– 21 as a necessity for the eventual restoration of the international gold standard. Thus, the recession of 1920–21 was but a short economic disruption after the tumult of WWI. In addition, many also considered the deflation of 1920–21 to be the first independent test (in the sense of not having to accommodate wartime finance concerns) of the Federal Reserve System, which the Federal Reserve was perceived to have passed convincingly (Friedman and Schwartz 1963; Eichengreen 1992). However, after approximate price stability throughout the remainder of the 1920s, the deflation of 1929–33 did not have such universal agreement regarding its origins or necessity and opinions on policy responses differed widely.