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1-1-1976

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Hyman P. Minsky Ph.D.

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Recommended Citation

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"DID MONETARY FORCES CAUSE THE GREAT DEPRESSION?" by Peter Temin

New York, W.W. Norton & Co. Inc., 1976 pp. xiii, 201 $8.95

From the title of this little book by Peter Temin of M.I.T. one has a right to expect an exploration of the causes of the Great Depression, with special emphasis on monetary and financial relations. Instead one gets a narrow academic exercise which uses data from the Great Depression to test the relative validity of two currently fashionable views: the "Money hypothesis", identified with the "monetarism" created by Friedman and Schwartz, and the "Spending hypothesis", as embodied in the "econometric" modeling due largely to Klein. Neither hypothesis really passes the tests, although the money hypothesis is so riddled by Temin's textual criticism and tests that the spending hypothesis survives as the more plausible explanation. Temin does not use the poor performance of the two theories he tests to introduce and examine alternative theories. As a result of this limitation the volume is of little value either as an explanation of the Great Depression or as a guide to the understanding of our economy in our time.

The volume has one virtue. It effectively disposes of the claim that monetarist doctrines are validated by evidence drawn from the Great Depression. Inasmuch as monetarist doctrines are taken seriously as a guide to current policy -- witness the recent attempt by Congress to legislate "the money supply" as an economic steering

wheel -- the puncturing of the myth that monetarism has a scientific basis due to its ability to explain history is valuable.

We have just gone through the most serious slump since World War II and the most trying period of financial disturbances since the Great Depression. If we allow for the special way in which the Federal Reserve System and the Federal Deposit Insurance Corporation treated the Commonwealth Bank of Detroit, four billion plus dollar banks failed over the years 1973-75. The recent record of losses and failures by larger banks is at least on a par with the experience in the first years of the thirties. In addition during 1973-75 a twenty billion dollar financial industry, the Real Estate Investment Trusts (REITs), lost its ability to sell debt in the market. Wholesale overt bankruptcy among the REITs was averted by the covert bankruptcy of debt restructuring. As a result of financial developments over 1973-75 which affected REITs, real estate, municipal governments, developed countries, and giant corporations, banking and financial institutions remain weakened even as an election year boomlet is taking place. The weakness of the financial structure is evident by the pace of bank failures: during the first five months of 1976 five commercial banks failed.

In the last half of 1974 and the first part of 1975, as the economy was plunging into a deep recession and as various financial difficulties were becoming "public knowledge" many feared that the sky was about to fall: that we were about to have a financial collapse

and another great depression. However the sky did not fall. The financial shocks were absorbed and the decline in income and the rise in unemployment were contained. The financial system and the economy exhibited "resiliance." A comparison of the debt-deflation, deep-depression of the 1930s and the financial-resiliance, contained-recession of 1973-75 is very much in order. Why a debt-deflation Great Depression took place in the 1930s and not in the 1970s is an important current question, especially as the temper of the times indicates that another age of reform may be dawning.

A first step toward answering this question is to develop, in the light of current theory about the workings of our economy, an understanding of the 1930s that may be relevant to our day. By title and by the claims of the dust jacket blurb it can be inferred that Temin addresses this problem. Unfortunately because of his narrow conception of the task and the limited scope and context of economic theory that he considers, Temin does not deliver upon the promise of his title and blurb.

Mainline, or neoclassical, economic theory has two branches: a "monetarist" school identified with Friedman and Schwartz and a "spending" school identified with econometric models as developed first by Klein. These two branches of standard theory lead to different views of the proximate cause of the Great Depression. The "monetarist" view emphasizes the level, rate of change, and rate of change of the rate of change of the money supply as the cause of business fluctuations.

The "monetarist" view of the Great Depression is that an inept Federal Reserve restricted the growth of the money supply so that otherwise innocent banks were forced into bankruptcy. In the "monetarist" view bank failures were critical in transforming a normal modest business cycle into the deep depression because bank failures were an essential step in the process by which the money supply fell.

To the spending school, which Joan Robinson aptly identifies as a "Bastard" Keynesianism, the depth of the depression is most usually laid to the exhaustion of investment opportunities and in particular to an overbuilding of housing. The peculiarity of the Klein approach, and this has continued to the current generation of econometric models, is that monetary and financial variables are either ignored or incorporated in naive and highly formalistic ways. In Temin's interpretation of the Klein school a "large" prior autonomous decline in investment or other dimensions of spending is necessary to cause the Great Depression. Temin does not find such a large prior decline in investment -- he does find that consumption in 1930 was lower than can be explained even after allowing for the stock market crash of October 1929. Thus Temin, who comes down on the side of the relative virtue of the spending hypothesis, explains the depression by an autonomous (i.e., unexplained) fall in consumption.

By using the spending and "monetarist" models as the outer limits of the spectrum of theoretical explanations to be tested Temin assures that his book will be of limited value. These two sets of

models are but variants of the neoclassical theory. Professor Temin is undoubtedly aware of the controversy over capital theory in which a number of his colleagues at M.I.T. participated. As a result of the controversy the logical basis of fundamental premises and constructs of neoclassical economics were undermined. It is now recognized that neoclassical theory has but limited relevance for an understanding of how our economy develops over time. Inasmuch as understanding the Great Depression or why the sky did not fall in '75 are not exercises in abstract theory but rather are problems of a flesh and blood economy, we can expect that neoclassical theory will not be able to explain what happened.

There are various serious formulations of how our economy works which are not neoclassical in their basic premises and which can easily incorporate the financial relations so important in the great depression. Inasmuch as some post-Keynesian models -- those of J. Robinson and P. Davidson come to mind -- explicitly account for capital-assets, financing, time, and uncertainty they offer a better framework for the analysis of the Great Depression than either the econometric or the "monetarist" models. The post-Keynesian framework for the analysis of cyclical behavior is much closer to the views on the causes of the Great Depression put forth in the 1930s by H. Simons, I. Fisher, A.G. Hart, E. Clark, and J.M. Keynes than either of the explanations considered by Temin. Even if Temin chose to ignore the work of his contemporaries who look beyond the narrow confines of

neoclassical theory his work would have been much stronger and much more relevant to an understanding of real work phenomena if he had considered the explanations of the "ancients".

Temin's work is further flawed because he accepts the Friedman-Schwartz definition of monetary forces as dealing with the path of the money supply and Klein's formulations of the spending hypothesis which ignores money, banking, and the financial structure. In our economy monetary forces encompass much more than the money supply and any serious formulation of the determinants of spending needs to consider financial relations. It was Keynes who emphasized that our economy is characterized by a system of borrowing and lending based upon various margins of safety and that borrowing finances demand. For our economy an apt definition of monetary forces necessarily encompasses the various dimensions of the "system of borrowing and lending", in particular the current payment commitments due to past decisions.

In particular, in a world with banking, the liability structures by which positions in assets are financed is a monetary force. Any serious inquiry into whether monetary forces caused the Great Depression requires a thorough investigation of the evolution of debt structures -- including the proliferation of new institutions with novel instruments and the consequent layering of debts -- during the 1920s and how this changing debt structure affected the domain of stability of the financial system. In the era since World War II,

the susceptibility of the economy to financial disturbances, so evident in the past decade, can be associated with an increase in the layering and complexity of debt structures. Thus to do better than either the money hypothesis and the spending hypothesis does in explaining the Great Depression, the scope of the inquiry has to include a wider spectrum of data and theories than Temin considers.

In the course of his analysis Temin shows that the interest rate data used by analysts of the Great Depression underestimates the effective rise in interest rates because a systematic downgrading of bond ratings took place during the contraction. This contribution by Temin could be integrated into the spending hypothesis. In fact Temin's analysis of effective interest rates is strong evidence for the interpretation of Liquidity Preference advanced by Keynes in his 1937 explication of _The General Theory_.

The downward shift in quality rating, as well as an increase in the differentials in interest rates between risk classes, of bonds that Temin shows took place means that the price of outstanding bonds fell. Inasmuch as the published interest rate series is for bonds of a constant high quality, the published series underestimates the fall in bond prices for those periods in which bond quality ratings are downgraded. In a capitalist world capital-assets owned by firms are best considered as if they were a type of bond -- with risk characteristics which depend upon the forecasts of future cash flows from operations. In an era when risk premiums are bing increased and "bonds"

are being systematically reclassified into "riskier" classes, the risk premium upon and the risk class of capital-assets would change so that the price of capital-assets would fall relative to the price of bonds and other at least partially protected assets. As a result the demand price for investment output will fall relative to both the price of bonds and the price of current output. Thus Temin makes a contribution to a study of how monetary forces affect the generation of income in a world of uncertainty, but this contribution is hidden because it has meaning only within theories of how our economy functions which lie outside the scope of the models he examines.

Throughout his volume Temin looks for a "big cause" to explain a "big result". However in a world where the domain of stability of the financial structure is determined by the extent and complexity of the debt structure, periods such as the 1920s and 1950s in which private debts grow relative to private incomes and secure financial assets will lead to a marked decrease in the stimuli needed to trigger an unstable reaction. The major initial impact of the unstable reaction will be in the relative prices of financial assets, capital-assets and current output. The full power of monetary variables in our economy is revealed only within a framework of the economy which integrates a broad definition of monetary forces with spending behavior.

Thus Temins book is worth considering by a professional not for its positive contributions but rather for the shortcomings it reveals in the explanatory power of both the conventional money and the

standard spending hypothesis. To a user of economic analysis, Temins book is valuable for it explodes the pretentions of monetarism as a "scientific" explanation of the Great Depression. These are minor virtues but nevertheless virtues.

Hyman P. Minsky
Department of Economics
Washington University
St. Louis, Missouri