

ECONOMIC HISTORY THEORY

A Monetary History of the United States, 1867-1960: A Technical and Analytical Deep Dive into Monetarism

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The publication of **A Monetary History of the United States, 1867-1960** by Milton Friedman and Anna J. Schwartz in 1963 represents one of the most significant intellectual shifts in 20th-century economic thought. Prior to its release, the prevailing Keynesian orthodoxy suggested that money was a secondary factor in economic fluctuations, often relegated to the role of a passive variable that merely responded to changes in investment and government spending. Friedman and Schwartz, through an exhaustive empirical study of nearly a century of American economic data, fundamentally challenged this notion, arguing instead that changes in the **money supply** are the primary drivers of price levels and real economic activity.

The Theoretical Framework: The Quantity Theory of Money Reimagined

At the heart of the technical analysis presented in the book is a sophisticated restatement of the **Quantity Theory of Money**. While the classical version of the theory focused on the direct relationship between money and prices, Friedman and Schwartz provided a more nuanced interpretation involving the demand for money as a stable function of several variables.

The Equation of Exchange

The operational framework relies on the identity **$MV = PY$** , where:

- M represents the nominal money supply (currency plus bank deposits).
- V represents the income velocity of money (the rate at which money changes hands).
- P represents the price level (the GDP deflator or CPI).
- Y represents real output (Real GDP).

Friedman's central thesis was that **V (Velocity)** is not a constant but a stable and predictable function of a few key economic variables, such as interest rates and the expected rate of inflation. Because V is stable, fluctuations in M (the money supply) are the dominant cause of fluctuations in nominal income (PY). If output (Y) is at its long-run potential, changes in M manifest almost exclusively as changes in P (inflation or deflation).

Technical Methodology and Data Reconstruction

One of the book's greatest achievements is its meticulous reconstruction of historical time series data. In the mid-20th century, consistent data for the money stock prior to 1914 was largely unavailable. Friedman and Schwartz utilized archives from the **National Bureau of Economic Research (NBER)** to build a monthly and annual series for the components of the money supply, including:

1. Specie: The amount of gold and silver in circulation and held in bank reserves.
2. Currency in Circulation: Notes issued by the Treasury and, later, the Federal Reserve.
3. Bank Deposits: A distinction between demand deposits (checking) and time deposits (savings), leading to the definitions of M1 and M2.

By analyzing the ratios of deposits to currency and deposits to reserves, the authors were able to identify whether shifts in the money supply originated from government policy, bank behavior, or public preference.

The Great Contraction (1929-1933): A Decisive Turning Point

The most famous and controversial section of the book is the analysis of the **Great Depression**, which Friedman and Schwartz termed the "Great Contraction." Contrary to the then-standard view that the Depression was an inherent failure of the capitalist market system or a result of autonomous investment declines, they argued it was the result of a catastrophic failure of the **Federal Reserve System**.

The Mechanics of the Collapse

Between 1929 and 1933, the quantity of money in the United States fell by approximately **one-third**. The authors identified four distinct waves of banking panics that the Fed failed to mitigate. In a technical sense, the Fed failed in its role as the **Lender of Last Resort**. Instead of injecting liquidity into the system to offset the public's desire to hold cash (which reduced the deposit-to-currency ratio), the Fed remained passive, and in some cases, actively tightened policy.

Determinants of the Money Stock (1929-1933)

Factor	Impact on Money Supply	Technical Description
High-Powered Money (Base)	Moderate Increase	The Fed did increase the monetary base slightly, but not nearly enough to offset internal drains.
Deposit-Currency Ratio	Massive Decrease	Public lost faith in banks, converting deposits to cash, which shrank the money multiplier.
Deposit-Reserve Ratio	Significant Decrease	Banks held more excess reserves out of fear, further contracting the money supply.

The technical conclusion was that the economic downturn turned into a "Great Contraction" because of the collapse of the banking system and the resulting shrinkage of the **M2 money stock**, which starved the economy of liquidity.

The Role of Gold and International Constraints

Friedman and Schwartz also examined the constraints of the **International Gold Standard**. They analyzed how gold flows influenced the domestic money supply. Under a fixed exchange rate system, an inflow of gold would technically increase the monetary base. However, they noted that the Federal Reserve often "sterilized" these flows-using open-market operations to prevent the gold inflow from expanding the money supply-which contributed to global deflationary pressures.

Comparison of Monetary Regimes

Era	Monetary Standard	Primary Driver of M	Volatility Level
1867-1879	Greenback Era	Government Policy (Fiduciary)	High (Post-War Adjustment)
1879-1914	Gold Standard	Gold Flows / Bank Behavior	Moderate (Frequent Panics)
1914-1933	Early Fed Era	Central Bank Policy / Gold	Extreme (The Great Contraction)
1934-1960	Post-Depression	Treasury & Fed Collaboration	Low to Moderate

The 1951 Treasury-Federal Reserve Accord

Another critical technical transition discussed in the book is the **1951 Accord**. During World War II and the immediate post-war years, the Federal Reserve was effectively an arm of the Treasury, committed to pegging interest rates at low levels to minimize the cost of financing government debt. This policy meant the Fed had no control over the money supply; it had to print as much money as necessary to maintain the interest rate peg.

The 1951 Accord restored the **independence of the Federal Reserve**, allowing it to focus on price stability and the control of monetary aggregates rather than supporting the price of government bonds. This shift is presented as a return to the principles of sound monetary management, setting the stage for the relatively stable growth period of the 1950s.

The Monetary Multiplier and Reserve Requirements

Friedman and Schwartz emphasize the technical role of the **Money Multiplier (m)**, defined by the formula $M = m * B$, where B is the monetary base (high-powered money). The multiplier is determined by the behavior of banks (reserve-to-deposit ratio) and the behavior of the public (currency-to-deposit ratio).

- Reserve Requirements: When the Fed increased reserve requirements in 1936-1937, it caused banks to fear for their liquidity. This resulted in a sharp increase in the reserve-to-deposit ratio, which reduced the money multiplier and triggered the recession of 1937-1938.
- Currency Demand: During periods of instability, the public's demand for physical currency rises. Without intervention, this acts as a massive drain on bank reserves, causing a multiple contraction of deposits.

Comparative Analysis: Monetarism vs. Keynesianism

The core of the intellectual debate sparked by the book is the relative importance of **Fiscal Policy vs. Monetary Policy**. The following table highlights the diverging technical views during the peak of the debate:

Feature	Keynesian View (Pre-1963)	Monetarist View (Friedman/Schwartz)
Primary Economic Driver	Aggregate Demand / Fiscal Spending	The Money Supply (M)
Transmission Mechanism	Interest Rates & Investment	Direct Portfolio Rebalancing
Policy Prescription	Discretionary Fiscal Management	Constant Money Growth Rule
Cause of Depression	Low Investment / Lack of Confidence	Contraction of the Money Stock

The Logic of the "Constant Growth Rule"

Based on their historical findings, Friedman and Schwartz argued that human error and the lag in monetary policy effects made discretionary policy dangerous. They proposed that the Federal Reserve should follow a **Fixed Monetary Rule**, such as increasing the money supply at a steady rate (e.g., 3-5% per year) corresponding to the long-run growth of real GDP. This, they argued, would prevent the large-scale monetary shocks that characterized the 1873, 1907, and 1929 crises.

The Policy Lag Problem

Friedman famously identified the "long and variable lags" associated with monetary policy. These lags are divided into two categories:

1. The Inside Lag: The time it takes for policymakers to recognize an economic shock and take action.
2. The Outside Lag: The time it takes for the change in the money supply to actually influence prices and output (estimated at 6 to 18 months).

Because of these lags, Friedman argued that "fine-tuning" the economy often resulted in the policy taking effect at the wrong time, potentially exacerbating the very problems it was meant to solve.

Practical Implementation: Identifying Monetary Shocks

For modern economists and analysts, the lessons from *A Monetary History* are applied through the monitoring of **Monetary Aggregates**. To identify a potential monetary shock, analysts look for deviations in the growth rates of M2 relative to nominal GDP.

Checklist for Evaluating Monetary Health:

- Liquidity Ratios: Are commercial banks increasing their excess reserves at a rate that offsets central bank injections?
- Velocity Trends: Is the income velocity of money shifting due to technological changes (e.g., digital payments) or changes in inflation expectations?
- Real Interest Rates: Are nominal rates low simply because the economy is weak, or is the central bank providing sufficient liquidity?

Case Study: Ben Bernanke and the 2008 Financial Crisis

The influence of Friedman and Schwartz's work was explicitly demonstrated during the **Global Financial Crisis of 2008**. Ben Bernanke, then Chairman of the Federal Reserve and a renowned

scholar of the Great Depression, famously stated at Friedman's 90th birthday: *"Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again."*

In 2008, when the banking system faced a collapse similar to that of 1930, the Fed did not allow the money supply to contract. Instead, through **Quantitative Easing (QE)**, the Fed massively expanded the monetary base to offset the decline in the money multiplier. This technical execution was a direct application of the lessons learned from *A Monetary History*.

Broader Implications for Economic History

The work of Friedman and Schwartz fundamentally altered the study of economic history by introducing rigorous **econometric analysis** and time-series data. It shifted the focus from qualitative descriptions of "business cycles" to the quantitative tracking of monetary variables. Beyond the United States, the methodology has been used to analyze hyperinflations in Europe and the "Lost Decades" in Japan.

While modern central banking has moved toward **inflation targeting** rather than strict money supply targeting, the core principle remains: the central bank is responsible for providing a stable monetary environment. The collapse of the money supply is no longer seen as a symptom of a recession, but as a potential cause of a catastrophe that must be prevented at all costs. The enduring legacy of the book lies in its proof that a sound economy requires a sound currency, and that the management of the money supply is the most potent tool in the arsenal of economic policy. Ultimately, *A Monetary History of the United States, 1867-1960* remains a testament to the power of empirical evidence in reshaping policy. It bridged the gap between historical narrative and technical economic theory, ensuring that the role of money would never again be ignored in the study of how nations prosper or fail.