The title of this session, “The Methodology of Economic History as an Approach to Assessing Monetary Policy,” is an invitation to reflect on how the approaches of economists and economic historians differ from one another. So one might start by playing devil’s advocate and asking: do they in fact differ? Economic and monetary historians, like economists, use statistics: statistics are abundant in Friedman and Schwartz’s *Monetary History of the United States* and its companion volume, *Monetary Trends in the United States and the United Kingdom*.¹ There is no shortage of them in Brunner and Meltzer or in Meltzer’s *History of the Federal Reserve*.² Monetary economists, for their part, make liberal use of qualitative sources. I conjecture that the economists in this room lost on average no less than 24 hours from their work schedules to recreational reading in the week of March 21st, when the FOMC released its transcripts from 2008.

So how, if at all, does the methodology of economic history differ? Some will argue, I suspect, that the approaches of economists and economic historians differ not at all, or that they differ only in that historians use dustier data. Naturally, I will push back against this view. I will argue that the economic historian’s approach differs in that it pays more attention to context, to politics and to institutions when evaluating both the formulation and effects of monetary policy.

I will illustrate these points this by referring to my own work on the 1930s.³ (This session is also, clearly, an invitation for the panelists to refer to their own work.) In seeking to understand the failure of central banks to respond more effectively to the Great Depression, I would argue first that it is important to understand the context for policy, which included a recent history of high inflation in a number of key countries – a historical context which fostered the belief that, even in liquidity-trap-like circumstances, inflation was right around the corner. (Sound familiar?) The context included the experience of a disruptive European war, which created nostalgia for idealized pr ewar policies, and therefore encouraged the adoption of what Peter Temin and I have called the gold-standard mentalité, and a presumption that policy should be passive rather than active.⁴

Similarly, it is important to understand the political environment in which central banks operated. Monetary policy had always been politicized in the United States, ever since the Bank War and the Populist Revolt, but it became even more politicized with the Goldsborough Bill and what would become the Thomas Amendment. Those politics largely explain why the Fed responded as it did in 1932, in one of the rare episodes in the Great Depression when it engaged in expansionary open market operations.

But if monetary policy had always been politicized in the United States, policy now became equally politicized in other countries, in Europe in particular. Post-World War I extensions of the electoral franchise made it more difficult for central banks to make credible commitments to monetary rules, whether those rules were rigid or contingent. That inability to

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commit made temporary suspensions of gold convertibility, like those which had been used to facilitate lender of last resort operations in crises before World War I, problematic now.\(^5\)

Similarly, politics made central bank cooperation, always important in crises, more difficult to arrange in the 1930s than before World War I. Lingering conflicts over reparations, war debts, and the provisions of the Versailles Treaty impeded efforts to organize international loans for Austria and then for Germany. This failure then permitted what started as a localized Central European financial crisis to develop into a global crisis.

Finally, institutions are critically important for understanding the conduct and effects of monetary policy in this period. One can’t begin to understand the policy decisions of the Federal Reserve in the 1920s and early 1930s without focusing on the decentralized structure put in place by the framers of the Federal Reserve Act (something that again reflected politics). One can’t begin to understand the monetary policy actions that contributed to the onset of the 1937-8 double-dip recession, which included policies of gold sterilization, without appreciating the fact that much responsibility for U.S. monetary policy had been shifted after 1932 from the Federal Reserve to the Treasury, which was in the driver’s seat when it came to gold policies.\(^6\) One can’t begin to understand how other countries were affected by U.S. monetary policy without reference to the institutions of the gold standard, or why it was that the interwar gold standard system was so fragile, without understanding the institutional evolution from the prewar gold standard to the 1920s gold exchange standard. One can’t begin to understand why international cooperation to aid Austria and Germany was so difficult to organize in 1931 without recalling that the institutional vehicle for that cooperation, the Bank for International Settlements, had been set up as a reparations bank (as a mechanism for transferring funds from Germany, not to it).

My argument, then, is that economic historians place more emphasis on context, politics and institutions. Of course, in order to realistically achieve this, the historian must sacrifice something else. Economic historians are no better than economists keeping a large number of different methodological balls in the air. There are tradeoffs in economic history as well as in economics. Economic historians attach less importance to theoretical purity. Undergirding one’s analysis with an explicit, internal consistent, uncompromising theoretical model has its place in economics. Theory has aesthetic appeal. It serves as a consistency check on one’s reasoning. Occasionally it yields unexpected insights. But for the analyst of monetary policy to engage seriously with context, politics and institutions, the strictures of formal theory must be relaxed. To be clear, I am not saying that economic history is atheoretical, only that the historians use of theory is more elastic. I’m not sure that’s a bad thing.

Now that I have offended the economists in the room, I would like to conclude by also offending the journalists. I will do so by asking: how does the historical approach to assessing monetary policy as I have described it differ from monetary journalism? There are similarities, of course. We are all in the story-telling game. I don’t want to sound too much like Deidre McCloskey, but a shared strength of economic historians and journalists is that we are conscious

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\(^5\) This point is elegantly made by Michael Bordo and Finn Kydland, “The Gold Standard as a Rule,” Explorations in Economic History 32 (4), pp.423-446.

– more conscious than most economists, I suspect – that we’re in the story-telling game. But, with the passage of time, economic historians acquire a richer documentary basis for our historical accounts than journalists, writing in the heat of events, typically enjoy. We are better able to avoid the Sir Walter Raleigh problem that plagues the monetary journalist: “Whosoever in writing a modern history, shall follow truth too near the heels, it may haply [sic] strike out his teeth.”

The life of the monetary historian is not without its luxuries.

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8 Sir Walter Raleigh, “Preface to the History of the World” (1614), paragraph 73.