Monetary Policy Before, During and After the 1929 Crash

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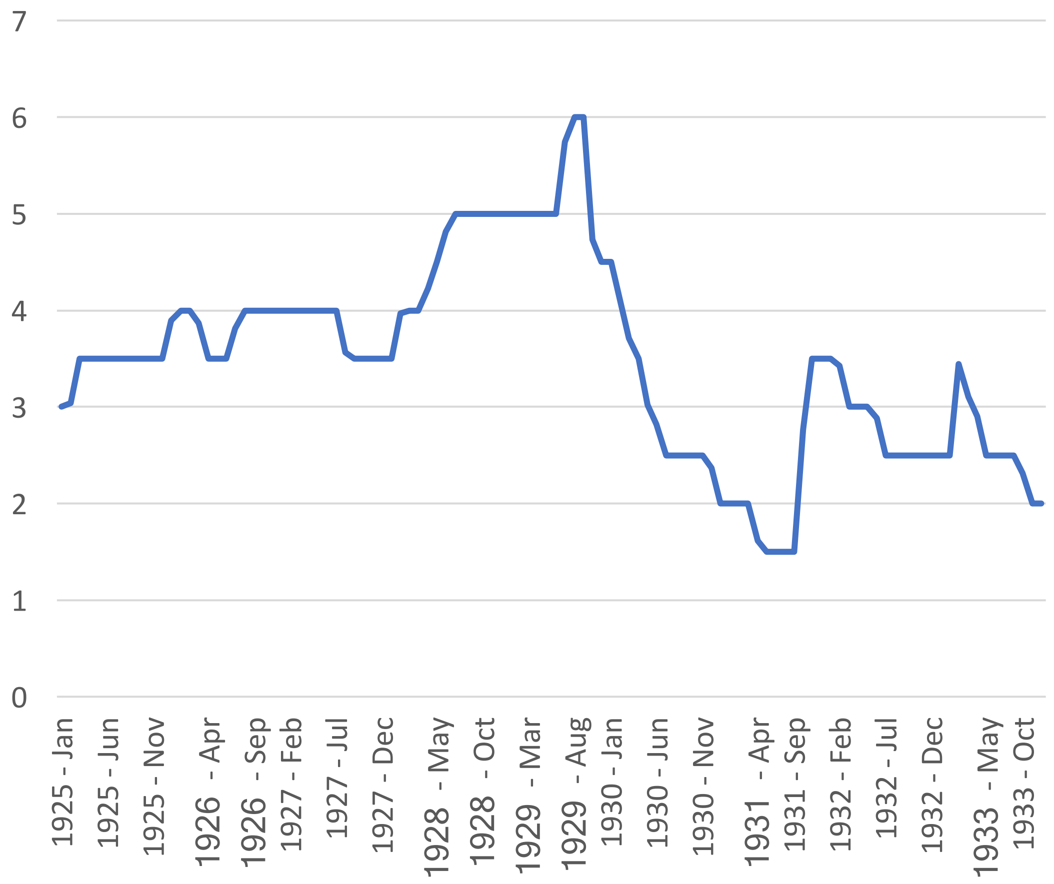
The Early Federal Reserve

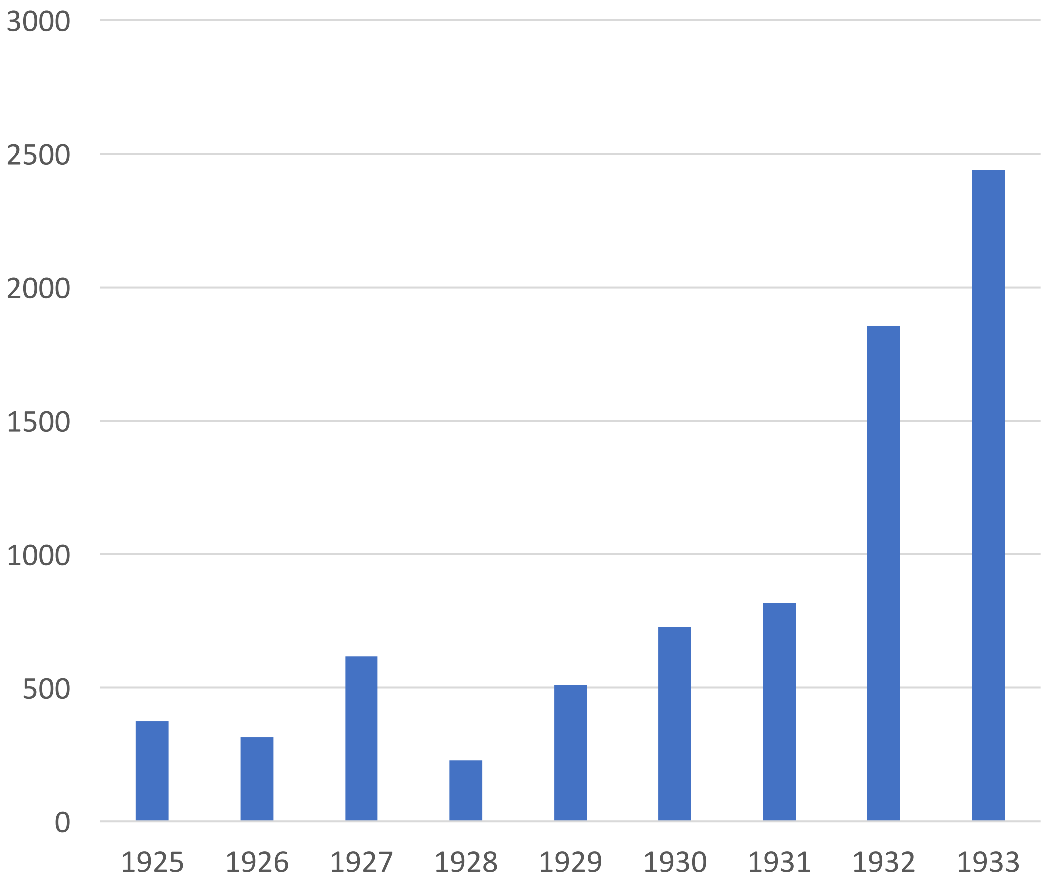
- On paper, structure similar to today's.
  - The 12 Regional Banks (chief officers were called "Governors" not "Presidents.")
  - The DC Board (only its Chair was called "Governor").
  - A committee to oversee the pooled investment portfolio of the 12 banks.
- But…
  - Basic mission was murky.
    - Clear need to lend to "solvent but illiquid" *member* banks.
    - Clear need to help defend the gold standard.
    - But what about the rest of the financial system? What about the overall economy? What measures to look at to get a sense of developments?
  - Decision-making was confused.
    - When was an action by a regional bank a policy change (needing pre-approval by the Board), as opposed to a routine operations.
    - Death of Benjamin Strong (first head of the NY Bank) in 1928 removed the individual who had prompted most Fed decisions; a vacuum emerged.

Federal Reserve Discount Rate



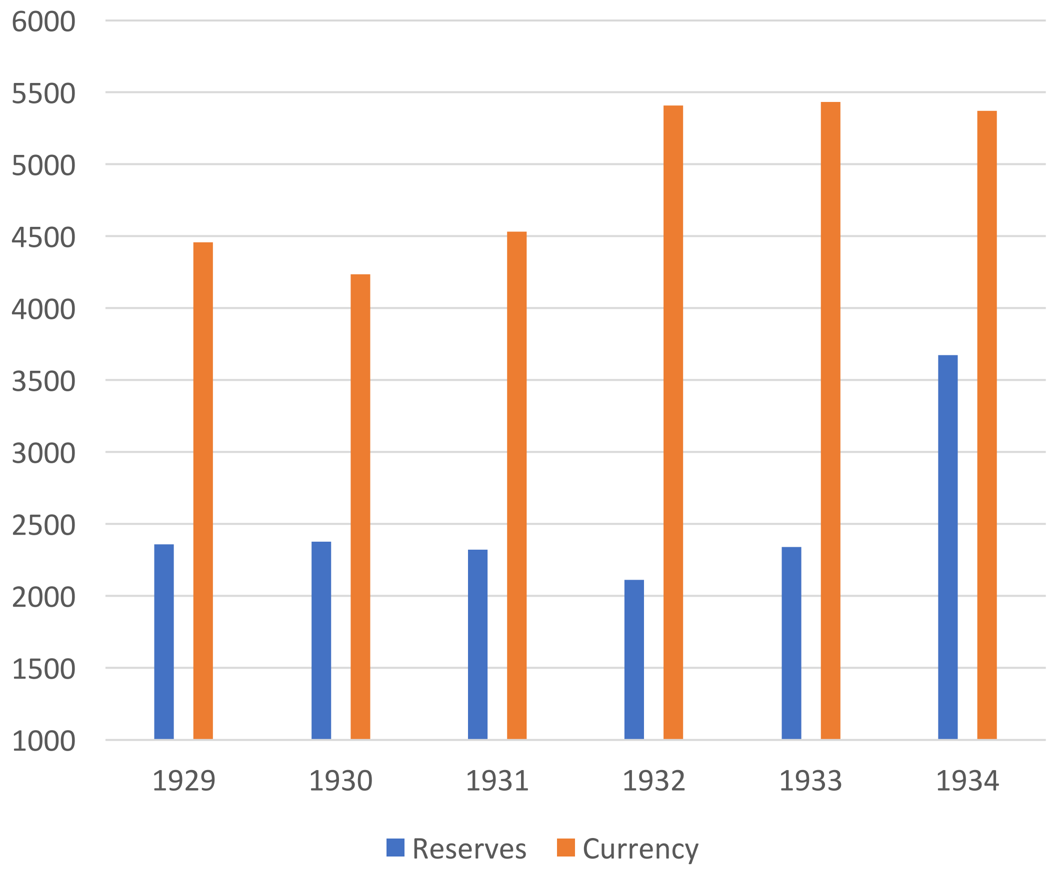
- Rates held relatively low until 1928; aided lending to Europe and held down the dollar's value.
- Marked increases afterwards in part directed at discouraging lending into the stock market boom.
- Decline in rates suddenly reversed in 1931 to defend gold standard.

Federal Reserve Holdings of Government Securities (year-end, millions of dollars)



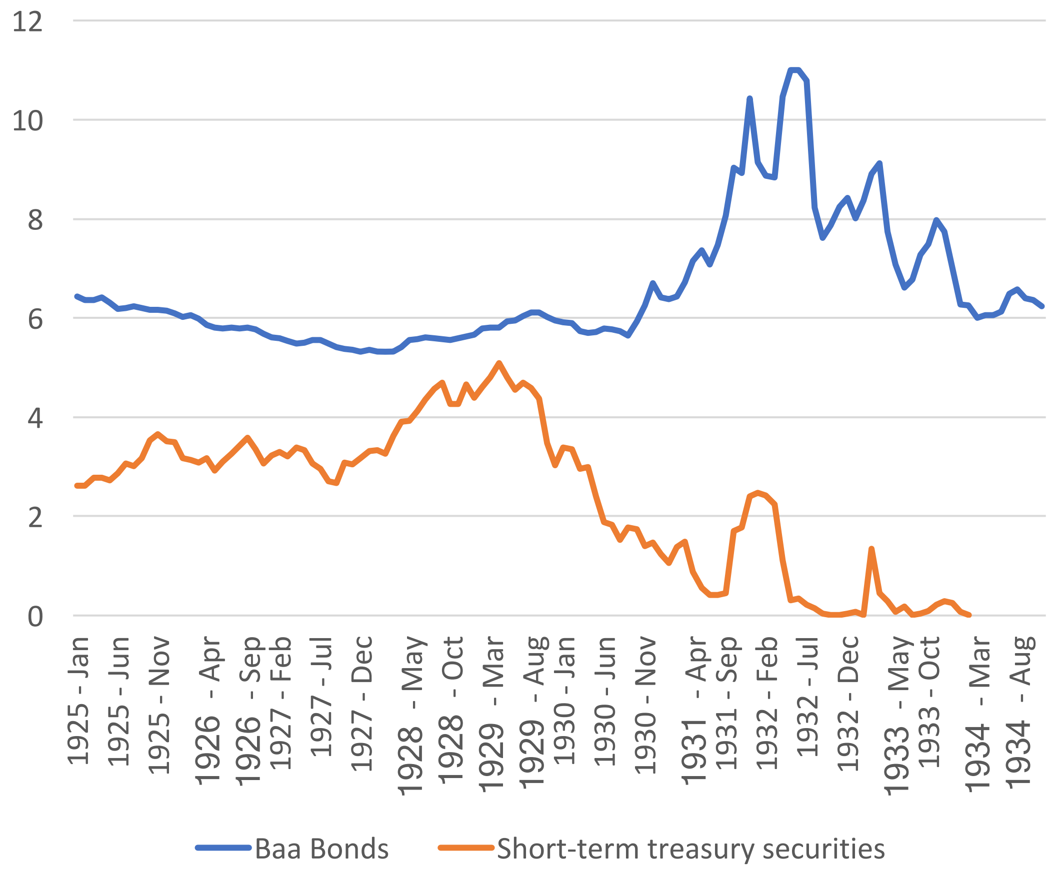
- The Fed made modest amounts of purchases at the start of the Great Depression.
- In 1932 there was a slightly more aggressive pace of purchasing, but it did little to stop the collapse of the financial system.

Reserves and Currency (millions of dollars)



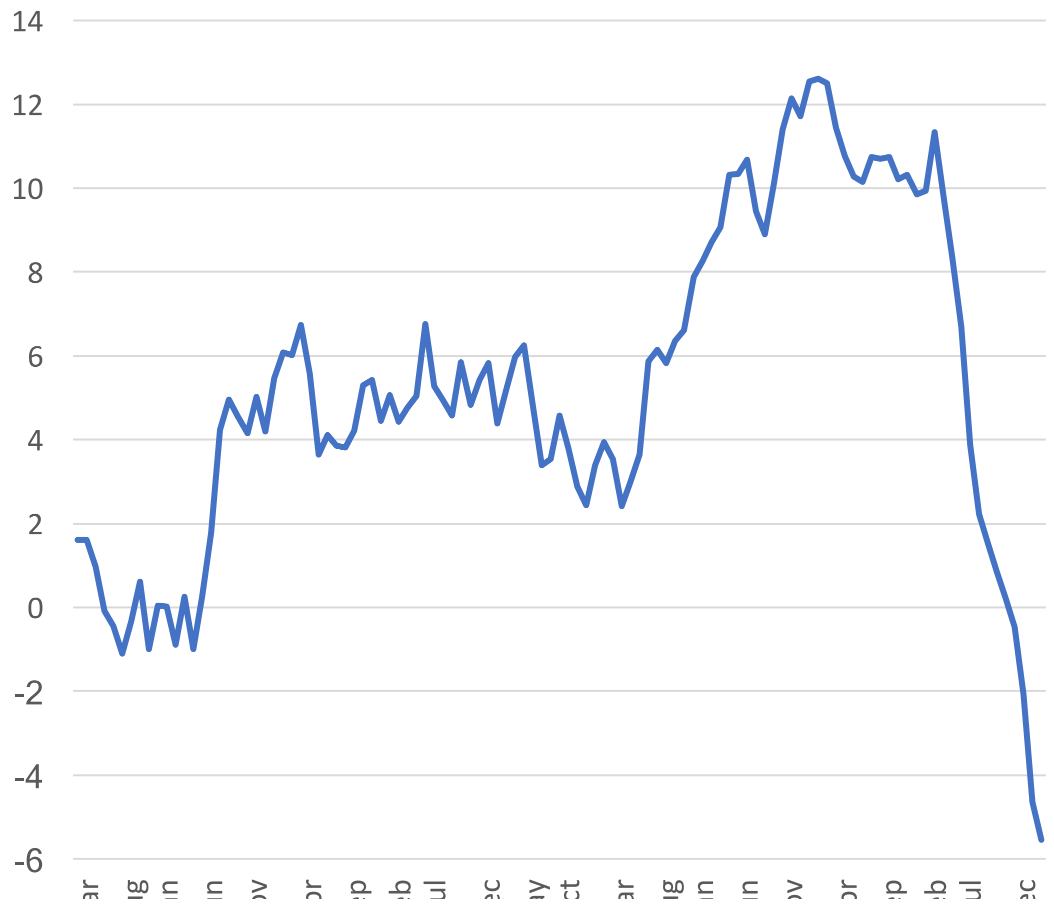
- Whatever modest efforts were made by the Fed to inject funds into the banking system were largely offset by the increased demand for currency.

Market Interest Rates



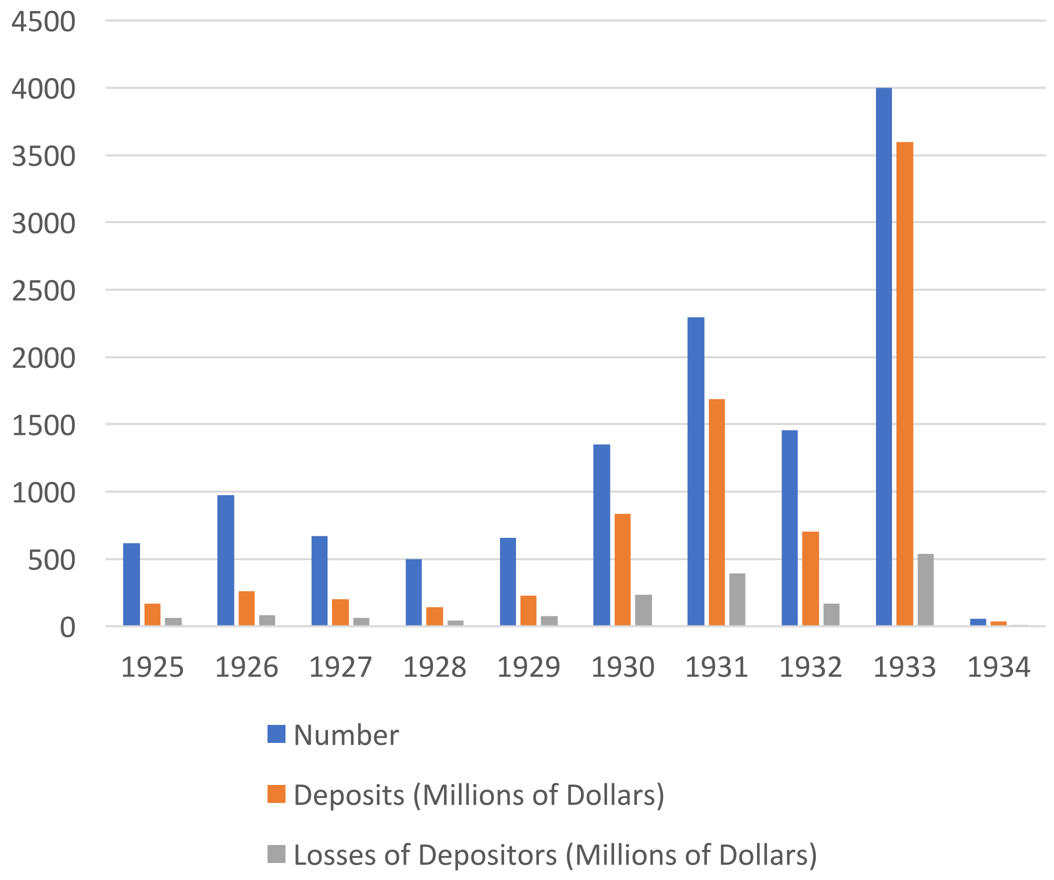
- Safe short-term rates plunged in the Depression, except for the period around Britain's departure from the Gold Standard.
- But risky long-term private rates soared.

Real Short-term Interest Rate (nominal rate less 12-month growth in the CPI)



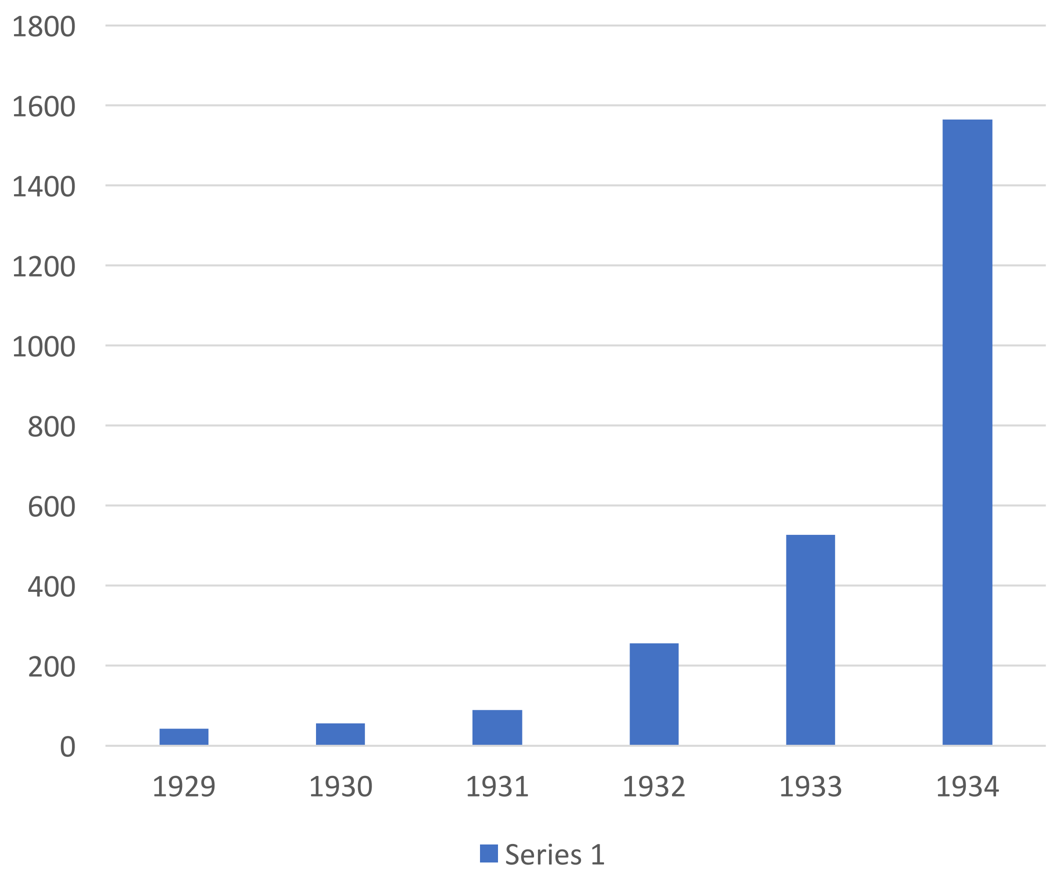
- Real rates rocketed up in the early 1930s as price deflation set in.
- A dramatic reversal occurred in 1933 as prices started to grow again.

Bank Failures



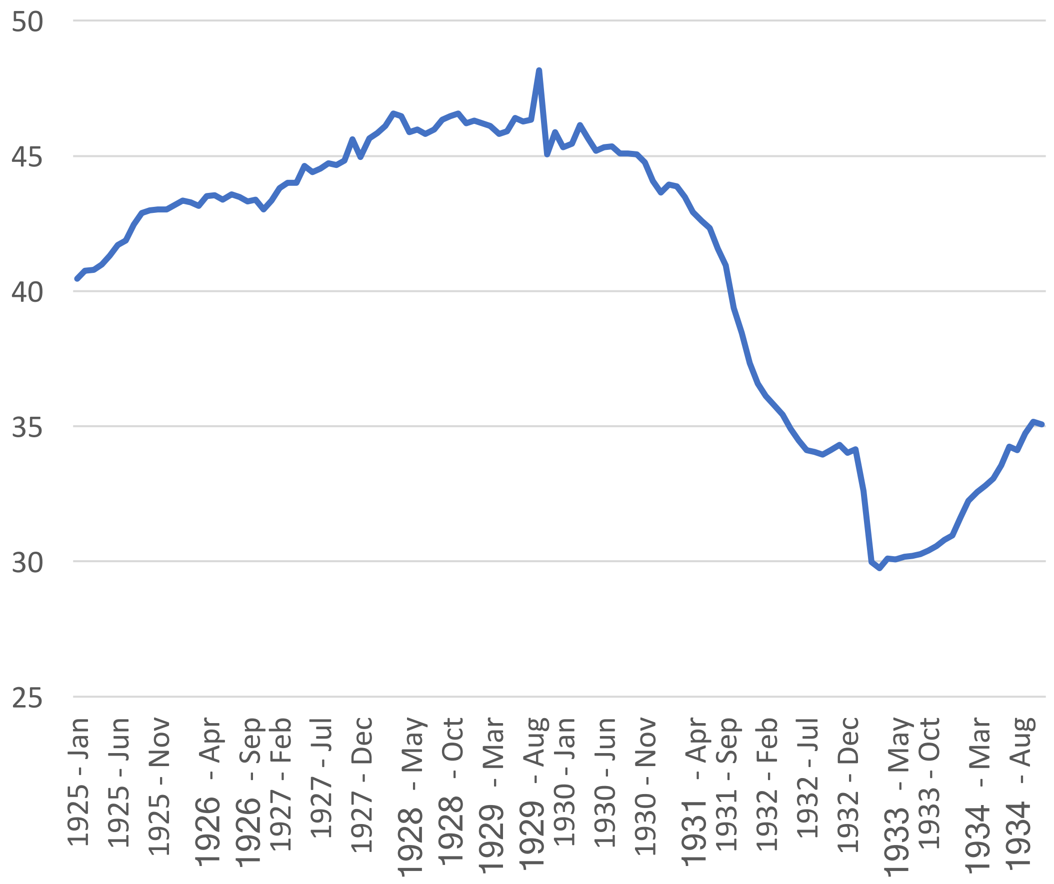
- Bank failures skyrocketed during the early years of the Depression.
- Depositors did recover more than 3/4 of their funds in the failed banks, but this is an average figure, and the timing of recovery was uncertain.
- Bank failures essentially ended after the purging of thousands of banks in the 1933 “holiday” and the start of an economic recovery.

Excess Reserves



- The Fed thought policy was ”easy”—look how low short-term rates were, and that the large and growing amounts of excess reserves implied banks could easily expand lending, and so risked inflation.
- This latter fear dominated Fed thinking through the 1930s, and re-emerged (outside the Fed) in recent years. The reality was policy was quite tight, as shown by the…

M2 Money Supply (billions of dollars)



- Friedman and Schwartz emphasized the importance of the drop.
- While the Fed could have looked at other measures (long-term rates, bank failures, real interest rates…) the lack of response to the 1931-32 plunge is still astonishing.

Conclusion

- A dismal performance.
- The Fed's role in generating the stock market boom and prompting the crash is debatable, and it's also arguable that the early stage of the Great Depression had little to do with Fed policy.
- But…
  - The Fed's failure to aggressively address the collapse of the banking and financial systems undoubtedly was a prime reason the Great Depression was so deep.
  - Friedman and Schwartz were correct in noting that paying more attention to, and responding to, the decline in the money supply would have alleviated the situation, though other, comparable signs were also there.

Comparison to Recent Times

- Like the stock market boom, there is debate as to the role of Fed policy in encouraging first, the bubble in housing prices (and the related boom in subprime mortgage activity), and later the collapse of the bubble.
- Unlike the 1930s, the Fed (and other government agencies) acted hyper-aggressively to prevent the total collapse of the financial system and economy.
  - Short-term interest rates under Fed control were reduced rapidly to virtually zero, and held there.
  - The Fed aggressively lent to many troubled financial firms (Lehman was the exception).
  - The TARP program allowed the Treasury to provide “loss-absorbing” capital to firms (similar to the Depression-era RFC, but more rapidly and aggressively deployed).
  - FDIC insurance expansion and guarantees of newly-issued bank debt kept that keystone of the financial system intact.
  - Federal fiscal policy responses to economic weakness, though criticized now for being too soft, were marked by historic standards (New Deal expansion occurred well after the trough of the Great Depression).
  - The “stress tests” of 2009 restored confidence in many financial firms (the comparable earlier event was the 1933 bank holiday and the reopening of banks deemed sound, but again that happened years after the financial system began to collapse).
  - Importantly, by chance, Bernanke had a great scholarly interest in the financial events of the Great Depression!