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Lessons from the 1930's for the Fed's Exit Strategy

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The Great Contraction from 1929-1933 and the recovery from 1933 to 1941 have considerable resonance for the situation facing the Federal Reserve today in the United States. The policies followed in the 1930s to extricate the U.S. from depression have both cautionary and salutary lessons for today's policy makers.

The Great Contraction

The Great Contraction during which prices, real output and money supply declined by about a third was precipitated by policy failures at the Federal Reserve. A tight monetary policy to kill stock market speculation in 1928 led to a recession beginning in August 1929. This policy was based on the real bills view that stock market speculation would lead to inflation, a bust and then deflation. The Stock market crash in October exacerbated the downturn but did not cause the depression. The failure of the Fed to follow its mandate from the Federal Reserve Act of 1913 to act as lender of last resort and to allay a series of four banking panics beginning in October 1930 led to the serious downturn that followed. The Fed adhered to the flawed Burgess Riefler doctrine (Meltzer 2003) which viewed low levels of its borrowed reserves(i.e discount window borrowing) and short-term interest rate indicators as signs of monetary ease and hence

did not act. In addition some Fed officials believed in the liquidationist doctrine and saw bank failures as beneficial. A major hike in the discount rate in the fall of 1931 to protect the dollar after sterling exited from the gold standard added fuel to the fire.

Recovery began in March 1933 with Roosevelt's banking holiday, ending the fourth banking panic. The nation's banks were closed for a week during which an army of bank examiners separated the insolvent from the rest. Insolvent banks were closed ending the uncertainty driving the panic. This action was quickly followed by FDR taking the U.S. off the gold standard in April, Treasury gold (and silver) purchases designed to raise gold prices and prices in general, and formal devaluation of the dollar by close to 60% in January 1934. These policies produced a big reflationary impulse from gold inflows which were unsterilized passing directly into the money supply. They also helped convert deflationary expectations into inflationary ones (Eggertsson 2008). Also of key importance in preventing future banking panics was the institution of federal deposit insurance (FDIC) in the Banking Act of 1933 which went into effect January 1 1934. The recovery of 1933 to 1941 was largely driven by gold inflows (initially reflecting Treasury policy and the devaluation, later reflecting capital flight from Europe as war loomed). Expansionary fiscal policy, despite the conventional wisdom, played only a minor role in the recovery of the 1930s (Romer 1992). Recovery was impeded somewhat by New Deal cartelization policies like the NIRA which in an attempt to raise wages and prices artificially reduced labor supply and aggregate supply (Cole and Ohanian 2004). Over the period 1933-1937 output increased by 33%.

The Federal Reserve was largely passive in the 1930s. It, along with the bankers, had been blamed by the Roosevelt administration for the failures of the 1920s and early

1930s . Major reforms in the Banking Acts of 1933 and 1935 greatly increased the powers of the Federal Reserve Board in Washington at the expense of the Reserve banks and especially the New York Fed. Despite its increase in power, the reconstituted Board of Governors under Chairman Mariner Eccles was passive and largely subservient to the dictates of Treasury Secretary Morgenthau. The Fed in the 1930s continued to follow the same precepts as it did in the 1920s and early 1930s. Its policy indicator continued to be the level of free reserves(excess reserves less borrowings from the Fed). In the 1930s borrowed reserves were negligible so excess reserves became the indicator. As the decade wore on member banks largely absorbed the gold inflows into excess reserves, held as a precaution against a repeat of the type of turbulence experienced in the early thirties. By 1935 excess reserves amounted to 50% of total reserves. Fed officials increasingly viewed the build up of excess reserves as a threat to future speculation and inflation. They also saw the presence of sizable excess reserves as preventing them from future tightening. Similar concerns have been voiced about the build up in bank excess reserves in 2008-2009. According to the Burgess Riefler doctrine which prevailed at the Fed, the way the Fed could control interest rates was by forcing banks to borrow from the Fed. Once excess reserves were less than the open market portfolio, then open market sales could force the banks to borrow. Banks would then want to reduce their indebtedness by contracting their lending (Meltzer 2003 pp 520-521).

The Recession of 1937-1938

The recovery was interrupted by a serious recession (the third worst of the twentieth century) from May 1937 to June 1938. Friedman and Schwartz (1963) and Meltzer (2003) and others attribute the recession to a serious policy mistake by the Federal Reserve. Mounting concern by the Fed over the build up in excess reserves in member banks led the Board to double reserve requirements in three steps between August 1936 and May 1937. The rationale for this action was to restore the Fed's control over monetary policy and remove the inflationary threat posed by the excess reserves. The Fed used the blunt instrument of raising reserve requirements rather than conducting an open market sale of securities because excess reserves exceeded the Fed's portfolio of securities and sales would reduce the income earned from it. According to Friedman and Schwartz the banks were holding excess reserves as a precaution against a repeat of the banking panics of the 1930s. When the Fed locked up these reserves the banks cut back on lending and sold earning assets to restore the precautionary cushion they had held. The Fed's contractionary policy action was complemented by the Treasury's decision in late 1936 to sterilize gold inflows in order to reduce excess reserves. These policy actions led to a spike in short-term interest rates and a severe decline in money supply precipitating a 5 % decline in real GDP.

Other explanations given for the recession of 1937-38 include: a tightening of fiscal policy when the Administration ended a generous veteran's bonus ,hiked income tax rates and imposed a tax on undistributed profits; gold hoarding brought about by fears of another dollar devaluation coupled with a boost to money wages by the Wagner Act (Sumner 2009)and a switch back from inflationary to deflationary expectations (Eggertsson and Pugsley 2006).

The recession ended after FDR in April 1938 pressured the Fed to roll back reserve requirements, the Treasury stopped sterilizing gold inflows and desterilized all the remaining gold sterilized since December 1936, and the Administration began pursuing expansionary fiscal policy. The recovery from 1938 to 1942 was spectacular, output grew by 49% fueled by gold inflows from Europe and a major defence build up.

The Liquidity Trap

The 1930s were characterized by very low interest rates. Short-term rates were close to zero through much of the decade. Long-term rates were close to 2%. The traditional Keynesian view has been that monetary policy was impotent because the U.S. economy was in a liquidity trap. Like the 1930s a Federal Funds rate in 2008 close to zero (the zero lower bound) has again raised the issue of policy impotence.

Subsequent research by Brunner and Meltzer (1968) found no evidence for the liquidity trap. There was a spectrum of rates well above zero throughout the 1930s and the Fed could just as easily have bought securities other than short-term Treasury bills (Basile and Rockoff 2009). The real problem was not that Fed policy didn't work but rather that the Fed was unwilling to use the tools that it had to conduct expansionary monetary policy because it feared a resurgence of asset market speculation and inflation (Orphanides 2004).

Lessons for Today

The history of the 1930s experience has several lessons for the present discussion over the policies that the Fed could follow to ensure a rapid recovery without engendering inflation.

The first lesson is that the Fed like its predecessor seventy years ago has the tools to reflate the economy and to prevent a resurgence of inflation. In the 1930's the Fed was only a minor player in the recovery because it was reluctant to use expansionary open market purchases for fear of rekindling speculation and inflation. It was not in reality stuck in a liquidity trap or hampered by the zero lower bound. Instead the Treasury through its policies towards gold and the consequence of devaluing the dollar did more the heavy lifting to promote recovery.

In the recent crisis the Fed's policy of sterilizing the effects on the monetary base of its diverse liquidity operations through much of 2008 (until September) made monetary policy tighter than it had to be and likely exacerbated the recession which began in December 2007(Hetzel 2009) .However since October 2008 the base has greatly expanded and the policy adopted in January 2009 of quantitative easing by purchasing long-term Treasuries and mortgage backed securities can be viewed as a replay of the expansionary Treasury gold policy of the 1930s.

Second, the Fed will eventually have to tighten as the economy recovers and excess capacity is reduced. Some have raised the fear that this could produce a repeat of the recession of 1937-1938 were the Fed to attempt to reduce the excess reserves and the banks(still gunshy from the recent crisis) to scramble to replace them. This should not be a problem for a number of reasons. First the excess reserves were built up in the two eras under very different Fed operating procedures . In the 1930s the Fed could not target the

interest rate as it had done in the 1920s because the banks were reluctant to borrow reflecting a stigma from doing so. Moreover the build up of excess reserves was a consequence of the gold inflows and, given the Fed's preferred operating procedures, created a problem for it.

Today the Fed follows an interest rate target and it can pay interest on reserves (IOR). The build up of reserves reflected sterilization of the Fed's liquidity operations using interest on reserves,(when the federal funds rate was close to zero), as the mechanism to get banks to hold them. Were the Fed to wish to tighten it can separate its monetary policy operations from its liquidity policy by changing the spread between the funds rate and the IOR. (Goodfriend 2009). Unlike the Fed of the 1930s, today's Fed can use reverse repos or open market sales of its long-term securities to do the tightening. Were it to wish to reduce excess reserves to encourage banks to lend it could pay negative interest on reserves as was done recently by the Riksbank in Sweden.

The main concern for today is not that the Fed can not exit from its present strategy because it can, but that when it exits and begins tightening that if unemployment were still to be high and were to begin to rise again in the face of the tightening, that the Fed would come under political pressure to abandon its efforts and cave in under the pressure. In that case inflationary pressures would build up as the markets and the public began to doubt the Fed's resolve. This is what happened in 1966 and 1969 under William McChesney Martin and in 1973 under Arthur Burns, leading to the Great Inflation. Moreover if the recovery turns out to be rapid as was the case in the 1930s(and virtually all the deep recessions in the twentieth century) (Mussa 2009),then inflationary pressure

may build up sooner than many have expected . In such a scenario does the current Fed have the resolve to follow through on an anti inflationary policy?

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