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The Great Contraction and the Current Crisis: Historical Parallels and Policy Lessons

The Great Contraction from 1929-1933 was the worst recession in U.S. history. Real output declined by 34%, prices by 24% and unemployment increased from 4% to 25%.

According to Friedman and Schwartz's monumental **A Monetary History of the United States** (1963), the contraction was largely due to a one-third collapse in the money supply precipitated by a series of four major banking panics which started in October 1930 and the failure of the Federal Reserve to follow its mandate and act as a lender of last resort and use open market purchases to offset them. The thousands of bank failures also led to an implosion of financial intermediation which further depressed the economy. These effects worked through deflation in both goods and asset prices .

The contraction ended in early March 1933 when FDR declared a one week banking holiday during which solvent banks were separated from the insolvent and only the solvent were allowed to reopen. Recovery was quickly spurred by the floating of the dollar in April 1933 and massive gold purchases by the Treasury which increased the money supply and converted deflationary into inflationary expectations. Historical research concludes that the fiscal stimulus programs of the New Deal only made a limited contribution to the recovery(Romer 1992).

Are there parallels for today? The current crisis which has led to a recession was not caused by a classic banking panic because the Federal Deposit Insurance Corporation (FDIC) instituted in 1934 effectively removed the incentives for depositors to stage runs

on their banks. Instead the causes were wealth losses associated with the collapse of housing prices and a stock market crash that led to even greater wealth losses, contracted consumer spending and investment. But a banking crisis is still a key element of present problems because the interbank lending market dried up, many banks became insolvent and lending is constrained. Also the collapse of the subprime mortgage market has led to the collapse of the derivatives markets, the collapse of the shadow banking system(following a run by creditors on the uninsured investment banks) and a massive credit crunch evident in large hikes in quality spreads (similar to the 1930s) and the paralysis of some credit markets. This has led to a serious recession which in turn has exacerbated the problems of the banking system and the financial sector in general. The current recession is similar to the Great Contraction in that it is driven by shocks to the banking and financial sector, but the orders of magnitude are much less now than then: real GDP five quarters after the start of the recession is about 6% below trend. At the same stage in the Great Contraction it was 12% below trend and at its trough in 1933 it was 30% below trend.

Unlike the Great Contraction the Fed has not sat back idly while the banks failed . In the fall of 2007 at the outset of the crisis it greatly expanded liquidity. Expansion of the money supply however has been erratic. Moreover the Fed has dealt with the credit crunch following Chairman Bernanke's(1983) interpretation of what happened in the Great Contraction. It has acted following his script by flooding the money markets with liquidity(cutting the Federal Funds rate from over 5% in the summer of 2007 to close to zero by the end of 2008) and by setting up numerous special facilities such as the Term Auction Facility(TAF) to encourage access to the discount window(allowing non

traditional assets to serve as collateral), to clear up bottlenecks in salient credit markets. Thus the Fed changed its tactics away from providing general liquidity via open market operations and allowing the market to distribute liquidity to individual firms . By creating these credit facilities the Fed has shifted towards a policy of credit allocation similar to the record of Hoover's Reconstruction Finance Corporation (RFC) established in 1932. It borrowed from the public and lent the funds to the banks and railroads. It also is similar to agencies set up by FDR in the 1930s like the Federal Housing Authority, the Federal Home Loan Bank Board and the Federal Credit Union System designed to improve credit intermediation. Similarly in the 1940's 50s and 60s credit allocation policies were followed by the Federal Reserve. Credit allocation represents a political decision which distorts market efficiency. The resultant massive increase in the Fed's balance sheet to over \$2 trillion at the end of 2008 with assets like mortgage backed securities whose prices are difficult to ascertain has raised the question of what the Fed will do when it needs to tighten. The Fed may then rely on the Treasury to absorb these loans. This threatens its independence.

In addition many of the assets purchased from late 2007 to September 2008 were automatically sterilized as a consequence of the Fed targeting the federal funds rate and then by the policy ,instituted in September 2008, of the Fed paying interest on reserves . Sterilization prevented asset purchases from increasing the money supply, yet the lesson of the Great Contraction taught us that expanding the money supply is a major prerequisite to counter recessionary forces. Fed policy through much of 2008 may actually have been contractionary as it was in the early 1930s—the Fed may not have cut

the funds rate fast enough to match the decline in the economy's natural rate of interest in response to the housing and financial shocks (Hetzel 2009).

Since September 2008 the Fed has been pursuing a more expansionary policy seen in a massive increase in the monetary base and in M2, and, since January 2009 in the face of the zero nominal bound on short-term interest rates, the Fed has shifted to a policy of quantitative easing by purchasing long term mortgage backed securities and more recently long-term Treasuries. This policy, with echoes to the expansionary Treasury policies from 1933 to 1935, will encourage substitution from Treasuries into assets like corporate bonds that will directly finance investment expenditures. The policy also can circumvent the bottleneck of reserves accumulating in insolvent banks reluctant to lend. The monetary authorities until the fall of 2008 viewed the crisis as primarily a liquidity crisis similar to the Wall Street crash in October 1929 when the New York Fed flooded the New York money market with liquidity to prevent a panic. They were slow to recognize that the deepest problem facing the banking system was **insolvency**. The problem stems from the difficulty of pricing securities backed by a pool of assets because the quality of individual components of the pool varies. The credit market is plagued by the inability to determine which firms are solvent and which firms are not. Lenders are unwilling to extend loans when they cannot be sure that a borrower is credit worthy. This is a serious and potentially dangerous shortcoming of the securitization process that is responsible for the paralysis of the U.S. credit markets.

To deal with the solvency issue the Treasury has tried two plans so far. The first, the Troubled Asset Relief Plan (TARP) plan of October 2008 to inject capital into the banking system and purchase troubled assets did not deal with the problem of bad assets

because of the difficulty of valuing them. Continuing declines in housing prices and other assets forced writedowns and hence increased the need for more capital. The second, the Public Private Investment Plan(PPIP) of March 2009, whereby private institutions will be highly subsidized by the Treasury, FDIC and the Fed, to acquire troubled assets may eventually work but the banks may be reluctant to sell their toxic assets fearing that this would further erode their capital bases.

What should be done? The experience of the Great Contraction has taught us that the contraction didn't end, and recovery didn't take root, until the Banking Holiday largely cleared away the bank solvency problem by closing the insolvent banks(over one sixth of the nation's banks). Moreover recovery required the Treasury(and not the discredited Fed) to engage in a massive program of unorthodox quantitative easing, aided by gold inflows from Europe as the threat of war loomed.

What needs to be done today to ensure a permanent recovery is a bold, decisive and quick resolution of the bank insolvency issue parallel to FDR's banking holiday. The Good bank/Bad bank approach taken by the Resolution Trust Corporation (RTC) in the 1980s and by Sweden in 1992 and by other countries in the 1990s had considerable success.

The Treasury and FDIC needs to quickly ascertain which banks are insolvent(possibly using the stress tests that are underway) and then take over the insolvent banks (appoint a conservator), remove their management, wipe out the shareholders(but protect the insured depositors). The authorities should then recapitalize these banks and sell them to new owners. At the same time they should strip away their toxic assets into bad banks

and dispose of them in an orderly manner. This approach has worked in effectively resolving banking crises in virtually every country that has tried it.

Concurrently the Fed should continue aggressive easing until the economy shows signs of sustained recovery and then quickly roll back the liquidity it has created to prevent a build up of inflationary expectations.

References

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