

## THE FED AND THE GREAT DEPRESSION

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A staple of current economic history is that the Federal Reserve pursued inappropriate monetary policy during the 1930s and, by so doing, it prolonged the Great Depression.(1) I will hereafter call this the Friedman-Schwartz view. A corollary claim is that the Fed caused - or helped cause - the depression in the first place through expansionary monetary policy during the 1920s, which created a stock market boom even though price levels remained relatively stable. I will call this the Robbins-Rothbard view, after Lionel Robbins' book *The Great Depression* and Murray Rothbard's book, *America's Great Depression*. To what extent are these incompatible views correct? Which is, to put it simply, "more true?"

It's unlikely that a definitive answer to this question of Fed causal responsibility will ever receive overwhelming support. There are too many potential caveats and confounding effects, too many agendas on the part of authors addressing the issue - myself included, I guess - and too much uncertainty in the weak predictive capabilities - even in hind-sight - of economic theory. It's always a difficult thing to assess cause in historical incidents, and we are always prone to that great logical fallacy - known affectionately by all historians: *post hoc ergo propter hoc*. Nonetheless, I will happily tread where many have tread before me, offering my own view of what happened, what went wrong, and why it stayed wrong for so long.

It is impossible to understand the 1930s without first examining the 1920s, just as understanding the 1960s helps one to understand the 70s, and an understanding of the 1990s helps us to understand why we are where we are right now. Nothing historical is understandable in a vacuum and, typically, it is probably true that there are so many potential causes for historical events that isolating any few is always questionable. But what alternative to understanding history do we humans have at our disposal? None. And so - David Hume be damned - we chug along pronouncing our hypothesized causal relationships as historical facts.

The most entertaining history of the 1920s is Fredrick Lewis Allen's wonderfully titled book *Only Yesterday*. Reading this famous work today, one cannot help but be struck by the similarities between the 20s, the 60s, and the 90s. The ancient Greeks Parmenides and Anaximander - on opposite sides - explored an interesting question: do things ever really change, or are things always changing? After reading Allen's entertaining, informative history, you might well wonder whether in fact we ever learn from history, and whether things do really change...at least insofar as social trends and stock markets are concerned. The chapter titled "The Big Bull Market" remains a fascinating - and *cautionary* - read. Let me quote a couple of things from the book to give you a scent of the work's flavor.

(Quote from pp. 195 and 248 here)

I can't spend any more time on this work, but Lewis's position, generally stated, is that the Fed knew exactly what was happening during the late 1920s and, although it tried to do something about it, failed. It failed, in the first place, because it was trying to help European economies - notably Great Britain's - instead of seeing to its own concerns. By lowering interest rates here, it helped prop up Britain's return to the gold standard at the post-WW1 rate of \$4.86/pound. That rate was too high and required coordinated macro policy here for its long-term survival. The Fed obliged. It shouldn't have. Using American monetary policy to help a nation try and pretend that it had the same status after WW1 as before was not - and never could have been - a good idea, notwithstanding that it was approved of by a majority of English citizens and both the British and American governments.

It failed because it did not want to precipitate a market crash as stocks climbed ever higher. It failed because the public would not go along with its policy initiatives. Corporations and non-national banks had little trouble evading the Fed's interest rate moves and verbal exhortations concerning speculation, especially as state chartered banks vastly outnumbered national banks, thus limiting the Fed's power to centrally control the monetary system.

I will, therefore, call the following contention G.D. Myth #1: the Fed was "clueless" about the impending market crash and the possible inflationary consequences of what was happening in the 20s or, in the view of some conspiracy theorists, the Fed actually *wanted* it all to happen. It's just not so.

And it is here that the nub of the differences between the Friedman-Schwartz view and the Robbins-Rothbard view becomes clear. During the 20s, according to the Friedman-Schwartz view, there was price stability and hence, no inflation. Therefore, there was no general loose money policy driving the 20s boom years. In the 30s, the Fed contracted severely when it ought to have inflated instead, thus causing a general deflation and contraction of the money supply.

In the Robbins-Rothbard view, the Fed inflated throughout the 20s, price indices notwithstanding, and then, in the early 30s, it did everything it could to reflate, but the process didn't work, as Allen's book argues as well. (3) Instead, we got deflation as a byproduct of causes other than Fed policy. The public lost confidence in the banking system and began to increase its demand for money to hold, including gold. The velocity of circulation fell, and so did prices. Concurrent fiscal policy, as will be discussed momentarily, was probably *as bad as it has ever been in American history given the circumstances in which it was carried out*.

One of the major Fed problems during the late 1920s - the most heated speculative period for stocks - was a disconnect, personal and professional, between the NY Fed and the system's Board of Governors in the person of NY's President, George Harrison, who had succeeded the legendary Benjamin Strong - and Harrison's board - and the Fed Board's Chairman, Roy Young. The central disagreement was over bank loans used for stock speculation, and what if anything to do about it. The NY bank wanted to raise the discount rate and voted to do so several times in 1929. The Board demurred, preferring to pursue a policy it called "direct pressure," or verbally chastising those banks that appeared to be funding "excessive" speculation.

(I don't want to engage in a lot of unnecessary and loose speculation, but this policy of direct pressure seems to have failed us.)

Even in this policy dispute, we can see that the Fed was concerned about the stock market, but unsure - *deja vu* all over again - exactly what to do about it. It was "irrational exuberance," 1929 style and, as was also true in the late 1990s, the Fed surely knew how to make the market crash, but it was even more reluctant to do so back then. It appears, to some extent, that maybe we did learn something from the history of the 20s...how better to handle the aftermath of a market downturn.

Eventually, the power struggle between the regional banks and the Board would be settled by 1935's federal Banking Act, which gave full control to the Board in Washington; but, until then, this conflict played an important role, and should be noted by anyone attempting to explain today what happened then.

### The Real Bills Doctrine

What was the Fed doing during the 1920s with monetary policy? We have to remember that Fed policy then was different from what we have today. The Board's head was the Secretary of the Treasury and Fed policy was always to be subservient to the Treasury. We were on a gold standard. Coordinated, national monetary policy was something the Fed had *not* been given the power to do under the 1912 enabling act, although it gradually moved towards that position over time, authorized or not. During the 1920s, the Fed generally pursued policy based on the doctrine economists call "real bills."

This idea is that the money supply can be increased proportionately with real output, there always being enough real output to "back" new money issues, therefore making inflation impossible. The money supply, under this view, can never be excessive so long as it is tied to real, productive transactions. The fallacy in the doctrine, not unknown even to nineteenth century economists - Henry Thornton is a famous example of such an opponent - is that, as prices rise, the numeric volume of transactions must necessarily rise, thus allowing, in the extreme case, no upper limit on money creation. Treating prices as given when, in fact, they vary with the money stock makes this a dangerous base upon which to try and conduct price stabilization policy.

Unfortunately, the Federal Reserve Act seemed to enshrine the doctrine into its institutional structure. The Act provided for the system to extend bank reserve credit via the Fed's rediscounting of eligible, short-term, self-liquidating commercial paper presented to it by member banks. The Fed's 10<sup>th</sup> annual report issued in 1923 states: "It is the belief of the Board that there is little danger that the credit created and distributed by the Federal Reserve Banks will be in excessive volume if restricted to productive uses." By this, the Board meant loans that financed the actual production and marketing of real goods, the classic real bills definition.

Further, it was during the 1920s that the Fed began to do open market operations even though these were not contemplated by the original enabling legislation. All things evolve, and that fact includes public institutions. And these early

open market operations were undertaken, unfortunately, to “sterilize” gold inflows from England’s overvaluation for its pound sterling.

Let me digress a moment and define sterilization: it is keeping the money supply constant regardless of the inflow of gold; ordinarily, under the international gold standard - in force at that time - the gold inflow into the US would have caused a monetization that would raise US prices and make Britain more competitive as its prices fell. The US and France prevented that from occurring, both nations’ gold stocks rising dramatically while, at the same time, the central banks sold securities to reduce the monetary impact of the new gold to zero. In fact, during the late 1920s, the US should have been experiencing inflation due to this gold inflow; but, it in fact experienced a mild *deflation* due to the sterilization policy.

So, on to Myth #2: “The Fed pursued a reckless policy of inflation between 1922 and the crash.” It didn’t.

By the late 1920s, Britain was desperate to get out from under its current account deficit position and a meeting was held in 1927 between representatives of the Bank of England, the Fed and the US Treasury. It was decided that the Fed would loosen by lowering interest rates in the US rather than Britain raising them, that nation already being in a worsening economic condition. This monetary expansion has been credited with precipitating the late 20s market boom by many, including both the Friedman-Schwartz and Robbins-Rothbard camps. Note however that the point of departure is 1927 and the policy lasted but a short time.

The joint policy agreed upon - and carried out in 1927 - failed for several reasons. As the stock market boomed here, money flowed here and capital exporting fell. American banks were more interested in financing domestic stock speculation than economic projects elsewhere in the world. This, in turn, slowed trade and economic output in other nations, thus hurting England all the more, and a recession began there in 1929 as their interest rates rose, their money supply tightened, their international exports declined, and their current account position continued to weaken.

Both Robbins-Rothbard and Friedman-Schwartz see the looser policy beginning in 1927 as creating what was to occur soon thereafter. For F-S, the perfect correlations between money and economic activity throughout the decade point to changes in money supply being the prime cause of the downturn and the boom that preceded it; for R-R, the story is more complex because their model of the cycle is based on the Austrian theory first propounded by Ludwig von Mises. Time does not permit me to elaborate fully on that model, but I can say that it is the view that booms are caused by bank credit expansions that then distort the consumption-saving-production time structure of the economy by sending an incorrect interest rate signal to business owners and entrepreneurs. The “artificial” boom, thus created, must be followed by a bust. A stable price level in no way means that the boom is not underway, since prices might have been higher than they were without the credit expansion, and therefore index stability merely masks the ongoing, real inflation picture. Eventually, money and credit must be tightened and the crash then looms. And that tightening came in the 1928-29 period so that, by August 1929, the recession had already begun, the market peaking on September 3<sup>rd</sup>.

So: here's easy Myth #3: "The stock market crash caused the Great Depression." The crash was a *symptom* of things unique to mid-to-late 1929, not the cause of what followed.

Regardless of how the market crash occurred, or who and/or what were to blame, there is also the issue of post-crash policy and whether it helped or hurt the prospects for recovery or, as Meltzer puts it in title to one of his book's chapters "Why Did Monetary Policy Fail in the Thirties?" This is not only an important question, but a divisive one as well, and there are many points of view among economists and historians.

One of the most prominent views is the F-S view, echoed by Meltzer, that monetary contraction between 1928 and 1933 produced deflation, and deflation produced - in a vicious spiral - worsening depression. These authors see a *clear causal connection* between the decline in the money supply and the depression that followed. Others do not believe the causality runs that way, seeing the public's distrust of the financial system as leading to an increase in the demand for money *outside the banking system* and the impotence of expansionary policy due to a sort of weird, and non-Keynesian *liquidity trap* situation where, due to public distrust and Fed policy toward banks - "Let them fail" - all monetary expansions ended up hoarded as people - and banks - waited for better conditions.

Some measures of the money supply shrank while others grew. It was a very different money supply then as well....not just M1 and M2 but a host of competing paper notes, national notes, bank notes, and gold coin as well. As banking crises - starting in 1930 - arose, people drained their accounts and hoarded cash out of a sound fear of the banking system's soundness. The Fed, acting as lender of last resort - *didn't*. The banks were allowed to fail...1400 in 1930, 2300 in 1931, almost 1500 in 1932, and a staggering *4000 more* in 1933. The failure of the Bank of the United States in NY city hit especially hard and, while there was a weak attempt to save it, it was also allowed to fail...with rather disastrous results. Most of the banks were state, and the Fed was under no obligation to assist non-Fed member banks. In retrospect, it probably should have but, realistically, it just couldn't have happened at the time.

Thus, R-R might be correct - contra F-S - that reflation *was* attempted by the Fed, but failed between 1930-33 because of the effects of these other ongoing occurrences.

To be fair to the Fed, we should survey other factors that were contemporaneous with the end of the bull market and the coming of depression, factors over which the Fed had absolutely no control. A short list must include the following:

1. the anticipation and eventual passage of the *Smoot-Hawley tariff* which led to a contraction of international trade - US exports fell by 2/3 between 1930 and 1933 - was precisely the sort of policy that *ought not to have been enacted* when it was. Hoover wanted to protect Republican-leaning agricultural interests and did - at a very high overall price for the nation;

2. the strong showing - in 1930 - for Adolf Hitler and his Nazi party in Germany's elections created havoc in the international bond market;
3. Hoover's wage policy, which was a misguided attempt - agreed to by major corporations - not to have wages fall during a depression, a surefire way to create unemployment that was, on its own terms and very unfortunately, hugely "successful" in raising unemployment;
4. Congress raising taxes during an economic downturn to balance the federal budget, thus increasing the tax burden on citizens whose incomes were already falling, was another perverse policy that was followed throughout the decade of the 30s, first during Hoover's - and then FDR's - terms, taxes being three times higher at the close of the 30s than they had been at their start: utterly perverse macro policy;
5. anticipation, in 1932, that FDR would abandon the gold standard if elected, and his failure to deny that rumor during the election, was also destabilizing; of course, once elected, he did a great deal more than simply abandon the standard - his administration outlawed the private ownership of gold, and confiscated it from all private citizens;
6. a great surge in economic regulation, both under Hoover, and then growing exponentially under FDR, spooked entrepreneurs and investors throughout the decade, aided by the capricious, back-and-forth court decisions on the regulations' constitutionality and the equally - and always-changing - policies that poured forth from Washington during FDR's terms;

Whatever policies the Fed might have followed - or did follow - between late 1929 and 1933 were the last ones to matter until after WW2. The Treasury took over policy, and the Fed played a much smaller role between 1934 and the end of WW2 than it had during the 20s and early 30s. What power there was at the Fed shifted to the Board in Washington. The seeds for the post-WW2 Fed we now have were sown by the Banking Act of 1935, finishing what the Banking Act of 1933 had begun.

After WW2, the regional banks became a good deal less important than the Board, and policy became centralized. It is hardly surprising that the Fed took a passive role during the New Deal - FDR was not one to share power easily, and so his Treasury Dept. - over which he had total control - became the center for national economic policy. It would be good if one could say it did better than the Fed had done but, of course, it didn't, and hardly could have given the economic capriciousness of FDR's attitudes and actions - all of which flowed from his general ignorance of, and contempt for, market process and business people.

(An example of FDR's capriciousness was his foolish personal setting of gold prices regardless of the effects his decisions had for the American and world economies. Believing, after he read George Fredrick Warren's peculiar argument in his book *Prices*, that the current gold price *caused* commodity prices to be what they were, he set about inflating the price of gold and, *ipso facto*, depreciating the dollar. Having confiscated privately held gold, and having prior contracts specifying payment in gold revoked by Congress, FDR decided - eventually - that the "correct" price for gold ought to be \$35/ounce.

Along the way, he would meet with the Treasury secretary - Henry Morgenthau - in the White House bedroom, setting that day's price for gold. One morning, FDR chose an increase of .21, and Morgenthau asked him why? "Because," FDR replied, "three times seven is 21, a lucky number." (4) Thusly did the New Deal pursue and implement important economic policy decisions. These manipulations of gold stocks and gold prices had no positive economic impact, but they did make the federal government, during the New Deal, the single greatest hoarder of gold in human history.

So we see that the Fed alone - Myth #4 - cannot be held responsible for the Great Depression. Two executive branches, and the Congress all played important roles in virtually guaranteeing that the depression would worsen after 1930, and be quite prolonged. And so it was. In a way, we learned a great deal about economic policy during the 1930s - we learned pretty conclusively what *doesn't work*. And that's a valuable thing to know. Unfortunately, the nation and its people paid a severe price for this particular collection of truths, and we remain in the shadow of many policy initiatives begun during the Great Depression that are, at best, dubious and at worse, might ultimately bankrupt us.

As for the Fed's responsibility...which view is more correct? Perhaps we can do no better than to quote Fredrick Lewis Allen on the business cycle:

Fundamentally, perhaps, the business cycle is a psychological phenomenon. Only when the memory of hard times has dimmed can confidence fully establish itself; only when confidence has led to outrageous excess can it be checked. It was as difficult for Mr. Hoover to stop the psychological pendulum on the downswing as it had been for the Reserve Board to stop it on the upswing.

(p. 285)

Thank you for your kind attention.

#### NOTES:

(1) See, for one of the most influential examples: Friedman, Milton and Anna Schwartz. 1963. *A Monetary History of the United States, 1867-1960* (Princeton: University Press), but also Meltzer, Allan H. 2003. *A History of the Federal Reserve, Volume 1* (Chicago: University Press)

(2) Humphrey, p. 11.

(3) Prochnow, chapter 15.

(4) Powell, p. 72.

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