Comments on Carlson and Wheelock

“Navigating Constraints: The Evolution of Federal Reserve Monetary Policy, 1935-59”

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What Does This Paper Do?

- Documents for 1930s through 1950s
  - Evolution of Fed Policy
  - New Policy tools given to the Federal Reserve
  - How constraints faced by Fed changed over time
- Explains why policies and outcomes were good during the 1950s
- Presents narrative and statistical evidence to support their argument

Key Arguments

- Factors “limited the Fed’s ability to conduct an independent monetary policy” in 1930s and 1940s
  - Roosevelt Administration gold policies
  - New Deal legislation
  - World War 2
- Constraints prevented Fed from reacting appropriately to expected inflation and economic fluctuations in 1930s and 40s, leading to bad policies and outcomes.

Key Quotes

- “An important part of the Fed’s success in the 1950s was the absence of political and international pressures that had constrained policy in earlier years.”
- “Freed from political and international constraints, the Fed responded more aggressively to expected inflation and fluctuations in economic activity in the 1950s than it had during 1935-50.”
- “During the 1950s, for the first time since the 1920s, neither international forces nor political pressures constrained the Fed. The resulting environment helped produce one of the most successful eras of the Fed’s first 100 years.”

Evolution of Policy Tools

New

- Margin Requirements (Securities Exchange Act 1934)
- Rates on Deposits (Banking Act 1935)

Expanded

- Open Market Operations (1932-35)
- Discount, Industrial, and Emergency Lending (1932-35)
- Reserve Requirements (1935)

Paper May Be Misleading

- New Deal legislation created the institutional foundations for independent, modern monetary policy
- Powers of the Federal Reserve
- Structure of the Federal Reserve

Backing of High Powered Money

Before 1932

$$currency + deposits\ at\ Fed$$
$$\leq gold + eligible\ paper\ AND \leq 2.5 * gold$$

After Roosevelt Administration

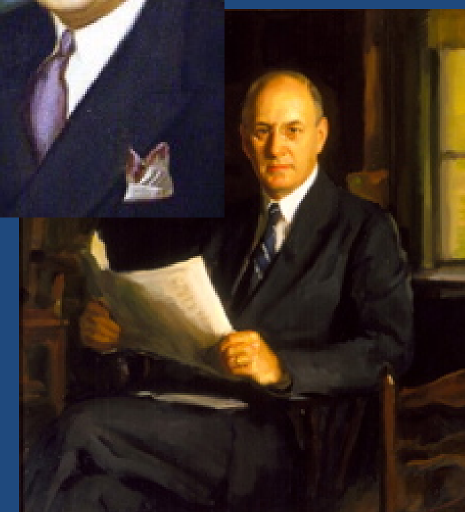
$$currency + deposits\ at\ Fed$$
$$\leq gold + assets + Treasury\ debt$$

Foundation for Fed Independence

Banking Act of 1935, Title 2

- FOMC’s modern structure created
- Removed from Federal Reserve Board
  - Secretary of Treasury
  - Comptroller of Currency
- Added to FOMC
  - Chair, Vice Chair, and governors of Fed Board

Carter Glass = Independence
Marriner Eccles ≠ Independence



Glass blocks Eccles version of Title 2, which would have placed Secretary of Treasury and Comptroller of Currency on FOMC

Photos: Glass, Eccles Fed, O’Conner OCC, Morgenthau Treasury

Questions About Coefficients

Table 2

Changes in Reserve Requirements and Macroeconomic Conditions

	Using the period 1935-1959
Predicted output gap	19.4*** (5.7)
Predicted rate of inflation	.54*** (.18)
Constant1	-1.7 (.5)
Constant2	4.3 (.9)
Observations	78
LR χ^2	43.2
Pseudo R^2	.35

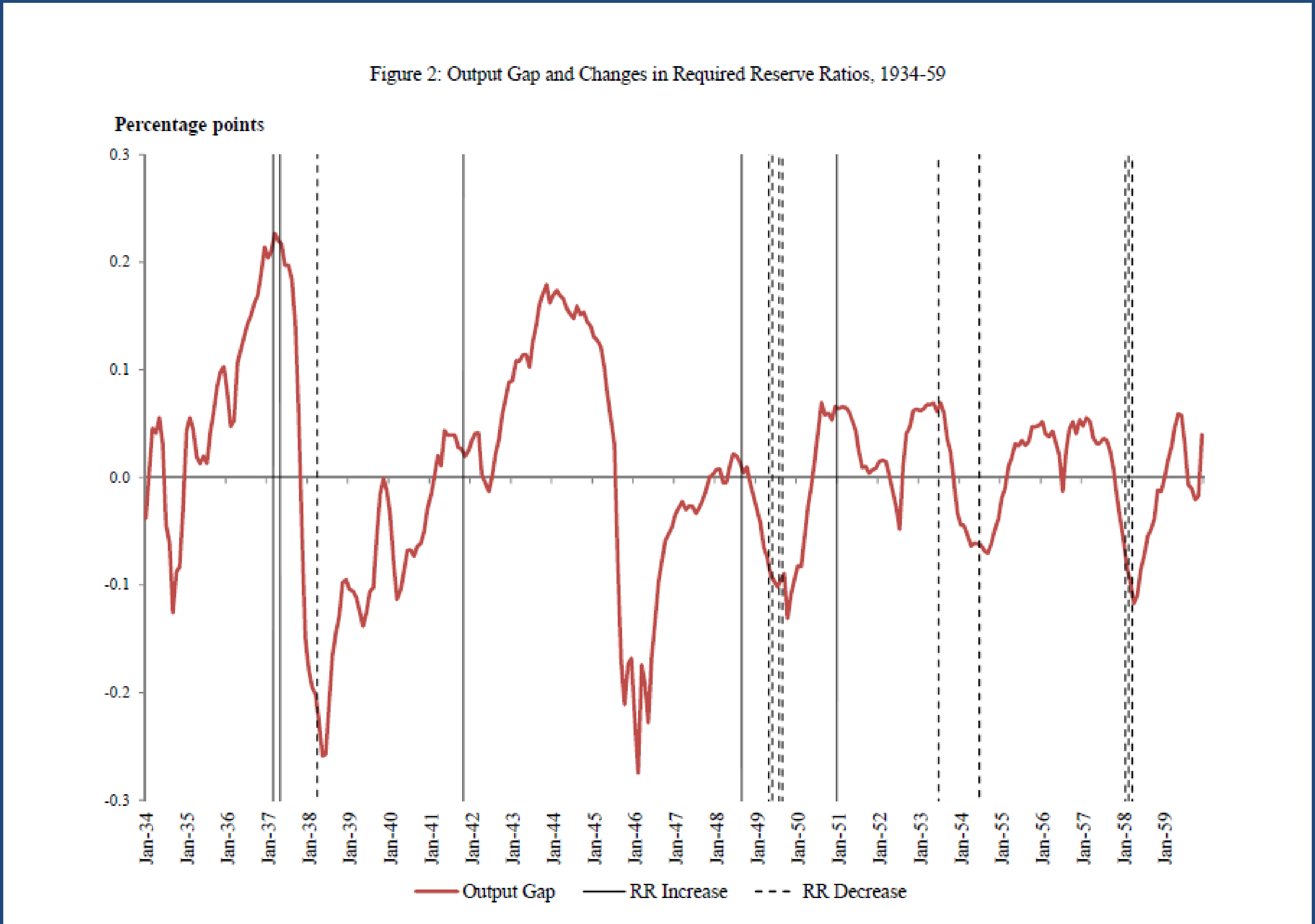
Data Allows Deeper Analysis

Table 1: Federal Reserve Member Bank Reserve Requirements, 1913-59

(Percent of Deposits)

	Net Demand Deposits			Time Deposits (all bank classes)
Effective Date[1]	Central Reserve City banks	Reserve City banks	Country banks	
1913—Dec. 23	18	15	12	5
1917—June 21	13	10	7	3
1936—Aug. 16	19.5	15	10.5	4.5
1937—Mar. 1	22.75	17.5	12.25	5.25
1937—May 1	26	20	14	6
1938—Apr. 16	22.75	17.5	12	5
1941—Nov. 1	26	20	14	6
1942—Aug. 20	24	20	14	6
1942—Sept. 14	22	20	14	6
1942—Oct. 3	20	20	14	6
1948—Feb. 27	22	20	14	6
1948—June 11	24	20	14	6
1948—Sept. 24, 16	26	22	16	7.5
1949—May 5, 1	24	21	15	7
1949—June 30, July 1	24	20	14	6
1949—Aug. 1	24	20	13	6
1949—Aug. 11, 16	23.5	19.5	12	5
1949—Aug. 18	23	19	12	5
1949—Aug. 25	22.5	18.5	12	5
1949—Sept. 1	22	18	12	5
1951—Jan. 11, 16	23	19	13	6
1951—Jan. 25, Feb. 1	24	20	14	6
1953—July 9, 1	22	19	13	6
1954—June 24, 16	21	19	13	5
1954—July 29, Aug. 1	20	18	12	5
1958—Feb. 27, Mar. 1	19.5	17.5	11.5	5
1958—Mar. 20, Apr. 1	19	17	11	5
1958—Apr. 17	18.5	17	11	5
1958—Apr. 24	18	16.5	11	5

Questions About Output Gap



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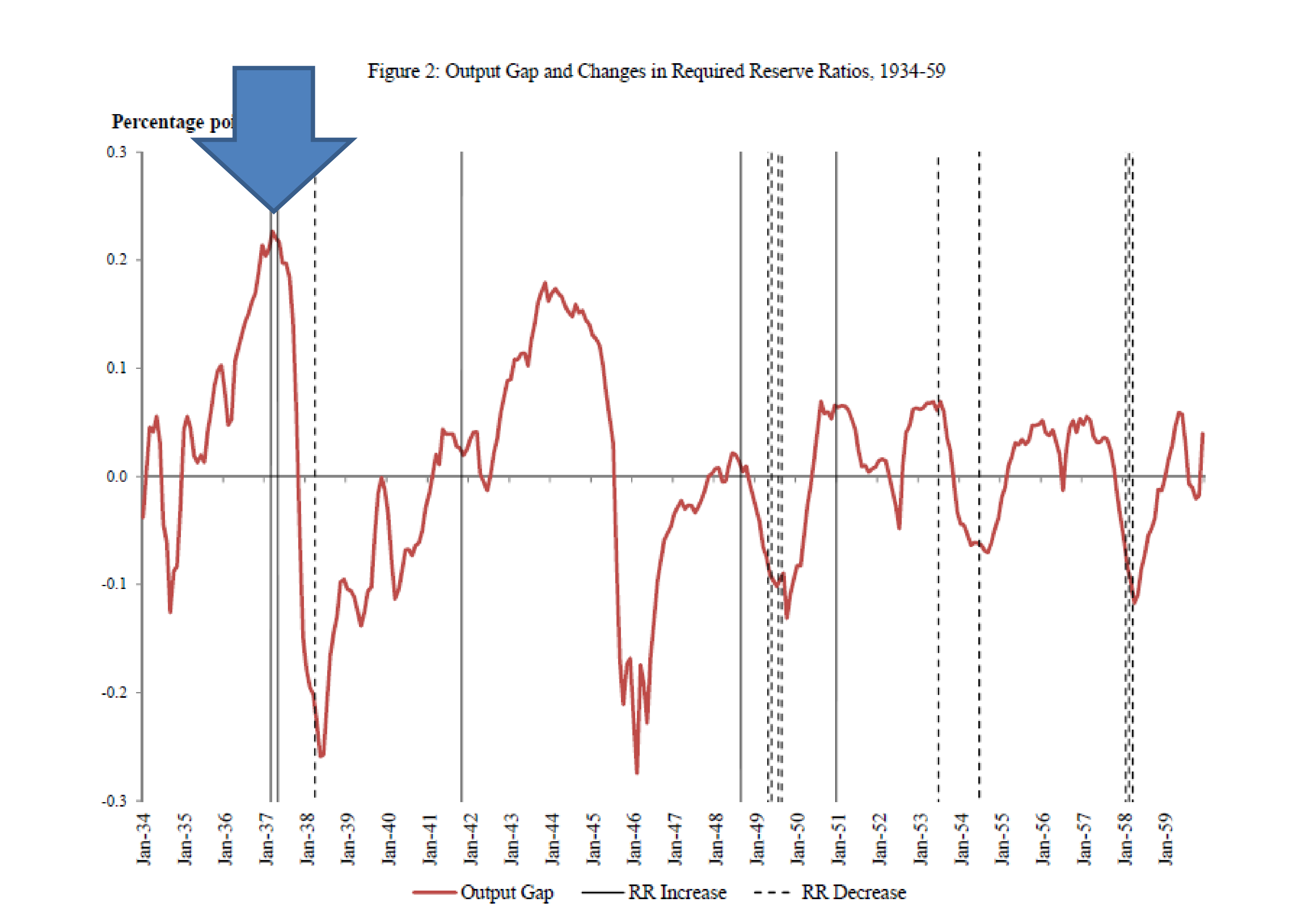

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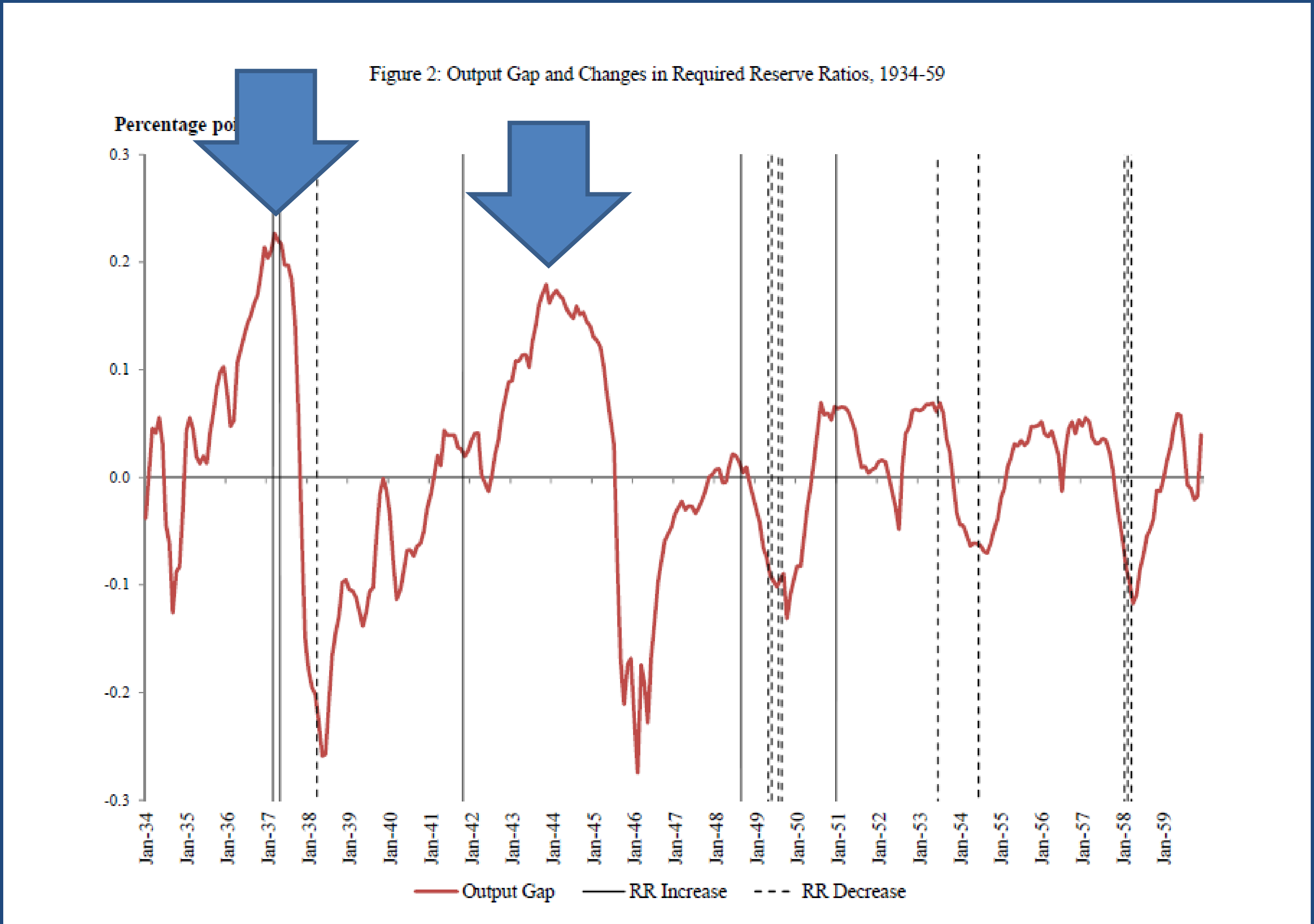
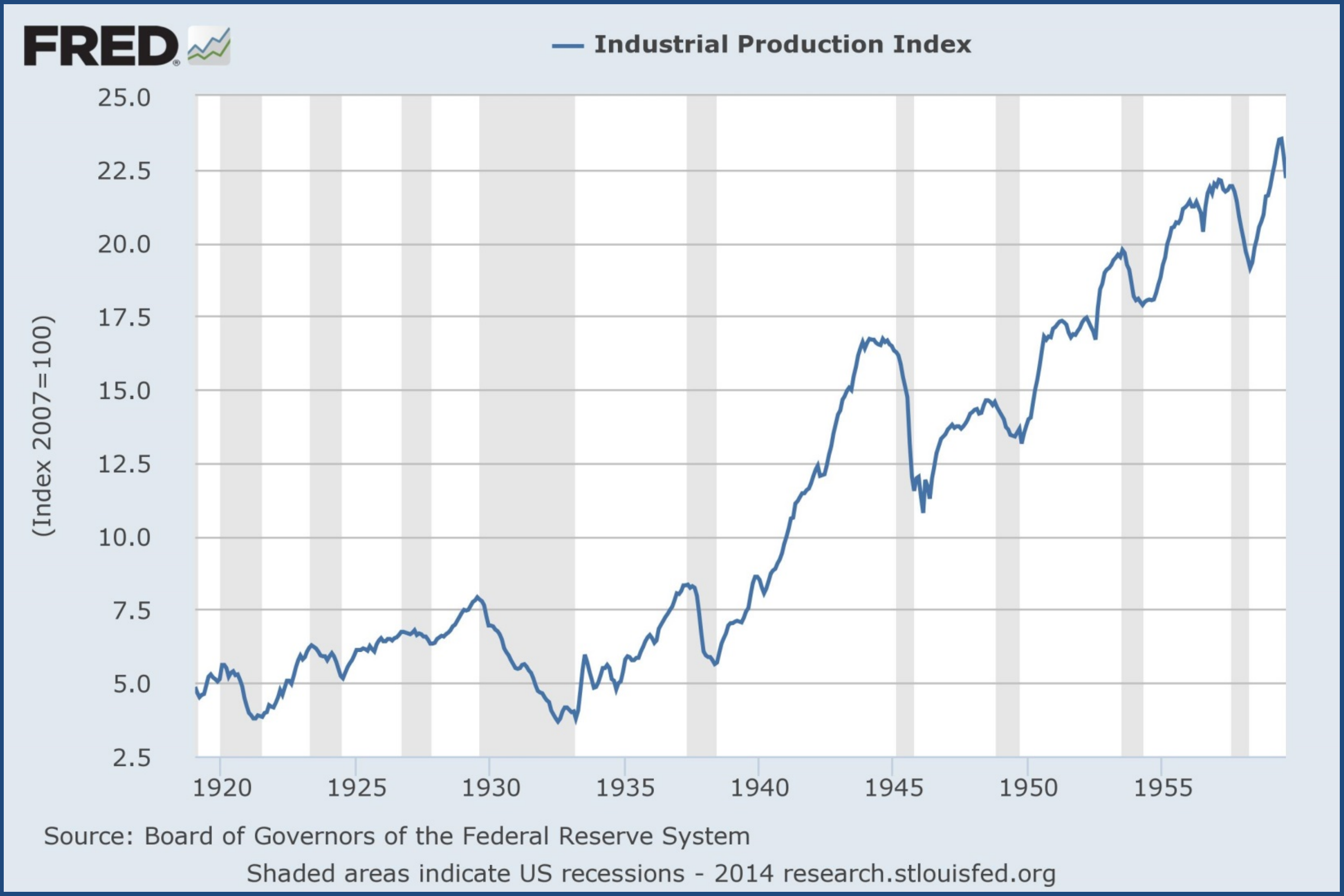


Trend and Endpoint Choices Matter



Reserve Findings

Table 3
Net free reserves and forecasted economic indicators in different time periods

	Period 1 1935q1 to 1941q3	Period 2 1947q1 to 1951q4	Period 3 1952q1 to 1959q3
Predicted output gap	-1214.5 (1970.5)	-1166.6 (1220.1)	-3735.7* (2055.0)
Predicated rate of inflation	25.9 (51.8)	16.1 (14.1)	-260.8** (114.9)
Constant	3502.3 (1644.2)	452.8 (105.4)	339.7** (157.2)
Observations	26	20	30
F-statistic	0	1.28	12.3
Adjusted R^2	-	0.03	.43

Notes: Standard errors are in parentheses. The symbols ***, **, and * denote statistical significance at the 1 percent, 5, percent, and 10 percent levels respectively. The regressions control for serial correlation.

Period 2 and 3 Similar

T-statistic
1.98 = 2.56/1.29

Table 4
Commercial paper rate and forecasted economic indicators in different time periods

	Period 1 1935q1 to 1941q3	Period 2 1947q1 to 1951q4	Period 3 1952q1 to 1959q3
Predicted output gap	-.05 (.25)	2.56 (1.29)	5.7** (2.02)
Predicated rate of inflation	-.004 (.006)	-.002 (.010)	.22 (.15)
Constant	.73*** (.10)	1.63*** (.38)	2.52*** (.42)
Observations	26	20	30
F-statistic	10.1	0	4.49
Adjusted R^2	.41	-	.19

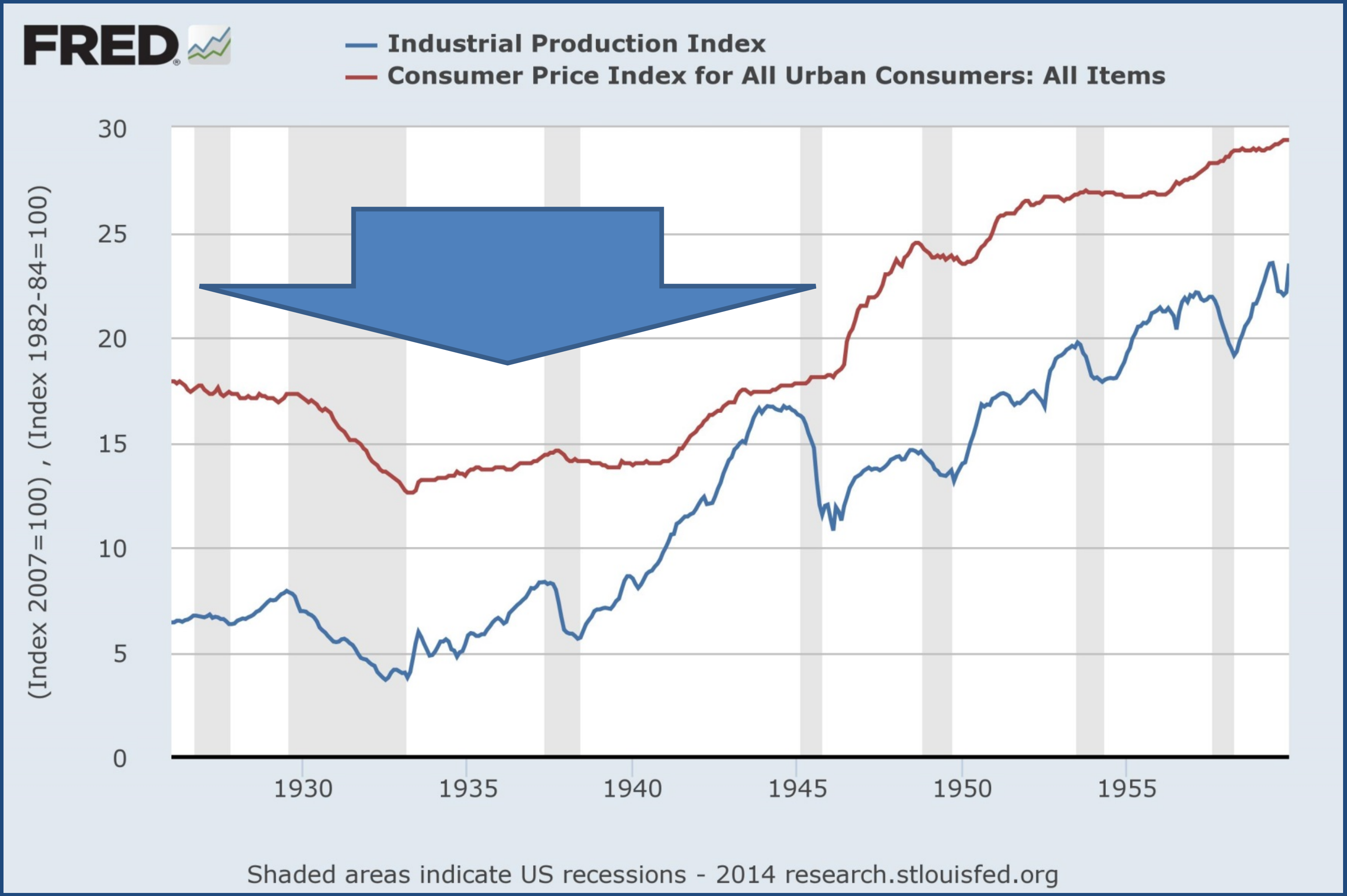
Notes: Standard errors are in parentheses. The symbols ***, **, and * denote statistical significance at the 1 percent, 5, percent, and 10 percent levels respectively. The regressions control for serial correlation.

What Do the Regressions Tell Us?

- Fed uses some policy tools consistently from late 1930s to late 1950s
  - Reserve requirements
  - Short-term interest rates

- Fed doesn't use other policy tools consistently. Prior to 1950s:
  - Less reaction to expected inflation
  - Less reaction to production above trend

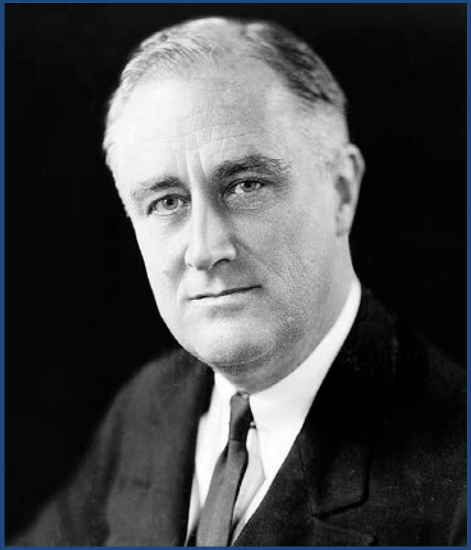
Fed Refuses to Respond to Deflation



Is Fed's Refusal Due to Roosevelt?

No

The deflation preceded



- New Deal
- Roosevelt Gold Policies
- World War 2
- Hoover's limited attempts at re-expansion via NCC, RFC, and banking acts of 1932.

Fed's Inaction Due …

- Institutional Constraints
  - Gold standard
  - Legal limits on open-market operations and discount lending

- Intellectual Constraints
  - Gold standard
  - Real bills