ECONOMY

‘The Fed, Now and Then’

Comparisons to the 1930s Continued

One year ago this week, President Obama recommended Ben Bernanke for another term as Chairman of the Federal Reserve. In his commendation speech, the President credited Dr. Bernanke for leading the U.S. economy through “one of the worst financial crises the nation, and the world, has ever faced.” He went on to remark, “As an expert on the causes of the Great Depression, I’m sure Ben never imagined that he would be part of a team responsible for preventing another.”

Comparisons between the current downturn and the Great Depression have become ubiquitous. As a student of business cycles, the gravity of such allusions is not lost on me. The idea that the U.S. economy may have just narrowly averted a repeat of the catastrophe of 1929-33 boggles the mind. After all, the average unemployment rate during the entire decade of the 1930s was just over 18 percent – more than 2.5 times greater than the 6.7 percent national average during the recent financial crisis. From 1929 to 1933, real GNP declined 29 percent. Contrast this to the 4 percent contraction in real GDP experienced during the recession that ended June of last year.

The economy’s escape from a more devastating fate underscores President Obama’s point – the aggressive work of the Fed to lower rates and pour reserves and liquidity into the banking system was salient in averting a far greater disaster.

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The extent of the willingness of the Fed to act is reflected in the growth of its balance sheet from $860 billion to $2 trillion during the financial crisis. Today, as the economy slows and the possibility of a follow-on recession increases, the Fed appears equally committed to maintaining the current low interest rate environment that it helped to create. This, coupled with my faith in the Fed’s willingness to take further action through quantitative easing, gives me confidence that the economy is likely to avoid another recession in the upcoming quarters. If you recall my analogy of the U.S. economy as a plane flying at minimum speed, I believe that in all likelihood the economy will avoid a near-term crash, although it may “buzz the tower.”

‘Heroes and Villains of the Great Depression’

In my grade-school days, I remember envisioning the Great Depression as a time when the world was literally falling apart. I imagined men and woman banging their fists on the shuttered doors and windows of banks, while others buried
coffee tins filled with dimes and nickels in their back yards. Watching the economy crumble was a laissez-faire President, Herbert Hoover, who stood idly by, waiting for the free market to right itself. Finally (at least according to my text-book trained imagination), Franklin Delano Roosevelt rode onto the scene and handed the American people shovels and hoes and got them busy digging ditches. By the time the battleships of World War II sailed safely back to harbor, the domestic economy had managed to stumble back to its feet.

The point of this child’s tale is that the aforementioned narrative has clear heroes and villains. The hero is Roosevelt (or more particularly his fiscal policies) and the villain is Hoover (or laissez-faire government). To be sure, the Roosevelt Administration is largely credited with the economic recovery from 1933 to 1937; however, it is debatable how much of the rebound was due to the economy finding an absolute bottom by the time he took office (a topic I will leave for next week). As for the villain, the reality is that it was not Hoover, or even the stock market speculators or the invisible hand of free market capitalism. With the benefit of hindsight, and the extensive work of the likes of Milton Friedman and Ben Bernanke, the real villain of the Great Depression has been unmasked. It was not a character from my childhood memory. It was the Federal Reserve.

‘Hindsight is Monetary’

In their 1963 book, “A Monetary History of the United States, 1867-1960,” Milton Friedman and Anna Schwartz were the first to empirically trace the cause of the Great Depression to the monetary policy missteps of the Fed during the 1920s and 1930s. As Ben Bernanke once concurred, “The errors of both commission and omission made by the Federal Reserve in the late 1920s and early 1930s led to an undesirable tightening of monetary policy, as reflected in sharp declines in the money supply ... By allowing persistent declines in the money supply and in the price level, the Federal Reserve of the late 1920s and 1930s greatly destabilized the U.S. economy and ... the economies of many other nations as well.”

It doesn’t take long to summarize the quandary of errors the Federal Reserve made during the Great Depression. The first monetary misstep was the “antispeculative” policy tightening of 1928-29. Concerned about the speculative use of credit in the stock market boom, the Fed addressed the problem through what Ben Bernanke described as “a monetary policy innovation,” i.e., it tightened without any regard to the state of output and prices.

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By July of 1928, the Fed funds rate was raised to its highest level since 1921, and the Fed had liquidated nearly two-thirds of its holdings in government securities. The steep rise in interest rates led to an economic downturn that began in August of 1929, two months before the October stock market crash. As Friedman and Schwartz would write, "During the two months from the cyclical peak in August 1929 to the crash [in October 1929], production, wholesale prices, and personal income fell at annual rates of 20 percent, 7.5 percent, and 5 percent, respectively."

According to many economists, recession was well under way by the time Black Tuesday rolled around on October 29, 1929. The tightening prior to the crash of 1929 was just the first in many missteps the Fed would make during the Great Depression. In subsequent years it would repeatedly tighten when the economy was begging for credit and less restrictive monetary policies.
The next major misstep occurred in September 1931, when a series of speculative attacks on the pound led Great Britain to abandon the gold standard. After Great Britain’s departure, speculators turned their eyes on the dollar, anticipating that the United States would be the next to leave the gold standard in favor of letting its currency float. In defense of the almighty dollar, in October of 1931, the Fed raised interest rates by an entire point in the span of just a few weeks. According to Friedman and Schwartz, the interest rate increase was “the sharpest rise within so brief a period in the whole history of the System, before or since.” This dramatic policy tightening, combined with the ongoing collapse of the banking system, caused the money supply to fall precipitously, which in turn led to further declines in economic output and prices.

During the Great Depression, the Fed injected little liquidity into the banking system, and it came to the aide of very few banking institutions in direct measure. Economists such as Friedman, Schwartz, and others have often speculated that at the time the Fed must have ascribed to the doctrine of Treasury Secretary Andrew Mellon, who had resolved to stand by and allow the market to work itself out. It was Mellon who is now infamous as saying, “Liquidate labor, liquidate real estate … values will be adjusted, and enterprising people will pick up the wreck from less-competent people.”

Whether the Fed’s inaction was intentional or the result of indecision, liquidation indeed ensued in the banking system. From 1929 to 1932 an estimated 10,000 banks were allowed to fail – roughly 40 percent of the entire banking system. The failures, combined with panicked withdrawals from the institutions that remained, served to greatly reduce the money supply and the velocity of money. As a result, output and price levels declined even further as fewer purchases were made and fewer dollars circulated in the economy. The banking panic ultimately wouldn’t subside until the newly-inaugurated Roosevelt declared a banking holiday as his first act as President. For 10 days in March of 1933, banks were allowed to legally refuse withdrawals. During the 10-day “holiday,” it is estimated that half of the surviving banks either closed or merged with other banks. The surviving entities were only allowed to reopen once certified by the government, a message of confidence that helped stem the tide of panic (something that sounds a lot like the recent bank stress tests). By the time the bank holiday ended, and the panic subsided to a large degree, the recession had essentially found its trough and there was nowhere to go but up.
‘An Abdication of Duty’

The Fed was created by an act of Congress in 1913 to help stabilize the banking system. It is ironic that during the worst banking crisis in the nation’s history the Fed failed to carry out its primary role as the lender of last resort. Rather than providing liquidity to the banking system, the Fed of the 1930s thought it better to watch the banking system collapse, oblivious to the effect such a contraction might have on the money supply. Bernanke has stated his belief that the Fed could have offset the decrease created by bank failures by engaging in bond purchases, but for some reason (possibly ignorance) it did not.

In Milton Friedman’s 1980 book “Free to Choose,” the renowned economist summarizes the Fed’s actions during the banking panics of the Great Depression as “hesitant and small,” noting:

‘THE FED OF ACTION’ – FEDERAL RESERVE BALANCE SHEET SIZE AND COMPOSITION

To President Obama’s point, the aggressive work of Federal Reserve to lower rates and pour reserves and liquidity into the banking system was salient in averting greater economic disaster. The extent of the willingness of the Fed to act is reflected in the growth of its balance sheet from $860 billion to $2 trillion during the financial crisis.

Federal Reserve Balance Sheet Size and Composition

Source: U.S. Federal Reserve

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The [Federal Reserve] System could have provided a far better solution by engaging in large-scale open market purchases of government bonds. That would have provided banks with additional cash to meet the demands of their depositors. That would have ended – or at least sharply reduced – the stream of bank failures and have prevented the public’s attempted conversion of deposits into currency from reducing the quantity of money. Unfortunately, the Fed's actions were hesitant and small. In the main, it stood idly by and let the crisis take its course – a pattern of behavior that was to be repeated again and again during the next two years.

Friedman goes on to say that the actions of the Fed were not only a complete abdication of its core responsibilities, but the primary cause of the Great Depression.

History judges the actions of the 1930s Fed with severity, but it is important to remember that the Fed was only just formed in 1913. Additionally, the teenage institution lost its first great leader, Benjamin Strong, in 1928. Nonetheless, the monetary policies of the 1920s and 1930s were consistently off-base and set a pattern for how not to deal with financial crisis – a pattern that Bernanke, the greatest student of the Depression aside from Friedman, would follow tenaciously during the financial crisis of 2007-2009.

‘The Other Side of the Coin: The Fed of Action’

In stark contrast to the passive, weak-hearted Fed of the 1930s, an organization whose sins of commission and omission led the U.S. economy to the depths of Depression, there stands the Federal Reserve of today. Dr. Bernanke himself described the juxtaposition of the Fed’s actions during these two periods of crisis as that of "aggressive" verses "largely passive." Learning from its mistakes during the Depression, the central bank poured reserves and liquidity into the banking system in order to keep the money supply from collapsing as it did during the Great Depression. In addition, it utilized a special amendment to its charter to shore up confidence in the financial system, save jobs, and bolster demand.

While Dr. Bernanke and his team may have been slow off the mark in recognizing the strains on the economy – which were apparent as early as February of 2007 – by the time summer rolled around the Fed was poised to
take action. In August of 2007, four months prior to the start of the recession, the Fed began lowering its target for the federal funds rate. By December 2008, the FOMC had moved its benchmark rate on short-term borrowing from 5.25 percent to 0.25 percent in just 16 months. In addition, the very month the recession began, in December 2007, the Fed created the Term Auction Facility (TAF) to directly provide trillions of dollars in interbank lending over the course of the recession.

‘The Section 13(3) Calling Card’

Ironically, it was during the height of the Great Depression that the Fed received the authority it needed to make its most decisive interventions nearly 75 years later. Under Section 13(3) of the Federal Reserve Act of 1932, the Fed was granted the authority to lend directly to any person or business if it deemed the borrower was unable to secure credit from the open market due to “unusual and exigent circumstances.” Thus, in 2008, the Fed invoked Section 13(3) and created the Primary Dealer Credit Facility to extend liquidity to primary dealers. Shortly thereafter, the Fed found itself invoking Section 13(3) on a more frequent (and previously unimaginable) basis, enacting the now famous loans such as the $29 billion used to fund the acquisition of Bear Stearns by JPMorgan Chase and the $85 billion that went to stave off the bankruptcy of AIG. Other unprecedented Federal Reserve actions included the approval of Goldman Sachs, Morgan Stanley, American Express, CIT, GMAC, and Merrill Lynch to become bank holding companies that could access Fed credit lines, and the creation of special entities to purchase commercial paper and other assets from money market mutual funds.

As extraordinary as the Section 13(3) actions of the Federal Reserve were, possibly more unprecedented was its decision to prop up a single asset class within the U.S. economy. During the financial crisis, the Fed’s single largest intervention was its $1.25 trillion program to buy mortgage-backed securities. This massive effort was enacted to reduce the cost of borrowing and increase the availability of credit for the purchase of residential real estate. The program, which ran from November 2008 to March 2010, has been credited with holding mortgage interest rates low and slowing the nationwide decline in home prices. It was notably unprecedented for the Fed to take such decisive and strategic action aimed at a particular segment of the economy. As David Wheelock of the St. Louis Fed

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recently wrote: “The move to support a particular market through open market purchases is highly unusual for the Federal Reserve and unprecedented on this scale since before World War II.”

In addition to its work at home, the Fed played a role in the stabilization of the global financial markets, not only through its example of leadership, but also through direct action, such as the establishment of swap lines with the European Central Bank and more than a dozen other central banks around the world to provide a source of dollar funding for the international financial markets.

‘Thanks to You, We Won’t do it Again’

Among the members of today’s Federal Reserve, I’ve heard the monetary policy of the Great Depression characterized as a series of “legendary failures.” The lethargic, passive, hyper-conservative mishaps of the Great Depression are now infamous among the leaders of today’s central bank. It is a source of embarrassment for the Fed to think that it once stood idly by while 40 percent of the banking system disappeared, prices declined by 30 percent, and the monetary base collapsed. The lethargy of the Depression-era Fed stands in sharp juxtaposition to the unprecedented activity of the Fed during the recent crisis. If the Fed is to be blamed for the Depression of the 1930s, I believe President Barack Obama is correct in his assertion that it should be heralded for preventing a potential repeat performance today.

On November 8, 2002, Ben Bernanke, then just a Fed governor, made a speech at Milton Friedman’s 90th birthday party, held at the University of Chicago. Bernanke concluded a long oration praising Friedman’s lifetime of work on the Great Depression with the following admission: “Regarding the Great Depression. You’re right, we did it. We're very sorry. But thanks to you, we won't do it again.”

To make amends, Dr. Bernanke has done more than just apologize on behalf of the central bank; he has done an admirable job leading decisive action during the recent financial crisis. Despite his best efforts, the Fed’s objectives of low unemployment and stable inflation remain far from a reality. Unemployment is currently 3 to 5 percent above the range the Fed would consider full employment and inflation is running somewhere between 1 and 2 percent below its informal target. Against this backdrop, all eyes will be on Jackson Hole this week to hear if Bernanke will reveal plans for continued action. The fact that the Fed stands ready with another round of quantitative easing, and that interest rates are at historically low levels, leads me to believe the economy will avoid the perils of a “double-dip” recession in the near term.

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Of course, monetary policy is but one of many important influencing factors. There remain questions about the impact of upcoming fiscal policy decisions, something I intend to address next week in greater detail.

‘Thoughts on the Market’

At a more micro level, the economy recently received another round of disturbing numbers, not least of which was the dramatic decline in the Philadelphia Manufacturing Index. The sharp contraction in the Philly Fed index raises a lot of concern, especially since it has historically been viewed as having the tightest correlation to U.S. manufacturing activity. As we all know, the consumer has not led this recovery; it has essentially been an inventory-building and export-led recovery. Now that imports are exceeding exports, it’s not an export-led recovery any longer. On top of that, the inventory build seems to be behind us as businesses are increasingly concerned about future economic activity. So to see the manufacturing data turn down is probably the worst omen that I’ve seen since the crisis ended.

‘LACK OF CONFIDENCE’ – THE PHILADELPHIA FED MANUFACTURING INDEX TAKES A DIVE

The sharp contraction in the Philly Fed index raises a lot of concern, especially since it has historically been viewed as having the tightest correlation to U.S. manufacturing activity.

Source: Philadelphia Federal Reserve
The bottom line is that the market, as a beast, is not going to be happy until it prices itself for recession. There are now enough recessionary clouds looming on the visible horizon that regardless of whether the economy will experience another downturn or not, given all the uncertainty, investors will be loath to commit large amounts of new capital until the market prices itself as if it’s facing an impending recession. I personally don’t think the U.S. will have another downturn this year, largely because interest rates are so low. With that said, there is an unmistakable doom-and-gloom mentality pervading the market, and I think the prophesy will become self-fulfilling in that the market will continue to trend toward pricing for an economic downturn.

In addition, this is a seasonally difficult time. The market generally goes through a rough patch in September and October, and for those who read last week’s piece, you’ll recall that the peak of the market in 1929 actually occurred on the last day of August. All this leads me to believe that volatility will continue through October. I think credit spreads will come under some pressure, but the impact will be muted because it will be associated with falling interest rates. The 2.50 range for the 10-year Treasury will provide some resistance to higher prices/lower yields, but ultimately, before everything is said and done and the end of the year comes to pass, I think the yield on the 10-year Treasury note will approach 2.0 percent.

As I previously stated, I don’t see the economy having a crash this year, but I do think we’ll “buzz the tower.” It will feel pretty bad and there will probably be a high degree of fear associated with the upcoming quarters, but at some point in the near term I believe there will be increasingly attractive buying opportunities for investors with cooler heads.