Ben Bernanke is a noted expert on the Fed’s monetary history, especially in the 1930s. When the FOMC meets on Tuesday, he may spare a moment to remember that this week sees the 80th birthday of a fateful Fed decision in 1932, a decision which some scholars believe led inexorably to the bank failures of early 1933, and the suspension of US membership of the Gold Standard. That decision was to end the only period of aggressive quantitative easing which was attempted by the Fed during the worst period of the Great Depression between 1929 and 1933.

The conditions the Fed faced in July 1932 do not represent a close parallel with the conditions they face this week. Far from it. Yet some of the arguments are uncannily similar, and the episode tells us what might have happened after 2008 if the Fed had adopted the same approach as it did in 1932. The lessons for the ECB this week may be more pertinent.

The 1932 episode, which is not as well known as the Fed’s notoriously mistaken tightening in 1937, came to my attention via this excellent piece by Bruce Bartlett, who has held many senior advisory roles in the Republican Party. Economic conditions in early 1932 were of course as dire as they had been at any time in US history. Real GDP and industrial production had not stabilised, and were on their way to declines from the 1929 peak of 27 per cent and 52 per cent respectively:
These declines in real GDP compare with a rise of 1.7 per cent in US GDP since the 2008 peak. Furthermore, in 1932, deflation was raging at an annual rate of -10 per cent per annum, thus increasing the real burden of outstanding debt at an alarming pace:

There had been two serious periods of bank failure before February 1932, which would eventually reduce the money supply (M1) by 33 per cent from its 1929 peak. In their classic history of American monetary policy, Milton Friedman and Anna Schwartz argue that most or all of this economic carnage could have been avoided if the Fed had taken steps to prevent the decline in the money supply after 1929. These steps would have involved more aggressive open market purchases of government bonds, crediting banks and others with enough liquidity to meet their rising demand for cash.

Instead, the scramble for liquidity caused runs on bank deposits and firesales of banks’ assets, which led inexorably to bank failures. By not accommodating the rise in liquidity preference, the Fed forced a huge contraction on the banking sector. Anyone who has not recently read the extraordinary Friedman/Schwartz narrative should do so, because it paints a picture of what might have happened after 2008 without the action which the Bernanke Fed has taken.
The Friedman/Schwartz conclusion is that monetary policy from 1929-33 was “inept”, and was based on faulty economic reasoning by the Fed. In particular, I interpret them as saying that the Fed should have adopted larger open market operations – quantitative easing in today’s language – to expand the monetary base more rapidly than actually occurred:

There was one exception to this blanket criticism of the Fed’s actions in the early 1930s, which was the period from February to July 1932, when the central bank embarked on large scale open market operations to ease monetary policy. Under pressure from a frightening collapse in the banking sector, and from the Goldsborough bill in the House of Representatives (which would have required the Fed to restore the price level to that seen in 1926 but which later failed in the Senate), Governor George L. Harrison of the New York Fed cajoled the Open Market Policy Committee to purchase $1 billion of government bonds in the summer of 1932, an amount equivalent to 15 per cent of the monetary base.

Harrison knew exactly what he was doing. His explicit intention was to arrest the decline in bank credit by increasing the excess reserves held by the commercial banks at the Fed. The public also knew what was happening. The New York Times said:

“By entering upon a policy of controlled credit expansion, designed to turn the deflation in bank credit and to stimulate a rise in prices, the Federal Reserve System has undertaken the boldest of all central bank efforts to combat the depression.”

Furthermore, according to Friedman/Schwartz, the open market purchases worked. Interest rates, which were previously under stress, tumbled. Activity data and price deflation showed signs of bottoming. Yet, 80 years ago this week, the Fed lost its nerve and stopped the open market purchase programme. Why?
This is still a matter of some dispute among economic historians. Barry Eichengreen, in his definitive book “Golden Fetters” argues that membership of the Gold Standard precluded a prolonged period of aggressive open market purchases, because this would have caused problems with the dollar’s gold parity. Yet, according to this 2006 paper by Chang-Tai Hsieh and Christina D. Romer, there is no evidence that the Fed took this into account in the critical months of 1932. Nor were there any strains on the dollar.

Instead, the Fed changed its mind because old orthodoxies about monetary policy rapidly reasserted themselves in policy makers’ minds as soon as the worst was over.

At the time, the Fed believed that monetary policy was axiomatically to be regarded as “easy” if commercial banks held any excess reserves at all at the central bank; the scale of these excess reserves did not matter. In fact, it was thought that adding additional excess reserves was pointless, since in a recession the banks would not lend these reserves to firms and individuals.

Furthermore, it was argued that open market operations would distort the market in government debt, creating artificially low interest rates for short term government securities.

Finally, it was believed that bond purchases would undermine the strength of the balance sheets of key District Reserve Banks, including the New York and Chicago Feds. Even Harrison believed that the Fed’s “ammunition” was limited, and (bizarrely) that it was best used when the economy was expanding, not contracting. In consequence, the open market operations were halted, and the Depression continued into 1933.

Many of these arguments will be heard, in more modern form, in the FOMC meeting this week. In 1932, they proved wrong, because they missed the point that a massive rise in the private sector’s precautionary demand for liquidity needed to be accommodated via an increase in the central bank balance sheet. That is a point which the ECB, in particular, should reflect upon this week.