The Great Depression of the 1930s from the Perspective of Today, and Today from the Perspective of the Great Depression

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Overview

- Ten years ago we had a view of the Great Depression
  - It was something that the Federal Reserve could have stoppec in its tracks
  - But the Federal Reserve did not understand the situation
  - And so it didn’t
  - We today, however, know better
- And five years ago we had a view of today
  - It was a thing like the Great Depression that we knew how tc stop
- In both cases, we were wrong

Outline of This Talk

- Introduction
- What the Federal Reserve thought the Great Depression was back in 1931
- What it did, and what happened
- What Milton Friedman and Anna Schwartz thought the Great Depression was in 1980
- How Ben Bernanke attempted to apply Milton Friedman and Anna Schwartz's cure in 2009-10
- What went wrong
- Conclusion: what could we try next?

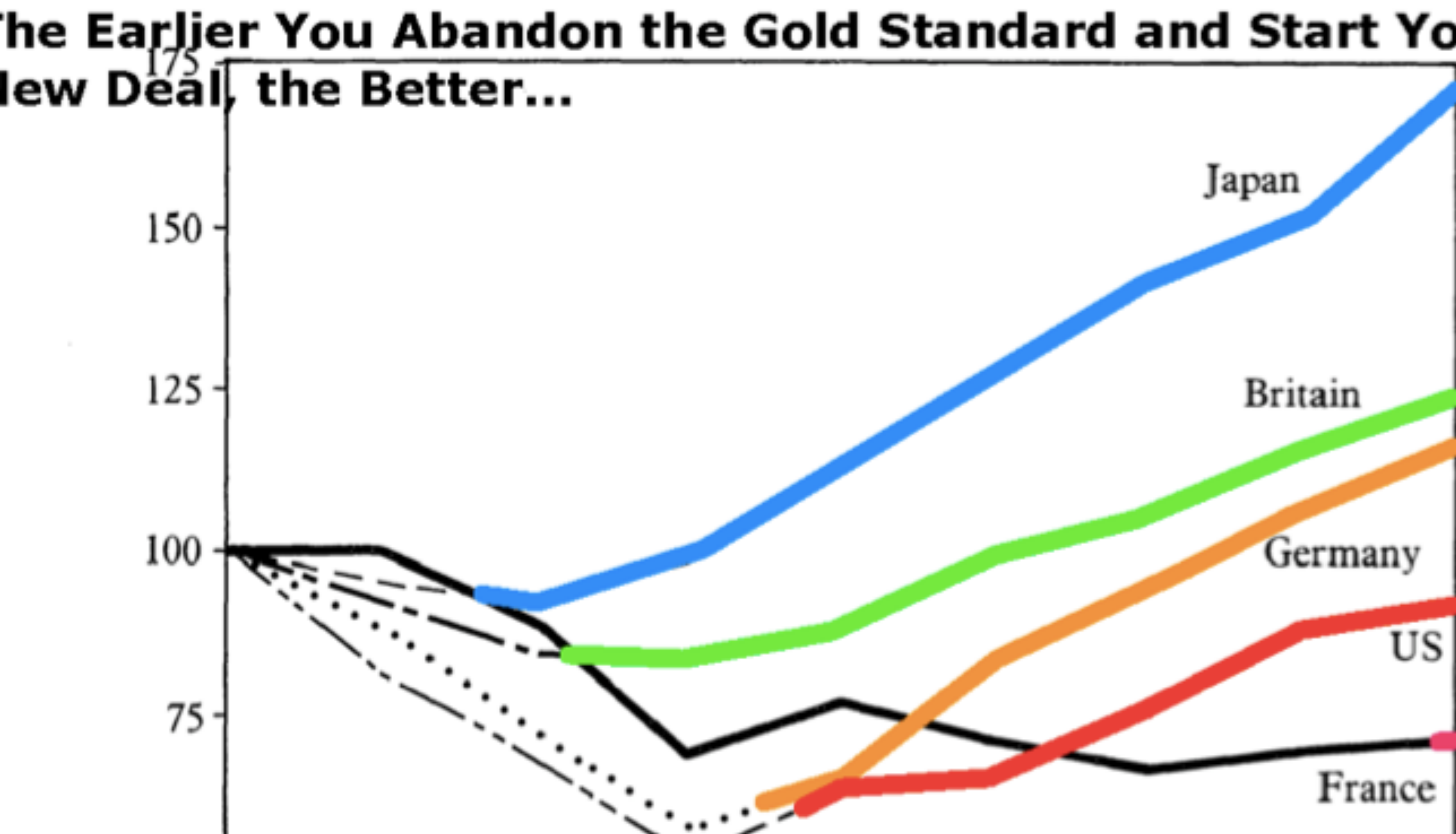
The View from 1931: Financial Crisis and Depression as Liquidity Squeeze

- The British Canal Bubble of 1825 and what followed
- The Bagehot Rule:
  - Lend freely
  - At a penalty rate
  - On collateral that is good in normal times
- Side constraints:
  - Liquidity and solvency
  - The dangers of inflation
  - The trustworthiness of the market
  - Gold and confidence

The Application Over 1931-33

- Deviation from the Bagehot Rule in the direction of ease:
  - Lend freely
  - Lend overfreely, in fact
  - Defend the gold standard and the government's credit
- Consequence: disaster
  - Insolvency and deflation
  - Economists disagree: Viner (Friedman, Keynes) vs. Schumpeter (Hayek, Robbins)

Does Not Begin Until the Gold Standard Is Abandoned



Schwartz's View from 1980

- A liquidity squeeze does not show itself necessarily as a high rate of interest on Treasury debt
  - People can be squeezed of liquidity and yet still be willing to hold government bonds
- A liquidity squeeze shows itself as a fall in the *quantity of money*
- Shovel enough reserves into the system to prevent a fall in the quantity of money, and you prevent the squeeze, and you prevent the depression

Implications of Friedman and Schwartz I

- Robert Lucas (2003):
  - Macroeconomics was born as a distinct field in the 1940's, as a part of the intellectual response to the Great Depression. The term then referred to the body of knowledge and expertise that we hoped would prevent the recurrence of that economic disaster. My thesis in this lecture is that macroeconomics in this original sense has succeeded: Its central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades... potential for welfare gains from better long-run, supply-side policies exceeds by far the potential from further improvements in short-run demand management.

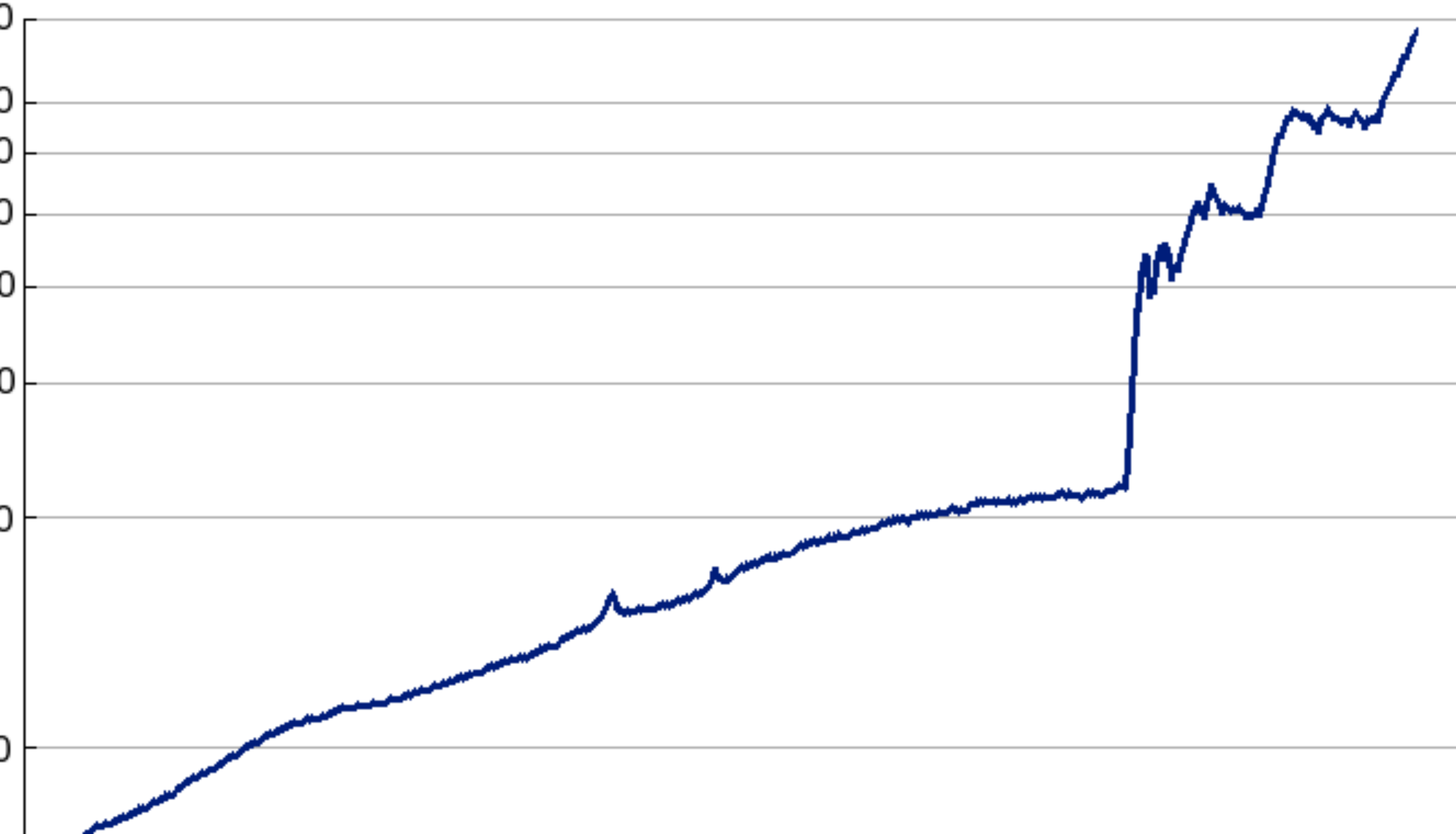
Implications of Friedman and Schwartz II

- Ben Bernanke (2002):
  - The brilliance of Friedman and Schwartz's work on the Great Depression... the texture of the discussion... the coherence of the point of view. .. [takes] seriously the issues of cause and effect in a complex economic system.... The best thing that central bankers can do for the world is to avoid such crises by providing the economy with, in Milton Friedman's words, a "stable monetary background"--for example as reflected in low and stable inflation. Let me end my talk by abusing slightly my status as an official representative of the Federal Reserve. would like to say to Milton and Anna: Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again.

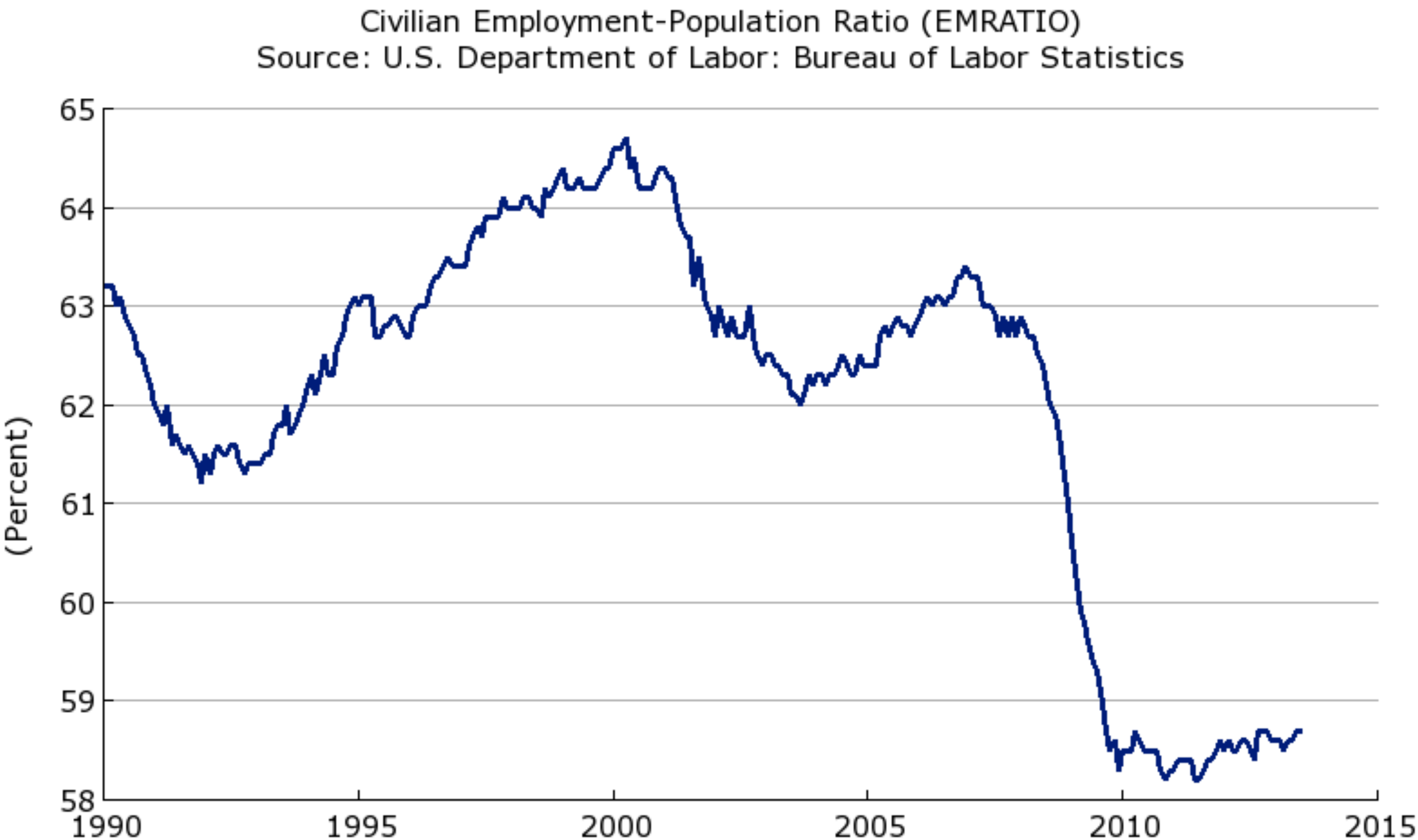
Ben Bernanke's Plan in 2008-9

- Recapitalize the banks so that there isn't this extra demand for safe outside-bank cash
- Shovel liquid cash reserves into the system
- Keep the *quantity of money* from declining
- Watch risk premia fall
- Wait for a strong recovery to establish itself

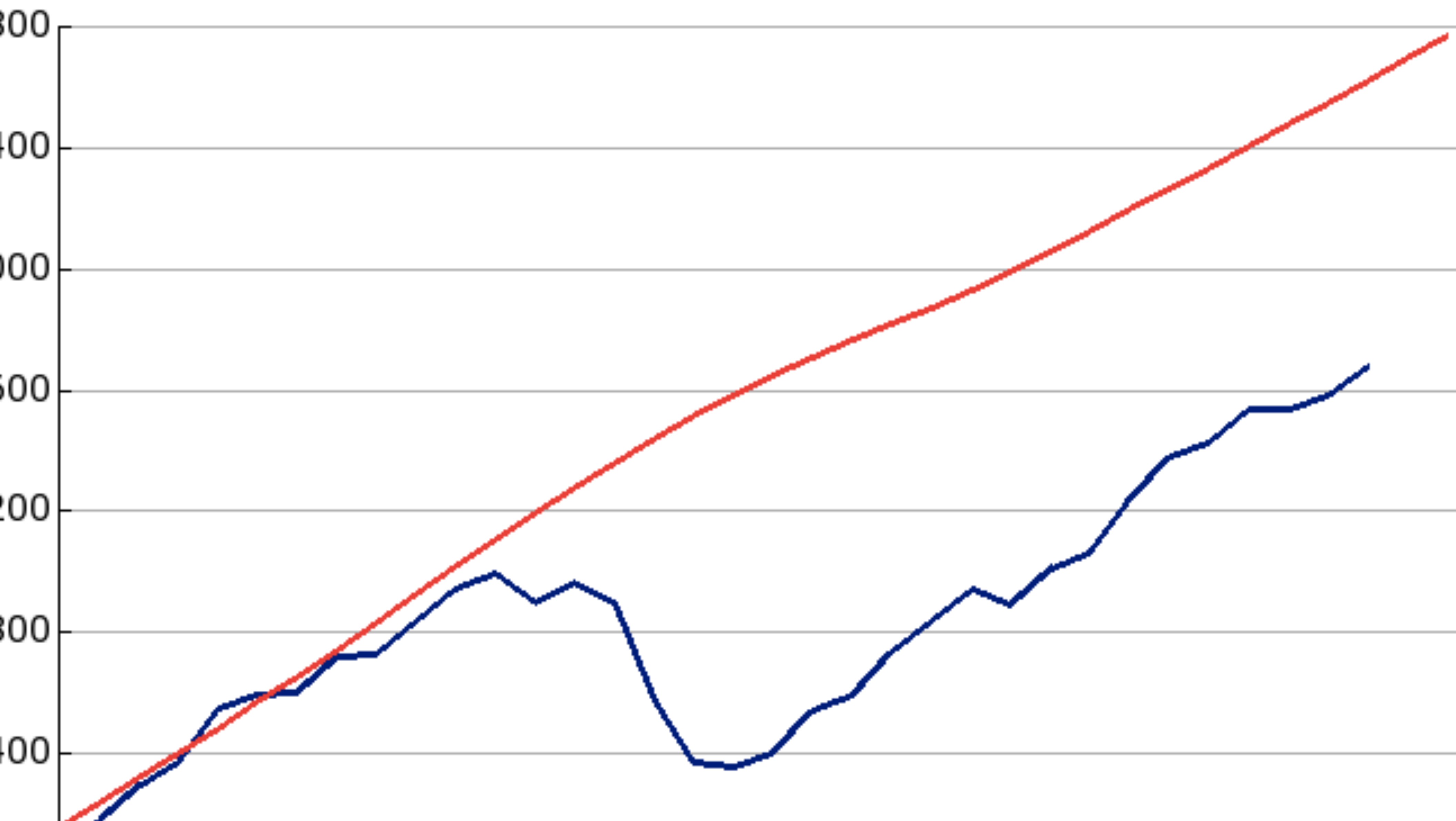
Ben Bernanke's Plan Was Carried Out



But It Didn't Work the Way It Was Supposed to



Next to No Gap Closing...



Recapitulation

- 1931: Prevent liquidity squeeze by keeping interest rates at low or normal levels, allow insolvent banks to fail
  - Didn’t work
- 2009: Prevent liquidity squeeze by keeping interest rates low; keeping banks from failing via recapitalization, subsidy, or forced merger; and keeping the *quantity of money* on track
  - Didn’t work (although quantity of FAIL certainly less)
  - Instead of going up by 18% points, unemployment only goes up by 6% points

Now We Have to Draw Lessons

- What actually was going on in the Great Depression, now that we think that Milton Friedman and Anna Schwartz had it wrong?
- What should the next Bernanke do the next time the balloon goes up, given that the Friedman-Schwartz cure looks insufficient?
- What should Bernanke's successor and Boehner-Reid-Obama try next?

What Was Going on in the Great Depression?

- Not a liquidity squeeze
- Another kind of squeeze—a nominal safety squeeze
- Expanding *the quantity of money* doesn't do much to alleviate the squeeze
- Needed: an expansion of safe wealth—or massive government deficit spending, or confidence that prices would be higher in

Fighting the Great Depression

- Successful anti-Depression policies by
  - Takahashi Korekiyo (高橋 是清)
  - Neville Chamberlain
  - Adolf Hitler

Roosevelt's New Deal a Mixed Bag...

- NIRA cartels
- Tax-financed government-employment programs
- Higher capital and reserve requirements for banks
- Public-utility network breakups
- Unemployment relief and farm subsidies
- Deficit spending
- Going off the gold standard, and subsequent expansion of the money supply

What Should the Next Bernanke Do?

- ????

What Should Boehner-Reid-Obama Do?

- The successful examples of rapid recovery from the Great Depression suggest what is needed for full and rapid economic recovery is:
  - Expectations of (somewhat) higher inflation (interwar Britain and Japan)
  - Large-scale government deficit-spending (interwa Germany)
  - Perhaps loan guarantees
- All three seem politically out of the question...