A CENTURY OF THE FEDERAL RESERVE: SUCCESS OR FAILURE?

Lawrence H. White
George Mason U.

Foundation for Teaching Economics
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00:50

WHY WAS THE FEDERAL RESERVE ESTABLISHED?

"Many people are free-market capitalists, and they always talk about free-market capitalism, and that is our economic theory. So why do we have a Fed? Is the free market – wouldn't the market take care of interest rates and all that?"

Daily Show, 18 Sept. 2007

01:04

WHY WAS THE FEDERAL RESERVE ESTABLISHED?

"You're raising a very fundamental question. … You didn't need a central bank when we were on the gold standard, which was back in the nineteenth century. And all of the automatic things occurred because people would buy and sell gold, and the market would do what the Fed does now."

Daily Show, 18 Sept. 2007

Note: Because the US *was* on the gold std. in 1913 *when the Fed Reserve Act was passed.*

03:00

PANICS OF THE PRE-FED ERA

Milder in 1884, 1890

More severe in 1873, 1893, and 1907
- widespread suspensions, runs
- "currency famine"

Run- and panic-proneness of US banks **not natural**, but due to policies that weakened US banks
- No such problems in Canada

Panic of 1907, NYC

03:40

POLICIES THAT WEAKENED NATIONAL BANKS

- restrictions on branching (contrast Canada)
  - poorly diversified banks→ failure-prone → run-prone
- collateral restrictions on note-issue (contrast Canada)
  - seasonal demands led to reserve drains
  - banks couldn't issue more notes to swap for deposits even in a currency famine

06:20

REFORM DISCUSSED BUT *NOT* ADOPTED

- Deregulation a la Canada: ABA's 1894 "Baltimore Plan"
  - end bond-collateral restriction on note-issue
  - branch banking to provide speedier drain for excess notes
  - opposed by small banks

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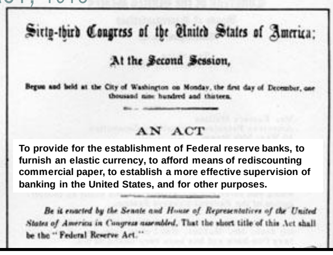
INSTEAD OF DEREGULATION: THE FEDERAL RESERVE ACT, 1913



Sixty-third Congress of the United States of America;

At the Second Session,

Begun and held at the City of Washington on Monday, the first day of December, one thousand nine hundred and thirteen.

AN ACT

To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the short title of this Act shall be the "Federal Reserve Act."

08:40

FEDERAL RESERVE ACT "NATIONALIZED" 3 KEY CLEARINGHOUSE ROLES

- bankers' banks
  - for interbank payments: check clearing and settlement
- lender of last resort
  - seasonal and emergency elasticity to currency, reserves
- supervision of member banks

10:50

THE FED ASSUMED TWO ADDITIONAL KEY ROLES

- Conducting an active monetary policy (during WWI)
  - FR Act assumed that gold standard will determine money supply
- Monopoly of paper currency issue (during the 1930s)
  - National Banks continued to issue notes until then

1929 notes

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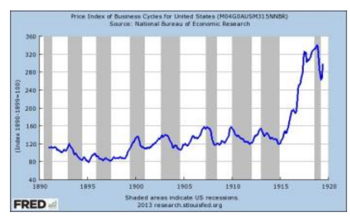
PRE-FED PERIOD VS. FED DURING WWI:
PRICE INDEX FOR 10 INDUSTRIAL AND AGRICULTURAL COMMODITIES



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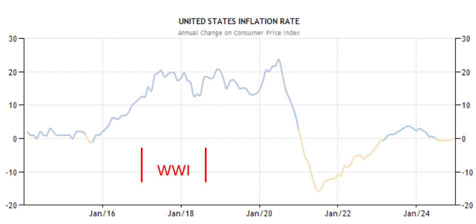
THE FED' 1ST DECADE, 1914-24: 20+% INFLATION, THEN SHARP (PARTIAL) CORRECTION



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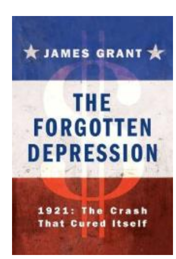

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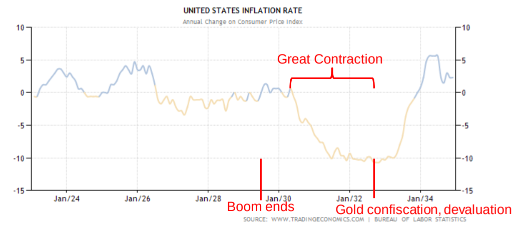
THE FED' 2ND DECADE, 1924-34: BOOM, BUST, GREAT CONTRACTION WITH 10% DEFLATION



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WHY DID THE FED FAIL SO BADLY TO PREVENT THE GREAT CONTRACTION?

Bordo and Wheelock (2010): The Federal Reserve Act

- failed to spell out the Fed's duty in a panic
- created a system that depended on the competence of authorities currently in charge, rather than on a set of rules
- failed to reform the crisis-prone U.S. banking system to allow a more stable branch banking system, such as Canada's

Friedman and Schwartz (1963):

The Fed took over the roles of the private clearinghouses, then did less than they had done in 1907 to stem panics

23:00

1934-54: DEFLATION, 20% INFLATION, THE ACCORD

25:30

1944: BRETTON WOODS BEGINS

Harry Dexter White, John Maynard Keynes: Bretton Woods, NH, July 1944

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1954-64: NOT SO BAD!

THE MOST SUCCESSFUL PERIOD FOR THE FED: DUE TO BRETTON WOODS CONSTRAINT?

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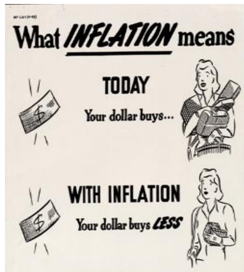

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1971: BRETTON WOODS ENDS

Pres. Richard Nixon, 8 August 1971

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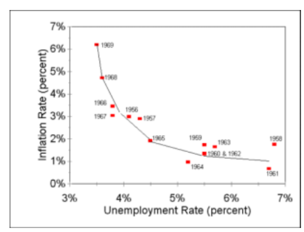
1964-84: THE PEACETIME GREAT INFLATION

THE SECOND-GREATEST FAILURE OF THE FED

30:40

PLAYING THE PHILLIPS CURVE, 1964-69



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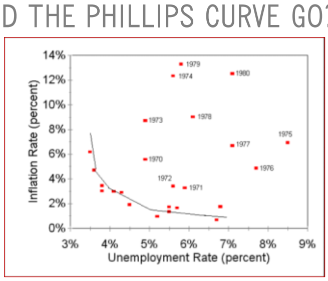
AFTER 1969: WHERE DID THE PHILLIPS CURVE GO?



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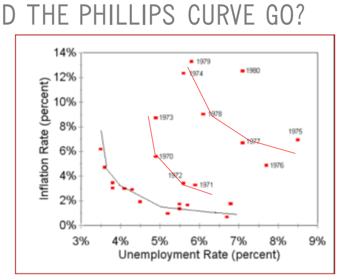
AFTER 1969: WHERE DID THE PHILLIPS CURVE GO?



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1984-2004: THE GREAT MODERATION

35:15

THE TAYLOR RULE

$R_t = 1 + 2.5\pi_t - 0.5y_t$, where

- R_t is current Federal Funds Rate target
- π_t is current inflation rate
- y_t is current "output gap" (estimated potential real GDP minus actual real GDP, in %)

A *description* of Fed policy 1987-2002

A *norm* for policy: Great Moderation while the Fed followed it

- Housing bubble when the Fed held R below Taylor Rule target (next slides)

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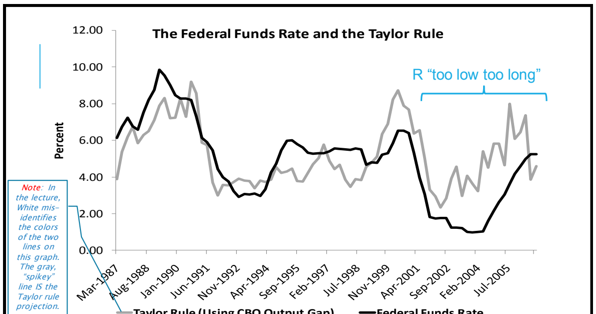

Source: L. H. White in Beckworth, ed., *Boom and Bust Banking* (2012)

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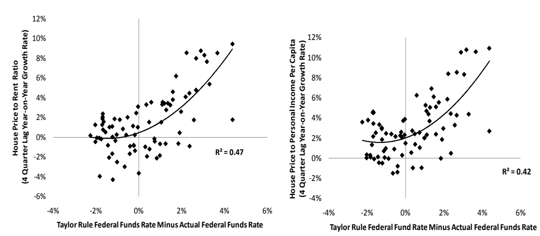
Taylor Rule Deviations vs. Housing Boom Indicators



Source: L. H. White in Beckworth, ed., *Boom and Bust Banking* (2012)

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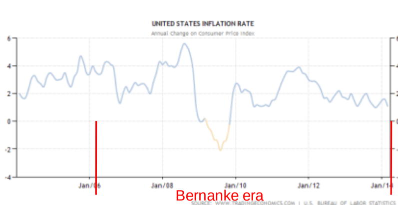
2004-14: HOUSING BOOM, GREAT RECESSION



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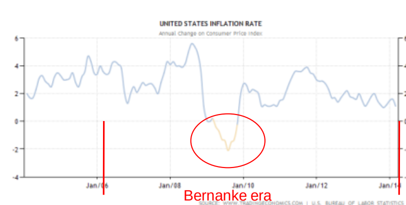
2004-14: HOUSING BOOM, GREAT RECESSION

2009 A YEAR OF DEFLATION



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BOOM GIVES WAY TO BUST, 2008

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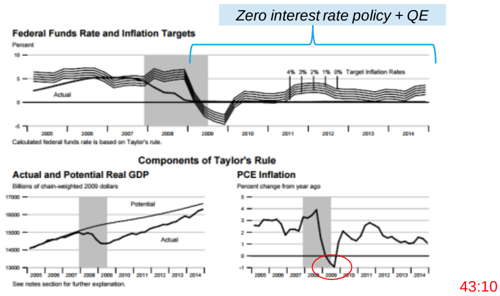

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Source: St. Louis Fed *Monetary Trends*, 14 April 2015

DANGERS OF INTEREST RATES TOO LOW FOR TOO LONG

Failure to clear out dead wood → "Zombie" finance, slow growth
- Zombie banks stay open at ultralow interest rates
- Zombie banks finance Zombie business firms that "basically drag [other firms] into the pit. Potential growth decreases. There are all kinds of evidence of this in Japan." --William R. White, 21 July 2014

New asset-price/credit bubble, setting stage for next crisis
- Stock markets at record high levels
- W. R. White: "For the G-20, the total debt the non-financial private sector climbed about 30% since the crisis."

Lax fiscal discipline
- At ultralow rates, spendthrift governments can pile up debt painlessly
- When rates return to normal, danger of Greek-style debt trap

46:25

INTEREST ON EXCESS RESERVES + QE

BoG press release, 6 Oct. 2008: "The payment of interest on excess reserves will permit the Federal Reserve to expand its balance sheet as necessary"
- Between the lines: without corresponding expansion in M2 or the price level
- Not a coincidence that IOER and QE1 began together

If it didn't raise the M2 path, because sterilized by IOER, what was the point of QE?
- **Credit allocation** -- to raise relative MBS prices
- **Disguised fiscal policy**: outside the debt ceiling limit, without Congressional vote

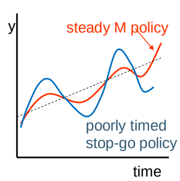
48:30

FED'S STABILIZATION TRACK RECORD IN SUM

Success requires the Fed to stabilize aggregate spending, i.e. to vary M in response to money hoarding faster than market prices adjust

Limited ability to forecast hoarding has made changes in M growth in practice
- poorly timed
- the wrong size
- E.g. expansion too little, too late to stop 2009 deflation

Yellen Fed may tighten too little, too late to stop next upswing in inflation



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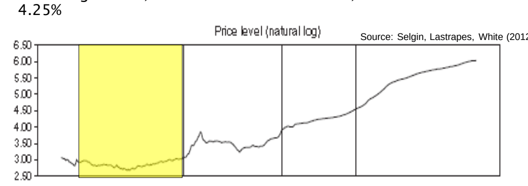
BY CONTRAST TO CLASSICAL GOLD STANDARD, THE FED HAS INCREASED THE AVG. INFLATION RATE

Pre-Fed gold std., 1879-1914: -0.05%   Fed, 1971-2013: 4.25%



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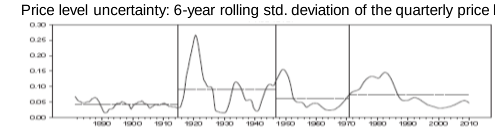
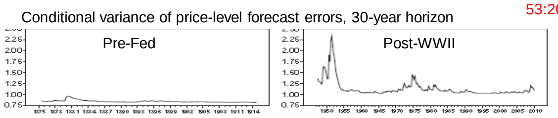
THE FED HAS INCREASED PRICE LEVEL UNCERTAINTY

Source: Selgin, Lastrapes, White (2012)

Price level uncertainty: 6-year rolling std. deviation of the quarterly price level



Conditional variance of price-level forecast errors, 30-year horizon



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THE FED HAS NOT REDUCED OUTPUT VOLATILITY

even though US output has become more diversified, with more fiscal "automatic stabilizers," and smaller measured supply shocks

In response to aggregate demand shocks, Fed has tended to *enlarge* deviations of output by inappropriate monetary policy

Output volatility (% std. dev. from trend), Romer Quarterly GDP ests.

1869–1914	1915–2009	1915–1946	1947–2009
2.7	5.7	9.2	2.6

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THE FED HAS NOT REDUCED UNEMPLOYMENT

US Unemployment rate, 1869-2009

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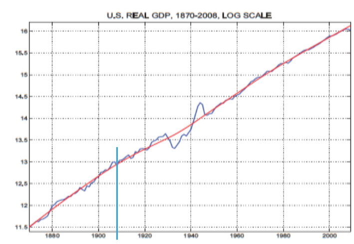
THE FED HAS NOT RAISED REAL GROWTH



Source: Robert E. Lucas, Jr. (2011)

55:20

HOW MIGHT WE GET BETTER RESULTS?

Bind the Fed with a weighted dual mandate
- i.e. make it stick to a specified Taylor Rule

Bind the Fed with a single mandate
- Target the path of a price level exclusively
- Better: Target the path of nominal GDP
  - Hayek (1931): stabilize "the money stream"
  - Productivity norm: when surge in output reduces inflation, don't offset with M injections, and vice-versa

End the Fed with a gold standard plus free banking
- If not politically feasible, at least a benchmark for Fed accountability