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# *Lessons Learned? Comparing the Federal Reserve's Response to the Crises of 1929-33 and 2007-09*

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## *Presentation Outline*

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- Summarize the Fed's Response in 2007-09
- Summarize the Fed's Response in 1929-33
- Consider whether the Fed has learned the lessons of the Great Depression

*The views expressed in this presentation are not necessarily official positions of the Federal Reserve Bank of St. Louis or the Federal Reserve System.*

# *The Financial Crisis and Recession of 2007-09*

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- Worst financial crisis since the Great Depression
- Severe recession, but not nearly as bad as the Great Depression
- Monetary and fiscal policy have been much more aggressive in 2007-09 than during 1929-33
- The Fed was “largely passive” during 1929-33 – *Why?*

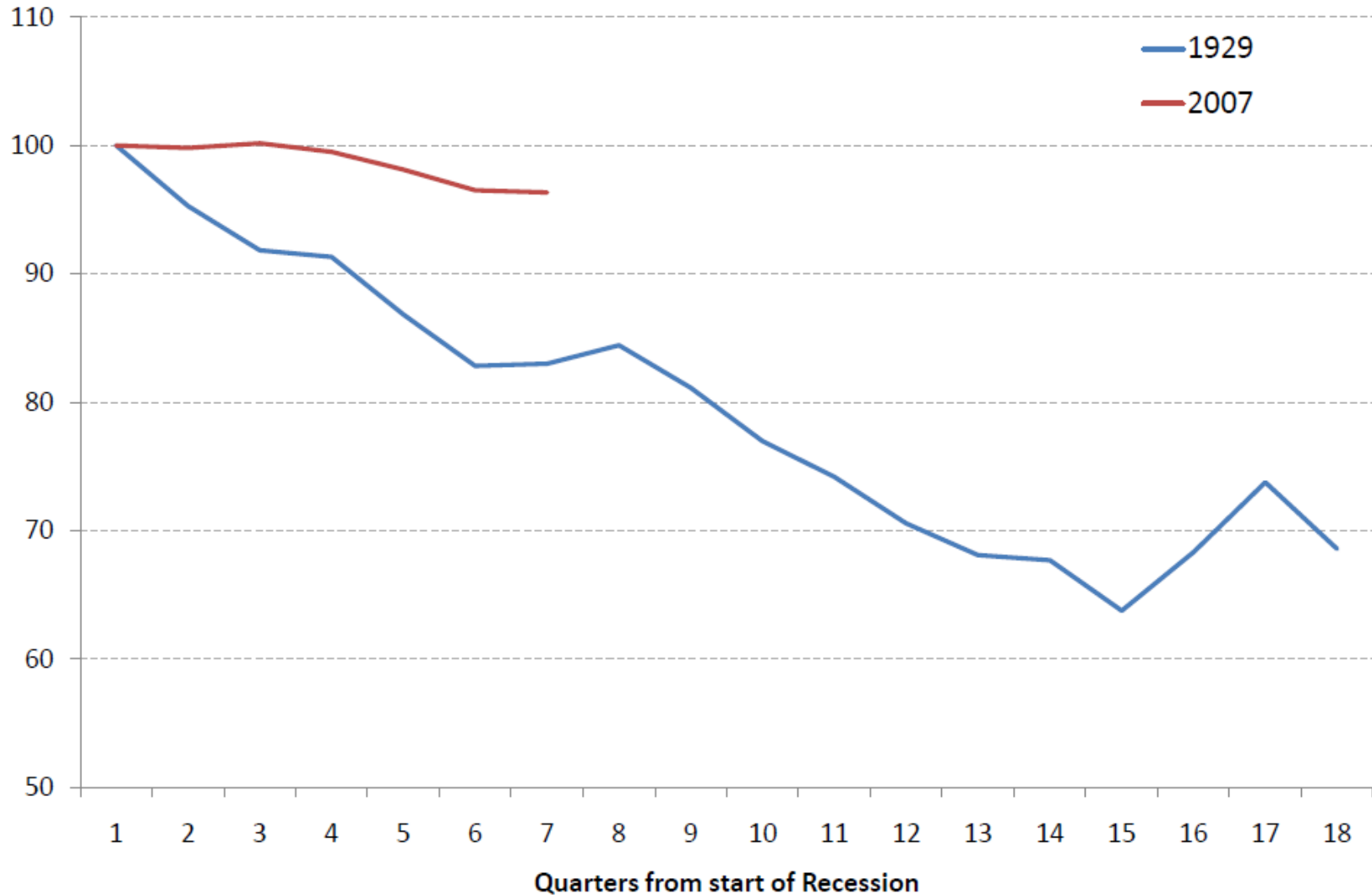
## *The Recessions of 1929-33 and 2007-09*

Recession	Length in Months	Real GDP: Percent Decline Peak to Trough	Unemployment: Max Value During Recession	CPI: Percent Change Peak to Trough
1929-33	43	-36.21%	25.36%	-27.17%
2007-09	20?*	-3.66%	9.50%	2.66%

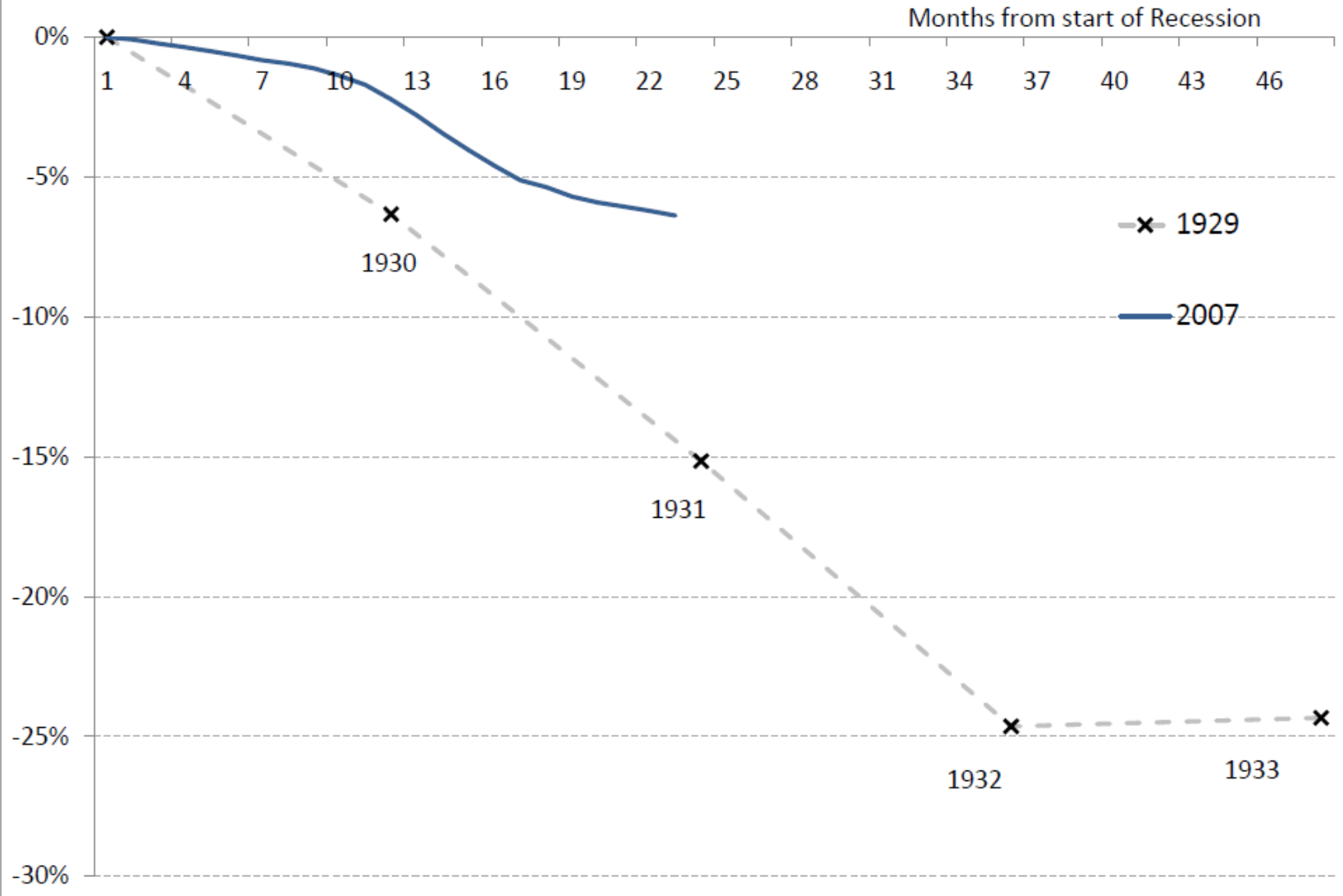
\* current recession end date not yet determined by NBER; data through 2009:Q2

## Total Decline in Real Output since start of Recession

1929:Q3 and 2007:Q4 set equal to 100

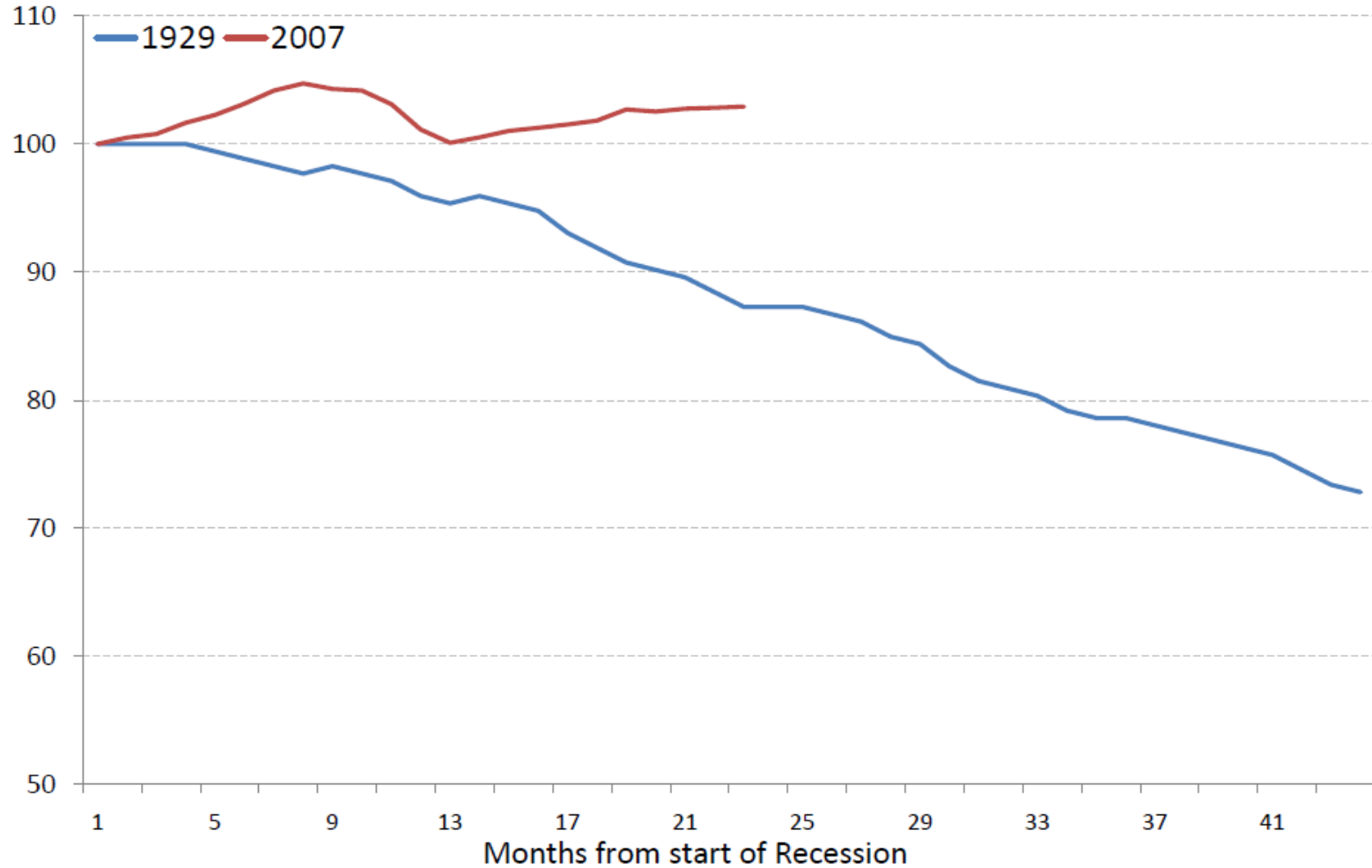


## Percent Decline in Employment since start of Recession



## Change in Price Level since start of Recession

Aug 1929 and Dec 2007 set equal to 100



## *Crisis of 2007-09: Initial Response*

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- August 2007: Fed reduces discount rate and reassures markets that its discount window is available
- December 2007: Fed creates the Term Auction Facility (TAF) to lend term funds to banks without the stigma associated with discount window borrowing
- December 2007: Fed establishes swap lines with ECB and Swiss National Bank. Later establishes swap lines with eight more central banks (including the Bank of Mexico).



## *Section 13(3) of the Federal Reserve Act*

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- Permits lending to any individual, partnership or corporation “in unusual and exigent circumstances” if the borrower is “unable to secure adequate credit accommodations from other banking institutions.” Such loans must be “secured to the satisfaction of the [lending] Federal Reserve Bank.”
- Added to the Federal Reserve Act in July 1932, but little used before 2008
- Used extensively in 2008-09 to provide loans to non-bank financial institutions and markets

## *Section 13(3) Actions in 2008-09*

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- Loan to facilitate the acquisition of Bear Stearns by JPMorgan-Chase (March 2008)
- Primary Dealer Credit Facility (March 2008)
- Loans to AIG (September 2008)
- Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (Sept. 2008)
- Commercial Paper Funding Facility (Sept. 2008)
- Term Asset-Backed Securities Lending Facility (Nov. 2008)

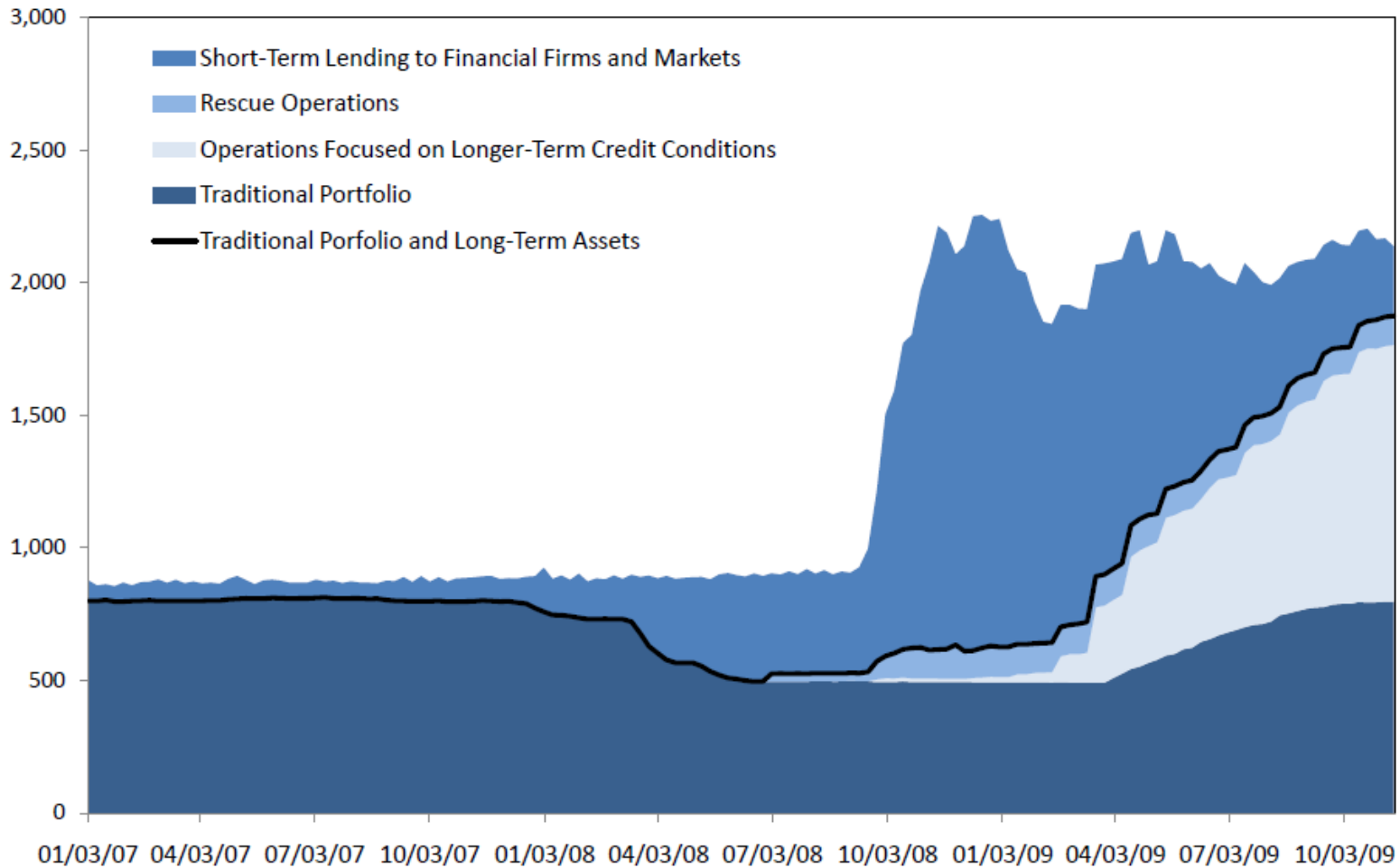
## *Other Fed Actions in 2008-09*

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- Federal funds target rate reduced to 0-25 basis point range
- Large-scale purchases of Treasury securities, agency debt, and agency mortgage-backed securities (MBS)
- These actions have resulted in a massive increase in the Fed's balance sheet and the U.S. monetary base; some increase in broader money (M2) growth.

## Composition of Federal Reserve Assets

Billions \$

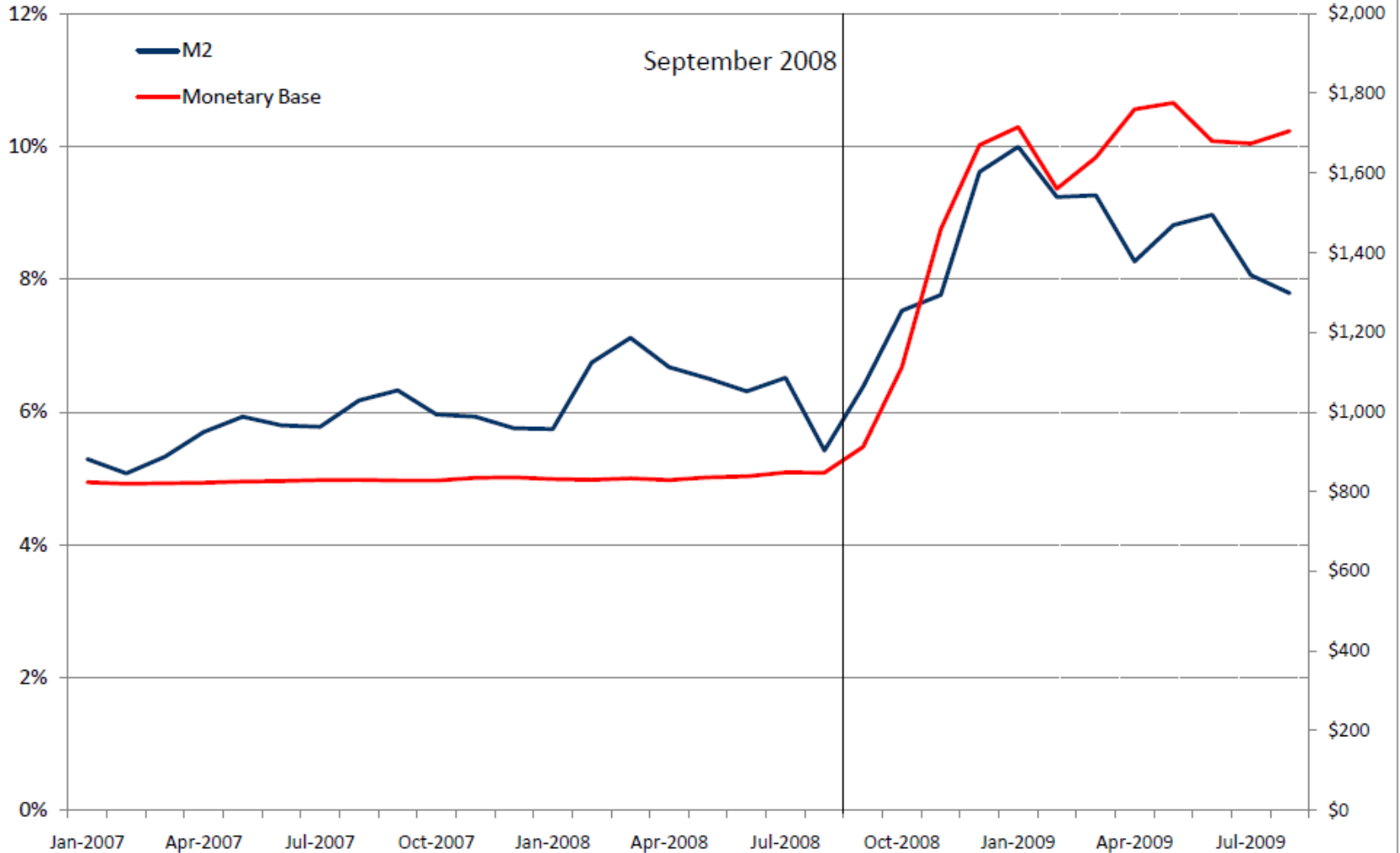


Last observation is week ending November 11, 2009.

## Money Growth, 2007-09

M2 year/year percent change

Monetary Base, Billions (\$)



## *Summary of Fed Response in 2007-09*

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- Increased lending via liquidity facilities
- Rescue operations to mitigate systemic risk
- Massive increase in Federal Reserve balance sheet and monetary base since September 2008 to prevent deflation and promote economic recovery

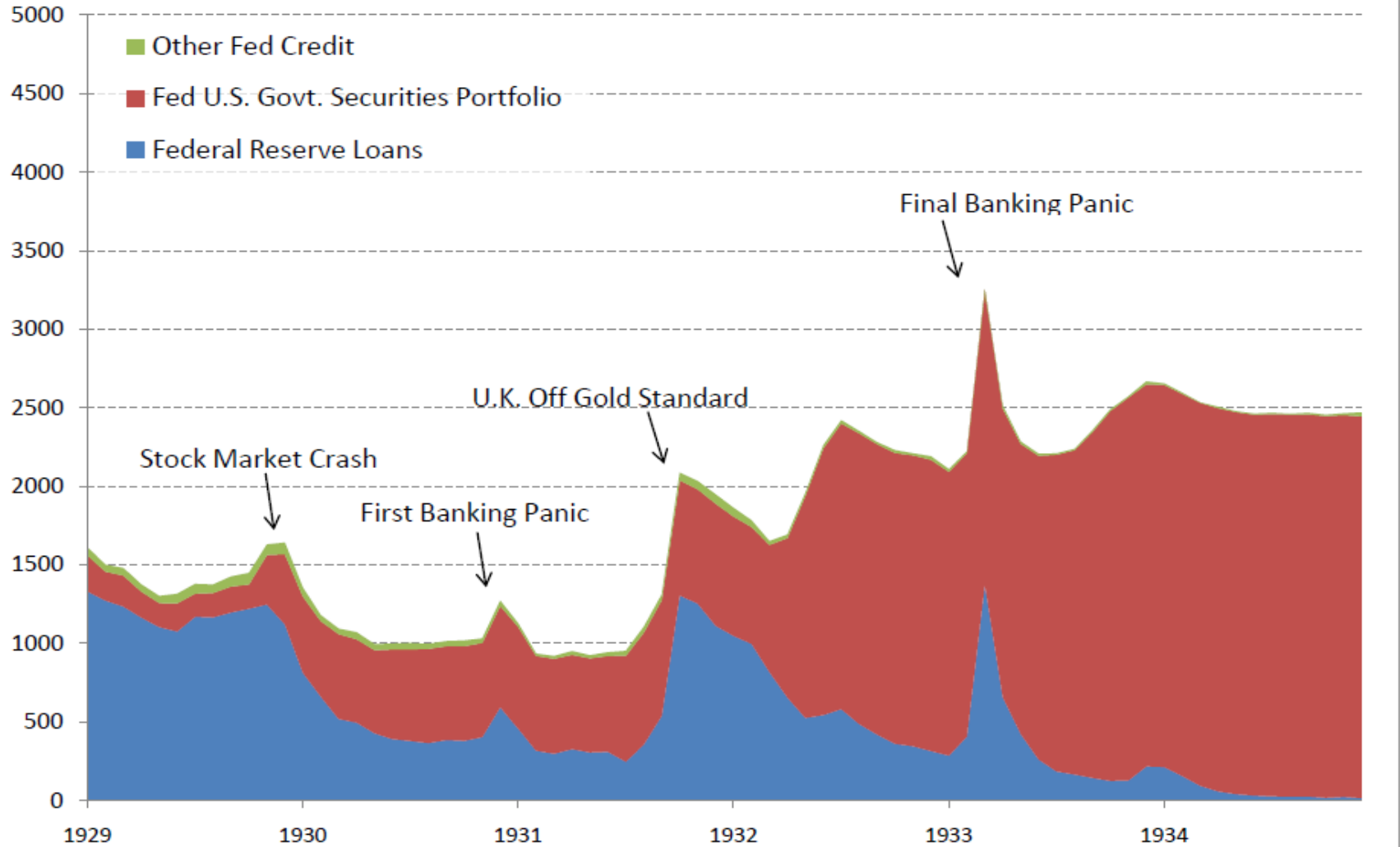
## *Federal Reserve Policy, 1929-33*

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- New York Fed responded swiftly to the stock market crash in 1929
- Fed largely ignored banking panics of 1930-33
- Federal Reserve credit contracted in 1930-31
- Increase in monetary base was not sufficient to prevent collapse of the money stock and price level

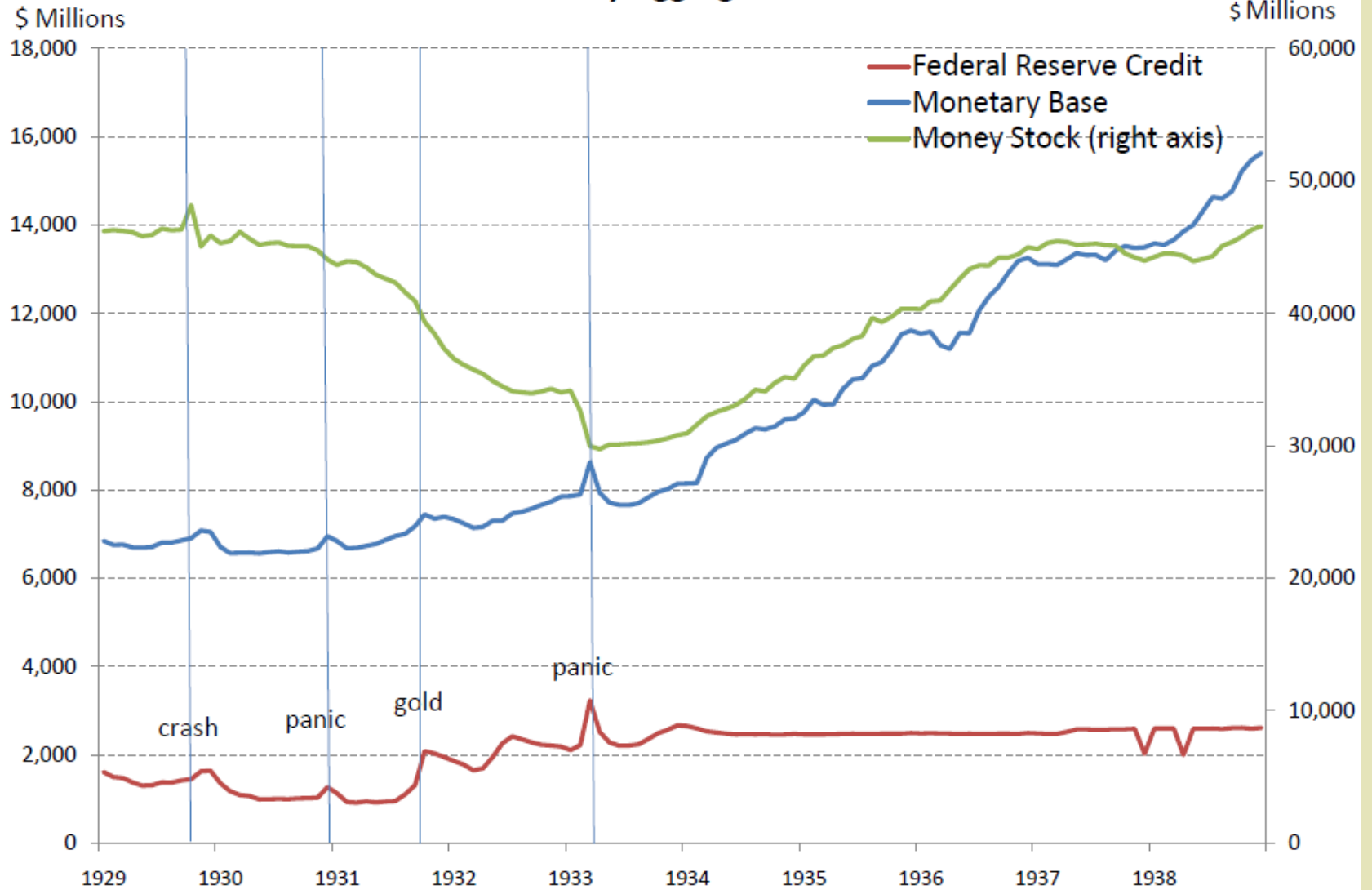
## Federal Reserve Credit, 1929-34

\$ Millions





### Federal Reserve Credit and the Monetary Aggregates



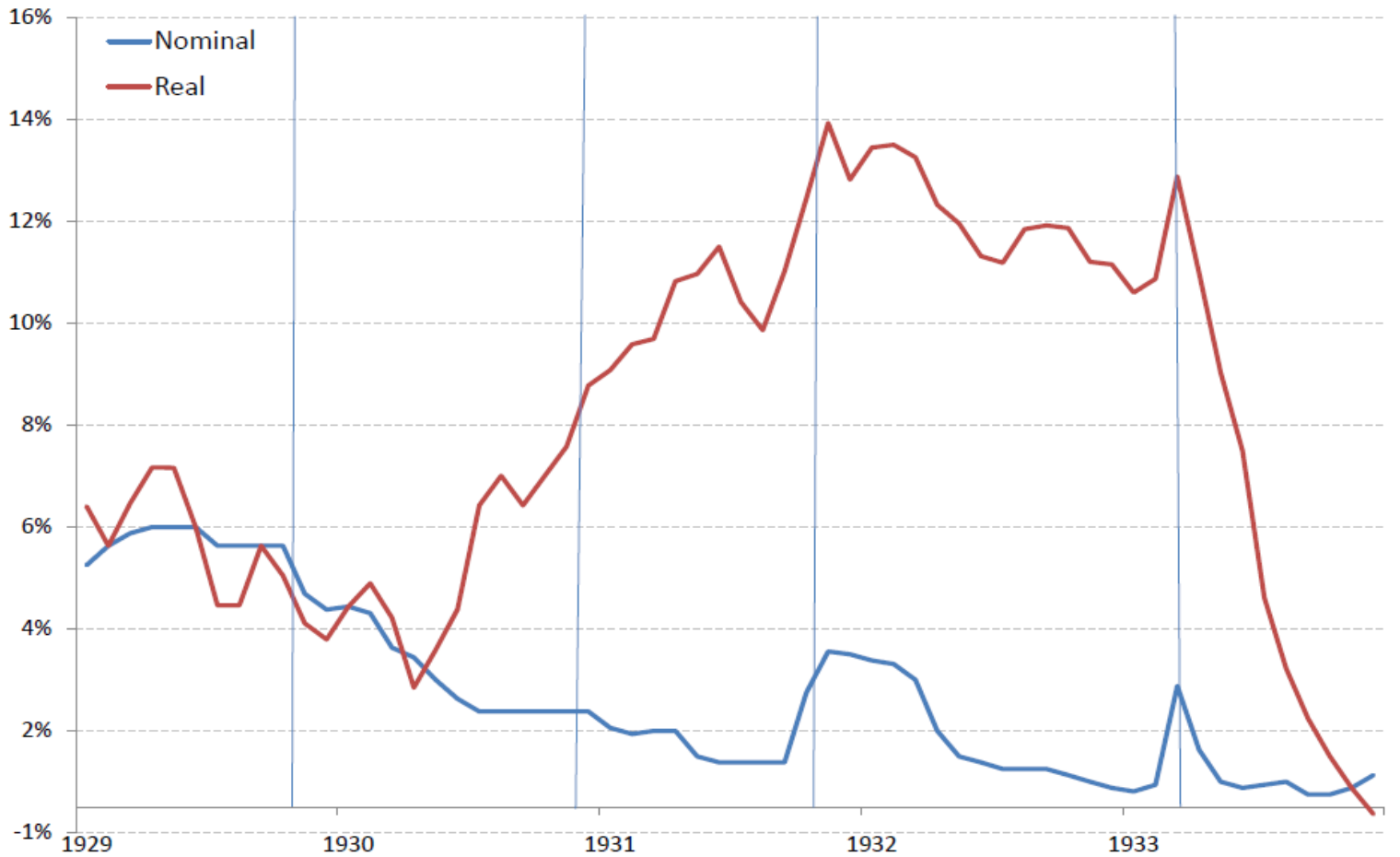
## *Why Wasn't the Fed More Responsive?*

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- Fed officials misinterpreted financial conditions
  - Low interest rates and little discount window borrowing were seen as evidence of monetary ease.

## Nominal and Real Interest Rates Diverge, 1929-1933

3-Month Banker's Acceptance Rate



## *Why Wasn't the Fed More Responsive?*

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- Fed officials misinterpreted financial conditions
  - Low interest rates and little discount window borrowing were seen as evidence of monetary ease.
- Federal Reserve Act limited discount window loans only to member banks with prime collateral.
- Some officials wanted tighter policy to discourage financial speculation.
- Officials thought that they were following Bagehot's Rule, especially in response to gold outflows in 1931 and 1933.
- Would Benjamin Strong have done better?

## *Lessons Learned?*

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- The Fed's response to the crisis of 2007-09 was markedly more aggressive than its response in 1929-33:
  - New liquidity facilities
  - Rescue operations
  - Large expansion of monetary base beginning in Sept. 2008
  - Deflation avoided
  - The Fed is unlikely to raise reserve requirements in order to reduce excess reserves, as they did in 1936-37

## *Lessons Learned?*

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- But,
  - Some critics argue that the Fed was too slow to increase the monetary base
  - Others criticize the Fed for not rescuing Lehman Brothers
  - Still others are concerned that rescue operations promote moral hazard and threaten the Fed's political independence
  - Will the Fed remove monetary stimulus in time to forestall higher inflation or another asset bubble?