



Episode 664: How the Fed Screwed Up Before and During the Great Depression

Guest: Jeff Herbener

WOODS: I want to talk about the Fed and the Depression, but I want to talk about the year – we'll talk about both before and after – before and during. But the during is the part that people know the least about. The Austrians among my listeners, who would be most of them, would know that there was an inflation of the money supply during the '20s, but they don't know, generally, most people – I don't want to say everybody listening does know. I mean they're less likely to know what the Fed's policy was after 1929, and I think that's true of most people. And yet, that's part of the story, because the – you know, I don't even want to steal our thunder by giving away the whole thing. Let's start off with the 1920s. There is actually some controversy about this, because I know Joe Salerno had an exchange back and forth in *The Freeman* with – who's that – do you know what I'm talking about?

HERBENER: Timberlake. Richard Timberlake.

WOODS: Yeah, that's right; Richard Timberlake, that's right. Over whether there even was an inflation in the 1920s. How can there be – if economists can't even decide on that, of what value is your field?

HERBENER: (laughing) Yeah, well, that's a good question. Part of it had to do with definitions, of course, and –

WOODS: Right.

HERBENER: – so Joe was holding to a monetary equation definition, and Timberlake was relying more on a price inflation definition. But even getting beyond that particular point, I think there was some controversy about the particular items that Rothbard included in his definition of the money stock, and Joe ably defended his inclusion of some items that Timberlake said, well, those shouldn't be included in the money supply and if you take those out it makes a big difference. But Joe showed that even if you take out the controversial items, it does not in fact make a big quantitative difference.

WOODS: No, it doesn't.

HERBENER: Yeah.

WOODS: Right. So I'm going to link to that exchange. I'm pretty sure it's online. If it is, I'll link to it at TomWoods.com/664. People can look at that. So in other words, basically Rothbard's thesis from *America's Great Depression*, his 1963 book, does hold up, in terms of the section on Fed inflation, that actually does hold up. The controversy was largely over the cash surrender values of life insurance policies, and Joe says they did not wind up including that in the true money supply, which is the measure that the Austrians, at least in the Misesian tradition, have been using for the money supply. But he did pick up a couple of books just at random off his shelf and find economists who did include that in the money supply.

HERBENER: Sure, and the difference numerically, Rothbard said the monetary inflation from the summer of '21 to the summer of '29 was 62% increase in the money supply. When Joe recalculated taking out the cash surrender value of life insurance policies, it wound up being 55%. Another point on this is Allan Meltzer, who's a typical mainstream monetarist economist, has written this great multivolume history of the Federal Reserve. He takes the Rothbard view of this. He also chronicles the inflation engendered by the Fed during the 1920s, and it's pretty much along the same lines that Rothbard had, that it came in waves that were mainly in 1924 and in 1927. In fact, he gives this great quote, Meltzer does in his book, by Benjamin Strong, the governor of the New York district bank and the sort of leader of the Fed in those years, where Benjamin Strong says that the inflation of credit in 1927 was the largest, I think it was one-year or 10-month increase in credit in the history of the American economy. It was like a \$200 million increase in reserves and a \$5 billion increase in bank credit.

WOODS: All right, why does it matter to the Austrian story that there was inflation during the 1920s?

HERBENER: Because the Austrian theory of the business cycle is based upon the credit expansion that monetary inflation brings about as banks build their reserves through the central bank open market operations and then issue fiduciary media by creating credit, and then they arbitrage this credit throughout the economy, and it distorts of course the intertemporal allocation of resources.

WOODS: So what Rothbard's doing is showing that in fact this most horrific of economic downturns does in fact conform to the Austrian model. It's not some outlier that can't be explained according to the Austrian theory. There's plenty of monetary inflation and credit expansion going on in the '20s. That's the point.

HERBENER: Yeah, that's exactly right, and of course Friedman, who takes the opposite view or rejects the Austrian story, says that everything is going along fine, and suddenly something happens to pluck the economy below its trend line.

WOODS: So his view would be that there's nothing wrong with the monetary policy of the 1920s?

HERBENER: That's correct. So the monetary policy of the '20s was wonderful and great, and Benjamin Strong was the big hero of the '20s, and prices were stable, and that's the way to judge that monetary policy was just right. And then it was the financial collapse and resulting bank failures of the early 1930s, Friedman blames for this plucking down of real production away from its trend line of real GDP growth.

WOODS: Why is price stability not the appropriate benchmark to be using to evaluate monetary policy?

HERBENER: Right, so price stability is not the benchmark, because – well, there are two reasons really. One is that within a matrix of stable prices, it may be that some prices are moving up quite dramatically while other prices are falling or, you know, maybe a majority of prices even are staying the same. So we get what now has become commonplace to call asset price inflation, and it's precisely the inflation in asset prices that leads to shifts of the profitability of the production of these assets, and then the movement of real resources away from where they're sustainably useful in the capital structure toward those boom lines that are engendered by this monetary inflation and credit expansion.

And the other aspect of this has to do with the money demand side of the price structure. So we know that the overall prices in the economy are determined by both the money stock and money demand, so while the money stock could be increasing, engendering this asset price inflation, it could be masked by an increasing money demand, leaving prices relatively stable overall and yet still having these imbalances in asset price inflation in certain areas.

WOODS: Now then let's ask another question related to Milton Friedman. I mean, the Austrians have a story, that you can believe it or you can disbelieve it, but it's a coherent theory that seems to be working out in practice in the case of the Depression and then these other booms and busts that we see. Now, the trouble is I don't see what the – the trouble is for me, anyway. I don't see what the Friedman story is. The Austrian story is you have the monetary inflation, works its way through the banks, this distorts entrepreneurial decision-making. From a time point of view, you make different types of investments that pay off in the longer run, and this is not in line with consumers' time preferences, and so you wind up with a discoordination. Okay, you got that, and I'll link to an episode at TomWoods.com/664 that walks you through that more simply than I just did. But what is the Friedman explanation? Everything's going fine in the '20s and then suddenly there's a huge stock market crash? What's the explanation?

HERBENER: Yeah, I think Friedman here is showing his Keynesian framework. He's really buying into the aggregate demand framework of Keynes. So he thinks that when the financial collapse occurs, then people start to move away from consumption and investment and toward hoarding or money holding. And it's this reduction in aggregate demand that generates a price deflation, and the price deflation then suppresses production, is kind of the standard Keynesian story I think that Friedman has behind his view.

WOODS: Whoa, whoa, whoa, what did you just say? What was that last sentence?

HERBENER: The last sentence was that it's a standard Keynesian story that Friedman adopts.

WOODS: Ah, care to elaborate on that interesting statement?

HERBENER: Well, I think it's fairly well accepted that in terms of the overall framework of aggregate demand/aggregate supply, this model, that Friedman is a Keynesian.

WOODS: Okay, I just want to make sure everybody's getting this. I just want to – (laughing) okay.

HERBENER: Yeah, there are certain inter-Keynesian disagreements among those economists who call themselves Keynesian and those economist who call themselves monetarists. They're kind of brotherhood battles. But they both accept the same overall framework of aggregate demand driving the economy, and their fear of price deflation, or at least their fear of certain expectations that prevent people from spending sufficiently and their fear of price deflation.

WOODS: Do you think I should link to – I know Roger Garrison's given a presentation on his – and not only that. He's written a book chapter, hasn't he, on "Is Friedman a Keynesian?" Is that worth linking, you think?

HERBENER: Sure, sure.

WOODS: All right, I'll put that up, TomWoods.com/664. Oh, this is getting to be a juicy show notes page already. All right, 664 is the number to remember. All right, so now let's talk about, we've had 1929. Let's talk about the years 1929 to 1932 and what Fed policy was, because the impression you would get reading Friedman and Schwartz, their 1963 book, the impression that you would get would be that the Fed more or less – either that the Fed sat back and let everything collapse and allowed banks to collapse and so on and didn't intervene, or they were simply too timid; maybe they acted, but it was too little too late. What's your interpretation of what was going on?

HERBENER: Right, well, again, I don't think we need too much interpretation here. The data is fairly clear that the Fed tried desperately to reflate in the wake of the stock market crash. Benjamin Anderson, for example, in his book *Economics and the Public Welfare* that he published in 1949 chronicles a lot of this, pointing out that in the immediate aftermath, the week following the stock market crash, that the Fed increased their purchase of commercial bills and government securities by 23%. So if you look at the period from October of 1929 to the end of the year, the holdings, the fixed balance sheet holdings of Treasury securities went up fourfold.

But what was happening in the rest of the economy, as we alluded to before, was this rush to liquidity, and so a lot of this was absorbed by the banks in terms of excess

reserves. And this just continued on into the fall of 1931. And in the fall of 1931, the Fed did for a few months slow down its attempt at expansion. But then after Glass-Steagall passed in February of 1932, they were at it again. The inflation was enormous. Rothbard points out in *America's Great Depression* that the period from February 1932 when Glass-Steagall passed to the summer of 1932, the Fed purchased \$1.1 billion of Treasury securities in open market operations.

WOODS: Now, it's hard in this day and age, with the numbers being so different, to appreciate the significance, the scale of that. But that was the largest – there's some superlative we can apply to that, right?

HERBENER: Well, to give you the relative size, the Fed's balance sheet holdings roughly in January 1933 were \$2.4 billion, so something close to 50% of what their total holdings became.

WOODS: Now, what about the claim that if – okay, actually, you know what? Let's try and evaluate it this way to understand what's going on. Joe uses, in order to explain what Fed policy really was, he distinguishes between controlled and uncontrolled reserves. Things that the Fed can control and things that are outside the control of the Fed. Now, if things that are outside the control of the Fed are moving in a different direction, well, that doesn't tell you anything about Fed policy, because the Fed doesn't control that. You try to figure out Fed policy by looking at what the Fed does control. How does that help us get a clearer picture?

HERBENER: Yeah, that's absolutely correct. He gets this, by the way, from Rothbard's discussion in *America's Great Depression*. By the way, just as an aside, when you read Rothbard's *America's Great Depression*, you find out by his language, just you can infer from the language he uses that this was standard analysis of monetary economists when he wrote the book in the early 1960s. He just talks about how other economists had controlled reserves, put in controlled reserves these items and had in uncontrolled reserves these other items, and he was trying to explain his position on this relative to what was in the literature. It's quite remarkable, actually. All of this dropped out, of course, in Friedman's analysis. We tend not to see this.

WOODS: Yeah, I'm going to make sure and put that at TomWoods.com/664, because if people haven't read *America's Great Depression* they should, and I'm afraid maybe we're slightly scaring them off, making them think that it's all numbers and it's all analysis of the 1920s. It's not. There is a big section on that, but then there is a lot of – just a lot of good business cycle stuff and there's a lot of analysis of Herbert Hoover. So all right, we're going to have a lot of good stuff linked here.

HERBENER: Yeah –

WOODS: Yeah, go ahead.

HERBENER: Yeah, to go back to the rough numbers here, just to give you an idea, to go back to the '20s where Rothbard chronicles the 62% increase in money supply from

the summer of '21 to the summer of '29, he points out that this was based on his calculation of 48% increase in bank reserves that the banks then issued fiduciary media on top of this. But he points out that the controlled reserves in the Fed over that period increased 138%, and the uncontrolled reserves fell 89%. So that 48% increase was masking the Fed's intention to inflate even more dramatically, or at least the effect of their inflation to overcome a fairly large deflationary effect on bank reserves through uncontrolled declines.

WOODS: Okay, I want to make sure everybody understands this, though. What does it mean that there were uncontrolled declines? Isn't the Fed the absolute master of its destiny? What do we mean when we say "uncontrolled"?

HERBENER: Well, just to give you the prime example, the main item in the '20s and '30s of uncontrolled changes in bank reserves was gold holdings. So the gold inflows and outflows into the country and into the reserves of banks were not controlled by the Fed. The Fed, as they do today, they engaged in open market purchases, so they bought Treasury securities, so they could influence bank reserves through the purchase of Treasury securities, and they bought what were called acceptances. Basically, these are bills of credit from commercial sources. So they bought securities. That would be the prime example of controlled reserves, where the Fed can increase them by 100 million, just like they do in open market operations today, or increase by 50 million if you want. And then the gold holdings were considered uncontrolled.

WOODS: Okay, but then also it's — to what extent is pushing on a string referring to uncontrolled aspects of monetary policy?

HERBENER: Yeah, I think pushing on a string is referring more to the absorption of the banks in excess reserves. So if the Fed is engaged in controlled reserves, trying to get the banks to reflate fiduciary issues, they may wind up ineffective because the banks simply hold the reserves instead of pyramiding their fiduciary media on top — which is precisely of course what the banks did.

WOODS: Yeah, okay, that's what I wanted to know.

HERBENER: Both in the '30s and today. Yeah.

WOODS: Yeah.

HERBENER: That's precisely what they did.

WOODS: So they held onto the — so in other words, the Fed can pump and pump and pump, but if the banks don't want to lend it out, that's it. That's what the Fed can do. It can try a few other things, but basically that's what the Fed can do. So to sit there and say if only the Fed had been more activists, it just seems to not quite get it.

HERBENER: Yeah, no, that's exactly right. This is what was happening, not only in the early '30s, but really throughout the '30s. The banks, even when the inflation began to

have — you know, after '34 the monetary inflation, as I said, began to have some effect. The banks were still building their excess reserves. Their reserve position went from something like a billion in 1934 to 7 billion in 1941, their excess reserve position. So they were still concerned about the conditions of lending in the economy. They were still leery of lending into this economy.

WOODS: Let's jump ahead now to 1937 to '38, because here's another area of controversy. Or in a way, it's not really controversy, is it, because the mainstream view is that everybody knows what happened in 1937-38 — although there are a couple different approaches. One is to say that Franklin Roosevelt stopped spending so much, and that was bad. But mostly it's that the Fed increased reserve requirements, which would mean that the banks would be able to create less money and extend fewer loans with a give amount of reserves, and that this obviously was a contractionary thing, and this accounts for why we have the so-called depression within the depression of 1937 to '38. What's wrong with that standard version of that story?

HERBENER: Right. First just one point of clarification. The situation is quite similar, we mentioned already, to the situation today, where the banks are holding an extreme amount, an unprecedented amount of excess reserves. So just to have the rough figures, let's say, today banks are holding 200% reserves relative to their accounts. So they're holding twice the reserves that they need to hold. So if their reserve requirement ratio were, say, 10%, and you doubled it to 20%, this would not put any pressure on them to withdraw their loans or cash out so that they could build up their reserve position. So it was the same thing in 1936, when the Fed began to increase reserve requirement ratios on banks. When they did this, it wasn't that the banks had to react to the increase in reserves by not renewing their loans and using the payoffs to build up their cash positions; this just reduced the degree of their excess reserves.

Friedman's argument, then, is that the banks wanted to keep a certain proportion of excess reserves relative to their normal reserves. They wanted to keep, let's say, 50% excess reserves, and so they built — they quit lending in order to build up their excess reserves back to the level it was at in 1936. Again, that claim seems a little less plausible than claims that the banks were fully loaned up and then the Fed raised the reserve requirement ratio and the banks had to cut back loans and so on in order to build their cash positions. So that's the first point to make, I think, with respect to the argument.

It should also be pointed out, if you look at the actual policy of the Fed, so in rough figures the Fed had reserve requirement ratios on the banks, the member banks, anyway, before 1936, before they began the raising, it was 10%. And they raised it to 20% on May 1st of 1937, and there was an intermediate step up. And then in response to the downturn, they lowered the reserve requirement ratios in April of 1938 from 20% to 17.5% and then raised them back to 20% in November of 1914. So there wasn't a dramatic reversal of policy, and even though the reserve ratios stayed elevated way above what they were before, the recovery did in fact come, so again, this seems to be a less plausible cause of the downturn than perhaps it sounds like at first.

Another thing to point out about this, Friedman's story is that when the Fed raised the reserve requirement ratio that the banks sort of – you would expect them to have increased the degree to which they were building up their reserves, but in fact, this is not true. Banks actually were increasing their reserves faster, at a greater percentage increase the two years before 1936 than the two years after 1936. So the two years before 1936, total reserves increased I think 50% roughly, and in the two years after the raising of the reserve requirement ratio, they only increased roughly 30%.

The other point with respect to the data about Friedman's story is that the bank loan portfolios actually peaked right at the end of June, so June 30th of 1937, and then they began to fall. They fell from about 14 billion to 13 billion over the next year or so. But the downturn began in May of 1937, two months before the peak of the loan portfolios. So this again doesn't seem to be a very robust explanation of what happened.

And the final point against Friedman's claim is that during the period of this credit crunch, where the loan portfolios of banks were falling, the interest rates in the economy also generally fell, and as all the Econ 101 student know, if you have the quantity of some good traded declining and the price also declining, this must be caused by a decline in demand and not a decline in supply. If you reduce the supply of something, then the quantity traded will fall but the price will go up. But interest rates did not go up, and so this isn't a credit crunch of banks withdrawing the supply of loans; it's demand for loans went down, and as the demand for loans went down, the banks of course made fewer loans. So the banks were just following the conditions of the economy.

And the reason why the demand for loans went down I think is most plausibly explained by Bob Higgs, where he points out that the tremendous uncertainty created by the variations of, well, of FDR's New Deal policies caused investors just to pull back and to build cash positions and to sit on the sidelines and wait until things became more clear to them. We see a similar thing again occurring in the downturn today.

WOODS: But yet, there's all kinds of crazy stuff coming out of Franklin Roosevelt for years. Why these particular years? Why '37?

HERBENER: Well, I think it might have to do – I don't know if Bob tries to answer that question exactly. You remember his article is based on survey data, business confidence survey data. But I think it's plausible to infer that the Supreme Court decisions that had been coming down in '35, '36 had something to do with this. There was the big increase in profits tax in 1936, so there was some churning, rechurning of policy by FDR in this period –

WOODS: Yeah, and labor policy in particular I think also, because then –

HERBENER: Yeah, labor policy was bad, right.

WOODS: Yeah –

HERBENER: And then Bob does point to the economic royalists speeches that FDR was making in the election of '36. You know, it's this rhetoric against businesses and so on that sort of suppressed their investing activity.

WOODS: You know, one of the points that our old friend Richard Vedder makes in the book that he coauthored called *Out of Work* about the 20th century and economics, when he talks about the 1930s – and actually when he talks about the whole century is to show when wage rates are artificially propped up you get more unemployment. He said that's a general rule that you can see over and over again. And the effects that FDR's labor legislation that was not going to be overturned by the Supreme Court had in that year starting in '37 was very substantial. It was like a double-digit percent wage rate increase in the middle of what was still a depression. Still double-digit unemployment, still terrible investment figures. So that would also would have been a contributing factor. So in other words, there's plenty going on at this time, such that we don't have to scrounge around looking for obscure monetary policy changes to account for why you would have this sudden drop in important signs of economic health in 1937 and '8.

HERBENER: No, that's absolutely right. In fact, just to give you the statistic on it, the M1 money supply fell 3.5% from the summer of 1937 to the end of the year, and then it began to increase. So it's, as you say, kind of a trivial thing, right, an obscure and pretty small – it's sort of like the claims by Keynesians and monetarists in a recent downturn that the stopping of inflation and the very mild one-quarter downturn in prices led to this double-digit unemployment and so on.

WOODS: Right. Right, right. And likewise, with claiming that price deflation was a major, major ingredient in why everything went so sour, when we have sitting right in front of us 10 years earlier the 1920-21 case where price deflation was much worse, and yet that was a much, much less severe downturn. So it seems like they've got to twist themselves into pretzels, or more likely, hope nobody knows about the earlier episode and then it makes it easier for their story to stick.

HERBENER: Right, right, indeed. Yeah, the deeper you look into the evidence, the less plausible their explanations become.

WOODS: All right, so if you had 30 seconds then to explain what are the basic contours of Fed policy from 1921 to, say, 1944, how would you describe it?

HERBENER: Well, it was precisely in this early period, '22-'23, where the Fed transitioned to the view that their monetary inflation and credit expansion should not be to accommodate the needs of trade but to stabilize prices and create macroeconomic stability. And then of course, exactly the opposite occurred, despite their frantic attempts to generate this stability once the financial crisis came in 1929. We got exactly the opposite. We got more instability. When the Fed reinflated in '34, when they finally were able to effectively reflate, as we just talked about, it generated more malinvestments for this secondary downturn triggered by this additional legislation by FDR. When they came into, even toward the beginning of the

war, unemployment was still by some measures 18, 19%, so the effect on the real economy of their attempts to stabilize things were ineffective, and of course the war changed the game significantly.

WOODS: All right, that's just what I wanted to know, and I told people at the beginning that you contributed to that Howden and Salerno book, *The Fed at 100*, that I also contributed to. The trouble is the book is called *The Fed at 100*, and I think the book costs \$100, so it's not very accessible (laughing).

HERBENER: (laughing)

WOODS: It's the story of the Fed *for* 100, basically. So this way we're able to sneak around that by just having you come on and talk about it. Just as good.

HERBENER: All right. Another public service by *The Tom Woods Show*.

WOODS: That's what I'm here for, Jeff. What can I tell you?

HERBENER: Absolutely.

WOODS: All right, well, listen – and a public service from you, too, Jeff, which I appreciate. I'm glad your semester, I guess – is it all over now?

HERBENER: It is indeed.

WOODS: Ah, that's great. So now you can rest and think up what your next Liberty Classroom course will be. Ha ha ha.

HERBENER: (laughing)

WOODS: All right, great talking to you. Thanks so much.

HERBENER: You too, Tom. Thanks.