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Lessons from the Great Depression

For the past few months the equity market has been tracking a decline characteristic of the Great Depression. The question now is, How bad could it get and how different will it be compared to that ominous bear market episode? Easy and superficial comparisons with the Great Depression are misplaced and misleading. On the surface there are uncanny similarities in the events that triggered the economic contraction but there are profound differences in policy responses. Policy errors of the Great Depression have been extensively studied, so there is hope that lessons have been learned and that this time it will be different.

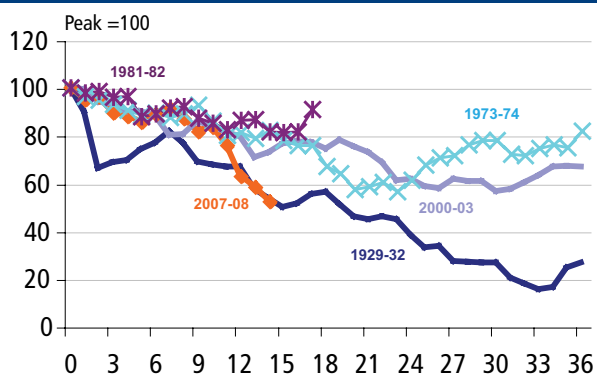
Three major policy errors during the Great Depression usually draw criticism: (1) a monetary response that allowed a deep deflationary spiral to develop, (2) an initial misguided fiscal policy as the government increased taxes and cut spending a year into a recession and (3) a foreign trade policy, which consisted mainly of raising tariffs, that contributed to a collapse of global trade. The current policy

responses have shown, if not a clear plan, at least a strong determination to avoid the mistakes of the Great Depression.

A different and more subtle lesson of history, however, is that powerful underlying systemic forces can sometimes shape outcomes despite the best policy intentions. One example of thwarted policy intentions is the money supply contraction that occurred during the Great Depression. The monetary base¹ actually expanded during that time — the thrust of monetary policy if not its magnitude had been correct — but the money supply contracted nonetheless.

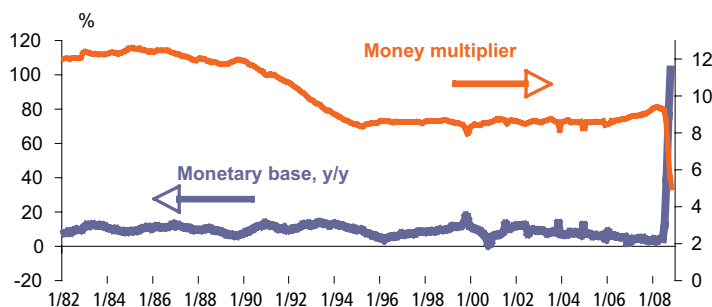
Between August 1929 and March 1933 the money supply fell 28%, causing the price level to decline by 22%. Some economists believe that this large decline in money supply was the primary cause of the unprecedented economic contraction during the Great Depression.² The fall in the money supply, however, cannot be attributed to a fall in the monetary base, which expanded by 18% during that period. The money supply fell due to the simultaneous rise in currency-to-deposits and reserves-to-deposits ratios. Bank failures raised the currency-deposit ratio by reducing public confidence in the banking system. In the absence of deposit guarantees, which we have now, people feared continued bank failures and began holding more currency relative to demand deposits. The process of money creation basically reversed itself as banks responded to lower deposits and widespread bank runs by reducing their outstanding loans and by holding more reserves than legally required, raising their reserve-deposit ratio by 50%.

Figure 1. The current bear market is tracking the Great Depression pattern.



Source: Bloomberg, R. Shiller, ING IM estimates

Figure 2. Explosive growth in the monetary base has not yet created enough traction.



Source: Federal Reserve Board, ING IM calculations

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Is the current deflationary pressure a real threat or just a temporary readjustment of the relative price level of various commodities? The recent data suggest that it could be both. Although the money supply as measured by M2³ is growing (it was falling in 1929–33), the banks are hoarding excessive reserves in an attempt to protect their deteriorating balance sheets. The excess reserves of depository institutions have expanded by 380% since July 2008, compared to only 60% growth of demand deposits in the same period. As banks are effectively tightening their lending, the ensuing credit contraction is creating the deflationary pressure.

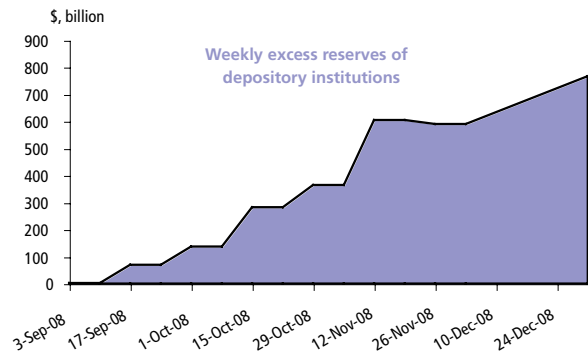
Commodity price readjustment is also adding to that pressure. The 58% decline in oil prices since last year constitutes a positive supply shock, which in normal times would increase output and reduce the price level. But even that benign influence might turn negative by reinforcing the overall deflationary pressure and further reducing overall production.

The Federal Reserve is actively fighting the specter of deflation with various unconventional means. The Fed started to employ unconventional monetary policy in early 2008 as dislocation in the financial markets impeded the traditional transmission mechanism of interest rate policy. Various special lending facilities were introduced in the course of the year. More recently, with nominal short-term interest rates near zero, the Fed has embarked on a quantitative easing.⁴ In response the monetary base, or high-powered money, has expanded an unprecedented 100% year-over-year as of December 2008. It remains to be seen, however, whether these measures will be sufficient to overcome the current deflationary pressures without creating a set of inflationary threats in the future. ■

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Figure 3. Excess reserves of depository institutions have increased 380% in six months.



Source: Federal Reserve Board

1 Monetary base is the most liquid form of money supply and comprises currency and commercial banks' reserves with the central bank. It is also called narrow money or high-powered money. Open market operations of the Fed directly affect the monetary base by expanding or contracting it according to a policy goal.

2 See for example: Friedman, M, and Schwartz, A.J., A Monetary History of the United States 1867 -1960, Princeton University Press, 1963.

3 M2 includes M1 (currency and checkable deposits) plus primarily household saving deposits, time deposits and retail money market mutual funds.

4 Quantitative easing refers to central bank measures to lower longer-term interest rates by buying large quantities of long-term securities.

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