



How to Exit from Monetary Ease: An Historical Perspective¹

Michael Bordo, Rutgers University

The recent recession is familiar in some respects but novel in others. It is familiar in the sense that the recession, although somewhat longer in duration and somewhat deeper than the postwar average, is within the realm of the postwar experience. It is novel in the sense that it was largely precipitated by a financial crisis following the end of a major housing boom. It has been argued by many that a key contributing factor (along with lax regulatory oversight and a relaxation of normal standards of prudent lending) to the asset boom was an extended period of loose monetary policy from 2002-2005 in reaction to overblown fears of incipient crises and deflation. Contributing factors to the asset bust include a return to tighter monetary policy in 2005, the collapse of the subprime mortgage market and the securitization model by which derivatives including toxic mortgages were bundled. The severity of the resultant recession from December 2007 to the summer of 2009 reflected both a credit crunch and tight Federal Reserve policies in 2008. The recession is in some respects the most severe event in the postwar period (real GDP declined by 3.7 percent and unemployment has so far reached 9.8 percent) and the financial crisis is without doubt the most serious event since the Great Depression (the BAA long term Treasury quality spread increased by 342 basis points by April 2009, which was higher than in 1929-33).

Both the crisis and the recession were dealt with by vigorous orthodox policy responses (expansionary monetary policy cutting the federal funds rate from 5.25 percent in early fall 2007 to close to zero by January 2009 and a massive fiscal stimulus package); and by unorthodox quantitative easing (the purchases of mortgage backed securities and long-term Treasuries since January 2009 ; and an extensive network of facilities (such as the TAF) created to support the credit market directly and reduce spreads involving a tripling of the Fed's balance sheet.

The recession is now over and it is likely that the Fed's expansionary policies (especially those which expanded the monetary base) contributed to its demise. The question now arises over how to return the economy to normal growth and low inflation—the exit strategy. This involves switching from expansionary to contractionary monetary policy, reducing the Fed's balance sheet and for fiscal policy, reducing the large fiscal deficits and increases in national debt. The key question is when should this happen. At present there are two views on this subject. One view argues that because of the financial crisis, the credit crunch, and the large overhang of nonperforming loans and toxic assets that the recovery will be slow and that the need to tighten will not occur for quite some time. This view is supported by cross country evidence which demonstrates that recessions accompanied by financial turmoil tend to be deeper and longer (Claessens et al 2008, Reinhart and Rogoff 2009). The alternative view is that the recovery will be V-shaped as was the case in most of the severe recessions in the U.S. in the twentieth century and especially from 1933 to 1941 (Mussa 2009). In that case, expansion would have been even more rapid if not for the New Deal cartelization policies like the NIRA and the Fed policy error of

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doubling reserve requirements in 1936, leading to the serious recession of 1937-38. Which scenario plays out will be crucial to the timing of the Fed's exit.

Based on the historical record we can classify the risks facing monetary policy with respect to the exit strategy as twofold: tightening too soon and creating a double-dip recession and tightening too late leading to a run up of inflation.

In this paper I consider the lessons from history on the risks of an incorrect exit policy. I focus on the Fed's exits from easing policy since 1920. Below I describe in some detail a few salient examples of both kinds of errors.

Tightening too soon

Two episodes of tightening leading to double dip recessions stand out: 1937-38 and 1980-82. The 1937-38 recession which cut short the rapid recovery from the Great Contraction of 1929-33 was a consequence of the Fed's doubling of reserve requirements in 1936-37 to soak up the banks excess reserves. The banks held excess reserves in reaction to their sad experience in the banking panics of 1930-33. Fed officials were concerned that these reserves would lead to an explosion of lending and would foster a reoccurrence of the asset price speculation of the 1920s. Speculation had led the Fed to tighten in 1928, killing the bull market and starting the contraction in August 1929 that would become the Great Contraction. They also believed that reducing excess reserves would encourage member banks to borrow at the discount window. The Burgess-Riefler Doctrine which prevailed at the time argued that the Fed could exert monetary control by using open market operations to affect member bank borrowing and hence alter bank lending (Meltzer 2003). The consequence of doubling reserve requirements in three steps from August 1936 to April 1937 was that the banks sold off their earning assets and cut their lending to restore their desired cushion of precautionary reserves. This, according to Friedman and Schwartz (1963) greatly reduced the money supply and led the economy into a serious recession—real output fell by 10 percent.

The 1981-82 recession quickly followed the recession of 1979-80. The background to both recessions was a long standing and severe buildup in inflation from about 2 percent in 1964 to double digit levels by 1979—referred to as the Great Inflation. In August 1979 President Carter appointed a well known inflation “hawk” Paul Volcker, as chairman of the Federal Reserve. Two months after taking office, Volcker announced a major shift in policy aimed at rapidly lowering the inflation rate. He desired the policy change to be interpreted as a decisive break from past policies that had allowed the run-up in inflation. The announcement was followed by a series of sizable hikes in the federal funds rate. The roughly 7 percentage point rise in the nominal funds rate between October 1979 and April 1980 was the largest increase over a six month period in the history of the Federal Reserve System. However the tight monetary stance was temporarily abandoned in mid 1980 as economic activity decelerated sharply. The FOMC then imposed credit controls and let the funds rate decline—moves that the Carter administration had politically supported. The FOMC policy reversal and acquiescence to political pressure was widely viewed as a signal that it was not committed to achieving a sustained fall in inflation. Having failed to convince price and wage setters that inflation was going to fall, the GDP deflator rose almost 10 percent in 1980.

The Federal Reserve embarked on a new round of tightening in late 1980. The Federal Funds rate rose to 20 percent in late December, implying an ex post real interest rate of close to 10 percent. This second and

more durable round of tightening succeeded in reducing the inflation rate from about 10 percent in early 1981 to about 4 percent in 1983, but at the cost of a sharp and very prolonged recession (Bordo, Erceg, Levin, and Michaels 2007).

Tightening too late

The key episodes here are in the 1960s and 70s. Over its history the Fed has always tightened monetary policy when inflation threatens and loosened in the face of recession. Before the mid 1960s, adhering to the nominal anchor of the gold standard meant that the price level was mean reverting and periods of inflation and deflation would be short lived. With the breakdown of Bretton Woods after 1965, the nominal anchor weakened and inflation became persistent (Bordo and Eichengreen 2008). After that point, when faced with incipient inflation the Fed would tighten, but when faced with falling real output and increases in unemployment, it began to cave in to political pressure to cease its tightening. In addition to political pressure was the belief in a permanent Phillips curve tradeoff whereby lower unemployment with assumed high welfare losses could be traded off for higher inflation with lower assumed welfare losses.

The first episode was in 1966 when the Fed, under Chairman Martin, tightened to offset the buildup in inflation since 1965—the Credit Crunch of 1966. Facing political pressure in the Congress from the housing industry which suffered under rising rates and credit rationing, the Fed backed off. A similar sequence of events occurred in 1969. Under Chairman Arthur Burns, tightening to fight inflation ended in 1973 in the face of rising unemployment and political pressure from the Nixon Administration. As a consequence of these policies, inflation and inflationary expectations ratcheted up as market agents came to doubt the credibility of the Fed’s commitment to fight inflation.

From 2001 to 2004 the Fed engaged in expansionary policy to head off incipient financial crises. After Y2K when no financial crises occurred, it promptly withdrew the massive infusion of liquidity it had provided. By contrast thereafter, it foresaw a series of shocks to the economy that might lead to financial crisis, e.g. the tech bust of 2001 and 9/11. In each case it injected liquidity, but when no financial crisis occurred, it permitted the additional funds it had provided to remain in the money market. In addition it overreacted to the threat of deflation in 2003-2004 which may have been of the good (productivity driven) variety rather than of the bad (recessionary) variety. If consequent upon these events the markets hadn’t been infused with liquidity as much as they were and for so long, then interest rates would not have been as low before 2005 as they were and the housing bubble which burst in 2006 might not have expanded as much as it did.

Some Possible Policy Lessons

The first lesson is that a repeat of 1937-38 can be easily avoided because the Fed can separate its tightening policy tools from the banks holding of excess reserves by paying interest on reserves. A second lesson is that following a stable and credible nominal anchor can make the exit strategy easier. The postwar exit before 1965 and the exit after 1982 when the Fed followed a credible nominal anchor worked better than those within the 1965 to 82 period. Moreover, had Volcker’s initial tightening been perceived as credible, the recession of 1981-82 would have been less severe. The third lesson from the Great Inflation period is for the Fed to avoid succumbing to political pressure at all costs. This issue may come up again in the near future if the next exit occurs when unemployment is still high.

Empirical Evidence

I plan to examine a panel of past recession events in the U.S. since 1920. For each NBER trough to peak I will compare the timing of changes in the behavior of several measures of Fed policy (the discount rate pre World War II, the Federal Funds rate since, various monetary aggregates and the Romer dates) with various macro indicators that could influence them. These include measures of inflation and inflation expectations, real growth and deviations of real GDP from trend, unemployment rates, measures of asset prices, indicators of financial turmoil such as quality spreads and the yield curve. This descriptive comparison amplified with an historical narrative should shed some light on the circumstances under which exit policies have occurred in the past. Also if time permits, I may run a regression across episodes which would take as dependent variable the time that elapsed from the recession trough to the change in policy stance from ease to tightness. As independent variables I would include various characteristics of the business cycle such as the depth of the recession, indicators of financial turmoil and measures of inflation and inflation expectations. Such a regression could tell us if there is an ideal timing for an exit strategy.

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