

Did Government Solve or Cause the Financial Crisis?

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Signs of a potential recovery have led policymakers and pundits to claim credit for the turnaround. Fed Chairman Ben Bernanke, President Obama and economist Paul Krugman have all weighed in with a similar theme—government has saved us from a second Great Depression.

If true, we should all be grateful to those in control of monetary and fiscal policy. However, before relinquishing our liberty to a growing and powerful bureaucracy it's crucial to answer a key question—did government save us from a Depression, or did it cause the financial crisis?

Interestingly, one who believes government saved us (Krugman) recommended in 2002 that we should “*create a housing bubble to replace the NASDAQ bubble.*” Another (Bernanke) was a member of the Fed when it helped create the housing bubble.

Bernanke now admits that the Fed was too expansive from 2002-05. If the Fed's admitted policy mistake helped produce the housing bubble, it raises suspicions about the extent to which government gets credit for saving us from financial Armageddon.

Before giving the Fed credit it for saving the economy, it's instructive to examine the extent to which Fed policy may have contributed to the financial collapse.

Milton Friedman created a revolution in economics by showing that the collapse in spending during the Great Depression was related to a restrictive monetary policy. It is surprising that there has been relatively little discussion regarding the extent to which Fed policy may have contributed to the recent collapse in spending.

Operationally, the Federal Reserve has a choice. It can buy and sell securities to

target interest rates or bank reserves. If it chooses to target interest rates, it must let bank reserves adjust to its interest rate target. Alternatively, if the Fed chooses to target bank reserves, it must let interest rates go where they may.

There is a long-standing debate over which procedure would produce a more stable monetary policy. Monetarists tend to believe that the Federal Reserve should avoid targeting interest rates and instead target bank reserves or some other monetary aggregate. Instead, the Fed has chosen to target a specific interest rate—the fed funds rate—and allowed bank reserves to adjust to its interest rate target.

Bank reserves are the one monetary aggregate that the Fed controls. Changes in bank reserves are the first step in the monetary process. When the Fed buys or sells securities, it either increases or reduces bank reserves. Increasing bank reserves tends to increase the money supply while reducing those reserves tends to tighten the money supply.

When targeting interest rates the Fed has to guess the specific fed funds rate that will producing the appropriate amount of bank reserves that the economy needs. If the targeted interest rate is too high, it won't create enough money for the economy to function properly. If the targeted rate is too low, it will create the type of excess money that the Fed now admits contributed to the housing bubble.

The Federal Reserve Bank of St. Louis calculates data for bank reserves (adjusted for reserve requirements) going back to 1918. The data show that, except for the aftermath of WW II, every recession since 1918 has been preceded by either a slowdown in the growth of bank reserves or an outright decline. Moreover, except for the outbreak of WW II, every

significant decline in bank reserves has been followed by a serious recession.

The three most serious recessions since the establishment of the Federal Reserve occurred in 1929-33, 1937-38, and 2007-09. The recession from 1929-33 was associated with a 15% decline in bank reserves over a three-year period. The recession of 1937-38 was associated with a 13% decline in bank reserves over 18 months.

The most recent recession was preceded by a 3% decline in bank reserves over a three-year period. The recent three-year period of declining bank reserves was the only time since the early 1930s that bank reserves had declined for three consecutive years. Moreover, the decline in reserves followed four years in which the Fed had increased bank reserves at a 5% annual rate. Hence, the shift from expansion to contraction amounted to eight percentage points.

The data strongly suggest that the Federal Reserve's policymakers made serious mistakes in the recent period. They inadvertently set their interest rate targets so high that it produced the most restrictive monetary policy since the 1930s.

The Fed's operational procedure extended the mistake long after it became obvious that the economy needed more bank reserves. From August, 2007 to August, 2008 Fed members consistently stated that they were adding liquidity to the economy. Instead, in an effort to achieve an interest rate target that was too high, the Fed offset its purchases of securities by selling \$300 billion in Treasury securities. This action left bank reserves unchanged for a year after the Fed intended to boost liquidity.

Recent moves by the Federal Reserve have finally increased bank reserves. In the wake of this increase, there were finally signs that the worst of the recession was over. Claims by Chairman Bernanke that the Fed's action has avoided another Great Depression are similar to those of

an arsonist who sounds the alarm after setting a building on fire, then wants credit for saving the inhabitants.

The President's claim that he saved us from a second Depression is similarly disingenuous. President Bush, President Obama and the Congress all contributed to an estimated 34% increase in government spending this fiscal year. If massive increases in federal spending have a positive impact, all of the above deserve credit. If these expenditures prove wasteful, all are to blame.

The implicit assumption behind the idea of fiscal stimulus is that government can spend money more effectively than those in the private sector. Before accepting this assumption, it's instructive to see the extent to which this has been true.

In the years from 1929 to 1932 government spending increased by 50%. This massive increase was associated with a 25% drop in spending and the worst economic decline in US history.

There was a cyclical recovery from 1933-37 that many attribute to the New Deal. During these years government spending more than doubled. However, bank reserves also more than doubled. The main difference between the two periods isn't the behavior of government spending; it's the behavior of bank reserves.

Recent experience suggests that the lessons from the 1930s remain relevant today. The economy still dances to the tune of monetary policy. To the extent that government spends lavishly, it can only boost the economy if it is accompanied by an expansive monetary policy.

The real legacy of the massive increases in government spending won't be found in the extent to which the economy experiences a cyclical recovery. Rather, it will be the extent to which living standards suffer from wasteful government spending.