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Monetary Lessons from the Not-So-Great Depression, A round-robin essay debate with Scott Sumner, James Hamilton, and George Selgin

JEFFREY ROGERS HUMMEL
San Jose State University, jeff@jrhummel.com

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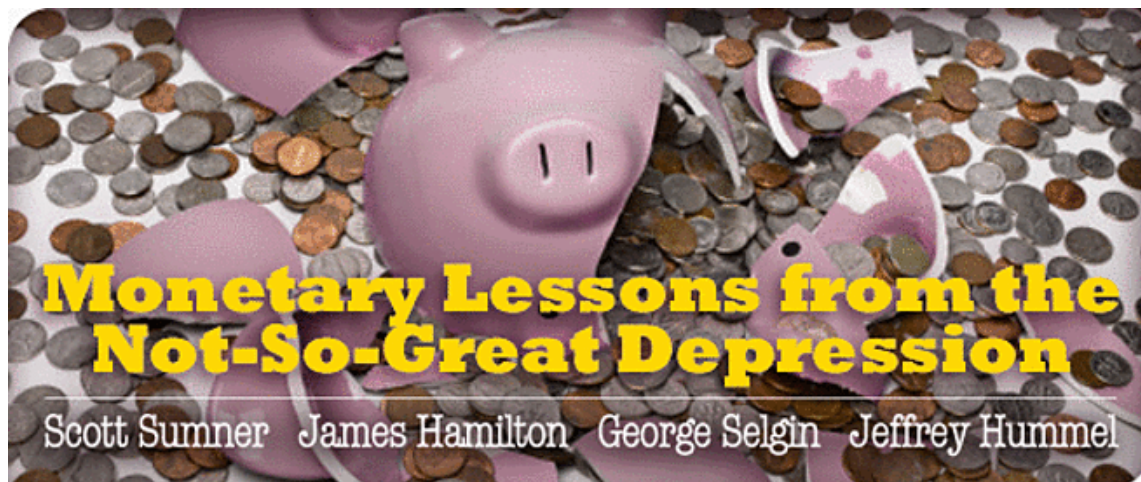


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Explanation vs. Prescription



By Jeffrey Rogers Hummel
Response Essays
September 21, 2009

Like others, I was unfamiliar with the work of Scott Sumner before he started his blog, “The Money Illusion” last February. But since then, his posts have proved so powerful, innovative, and challenging that he has commanded the attention of prominent macroeconomists from nearly all perspectives. Sumner’s distinctive analysis — what might be labeled “neo-monetarism” — strives to provide both an explanation for the financial crisis and a prescription for monetary policy.

Let me comment first on his causal explanation, with an excursion of my own into the development of economic thought. The business cycle remains the major unresolved problem in macroeconomics. None of the competing theories have yet achieved a consensus within the profession, in part because none are fully satisfactory. As a result, the business cycle has, over my lifetime, migrated from the front end of most macro texts to the back

end, situated behind the topics of growth and inflation, about which economists know and agree more. So we must approach this problem with a measure of epistemic humility.

Outside of real business cycle theory and Austrian business cycle theory, all the alternatives, including Sumner's, blame depressions and recessions on negative shocks to what economists call aggregate demand, the total level of spending. Orthodox monetarists attributed such shocks to declines in the rate of monetary growth, whereas traditional Keynesians blamed declining autonomous expenditures. Both of these sources are captured in the well known equation of exchange: $MV = Py$, in which MV (money times its velocity) is equivalent to aggregate demand, and Py represents nominal GDP, the product of the price level and real output. In other words, a fall in velocity (V) is equivalent to a Keynesian fall in autonomous expenditures, which can happen only if people in the aggregate are holding (or hoarding) more money. Although this basic truth is sometimes overlooked in the recent debates over fiscal policy, in which economists replay (often with far less theoretical sophistication, despite greater mathematical pizzazz) the forgotten Keynes versus the Classics controversies, a negative shock to aggregate demand must involve either (a) a decline in the money stock's growth rate or (b) an increase in the demand for money.

During the 1980s the behavior of velocity became more erratic than seemed consistent with monetarist predictions. Many macroeconomists turned toward a New Keynesian synthesis, in which shocks can arise from *either* M or V , and the goal of monetary policy is to offset them. The best way to do that, according to New Keynesians, is with some kind of interest-rate target, like the famous Taylor Rule, which allegedly adjusts for the impact of inflationary expectations on observed interest rates, so that the Fed can stabilize growth of MV and thus Py .

The recent recession actually raises two related questions: (1) what caused the initial downturn in late 2007; and (2) why did a mild, garden-variety recession start to turn into a major financial panic in late 2008. The same

two questions apply to the Great Depression, despite the fact that the current recession is so far nowhere near as severe. A recession that began in 1929 only turned into a Great Depression beginning in October 1930 with the most massive series of banking panics not just in U.S. history but also in world history. Milton Friedman and Anna Jacobson Schwartz's seminal 1963 study, *A Monetary History of the United States, 1867-1960*, decisively confirmed for almost all macroeconomists the role of this severe banking crisis in bringing on what Friedrich Hayek called a "secondary deflation," although economic historians still debate what triggered the banking panics and what caused the initial recession. Friedman and Schwartz held Fed-induced monetary tightness responsible for both; Keynesians continue to blame velocity shocks; the Austrians attribute the initial 1929 downturn to a malinvestment bubble brought on by monetary expansion during the 1920s; whereas New Classical economists along with other supply-siders sometimes point to such supply-side shocks as the Smoot-Hawley tariff.

Sumner attributes the mild recession that began in 2007 to the supply-side shock of subprime defaults. His real concern, however, is the subsequent financial panic. Although he identifies monetary policy that was too tight as the underlying cause of increasing distress, he defines "tight" and "loose" relative to velocity rather than relative to the money stock. What he is really saying is that for some unspecified reason the economy was hit with a negative velocity shock, and the Fed failed to respond promptly and strongly enough. I would like to see him address in greater detail the origins of this shock; attributing it to an expected *future* decline in nominal GDP doesn't get us very far. Did these expectations result from the subprime crisis, from an unpredictable attack of Keynesian "animal spirits," from the declining rates of monetary growth over the previous five years, or from something else? In fact, I believe he goes a bit too far when he suggests that it was the fall in aggregate demand that caused all the financial failures. Surely, once the process is underway, you can have both reinforcing each other, as clearly happened during the Great Depression.

Sumner's focus on 2008 is thus consistent with a variety of stories about the earlier onset of recession, even the Austrian story that David Henderson and I critiqued in our Cato Briefing Paper and in our reply to critics, as well as our preferred story that brings in volatile international savings flows. Yet Sumner has convinced me that in light of the looming financial panic, whatever its source, Ben Bernanke's response of targeted bailouts was too tight as well as misdirected. Beginning with the Fed's creation of the Term Auction Facility in December 2007, nearly every dollar that Bernanke injected into financial institutions was sterilized with the withdrawal of dollars through the sale of Treasury securities. Not until September 17, 2008, did a panicked Fed finally set off a monetary explosion, doubling the base in less than four months.

Even then, as Sumner astutely emphasizes, Bernanke accompanied this inflationary step with the deliberately deflationary step of paying interest on bank reserves. Henderson observes in a recent post how this stands in marked contrast to what Alan Greenspan did when faced with a mere whiff of panic in anticipation of Y2K and after 9/11. In both instances, Greenspan flooded the system with liquidity and then, when any financial uneasiness calmed, rapidly pulled the money back out, a policy far more consistent with the implications of Friedman's research. I thus am persuaded that financial failures under Bernanke would have been far less serious if the Fed had simply started expanding the base well before September, and had done so without any direct bailouts that exacerbated moral hazard.

I also wholeheartedly accept Sumner's criticisms of the current obsession with interest rates as *the* indicator of monetary policy. I have repeatedly stated myself that interest rates, whether real or nominal, have never proved an adequate gauge of what central banks are doing: not during the Great Depression, when nominal rates were very low despite a collapsing money stock; not during the Great Inflation of the 1970s, when nominal rates were high despite an expanding money stock; not during Japan's lost decade; and not under Greenspan or Bernanke. Moreover, Sumner is

absolutely right that zero interest rates are no obstacle to an expansionary monetary policy. The Fed could easily increase the monetary base well beyond its current \$1.7 trillion with traditional open market operations alone, up to the Treasury's total outstanding debt of nearly \$7 trillion, while avoiding any loans whatsoever to specific depositories, investment banks, or other financial institutions. Eventually some of those reserves would be converted into currency, which the public would start spending.

What does cripple monetary expansion is paying interest on reserves, something other major central banks were already doing before the Fed. The practice is not merely deflationary, other things equal. It essentially converts monetary policy into fiscal policy, since in effect the Fed is now doing the same thing as the Treasury, borrowing money on one side of the balance sheet, through interest earning reserve deposits, in order to spend or lend it on the other side. Symptomatic of this subtle transition in the Fed's role was the fact that in the midst of its monetary explosion, the Fed's total balance sheet exceeded the monetary base by half a trillion dollars. That difference represented money that the Treasury had borrowed from the public for the express purpose of lending it to the Fed, which in turn employed it for more loans, in this case, primarily foreign currency swaps. In short, interest-earning reserves have created a self-fulfilling Keynesian liquidity trap. And if one inspects some of the most advanced academic writing on monetary policy, one discovers that some central bankers now view centrally planning the economy's interest rate as their primary function, with the ultimate ideal of separating that role entirely from anything happening to the money stock.

This brings us to the second issue of monetary prescriptions. Here I decisively depart from Sumner's recommendations. I agree with him that the Taylor Rule or other forms of interest-rate targeting are inadequate. But his alternative, to somehow have central banks target expectations about nominal GDP growth, has its own defects. It does, admittedly, preclude a Fed tightening during negative supply shocks, when the price

level should be allowed to rise to reflect increasing scarcity. Indeed, it was probably such shocks from climbing oil and commodity prices in 2007 that encouraged a Fed reaction to the subprime crisis that was too tight. But this advantage over straight inflation targeting is something Sumner's Rule has in common with the Taylor Rule.

On the down side, Sumner's Rule implicitly shares the current bias against any price deflation at all. Sudden, sharp deflation, which generates serious economic dislocations, should be distinguished from mild, secular deflation. The latter has historically been benign, and George Selgin has argued that it is actually optimal. Of course, Sumner could in theory set the target for the growth of nominal GDP expectations at zero or even at a negative rate. But the more critical defect of Sumner's Rule is its blithe assumption that money, unlike any other good or service, requires not merely government provision but detailed, sophisticated, and flexible government management.

Which brings me full circle to my earlier caution about epistemic humility. No one yet knows or understands the full causes and cures for the business cycle, and any claim to the contrary is pure intellectual hubris. As we have already observed, Sumner himself is somewhat tentative about what brought on the initial downturn in 2007 and silent on how or why this evolved into a negative velocity shock. It may well be that Sumner's Rule would outperform the alternatives tried so far, but in light of the Fed's inept and often disastrous record until the Great Moderation during the two decades following the mid-1980s, that is not saying a lot. Would Sumner be willing to bet against any future research or financial innovations either discrediting his rule or making it obsolete? Moreover, even if Sumner's Rule is the best we can ever expect from the State's central bank, how likely is it that the rule will be adopted and consistently applied? Does anyone really believe that political pressures had absolutely no influence on Bernanke's bailouts?

Given that the financial sector, from which business cycles apparently emanate, is one of the most heavily regulated within the U.S. today and, in fact, has never been fully deregulated, *ever*, we should instead be looking at deregulation and privatization, rather than better fine tuning. Sumner has, I believe, made a major contribution to the debate over the recent recession. Yet with all his close attention to the work of Milton Friedman and his sympathy for free markets, I am puzzled that he has said little (as far as I know) about Friedman's conclusion that private currency issued under the Aldrich-Vreeland Act headed off a panic in 1914 and would have done a far better job than the Federal Reserve during the Great Depression. Nor am I aware of his addressing the arguments of Selgin and Lawrence H. White that free banking would spontaneously stabilize *MV* through the automatic operation of the clearing system. In the final analysis, only abolition of the Fed, elimination of government fiat money, and complete deregulation of banks and other financial institutions offer any long-term hope of bringing better macroeconomic stability.

ALSO FROM THIS ISSUE

Lead Essay

- **The Real Problem was Nominal** by Scott Sumner

In this month's sure-to-be controversial lead essay, Bentley University economist Scott Sumner argues that almost everything economists and economic policymakers thought they knew about the role of monetary policy in the recent recession and financial collapse is wrong. Sumner contends that the resources of monetary policy were not exhausted, as many economists believed, but were barely used. Flying in the face of conventional wisdom, Sumner maintains that monetary policy in the run-up to the financial crisis was not highly expansionary, but was in fact disastrously contractionary. Sumner offers a short history of monetary economics to put into historical perspective the role of allegedly failed monetary policy in the financial crisis and recession. He proposes a strategy for central bankers – targeting forecasts of nominal GDP – that might help avert future crises. In conclusion, Sumner warns of the political dangers of misdiagnosing the crisis: unless the record is set straight, free markets will once again take the fall for a failure of monetary policy.

Response Essays

- **It's Harder than It Looks** by James D. Hamilton

University of California, San Diego economist James D. Hamilton disputes Scott Sumner's claim that the sub-prime crisis was a fluke with few lessons for macroeconomics. According to Hamilton, the booming U.S. housing market represented a "huge misdirection of capital," and the overexposure of key financial institution to the housing market's downward correction crippled lending and sent the economy into a nosedive. Hamilton agrees that the Fed might have limited the damage had it kept the growth rate for nominal GDP higher, but he disagrees with Sumner about the tools available to the Fed to achieve this. Hamilton notes that tools available to the Fed depend on which of the possible specifications of the money supply and its velocity actually determine nominal GDP. Hamilton says unconventional paths to monetary stimulus were open the Fed in late 2008 and that "the preferred policy ... would have been to acknowledge more aggressively the losses financial institutions had absorbed on existing loans, impose those losses on stockholders, creditors, and taxpayers, and retain as the Fed's first priority the stimulus of nominal GDP rather than trying to lend to everybody." Hamilton concludes with some worries about Sumner's favored tool for targeting nominal GDP growth.

- **Between Fulsomeness and Pettifoggery: A Reply to Sumner** by George Selgin

University of Georgia economist George Selgin agrees with Scott Sumner that "tight money was the proximate cause of the post-September 2008 recession" and that "a policy of nominal income growth targeting might have prevented the recession." Selgin encourages Sumner to acknowledge the role easy money played in the subprime crisis, and argues that Sumner's five-percent nominal income growth target is "unnecessarily and perhaps dangerously high." Selgin favors a two or three percent target, which he contends would be less likely to perpetuate boom-bust cycles.

The Conversation

- **Almost on the Money: Replies to Hamilton, Selgin, and Hummel** by Scott Sumner
- **There Are Limits to What Monetary Policy Can Accomplish** by James D. Hamilton
- **A (Gentle) Nudge Toward Gentle Deflation** by George Selgin
- **From Discretion to Futures Targeting, One Step at a Time** by Scott Sumner

- **Yes, the Lags Are Long and Variable** by James D. Hamilton
- **Agreements and Disagreements** by Jeffrey Rogers Hummel
- **Score-Keeping with Selgin** by Scott Sumner
- **Taxing Banks for Holding Reserves** by Jeffrey Rogers Hummel
- **Clearing up Some Miscommunication** by Scott Sumner
- **Let's Make a Deal** by George Selgin
- **Defining the Stance of Monetary Policy Is Harder than It Looks** by Scott Sumner
- **Some Final Thoughts** by James D. Hamilton
- **We Can't Agree on Everything, George...** by Scott Sumner
- **Parting Shots** by Jeffrey Rogers Hummel
- **Final Thoughts and Thanks** by Scott Sumner