

ECONOMICS U\$A
21st Century Edition

PROGRAM #21

THE FEDERAL RESERVE: DOES MONEY MATTER?

AIRSCRIPT

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Final Transcripts

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DAVID SCHOUUMACHER: 1931. The Great Depression. Banks were failing by the thousands. The Federal Reserve, created to prevent such a tragedy, only made things worse. What had gone wrong? 1951. When the United States entered the Korean conflict, President Truman also faced a battle on another front...a battle between the Federal Reserve and the Treasury over financing the war. How would it be resolved? 2008. The Great Recession had begun. How would the Fed respond to its greatest threat since the Great Depression?

The nation's central bank...originally created to protect the banking system against panics...evolved into an institution with more power to affect the economy than even it had imagined at the outset. The Federal Reserve: Does Money Matter? With the help of Economic Analysts Nariman Behravesh and Richard Gill, that's the question we'll explore on this 21st-Century Edition of Economics U\$A. I'm David Schouumacher.

(MUSIC PLAYS—OPENING TITLES)

PART I

DAVID SCHOUUMACHER: Coins...bills...checks...our basic money supply. The amount of money and where it goes within the banking system has been the main concern of our nation's central bank. At the Fed's headquarters here in Washington, D.C., deliberations are held behind closed doors by experts who continuously monitor our financial health and prescribe remedies. So, how did this esteemed body of experts manage to prescribe a remedy that plunged the nation even deeper into the Great Depression?

In the early part of the 20th century, American banks operated with little regulation and great vulnerability. In 1907, that vulnerability became apparent when depositors lost confidence in the banks and demanded their money. Banks had no reliable place to turn for short-term loans, and many collapsed. It took a powerful banker, J.P. Morgan, to end the Panic of 1907. But should an entire country be dependent on the whims of an individual? A central bank, a lender of last resort, seemed to be a better solution. Just before Christmas of 1913, President Wilson signed the Federal Reserve Act into law. It created a Federal Reserve System. Though its real operating powers were delegated to 12 regional banks across the country, its official headquarters was in Washington, D.C. Merritt Sherman, active with the Fed since 1926, describes one of its early tools to regulate banking activity...the discount rate.

MERRITT SHERMAN: "That was the first tool used when the Fed was created...the discount rate being the rate that is charged to member banks when they need to come in to get additional reserves, and it is raised to restrain their borrowing...lowered to encourage their borrowing."

DAVID SCHOUUMACHER: Through World War I, through the roaring '20s, most bankers believed the banking system was safe, and they went about the business of helping the economy grow. Then one day it all came tumbling down. October 24, 1929, the greatest stock market crash in history marked the beginning of years of economic devastation. Banks failed by the thousands. Why did the Fed fail its first major test?

We asked economist Lester Chandler for an explanation. Professor Chandler, the Fed was set up after all to prevent bank failures and avoid depressions...and there they were in the 1930s with thousands of banks failing and in a whale of a depression. What went wrong?

LESTER CHANDLER: "Within the Federal Reserve System, nobody knew who was to do what...at least as far as the Federal Reserve Act was concerned. They'd turned down the Aldrich Plan for one central bank with branches and adopted a system of twelve independent banks, and then on top of that they'd put a Federal Reserve Board that was supposed to do something centrally, but they couldn't decide who was to do what."

MERRITT SHERMAN: "Well, I'll put it this way. We didn't have very many central bankers around in this country in 1914. Central banking was not a recognized profession."

DAVID SCHOUUMACHER: Fearful that the United States was not a "safe harbor," foreign investors began to withdraw their gold deposits from American banks. In a short time, 30 million dollars in gold was shipped overseas. We asked Dr. Andrew Brimmer, former member of the Federal Reserve, why the loss of gold reserves gave the Fed cause for alarm.

Dr. Brimmer, in 1931, foreign investors were pulling their gold out of American banks...in other words, reserves were being depleted. Even though that gold reserve no longer plays the role it once did, what does that do to a bank and what does the bank and the Federal Reserve do to try to combat it?

ANDREW BRIMMER: "For the banking system as a whole, if it experiences a significant reduction in reserves, from whatever source, it has to cut back on loans and the extension of credit unless it can get some relief. And only the Federal Reserve, acting as a central bank, can provide more relief. So in 1931, as the gold flowed out of the

system to Europe and so on, that was a loss in reserves and the central bank had to step in to make it up.”

DAVID SCHOUMACHER: The Fed was not going to stand by while American banks were drained of their reserves. It raised its discount rates...in order to force banks to push up the rate of interest paid to their depositors. The result...foreign investors earned more interest and were enticed to leave their money in U.S. banks. That ended the gold drain...but raising the discount rate had other less fortunate consequences.

ANDREW BRIMMER: “If the Federal Reserve raises the discount rate, that transmits a message. It says to banks and markets...the money market generally...that the Federal Reserve wants to be restrictive.”

DAVID SCHOUMACHER: For the economy as a whole, the result was disastrous. High interest rates discouraged borrowing and choked off the flow of money to business. More businesses failed, more jobs were lost, and more banks collapsed. The country was pushed deeper into the Great Depression.

Well, Professor, if you were going to give a letter grade to the Fed...A,B,C,D,F...what would it be in the 1920s?

LESTER CHANDLER: “I would grade it as an ‘F,’ applying today’s standards...probably a ‘D,’ applying even the most advanced standards of that day.”

MERRIT SHERMAN: “Sure, you can criticize the Fed...it made mistakes...but what it did wrong was a matter of degree mostly, rather than total mistakes of policy.”

DAVID SCHOUMACHER: The men who met around this table were some of the most influential bankers in the country. They were the Board of Directors of the Federal Reserve. And when the Board met here, trying to protect its member banks by changing discount rates, they sent ripples across the entire nation. In a sense, they were practicing a rudimentary form of monetary policy. In other words, they were affecting the money

supply. How important was the money supply? For an analysis, we turned to economist Richard Gill.

(MUSIC PLAYS – COMMENT AND ANALYSIS I)

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RICHARD GILL: In order to understand this question we have to have some sense of how the money supply affects the general workings of the economy and how the Fed, in turn, can affect the money supply. This diagram suggests the general nature of the answers to these questions. Theoretically, in a depression situation, the Fed should have been trying to increase the reserves available to the commercial banking system...provide more reserves...as stated in the first box. The hope is, then, that banks will lend out more credit to businesses, thereby increasing the general quantity of money in the economy. Thus, more money. More money, in turn, should lead to more spending...by businesses who have borrowed to invest in new machinery, plants, and factories...possibly also by consumers like ourselves. More spending, in turn, should lead to higher GNP and more jobs for everyone. It may also lead to higher prices, though that didn't seem much of a problem in the 1930s when prices were generally falling. Now when the Fed tried to stem the gold outflow by raising the discount rate in 1931, it was effectively doing exactly the opposite of what this analysis suggests. It was making it more difficult for the commercial banks to borrow from the Fed, creating a negative effect on reserves. In fact, during those years of the Depression, the country's money supply shrunk drastically. A number of economists today believe that the misdirected policies of the Fed were a major factor in turning an ordinary economic downturn into a Great Depression! We should quickly add, however, that most economists, in the years immediately following, came to a quite different conclusion. Their conclusion was that there was very little the Fed could have done anyways, that these links suggested by the arrows in our diagram would simply snap in the face of a serious depression. The Fed might make more reserves available, but the banks might be too scared to lend them out and businesses too frightened to borrow. More reserves might not mean more money! Snap! Even if more money were somehow created, people wouldn't spend it. They would hoard it, have a strong desire for liquidity in such treacherous times. Hence, more money might not lead

to more spending. Snap! But without more spending, the final link to the great objective...raising the GNP and employment...would never have a chance to come into play. In fact, for a number of years, monetary policy was generally in disrepute in this country, particularly when it came to curing a business downturn. "You can lead a horse to water, but you can't make him drink!" "You can pull on a string but you can't push a string." Such was the common opinion. Our great new Federal Reserve System, like the economy it was supposed to defend, had come upon hard times indeed!

PART II

DAVID SCHOUMACHER: The Banking Act of 1935 gave the Fed the authority it needed to use monetary policy to stabilize the economy. It also provided for an important new tool in the Fed's arsenal – open market operations. Why then, when the Fed attempted to fully exercise its authority 15 years later, did they find themselves in open and direct conflict with the Treasury?

SPEAKER: "Our union is asking its members to invest every dollar it can in these bonds...and with God's help and your dollars we'll win this war for democracy."

DAVID SCHOUMACHER: In World War II, as part of its powers to conduct open market operations, the Fed bought bonds from the Treasury to help finance the war. Fed officials felt that providing that service was essential to victory.

ANDREW BRIMMER: "As we entered World War II, the Federal Reserve undertook a commitment, in January, 1942, to support the market for government securities... meaning that it would buy and sell all the government securities anybody wanted to offer on the market...to keep interest rates from rising."

DAVID SCHOUMACHER: So the Fed bought all the bonds the Treasury wished to issue...that were not bought by the public. Dr. Brimmer explains more on open market operations and how they affect the economy.

ANDREW BRIMMER: “Open market operations consist of purchase or sale of government securities. Purchases will supply reserves...Sales will reduce reserves. And the reserves are the basis for expanding loans and therefore expanding money and credit. Very important activity...”

DAVID SCHOUMACHER: Pumping so much money into the economy through the purchase of government bonds did not lead to inflation because the economy had room to expand, and because strict controls were imposed on wages and prices. It was only after the Allied victory, and the Treasury insisted on keeping the same arrangement with the Fed, that the controversy began. The Fed was as patriotic as anyone else, but they felt they were merely acting as an agent of the Treasury...and it was unclear how long the Treasury’s demands would continue. As far as the conduct of monetary policy was concerned, the Treasury was putting the Fed in a “straight jacket.” Why were their interests in conflict?

ANDREW BRIMMER: “As the economy began to expand after the war, the demand for credit rose. Banks found the opportunity to lend to private companies, individuals, and so on. Where will they get the reserves? Where will they get the cash to do that? Sell your government securities...these were very low-yielding government securities...two and one half percent interest...two and one quarter percent interest...when you could lend, get five to six percent lending to private borrowers. So the banks...insurance companies...others...began to sell off government securities. The Federal Reserve was committed to buy them because of that legacy of war commitment. As it bought securities, it added to bank reserves and that gave the banks the basis for new lending. So the banks would lend and lend...sell government securities...get their deposits...make more loans. And that was adding to an enormous expansion in the money supply and availability of bank credit. And the Federal Reserve was afraid that such an expansion of money and credit would lead to inflation, and it wanted to restrain that.”

DAVID SCHOUMACHER: Then, in June of 1950, fighting broke out in Korea. It was a limited but very costly war, and it brought to a head the conflict between the Treasury and the Fed.

ANDREW BRIMMER: "The Treasury is a part of the Executive Branch. The Federal Reserve is an independent agency. The Federal Reserve is a creature of Congress ... created by Congress...with independence of the political pressures from the White House...and so in that sense the Treasury was not able to mandate instructions to the Federal Reserve."

DAVID SCHOUMACHER: Chairman Thomas P. McCabe believed the Fed's proper role was to restrain inflation, but Treasury Secretary John Snyder, and President Truman, wanted the Fed to join ranks and help finance the war.

ANDREW BRIMMER: "President Truman, in his memoirs, described the experience he had in 1917. He bought Liberty Bonds. At the time he didn't know, and most people didn't know, that those Liberty Bonds...certainly the series he bought...went up and down with market prices. And after the war, interest rates rose, bond prices fell, and many people lost a lot of money because they had to sell those bonds below what they had paid for them. Truman never forgot that experience and he thought the Federal Government had an obligation not to cheat people."

DAVID SCHOUMACHER: Truman called the entire Federal Open Market Committee to the White House to give them a tongue-lashing. Never before had a president gotten so directly involved with trying to influence Fed Policy. There was so much misunderstanding on both sides of the issue that Truman ordered a commission to study the matter and recommend changes at the Fed. Rather than let a third party dictate a settlement, the Fed and the Treasury elected to meet on their own and work out a solution. The result was the Accord of 1951.

ANDREW BRIMMER: "The Federal Reserve would be free to control money and credit without having to buy government securities. The Treasury agreed to issue some non-marketable bonds that carried a somewhat higher interest rate."

DAVID SCHOUUMACHER: As in any battle, there were casualties. Thomas P. McCabe resigned under pressure from Truman. He was replaced by William McChesney Martin, a key negotiator of the Accord, and, ironically, an Under Secretary of the Treasury. Following the Accord, the Fed was free to conduct monetary policies, unhampered by the constraints of the Treasury. The Fed had flexed its newly discovered muscle, and won. Using open market operations in the '50s...it proved to be very effective in combating inflation. The relationship with the Treasury became more equal and symbiotic. For more on open market operations we talked with Economic Analyst Richard Gill...

(MUSIC PLAYS – COMMENT AND ANALYSIS II)

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RICHARD GILL: When the Fed was engaging in open market purchases of government securities, as it was prior to the Accord of 1951, it was effectively increasing the reserves available to the commercial banking system and thus, potentially at least, making more money available to the economy in general. The way it works is this. The Fed purchases, say \$1 billion of government bonds from the Treasury. It pays for these bonds by adding \$1 billion to the Treasury's account with the Fed. The Treasury then uses this account to write checks to businesses, labor, and so on, who are providing services to the government. These private individuals then deposit these checks in their own commercial banks. These deposits, in turn, become part of these banks' reserves with the Fed. And, on the basis of these new reserves, the banks can create more money in the economy generally. Now, in fact, this is very much like "printing press" money, and what the Fed was saying at the time of the Accord was that this kind of easy money policy, that may have been appropriate in the Depression years, was no longer appropriate to an economy that was beginning to show definite inflationary tendencies. It was also serving notice that monetary policy, in general, might not be quite so weak and impotent a tool as once imagined!

PART III

DAVID SCHOUUMACHER: The Federal Reserve's mandate from Congress was to provide the nation a safe, flexible, and stable monetary and financial system. And Congress gave it powerful tools to do its job. It's been a daunting challenge. In the past 40 years there have been periods of sustained growth...along with six recessions, capped by the Great Recession of 2008. How did the Fed use its power to deal with that crisis?

DONALD KOHN: "The first duty of the Central Bank really is to control prices, to control inflation. In terms of the business cycle, the Federal Reserve has an extensive staff that it uses to help predict the economy."

DAVID SCHOUUMACHER: Donald Kohn worked for the Federal Reserve for forty years, retiring in 2010 as its Vice Chairman.

DONALD KOHN: "So before the Federal Reserve makes a decision at its eight times a year meetings about monetary policy, the decision makers receive quite extensive briefings and background materials that have predictions about what is going to happen to the economy and inflation over the next several years."

DAVID SCHOUUMACHER: In 2006, when Benjamin Bernanke took over as Chairman of the Fed, the housing market prices had already been heating up.

DOUGLAS ELLIOT: "There were a small number of people who very early thought we were in an unsustainable bubble, but it was a very small number of people. What really happened was we hit a point where house prices started to go down, and that made people focus on what might happen if they went down a lot, but it took a while for that to sink in, but as it did, you had the reverse of a bubble."

DAVID SCHOUUMACHER: When the money merry-go-round stopped, the world as we knew it seemed on the brink of economic disaster.

DOUGLAS ELLIOT: "Lehman went under, Fannie Mae and Freddie Mac, which are hugely important, had to be taken over. AIG, the world's largest insurance company, ran into very, very serious problems. The world was in terrible shape and people had lost all confidence in the financial system. The government was at a point where it had to do something, and so it came up with a program that came to be called the Troubled Asset Relief Program, the TARP. It is kind of a misnomer because the way it was really used in the end was as a way of injecting capital into banks...so the government became a partner with the banks and with the insurance companies."

DAVID SCHOUMACHER: More than anything else, TARP averted a panic and restored America's confidence in the banking system. Many economists felt that we were fortunate that, at this moment, Benjamin Bernanke was Chairman of the Fed. Bernanke was known to be a scholar of the Great Depression. And he began to do many of the things he had written about. But it wasn't easy.

DOUGLAS ELLIOT: "For instance, the Federal Reserve, to their credit, did notice that we had a similar problem growing in the commercial real estate market...But when the Feds started trying to put some rules out there, just to say 'be careful, Guys,' the Congress slapped them down...And that is one of the worries about any future regulatory environment as you are heading towards a crisis. Bubbles are fun. Bubbles seem to make everybody money, and so it's really hard to find a constituency that wants you to stop the bubble."

DAVID SCHOUMACHER: As foreclosures mounted and the economy stalled, unemployment began to rise. What could the Fed do to loosen the credit market and start money flowing through the system?

DONALD KOHN: "The primary tool that the Federal Reserve has used as an instrument on monetary policy over the years has been a very short-term interest rate. The Federal Funds Rate is an overnight interest rate that is the rate at which banks trade reserves with each other...so when the Federal Reserve moves the Federal Funds Rate it will adjust the whole path of the Federal Funds Rate going forward and that will have an important

effect on mortgage rates. It's also not only what the Federal Reserve does with the Federal Funds Rate, but what it says about how it's looking at the economy. So all those things will affect intermediate and longer-term interest rates, which make it more or less expensive for us to buy cars, or houses, or businesses to buy new equipment or put in new plants. It also, when those interest rates move, has an effect on the stock market."

DAVID SCHOUMACHER: In December, 2007, the Fed started to move the interest rates down, trusting the banks would open the lending spigot. And by November of 2008, those interest rates came close to zero. Still, the banks held back. Once again the Fed, under Bernanke, acted.

DONALD KOHN: "The way the Federal Reserve chose to do that was to purchase intermediate and long-term securities and hopefully drive down the interest rates, reduce the interest rates on the intermediate and longer-term securities, having the same effects I talked about on the incentive to spend on houses, and cars, and capital equipment."

BENJAMIN BERNANKE: "We thought this was an important step and it was at an important time when we were all worried about a double dip. We were worried about deflation."

DAVID SCHOUMACHER: Slowly, it seemed, the economy began to recover. All the forces of the government were mobilized to bolster the fragile economy, which like a punch-drunk fighter struggled to stay on its feet. By 2009 many economists thought the recession had bottomed out, though employment stubbornly remained at a debilitating nine percent. We asked Economic Analyst Nariman Behravesh to comment:

(MUSIC PLAYS – COMMENT AND ANALYSIS III)

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NARIMAN BEHRAVESH: Most economists agree that the Fed did a much better job of crisis management in 2008 and 2009 than during the Great Depression. In the 1930s, the Fed effectively tightened monetary policy, turning a garden-variety recession into

something much worse. The Fed did not make the same mistake in the wake of the sub-prime crisis and the Great Recession. It effectively pulled out all the stops. Not only did Mr. Bernanke and his colleagues push short-term interest rates all the way down to zero, but they also tried to push long-term interest rates down as well—something the Fed does not normally do. Did it work? Yes and no. The recession was officially declared over by June of 2009, and by early 2011 the level of inflation-adjusted GDP was above where it was before the financial crisis. Unfortunately, employment was still seven million below where it was at the beginning of the Great Recession. Some of this is simply due to the fact that the recovery in employment always lags behind the recovery in GDP. Some of it reflects the reality that the Fed is not all-powerful.

DAVID SCHOUMACHER: The Fed was created as a “banker’s bank,” but it has developed over the years into an institution with a much broader mandate. The role of monetary policy has evolved by fits and starts and in response to the demands of history. There is a good deal more to be learned about monetary policy and its effectiveness, so it’s a subject that we’ll be returning to again on this 21st-Century Edition of Economics U\$A. I’m David Schoumacher.

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