Governor Eccles

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 2, 1951.

To Chairman McCabe

From Woodlief Thomas

Subject Effectiveness of High Interest Rates in 1920 and 1929.

In press accounts of an interview with the Secretary of the Treasury, the following statement appears:

> "As in his recent New York Board of Trade address, Secretary Snyder challenged the widely accepted concept that higher interest rates could be an important factor in curbing inflation.
>
> "'As a matter of fact,' Mr. Snyder said with emphasis, 'our recent financial history would indicate the contrary. In 1919-20 short-term money was available to the Federal Government only at 6 per cent and "call money" went to about 33 per cent. Yet there was no noticeable effect of such rates on inflation, which did not end until the crash.
>
> "'It was the same again in 1929 when Government short-term money went to 5 per cent and "call money" couldn't be had for less than 20 per cent. Yet such rates had no apparent effect on the inflationary spiral which continued until it, too, ended in the big crash.'"

This is a rather surprising statement because these two periods, 1919-1920 and 1928-1929, have been generally considered as examples of the results of following easy money policies too long before shifting to tight money policies. It would hardly seem supportable, moreover, to use them as examples of the ineffectiveness of higher interest rates, because in each case the boom came to an end within a relatively short period after the imposition of high interest rates. The principal criticism that has been made of policy in these periods--probably justifiably--is that the long delay in imposing restrictive policies permitted the boom to go too far and brought on a more severe crash than might otherwise have resulted. Further details of the developments in the two periods do not support the Secretary's theory regarding them.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

1919-1920. The crash that occurred in 1920 is a perfect example of the dangers that lie in central bank financing of government deficits. The first World War was financed to a large extent by selling securities to investors on the basis of borrowing from banks at preferential interest rates and having the banks in turn borrow from the Federal Reserve at relatively low discount rates. The tremendous volume of indebtedness thus built up had subsequently to be liquidated and this liquidation contributed to the sharp recession which followed.

After the end of the war, when loans on Government securities declined, other loans increased sharply based on growing rediscounts at the Federal Reserve Banks. Federal Reserve action to restrict such borrowing was delayed in order not to interfere with Treasury financing operations. Rediscount rates began to be raised in November 1919 and were sharply increased in the early months of 1920. Other measures were also taken to discourage member bank borrowing at the Federal Reserve. In the spring of 1920, the boom came to an end and prices began to decline. A common view as to these developments is that Federal Reserve action brought on the crash rather than that it was ineffective.

There were, of course, many other factors in this situation and it is never possible to know what would have happened if monetary policies had been different. One of the special aspects of that period was the tremendous boom in agriculture—the rise in land values and the very large volume of farm debt that had been built up over the course of the previous two decades. Another related development was the excessive chartering of banks in rural areas and the extended position of those banks. Readjustments were inevitable.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

In retrospect, it would appear that ~~the~~ earlier and more vigorous restrictive measures might have restrained the boom and thus made possible a smoother readjustment. It also seems clear that easing measures should have been taken in late 1920 and in 1921 to alleviate the development of economic depression. On the other hand, it might also be said that the declines which occurred were short-lived and that they brought about quickly the inevitable readjustments in the economy and thus laid the basis for a few years of exceptional prosperity in this country as well as for economic reconstruction in Europe.

1928-1929. Developments in 1928-1929 were of a completely different character from those in 1919-1920. It is believed by many that the stock market boom that developed in those years was aided by the easy money policy adopted by the Federal Reserve System in 1927. When this policy was reversed in 1928, the restrictive measures adopted were very mild. In August 1929 more vigorous measures were adopted and the stock market crash shortly followed, probably as a result of its own excesses.

It is reasonable to conclude that the rise to 5 per cent in interest yields on U. S. Government bonds, mentioned by Secretary Snyder, had an influence in bringing to an end the stock market boom. During that period there was considerable discussion, supported by careful statistical analysis, to the effect that when bond yields rose above a certain relation to yields on common stocks a shift from stocks to bonds was advisable. This is *theory*, but in retrospect it would have served as an excellent guide to investors.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The 1928-1929 boom was largely a very specialized one occurring principally in the stock market and financed by loans made outside of the banking system, although it was initiated by bank loans. It could no doubt have been prevented by the imposition of margin requirements which have subsequently been authorized on the basis of that experience. It can not, however, be said to be an example of the ineffectiveness of high interest rates in checking a boom.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis