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ROLE OF THE FEDERAL RESERVE SYSTEM IN  
THE 1937-38 RECESSION

An opportunity for the Board of Governors of the Federal Reserve System to make a serious mistake in the exercise of its responsibility for taking monetary actions which will contribute to economic stability occurs only infrequently -- not more than once or twice a decade -- due to the relatively long periods between major turns in the business situation.

Furthermore, although the Banking Act of 1935, for example, gives the Board the power to change reserve requirements "in order to prevent injurious credit expansion or contraction", the possibility of making a serious mistake actually occurs primarily when the Board attempts to use its powers "in order to prevent injurious credit expansion" -- namely, in a period of business prosperity when it endeavors to check an incipient boom by restrictive monetary measures. In the first place, there is very little possibility that any monetary measures undertaken by the Federal Reserve System in a period of business depression will prove over-expansionary; whereas the dangers of over-restrictive monetary measures in a period of prosperity are very real. In addition, the deflationary results of over-restrictive measures are more generally distressing than the results of any over-expansionary measure could possibly be -- unemployment and low production in themselves work more hardships than full employment and full production, even when the latter is accompanied by a substantial degree of inflation.

During the period since 1933, the Board of Governors has had only one major opportunity to impose over-restrictive monetary measures on the economy. This opportunity occurred early in 1937 when business finally showed a substantial recovery from the depression of the early Thirties.

In January 1937, the Board announced that member bank reserve requirements, which were at that time halfway between the minima and the maxima provided by law, would be raised to the maxima in two steps -- one half of the increase to be effective on March 1 and the other half on May 1. This increase followed a similar action in the middle of August 1936, when reserve requirements had been increased from the minimum statutory requirements to the level mentioned above -- an increase of 50 percent. These actions taken together resulted in the doubling of reserve requirements in a period of only eight and one-half months.

There is rather general agreement that the raising of reserve requirements contributed materially to the downturn in business during the summer of 1937 which marked the beginning of the 1937-38 business recession. In retrospect, it is difficult to imagine why any restrictive action at all should have been thought necessary in a period when average annual unemployment never declined as low as 7-1/2 million. The following quotations from a number of financial and business papers are indicative of the blame which has been laid at Federal's door for this recession:

"Without question one of the major factors responsible for the drastic decline in business volumes in the past year was the deflationary effect of a decline in federal deficit spending accompanied by a forced deflation of bank credit. The action of the Federal Reserve Board between July, 1936, and May, 1937, in progressively increasing the amount of reserves required to be maintained by member banks against their deposits forced an accompanying liquidation of securities (chiefly Governments) by these banks. The aggregate amount of bank credit outstanding was thereby forcibly reduced some \$1,500,000,000, or about 6%."

--Standard Trade and Securities,  
April 22, 1938

". . . The restrictive steps taken in 1936 and 1937 by the authorities are quite generally believed to have been one factor in the severe business and market declines of 1937."

--Moody's Bond Survey,  
November 28, 1938

"It might be no great exaggeration to say that the end of this upward movement [in business activity] was fore-ordained as early as July, 1936, when the first increase in member bank reserve requirements was decreed by the Federal Reserve Board. This was the first step in a deflationary policy which was carried on by orders for further increases in required reserves issued in January, 1937, and the Treasury's policy of 'sterilizing' incoming gold which was adopted in December, 1936. These policies were admittedly deflationary, but proved to be much more far reaching in their effects than the authorities had anticipated. They signaled the end of the 1935-37 advance in business activity and the markets."

--The Financial World,  
July 27, 1938  
"What is Back of This Market?"  
by George H. Dimon

[It should be noted that it was at the strong urging of the Board that the Treasury Department adopted, on December 22, 1936, the policy of holding new acquisitions of gold in an inactive gold account. This policy was not finally abandoned until April 19, 1938; although the Treasury had released \$300 million of gold from the inactive account in September 1937 and had materially modified the program, effective January 1, 1938. The inactive gold account had a strongly restrictive effect and was continued long after such effect was appropriate -- if, indeed, that had ever been the case.]

"Referring to the very recent situation -- the 'boom control' efforts which were instituted last winter and spring had the theoretically defensible or laudable purpose of preventing over-expansion -- therefore of preventing an ensuing 'depression'. But the inexactitude of their application seems to have contributed to net results quite different than intended.

". . . The decline itself cannot be blamed on the Government. But it does appear clear that the 'boom-control' weapons which were applied last winter and spring directly accentuated the decline and also put the Government in a position where it has been, up to very recently, practically unable to take effective steps against the decline."

--Moody's Stock Survey,  
November 1, 1937

"Assume the following developments . . . ; (2) action by the Reserve Board to lower member bank reserve requirements, thus reversing the highly deflationary move into which bad judgment led it in the closing months of 1936 and thus putting strong pressure on the banks to expand investment holdings;. . ."

--The Magazine of Wall Street and  
Business Analyst, January 29, 1938  
"The Way to the Next Production  
Peak", by Laurence Stern

"The Board had been careful to make it clear that they had no intention of forcing a contraction of the volume of credit, still less a rise in interest rates. Their sole object was to put themselves in a position to control any further expansion. . . .

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"It soon became apparent, however, that the policy was having unexpected results. True, there was no contraction in the total of deposits, and the rates of interest charged by banks to their customers continued to decline. But there was an undesired reaction upon the bond market. . . .

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"This weakness in the bond market was not the only disconcerting change in the outlook. The level of other security prices was affected and though Washington, under the present Administration, may profess a fine disregard for Wall Street, it must nevertheless pay attention when the market is as weak as it has been recently. Moreover, there are now signs that industrial activity itself is being adversely affected. This may not be directly due to Federal Reserve policy, but a period of hesitating industrial activity is one for expansion, rather than for contraction, of credit."

--The Economist, (London) October 16, 1937

The 1937 episode is still very much in the mind of the business community, as is indicated by the following quotation from Business Week for August 7 of this year:

"The danger is that the board [Federal Reserve Board] might slip. A mistake in timing, a little too much pressure in the wrong place, and the whole credit balloon might pop. In all probability, that would be the end of our boom.

"It was the Reserve System that pulled the trigger in 1920 and 1937. And Reserve policy had at least something to do with the 1929 crash.

"Of course, all three of those booms were past their prime and ready for collapse anyhow. But then, what about the present boom?"