Opinion

History as a Useful Guide … When Read Carefully

BY JOHN A. WEINBERG

The Great Recession has led to many comparisons with the Great Depression of the 1930s, enough to earn the same adjective. The current, slow recovery from the very deep recession of 2007-2009 and the persistently high unemployment we continue to experience have prompted painful memories of that earlier time — although the magnitude of the declines in output and employment, relative to the size of the economy, was much larger in the 1930s. But there are other parallels as well. Like the recent recession, the onset of the Great Depression was associated with a widespread financial panic, which in turn led to significant new financial regulation. Some students of the Great Depression have emphasized the role that government interventions — those which placed artificial upward pressure on wages and prices — may have played in worsening and prolonging the contraction. Similar arguments about a potential drag from actual or prospective legislative action have found their way into discussions of the current situation as well.

References to the Great Depression have also figured prominently in arguments about what monetary policy can and can't do to further stimulate economic growth and job creation. In this regard, two episodes from the 1930s figure most prominently. The first occurred in 1933, when the new Roosevelt administration took the dollar off of the gold standard. This action contributed to the end of a deflation that had continued for three years at rates close to 10 percent per year. This amounted to a substantial reversal of monetary policy, as the money supply stopped shrinking and began growing. Many historians see this policy change as key to the positive economic growth that began in that year.

The second episode from the 1930s used to highlight the real effects of monetary policy is the move by the Fed to increase banks' reserve requirements in 1937. This act generally had the effect of slowing the growth of the money supply, contributing to a fall in inflation (in fact, a reappearance of deflation) and the second economic contraction of the Great Depression.

Economic historians continue to debate the relative contributions of both of these monetary policy moves to the overall path of the economy in the 1930s. Certainly, at any one point in time, there were other things happening as well, and it's always difficult to identify a single factor as the unique cause of the ups or downs in the economy. Still, arguments that monetary factors were important in these two turning points seem convincing. So it's possible to take away from this history the conclusion that shifts in monetary factors can have a sizable effect on real economic activity, particularly in a setting where the economy is operating below its long-term trend.

But in both of these examples, the change in direction of real activity came along with large changes in inflation — from close to negative 10 percent per year to around zero in the first case, and in the second, from an average annual rate of nearly 4 percent in 1937 to negative 2 percent in 1938. Not only were these changes in inflation large but they were arguably unexpected. This last fact is consistent with the notion, originally developed by Milton Friedman and Edmund Phelps, that changes in inflation that take economic decisionmakers by surprise can have real effects, while expected changes in inflation are less likely to affect real activity.

> It's proven fairly difficult to fine-tune the relationship between changes in inflation and changes in the path of real activity.

Of course, the lesson of both economic research and experience since then is that policymakers cannot count on always being able to surprise the public. Changes in inflation eventually affect future expectations, meaning the stimulus achieved by moving inflation from negative 10 percent to zero, for instance, couldn't be repeated simply by holding inflation at zero. It would take higher inflation still. And as higher rates of inflation become embedded in people's expectations, bringing down inflation gets costly. The example of 1979-1982, when the Federal Reserve pursued tighter monetary policy to bring inflation in check, is a good example. Price stability was achieved and was crucial to subsequent economic growth, but it required actions that produced a steep recession first.

The existence and the nature of a trade-off between inflation and real economic activity have been debated by economists for more than 60 years. On balance, it's proven fairly difficult to fine-tune the relationship between changes in inflation and changes in the path of real activity. The events of the Great Depression showed us that large changes in inflation (and inflation expectations) can have sizable effects. While that experience provides useful evidence on this matter, the size of the movements seen in that period were large compared to anything we have seen since. In short, stimulating the economy seems to have required very significant policy changes then, arguably beyond the range of much of what has been discussed in the current environment. This suggests caution may be warranted in drawing broad generalizations from past experience. **RF**

John A. Weinberg is senior vice president and director of research at the Federal Reserve Bank of Richmond.