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A frustrated Fed

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The Fed turns 100 Monday. A century ago — on Dec. 23, 1913 — President Woodrow Wilson signed legislation establishing the Federal Reserve. Broadly speaking, it was charged with preventing financial crises and preserving prosperity. The record is mixed. Despite many successful years (the 1920s, 1940s, 1950s, 1980s and 1990s), the Fed's performance is marred by three huge blunders: the Great Depression of the 1930s, the Great Inflation of the late 1960s and 1970s and the 2008-09 financial crisis. Had the Fed acted differently in each case, the outcome would have been different and better.

There's a disheartening consistency to the Fed's cycles of success and failure. The beliefs and policies of one era aren't suitable to the conditions and challenges of the next, but the Fed adapts only slowly under the press of events.

Created after the Panic of 1907, the Fed first focused on averting bank runs. At the time, loan demand and interest rates were highly seasonal; they rose in the spring and the fall, reflecting the credit needs of planting and harvesting crops. Any nasty surprise (bad harvests, business failures, stock market losses) risked a run, as depositors feared that strapped banks couldn't return their money. After all, most of it had been lent out. Unlike today, deposit insurance didn't exist.

The Fed solved this problem, says Harvard economist Jeffrey Miron. Money became more "elastic." When credit demand was high, the Fed lent more. Seasonal interest-rate swings subsided. Confidence grew because depositors knew that, in a panic, banks could borrow from the Fed to meet currency demands. In the 1920s, there were no major bank runs.

But what succeeded in the 1920s backfired in the 1930s. Faced with a collapsing economy, "the Federal Reserve did next to nothing to foster recovery," writes economist Allan Meltzer in his exhaustive history of the Fed. It was passive, because — based on its 1920s experience — weak loan demand signaled that there was little for the Fed to do. Credit seemed easy; loanable funds seemed ample.

This was a fatal error. Weak loan demand mainly reflected the economy's devastated state. To promote revival, the Fed needed to pump money aggressively into the financial system. It didn't. From 1929 to 1932, real gross domestic product (GDP) fell 25 percent. (For comparison, GDP's drop in the recent Great Recession was 4.3 percent.) In 1932, the unemployment rate was 23 percent. Many, probably most, economists think a lax Fed converted an ordinary slump into the Depression.

By contrast, the mistake of the 1960s and 1970s was just the opposite: not passivity, but activism. The 1930s lesson — “do more” — was learned too well. The Fed assumed that shifts in interest rates could keep the economy near “full employment,” defined as 4 percent unemployment. In practice, the commitment to full employment, also embraced by successive presidents beginning with John Kennedy, unleashed inflationary expectations (why restrain wages and prices if government guarantees prosperity?) and easy credit. By the late 1970s, inflation was spiraling out of control at 13 percent.

Subduing it was a triumph of economic policy. After Paul Volcker, Fed chairman from 1979 to 1987, accomplished this with a brutal recession (unemployment reached 10.8 percent) in the early 1980s, the lesson seemed self-evident: Keep inflation low and stable. The uncertainties of volatile prices would fade. Steady growth and prosperity would follow. So it seemed. From 1982 to 2007, there were only two mild recessions. The Fed, mostly under Alan Greenspan, seemed omnipotent. It controlled inflation and repulsed threats to economic growth: the 1987 stock crash, the Asian financial crisis and the Sept. 11, 2001, attacks.

Unfortunately, this success abetted the 2008-09 financial crisis. Prolonged prosperity seemed to reduce risks; investors could rationalize taking more risks, because the downside seemed limited. Sloppy, dangerous and unethical practices spread at banks and other financial institutions. Meanwhile, low inflation reassured the Fed. It distracted attention from the financial system, whose overall stability, in any case, didn’t worry most officials. An American financial collapse hadn’t happened since World War II and was an unthinkable abstraction, outside their personal experience. The result was that “we were slow to recognize the crisis,” as retiring Fed Chairman Ben Bernanke said recently.

What’s clear is that the Fed isn’t as powerful as it seemed under Greenspan. True, once Bernanke acknowledged the crisis, he acted forcefully to pump funds into the financial system. For this, he has been widely and deservedly praised. A second Great Depression was possibly avoided; the 1930s failure was not repeated. But the Fed has discovered that it lacks the power to resuscitate the economy single-handedly. Five years of short-term interest rates near zero and roughly $3 trillion of bond-buying have, at most, modestly improved a weak recovery. On its centennial, one word best describes the Fed: frustration.