Ben Bernanke’s early research tells us a great deal about the real job of the Federal Reserve. But the press and Fed watchers don’t look at it. Instead, they focus eagerly and narrowly on monetary policy—which was never as important as its adherents believe, and which is becoming steadily less so.

**THE PROBLEMS WITH FRIEDMAN AND SCHWARTZ**

How powerful is conventional monetary policy—the adjustment of interest rates via open market operations? Those who say monetary policy is very powerful are today, as they have been since 1963, followers of Milton Friedman and Anna Jacobson Schwartz, whose extremely influential treatise *A Monetary History of the United States* attributed the coming of the Great Depression to a Great Contraction of the money supply from October 1929 to March 1933.

But Friedman and Schwartz’s claim faces two serious difficulties. First, as Table 1 shows (see next page), both nominal high-powered money and nominal currency held by the public actually rose during the Great Contraction of the money supply. The Great Contraction is entirely in bank deposits.

Second, why was there no Great Expansion of the economy in response to the Great Expansion of the money supply from July 1933 to January 1939? As Table 1 also shows, over the 67 months from July 1933 to January 1939 high powered-money, demand deposits, time deposits, and currency all increased. Industrial production did rise, but at a slow average monthly rate of 0.25 percent that left it in January 1939 still below its October 1929 level. Friedman and Schwartz might respond that it is naive to expect too much stimulating effects from this monetary expansion. But why should monetary policy be so asymmetric in its effects, with powerful effects during the money supply’s contraction but only modest effects during its expansion?

**LESSONS FROM BERNANKE**

Ben Bernanke provided a better explanation of the Great Depression back in 1983 in a seminal article in the *American Economic Review*: widespread bank failures were the critical factor behind the Great Depression. Markets cannot

---

*Lester G. Telser is Emeritus Professor of Economics, University of Chicago. He is a Fellow of the Econometric Society and the American Statistical Association. In 2004 he received the St. Clair Drake Award for Distinguished Scholarship from Roosevelt University.*
function without acceptable means of payments. Bank failures caused people to lose confidence in the safety of their deposits. More than 17 percent of all National Banks never re-opened their doors after the end of the Bank Holiday declared by President Roosevelt in March 1933. The real job of the Fed was one it failed to do: to maintain the solvency of banks. The Great Depression was the result.

THE CHANGING NATURE OF BANKING HAS LIMITED THE ROLE MONEY HAD

Friedman and Schwartz would say that the real job of the Fed is to stabilize the money supply. Bank reserve requirements exist not to ensure the safety and soundness of banks but rather to provide the lever by which open-market operations that change the supply of high-powered money affect the money stock.

Since 1990, however, the power of open market operations has been greatly weakened. Time deposits are no longer subject to reserve requirements. Demand deposits are still theoretically required to have reserves equal to ten percent of their total, but—as Anderson and Rasche explain—banks now can automatically sweep demand into time deposits provided they can cover checks written on demand accounts without delay. Banks can and do hold reserves, but they themselves decide the amount. Thus open market operations lack their old bite: there is no transmission mechanism from changes in the amount of high-powered money to changes in the quantity of liquid monetary assets in the economy as a whole.

The Fed now confines its monetary policy to announcing the Federal Funds Rate—the interest rate charged by banks for overnight loans to each other. The Fed does not trade in this market. Yet today the Prime Commercial Rate moves in lock step with the Federal Funds Rate which is closely followed by short term rates such as Treasury Bill Rates. Before 1992 no such lockstep movement between the Prime Rate and Federal Funds Rate existed. It looks as if, since 1992, the role of the Fed is as a price leader for member banks.

Is this limited role still important? Does it have significant effects?

THE BOTTOM LINE

Business reporters and Fed watchers continue to focus on monetary policy, but that is no longer, if it ever was, the Fed’s main job.

The Fed’s main job today is to respond to crises, like the stock market crash in October 1987, the collapse of Long Term Capital Management in September 1998, and the terrorist attack on September 11, 2001 (as described by Christopher Neely). When crises threaten the financial system, the Fed puts out the flames. The record shows that Alan Greenspan’s Fed did

---

Table 1: Money Stock and Industrial Production
October 1929–January 1939

<table>
<thead>
<tr>
<th>Date &amp; Monthly Rates of Change</th>
<th>High Powered Money* billions</th>
<th>Commercial Banks Demand Deposits* billions</th>
<th>Commercial Banks Time Deposits* billions</th>
<th>Currency Held by Publics* billions</th>
<th>FRB Production Index 2002=100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level in October 1929:</td>
<td>8.116</td>
<td>24.432</td>
<td>19.891</td>
<td>3.832</td>
<td>8.3875</td>
</tr>
<tr>
<td>Level in March 1933:</td>
<td>8.414</td>
<td>13.543</td>
<td>10.918</td>
<td>5.509</td>
<td>4.2389</td>
</tr>
<tr>
<td>Monthly Rate of Change:</td>
<td>0.71%</td>
<td>-1.15%</td>
<td>-1.17%</td>
<td>0.71%</td>
<td>-1.33%</td>
</tr>
<tr>
<td>Monthly Rate of Change:</td>
<td>1.05%</td>
<td>0.91%</td>
<td>0.45%</td>
<td>0.23%</td>
<td>0.25%</td>
</tr>
</tbody>
</table>

*Friedman and Schwartz, Table B-3; bTable A-1; cFRED II

---
learn the lesson taught by the Great Depression. Let us hope that Ben Bernanke’s Fed continues on this road.

Letters commenting on this piece or others may be submitted at http://www.bepress.com/cgi/submit.cgi?context=ev

REFERENCES AND FURTHER READING


