

Lessons of the '30s
Long Study of Great Depression Has Shaped Bernanke's Views
Fed Nominee Learned Perils Of Deflation, Gold Standard And Pricking of Bubbles
A Grandmother's Explanation

By GREG IP
Staff Reporter of THE WALL STREET JOURNAL
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In 1983, Mark Gertler asked his friend and fellow economist Ben Bernanke why he was starting his career by studying the Great Depression. "If you want to understand geology, study earthquakes," Mr. Bernanke replied, according to Mr. Gertler. "If you want to understand economics, study the biggest calamity to hit the U.S. and world economies."

Mr. Bernanke's fascination with the economic earthquake never abated. "I am a Great Depression buff, the way some people are Civil War buffs," he wrote in 2000. "The issues raised by the Depression, and its lessons, are still relevant today."

Mr. Bernanke's interest in the Depression, which dates back to his childhood, is a guide to the evolution of his thinking. In particular, his groundbreaking research on how mistakes by the Federal Reserve compounded the catastrophe is likely to influence how he steers the economy once he succeeds Alan Greenspan as its chairman early next year.

The Depression, he contends, has taught the importance of avoiding both deflation -- that is, generally falling prices -- and inflation. It has also shown the threat that falling asset prices -- such as, potentially, in housing -- and weakened banks can pose. Most important, it shows the damage the Fed can do when it follows wrong-headed ideas.

The economies of today and the 1930s could scarcely be more different. Between 1929 and 1933, U.S. economic output plunged almost 30%, the unemployment rate soared to nearly 25% and thousands of banks failed. Overall prices fell about 10% a year. As wages, prices and real-estate values spiraled down, millions of homeowners and businesses struggled to pay their debts.



Ben Bernanke

Today, growth is strong, unemployment is just 5% and housing prices are lofty. The Fed is raising interest rates to prevent a rerun of the 1970s, when high oil prices and a loose monetary policy unleashed double-digit inflation.

But beneath the surface are trends that suggest the lessons of the Depression remain relevant to the Fed. Mr. Bernanke's study of the era influences his belief that the Fed should not only aim for low inflation but publicly put a number on the inflation rate it wants to achieve. While the principal benefit of doing so would be to hold down inflation by stabilizing the public's price expectations, Mr. Bernanke has argued that an even more important benefit would be to prevent the Fed from

stumbling into deflation. Its inflation target would be a lower limit as well as a maximum.

Mr. Bernanke, now chairman of President Bush's Council of Economic Advisers, and some Fed officials have said they prefer to keep inflation between 1% and 2%, excluding food and energy prices, which are volatile and can mask the long-term trend. Inflation at that level would be low enough that a deep recession or major shock could push it below zero, into deflation. Avoiding that is "going to be a more important policy concern than in many decades," predicts Brian Sack of Macroeconomic Advisers LLC, who once worked with Mr. Bernanke at the Fed. He says Mr. Bernanke's interest-rate actions thus may resemble Mr. Greenspan's maneuvers of the early 2000s: aggressive cuts when recession threatens, gradual increases when the economy recovers.

Mr. Bernanke's Depression research has emphasized how declining asset prices and weakened banks can choke off new lending and economic growth. Falling house prices, for instance, "would significantly disrupt the net worth of many borrowers," notes Glenn Hubbard, a Columbia University economist who, as Mr. Bush's Council of Economic Advisers chairman, helped persuade Mr. Bernanke to leave Princeton University to be a Fed governor in 2002. "Ben will look hard at [such] balance-sheet effects." That means he might keep interest rates lower than others would in such circumstances.

Perhaps the most important lesson Mr. Bernanke draws from the 1930s is the importance of thinking creatively when faced with unusual economic challenges. While some have criticized him for saying in 2002 the Fed could print money to end deflation, the comments typify his willingness to question orthodoxy. Mr. Bernanke has written that President Franklin Roosevelt's most important contribution to ending the Depression was "his willingness to be aggressive and to experiment."

Even as a child, Mr. Bernanke, now 51 years old, was intrigued by the Depression. As a child of six or seven, he visited his maternal grandmother, Marcia Friedman, in Charlotte, N.C., and sat on her front porch as she described life as a young mother during the 1930s in Norwich, Conn. Mrs. Friedman, whose husband taught Hebrew and worked in a furniture store, was proud they could buy new shoes for their children each year. But many neighborhood children had to go to school in tattered shoes or barefoot.

"Why didn't their parents just buy them new shoes?" young Ben asked. Because their fathers had lost their jobs when the shoe factories closed, she said.

"Why did the factories close down?"

She replied, "Because nobody had any money to buy shoes."

The circularity of her logic, which he later recounted in a textbook, bothered him yet illustrated a key puzzle of the Depression: Why was there so much idle capacity when there were so many unmet needs? For decades, many economists and policy makers thought the Depression was the inevitable consequence of excess investment, flawed corporate governance and speculation in the 1920s, culminating in the 1929 stock-market crash. That view was reinforced by John Kenneth Galbraith's 1955 book "The Great Crash, 1929."

Far From Inevitable

Milton Friedman and Anna Jacobson Schwartz upended that view in 1963. In "A Monetary History of the United States, 1867-1960," they argued that the Depression was far from inevitable, but brought about by an "inept" Federal Reserve. First, they said, the Fed foolishly raised interest rates in 1928 to end speculation on Wall Street, causing a recession the next year that precipitated the crash. Then, it let thousands of banks fail and the money supply shrink. In part, it thought weak banks should be allowed to fail. It also feared that lower interest rates might lead foreigners to dump dollars, straining the currency's link to gold.



Milton Friedman

Mr. Bernanke read the book as a graduate student at Massachusetts Institute of Technology in the 1970s. "I was hooked, and I have been a student of monetary economics and economic history ever since," he recalled at a 2002 conference honoring Mr. Friedman's 90th birthday. Mr. Bernanke, by then one of the Fed's seven governors, told Mr. Friedman: "Regarding the Great Depression. You're right, we did it. We're very sorry. But thanks to you, we won't do it again."

In 1979, Mr. Bernanke went to Stanford to teach economics. The first summer, he and his wife rented a big house on the campus with Mr. Gertler, who had just finished graduate studies at Stanford, and another young professor. Sitting by the pool, they would talk baseball and economics.

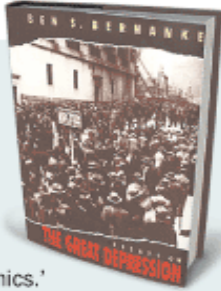
Monetary policy wasn't a rewarding field for ambitious academics then, says Mr. Gertler, now head of New York University's economics department. The 1970s' high unemployment and inflation had diminished the Fed's reputation, and new economic theories of "rational expectations" and the "real business cycle" held that the central bank could do little to affect growth and jobs.

Mr. Bernanke nonetheless threw himself into studying the role of monetary policy in the Depression. He later wrote that figuring out its origins was the "Holy Grail of macroeconomics." While the Friedman-Schwartz theory had revolutionized thinking about the Depression, it couldn't fully explain the downturn's length or depth.

Theoretically, neither deflation nor inflation ought to affect long-run growth or employment. After a while, people and businesses get used to changing prices. If prices fall, eventually so will wages, and the impact on profits, employment and purchasing power will be neutral. Borrowers suffer during deflation because their debts are fixed in value, but creditors benefit because the dollars they get back will buy more. For the economy as a whole, deflation ought to be a wash.

Mr. Bernanke published his first major paper on the Depression in 1983. Borrowers, he said, get bank loans in part by putting up some of their own money to buy a house or start a business. But deflation, even though it leaves the loan's value untouched, erodes the value of the collateral and shrinks the borrower's equity. While wages can adjust to falling prices, debts cannot, because interest rates can't go below zero.

This made the typical borrower a riskier prospect, and banks more reluctant to lend, preferring to put their money in government securities. And banks themselves might fail if enough borrowers defaulted and the deflated collateral didn't cover the debt. In effect, deflation "dammed" the flow of credit, which is vital to economic life. Mr. Bernanke applied a battery of statistical tests and concluded: "My theory seems capable, unlike the major alternatives, of explaining the unusual length and depth of the Great Depression."



History Course

In his book (*at right*), Ben Bernanke calls understanding the Depression 'the Holy Grail of macroeconomics.'

Some conclusions he has drawn:

1. Beware of outdated orthodoxies such as the gold standard.
2. A stable banking/financial system is critical.
3. The Fed's key objective should be stable prices.
4. Don't try to prick asset bubbles.
5. An inflation target can defend against deflation and inflation.

Sources: Bernanke book, speeches, articles

The statement reflected an intellectual boldness that verged on cockiness. Messrs. Bernanke and Gertler began a lengthy collaboration refining what became known as the "financial accelerator" because it explained how the financial system could compound an economic downturn. The two had complementary roles, with Mr. Bernanke usually pushing for a bold statement and Mr. Gertler, he recalls, "telling him what's wrong with the statement."

Some scholars challenge the importance of deflation in the Depression. Other factors, such as the adherence of so many countries to the gold standard, now are recognized as major. Still, the financial accelerator has become a key part of modern macroeconomic theory, used to explain both the U.S. credit crunch of the early 1990s and the East Asian crisis of the late 1990s.

Mr. Bernanke took particular interest in Japan's struggle with stagnation and deflation. Like the Fed

in the 1920s, the Bank of Japan set out, in the late 1980s, to prick a bubble, this time in stocks and property. Like the U.S., Japan then experienced deflation and depression, though far milder than the U.S. did. Like the Fed in the 1930s, the Bank of Japan, in Mr. Bernanke's view, bore much of the blame.

He offered a drumbeat of often harsh criticism and advice to the Bank of Japan, suggesting it copy Roosevelt's 1933 moves of driving down the exchange rate and repairing the banks. The Bank of Japan "seems to be suffering from a self-induced paralysis," he wrote in 2000. "Perhaps it's time for some Rooseveltian resolve in Japan."

The advice fell on mostly deaf ears in Tokyo. But Mr. Bernanke's Depression research soon found a U.S. role. Some analysts had called on the Fed to rein in the galloping stock market in the late 1990s. But, addressing the Fed's Jackson Hole, Wyo., conference in 1999, Mr. Bernanke and Mr. Gertler said the Fed should raise rates if rising asset prices fuel inflation, but not to prick a bubble. "A bubble, once pricked, can easily degenerate into a panic," they said. When the bubble eventually collapses on its own, the Fed should cut interest rates to limit the damage to the financial system and the broad economy.

Lessons of Bubble-Pricking

The lessons of Fed bubble-pricking in the 1920s and the Bank of Japan's in the 1980s is that "asset price crashes have done sustained damage" only when the central bank failed to respond, or "actively reinforced deflationary pressures."

Mr. Greenspan had reached the same conclusions. "After we presented our paper, he walked by me and said, 'You know, I agree with you,' " Mr. Gertler recalls.

In August 2002, Mr. Bernanke became a Fed governor. At the time, a stubbornly slow economic recovery and declining inflation aroused fears of deflation. The Fed appeared almost out of ammunition. Seeking to kick-start growth, it lowered its target for the federal-funds rate, charged on overnight loans between banks, to 1.25% that November.

A few weeks later, addressing a group of economists at a Chinese restaurant in Washington, Mr. Bernanke -- citing strong banks and household balance sheets -- said the risk of deflation was "extremely small." But he said the Fed had numerous tools to combat it, even if the Fed funds rate, its principal instrument, fell to zero.

He said his preferred alternative tool was for the Fed to reduce long-term interest rates by buying bonds, as it did in the 1940s. Long-term rates have a more direct impact on mortgage and corporate loan rates than the Fed funds rate. He also suggested more-exotic tactics such as a tax cut financed by printing money, or pushing the dollar down on world currency markets.

The speech reflected his intellectual boldness but also his lack of real-world experience. Over the following months, Fed staffers concluded that targeting long-term interest rates by intervening in the bond market was probably impractical. "Once you've made the commitment, how do you get out of it?" says Kenneth Kuttner, then an economist at the Federal Reserve Bank of New York and now at Oberlin College. If investors even suspected the target wouldn't last, they would unload bonds, driving long-term rates up. Like a fixed exchange rate under attack by speculators, the Fed would "get into a position of having to defend something that's untenable," says Mr. Kuttner, who nonetheless credits Mr. Bernanke for exploring the possibility.

Mr. Bernanke dropped the idea of targeting long-term rates, but continued to study other antideflation strategies. Some critics now say he created undue alarm over deflation. He and his defenders say one reason deflation didn't occur was that Fed officials took the threat seriously and kept the Fed-funds rate at rock-bottom lows until the middle of last year.

The deflation scare has passed, and energy prices have recently pushed inflation over 4%. Fed officials say they are concerned about inflation rising. Yet excluding food and energy prices, inflation remains near 2%. The next recession could again threaten to push inflation into negative territory and the Fed-funds rate to zero. A 1998 Fed staff study predicted that if the Fed set an inflation target of 2%, actual inflation would be negative in one quarter out of every nine, but if it set an inflation target of 4%, it would almost never be negative.

As Fed chairman, Mr. Bernanke probably will not be talking much about the Depression, but it is

unlikely to be far from his mind. In 2000, he began writing a book called "Age of Delusion: How politicians and central bankers created the Great Depression." He hoped it would displace Mr. Galbraith's 1955 classic in shaping the public's view of the Depression's origins, says Jack Repcheck, an editor at publisher W.W. Norton & Sons.

Mr. Bernanke got only about 120 pages written before putting it aside in 2002 as a condition of government service. He offered to return his modest advance. Mr. Repcheck declined. "If he ever decides to step down in 15 years, we'll want to publish it," the editor says.