View metadata, citation and similar papers at core.ac.uk
brought to you by CORE
provided by Research Papers in Economics

A Tale of Two Fed Banks

BY DANIEL BROOKS

Economists continue to debate whether the Federal Reserve would have been able to mitigate the banking crisis that preceded the Great Depression. Some believe that regardless of what the Fed might have been able to do, banks would have continued to fail because the economy contracted so dramatically. Others believe that the Fed could have served as a lender of last resort in response to the widespread run on the banks and avoided their collapse.

Even with the right data, properly evaluating the role of monetary policy — and public policy generally — during the crucial years before the Great Depression poses several challenges. Both federal and state governments changed policies often in light of economic conditions. Additionally, shocks to markets were transforming the economic landscape. These dimensions make discerning the impact of Federal Reserve policy difficult.

In order to overcome such obstacles, Gary Richardson of the University of California, Irvine, and William Troost of the University of Southern California set out to find a group of banks within an economically similar environment which were subject to the same state regulations but influenced by different monetary policies. Banks in Mississippi fit the bill. In 1913, the state was split evenly into two Federal Reserve districts. The top half of the state was placed in the Eighth District presided over by the St. Louis Federal Reserve Bank. The lower half was part of the Sixth District which was the domain of the Atlanta Fed.

"Mississippi was homogeneous economically and demographically," write the authors. "Unemployment rates were low. Farm debt hovered around one-third to one-fifth of farm value. Rural counties concentrated on cultivating cotton." Yet, the approach to monetary policy taken by the Fed bank in each district could not have differed more. The Atlanta Fed followed a policy of lending based on "Bagehot's rule." According to that doctrine, the central bank should act as a lender of last resort and provide credit to troubled institutions based on good collateral and at a penalty interest rate. By contrast, the St. Louis Fed adhered to the "Real Bills" doctrine. Under that view, monetary policy should allow the supply of credit to contract as the economy contracts because less credit is demanded during times of weak economic activity.

In order to assess the outcome of this natural "quasi-experiment," the authors needed a wide range of sources to provide the basis for their historical analysis. Archives of the Board of Governors detail communication between the Board and both regional banks and illustrate the approach of each. A wide variety of Census Bureau sources allowed them to control for the differences between Federal Reserve districts.

Although a number of different statistical methods were used to analyze the data, the results tell very similar stories. In the Sixth District — where the Bagehot intuition governed policy — the rate of bank failure was lower than in the Eighth District.

The authors note that one criticism of this type of analysis is that the results may apply only to this region during the time period studied. Yet there are real lessons that can be drawn from such a natural experiment. The evidence in this study is important to understanding the link between banking panics, monetary policy, and the real effect of both on the economy. In fact, Richardson and Troost look deeper at the economic outcomes in these two Fed districts and discover that commerce slowed down less in the Sixth District as a result of a comparatively stronger credit market in the southern part of Mississippi that resulted from the Atlanta Fed's actions. The drop in the number of wholesale firms, which relied on available credit, was about half as much in the Sixth District portions of the state as it was in the Eighth District portions. Additionally, net sales did not drop as much in the Sixth District portion as they did in the Eighth District portion.

All in all this paper supports other studies that suggest stopping bank panics could have led to a smaller contraction for the economy as a whole. It also reinforces the idea that Federal Reserve banks missed an opportunity in the 1930s to stabilize the banking sector and potentially avoid the severe downturn that followed. Whatever caveats can be ascribed to a historical study of the sort authored by Richardson and Troost, this paper is a strong addition to the body of research detailing the failures of monetary policy in the 1930s. Such lessons are important today, particularly as they relate to how the Fed can best perform its role as lender of last resort. **RF**

"Monetary Intervention Mitigated Banking Panics during the Great Depression: Quasi-Experimental Evidence from a Federal Reserve District Border, 1929-1933." Gary Richardson and William Troost. *Journal of Political Economy*. December 2009, vol. 117, no. 6, pp. 1031-1073.