
Economic Stimulus via Monetary vs. Fiscal Policy

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Discussion seems to be turning lately to how re-establishing New Deal agencies can help today's economy. That discussion is fundamentally misguided. First, few of those New Deal agencies had an important effect. Second, most of the novel policies that did have an effect lie far beyond today's policy options. Last, the New Deal policies that had the most effect lie squarely in the aegis of well-coordinated monetary and fiscal policy. Congress, therefore, needs to get on board.

MOST NEW DEAL AGENCIES DID NOT HELP

My article, "Do Lender of Last Resort Policies Matter? The Effects of Reconstruction Finance Corporation Assistance to Banks during the Great Depression," published in the *Journal of Financial Services Research* in 2001 showed that various assistance programs targeted to stimulating bank lending (including indirect assistance to borrowers through the precursor to the Home Owners' Loan Corporation, which has been cited frequently in the press lately), had little effect. The article was the first to test the effects of New Deal programs on a microeconomic basis, and began a stream of literature to apply the same style of analysis to other programs.

Bank assistance in the Great Depression began with programs to add liquidity by increasing the types of paper acceptable at the discount window. (Sound familiar?) The problem at the time, however, was that the Federal Reserve did not want responsibility for the program, so an agency called the Reconstruction Finance Corporation (RFC) was developed to act in its place (although Federal Reserve powers were always kept on par with those of the RFC).

The RFC made loans to weak banks on a wide variety of collateral, but the plan didn't work. The reason is simple: granting more leverage to weakened financial institutions only reduces further their free cash flow, leading them to hoard cash. Hence, the RFC was powerless to stem banking panics like that in Chicago in June 1932 (see Joseph Mason and Charles Calomiris, "Contagion and Bank Failures during the Great Depression: The Chicago Banking Panic of June 1932," *American Economic Review*, December 1997 (87:5), pp. 863-884) and the massive bank closures that led up to Roosevelt's inauguration in March 1933.

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THE POLICIES THAT WORKED ARE BEYOND TODAY'S POLICY OPTIONS

Contemporary policy observers are maintaining that a reincarnation of the Home Owners' Loan Corporation would help today's economy. Look how much that helped in the Great Depression, they say. The problem with that observation is that there were a vast number of New Deal programs in place by the time Roosevelt took office, and attributing the effects to one relatively minor program is a fundamental misreading of history.

Many of "Roosevelt's" New Deal programs were actually merely adaptations of programs initially begun by Hoover. The Home Owners' Loan Corporation was one of those, and as mentioned above, it didn't work well.

Furthermore, once Roosevelt took office he implemented a lot of extremely drastic measures. For instance, he immediately ordered all the banks in the country closed until they could be examined and promised the public that only sound banks would be allowed to reopen. That measure dealt a blow to the information problems that had plagued depositors and allowed them to redeposit money in the banking system with confidence regarding bank solvency – a confidence many investors crave similarly today.

But there was even more. The RFC under Roosevelt was empowered (along with the Federal Reserve) to purchase voting bank stock, which it did en masse. By the time Roosevelt's RFC was through it owned stock in nearly every bank in the U.S., and often owned the largest voting bloc in weak banks. Roosevelt's RFC changed management and installed officers and directors at will in order to force banks back to solvency. At its heart, the program was one of nationalizing the banking sector. It worked. But it is not likely to be repeated, today.

THE SUCCESSFUL PROGRAMS COORDINATED MONETARY AND FISCAL POLICY

It is well-known by now that the Federal Reserve helped cause the Great Depression by trying to maintain gold parity with the rest of the world. The actions needed to maintain the dollar value of gold are now known to be the same as those used for contractionary monetary policy, so that Federal Reserve monetary policy turned a sharp recession into a Great Depression.

We understand now how Roosevelt relieved that pressure by devaluing the dollar, alleviating the monetary policy strains on the Federal Reserve. Roosevelt even famously manipulated the gold price of the dollar daily, so that it appeared that the dollar sought a new market price as it declined in value. The inflation brought about by devaluation was an economic stimulus, pure and simple.

The devaluation, along with other fiscal policies to decrease taxes and increase earnings, provided the economic stimulus to cease the downturn, although the economy did not fully recover until confidence was restored. Nonetheless, the fiscal policy could not have worked without removing the monetary policy pressure from the Federal Reserve in a coordinated fashion that is now taught in nearly every college introductory economics course.

So where is that monetary and fiscal policy coordination today? Congress is mired in conflict, posting worse public approval ratings than President Bush. Without agreement, fiscal policy will not be forthcoming and the Federal Reserve will be left to the task of economic stimulus with one hand tied behind its back, solely relying on monetary policy. But the Federal Reserve, by itself, cannot turn

around a significant economic downturn. We saw the Federal Reserve cut the Fed funds rate by 100 basis points in the last half of 2007, although market growth remained limp at around 2.5%. Furthermore, the Fed funds rate is getting low. The Federal Reserve cannot keep cutting rates for long before they hit zero, which will not be pretty.

It is time for Congress to coordinate economic policy. Forget about resurrecting isolated New Deal programs unless you want to resurrect them all. The Federal Reserve cannot do the job alone. Cut taxes and let the Federal Reserve fight the resulting inflation.