The Federal Reserve: Then and Now

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A good friend of mine has two sons who, in their youth, were unusually mischievous. On one occasion, when my friend had just replenished his liquor supply in preparation for a cocktail party that evening, his sons decided that a liquor cabinet was a pretty good substitute for a chemistry set. They broke the seals and poured from one bottle directly into the next: scotch into rum; rum into gin; gin into scotch. And they added a little créme de menthe all around. When their father discovered the deed (not in time to save the evening guests from some innovative cocktails), he issued punishment in the form of reduced allowances and increased yard duties. The two boys accepted the punishment gracefully and promised never to do that again. "You know," my friend told me, "I believe them. They'll never do *that* again. The next time, it'll be something else."

And so it is with the Federal Reserve. Mischievous by its very nature, it rarely does the very same thing twice. Fed-watchers, always looking for a precise pattern in monetary aggregates, hoping to get an exact fix on the Federal Reserve's *modus operandi*, are almost sure to be disappointed. The enduring capacity of the Federal Reserve to exert a powerful influence on the course of economic events derives importantly from its adaptability. New trends in fiscal policy and modifications in the regulatory environment can change the nature and significance of Federal Reserve actions in ways that are difficult to perceive until after the fact.

In recent years, difficulties in perceiving just how the Federal Reserve is affecting the course of the economy have translated

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into doubts that the Federal Reserve has a significant effect—doubts even that money has much to do with the cyclical variation of employment and output. So-called real theories of the business cycle account for each departure from trend-line growth in terms of some real shock to the economy—which typically means a change in technology or in resource availability.[1] In turn, the focus on macroeconomically significant real shocks, which are relatively few and far between in comparison to monetary shocks, has caused many modern macroeconomists to believe that business cycles themselves are far less troubling than was once thought.[2] To similar effect, the increasing reliance on an analytical framework that reduces all macroeconomic phenomena to considerations of aggregate demand and aggregate supply has led textbook writers to emphasize the temporariness of cyclical variation rather than the pervasive discoordination and painful recovery that characterize boom and bust.[3]

Such treatments of cyclical variations and of the relationship between monetary and fiscal policy are fundamentally flawed. While important changes in the fiscal and institutional environment underlie the comparison between the Federal Reserve then (1920s–1930s) and the Federal Reserve now (1980s–1990s), the Federal Reserve's power to create money must figure importantly in the accounts of both periods. Understanding just how, though, requires an analysis that makes use of a level of aggregation much lower than that of conventional macroeconomics.

[1]Real business cycle theorists take the empirically demonstrated links between money and economic activity to be a result of "reverse causation": changes in the money supply are seen as the effect rather than the cause of changes in economic activity. For a critical account of this and other aspects of real business cycle theory, see Mark Rush, "Real Business Cycles," *Federal Reserve Bank of Kansas City Economic Review* 72, no. 2 (February 1987): 20–32.

[2]"Real cycle theorists question . . . the conventional wisdom, which asserts that business cycles harm the economy." Ibid. p. 26. Rather than causing the economy harm, minor changes in the economy's output are understood to be a consequence of an efficient market coping with minor (macroeconomically speaking) changes in underlying realities. (In this context, the Great Depression is seen as something of an "outlier" not well accounted for by this or any other theory of the business cycle.)

[3]Long-run aggregate supply, which reflects resource availabilities and technology, is invariant with respect to the price level and hence is represented by a vertical supply curve. Thus, the real effects of a money-induced change in aggregate demand, as would be measured horizontally, are strictly temporary, lasting only until the price level has become adjusted to the larger money supply.

From Textbook Macroeconomics to Macroeconomic Realities

Macroeconomic policy is conventionally divided into two categories: monetary policy, which is formulated and implemented by the Federal Reserve, and fiscal policy, which is the net effect of the many spending and taxing decisions made by Congress. Macroeconomic textbooks typically introduce monetary and fiscal policies in separate chapters and then deal with the interplay between the two by constructing multi-quadrant graphs in which the money supply, government spending, and the level of taxation, each represented in separate quadrants, have a combined economywide effect on the rate of interest and the level of income.

There is a certain logic to this policy decomposition. Inflating, spending, and taxing in the conventional macroeconomic framework have their own separate short-run effects on the interest rate and income level: expansionary monetary policy causes incomes to rise and interest rates to fall; expansionary fiscal policy (increased government spending or decreased taxation) causes both incomes and interest rates to rise. The effect of coordinated monetary and fiscal policy is simply the sum of the individual effects. Economic expansion driven by both the Federal Reserve and the federal budget, for instance, has a double-barreled effect on the level of income while leaving the rate of interest unchanged.[4]

Yet the relevance of such textbook treatments of policy hinges on several critical assumptions. By expanding the money supply, policymakers intend to affect output and employment rather than prices and wages. Any hopes for these intended real effects—as opposed to purely nominal effects—must be based on the assumption that prices and wages are somehow stuck above their market-clearing levels at the outset of the expansion and that the new money lent at lower interest rates is used only to mobilize otherwise idle resources. If, instead, pre-expansion prices and wages are fully adjusted to their market-clearing levels, then the effects of monetary expansion are only temporary. In the long run, real incomes return to their pre-expansion levels as prices and wages adjust upward; real interest rates return to their pre-expansion

[4]A typical textbook treatment of macroeconomic policy is contained in William J. Baumol and Alan S. Blinder, *Economics: Principles and Policy*, 5th ed. (New York: Harcourt, Brace, Jovanovich, 1991), chaps. 11 and 13 and *passim*.

levels as rising prices and wages build an inflationary premium into the structure of nominal interest rates. Similarly, expansionary fiscal policy, which increases real rates of interest, has only a temporary effect on incomes under conditions of flexible prices and wages. These assumptions and qualifications are acknowledged—though sometimes cryptically—in most modern macroeconomic textbooks.

But these treatments employ an exceedingly high level of aggregation, whereby "income" summarily measures both the total output produced in exchange for that income and the spending power capable of buying that output. This aggregation causes the phrase "temporary effects of fiscal and monetary policy" to seem innocuous or benign, seriously understating the actual effects of policy. The conventional wisdom is that policy in the form of such "stimulus packages" may temporarily push the activities of producing, earning, and spending beyond levels that can be sustained. At worst, the dynamics of policy-induced changes in macroeconomic magnitudes give scope for political chicanery as incumbent administrations resort to fiscal and monetary stimulants just prior to elections.[5]

According to an increasingly common view, cyclical movements in income and output—whether attributable to policy actions or to real factors—are considered harmful only in that the timing of consumption is slightly less than optimal. This assessment allows for a quantitative estimate of the welfare loss due to temporal suboptimality of approximately one tenth of one percent of total consumption—which translates into about $8.50 per person per year.[6] Disaggregating the economy's investment sector into policy-relevant patterns of investment, however, reveals that the temporary effects are not so benign. The scope for harm caused by monetary and fiscal stimulants can instead be seen in

[5]For early and non-trivial formulation and application of modern political business cycle theory, see William D. Nordhaus, "The Political Business Cycle," *Review of Economic Studies* 42, no. 130 (April 1975): 169–90 and Edward R. Tufte, *Political Control of the Economy* (Princeton: Princeton University Press, 1978).

[6]Robert E. Lucas, Jr., *Models of Business Cycles* (London: Basil Blackwell, 1987), p. 27. Despite his low estimate of the social cost of cyclical variation of output, Lucas rejects real business cycle theory on the grounds that the candidates for real shocks are too small to account for actual fluctuations. Ibid., p. 71. Textbook authors typically offer no quantitative estimate of the harm attributable to business cycles, but the fact that Baumol and Blinder's 900-page textbook devotes less than six pages—and nowhere more than two consecutive pages—to the subject of business cycles carries its own message.

terms of unsustainable changes in the pattern of investment. Even if the spending power of income earners equals total output in aggregate terms, a systematic, policy-induced mismatch between decisions in the investment sector and the underlying preferences of consumers and wealth holders can lead to severe economic downturns and painful recoveries.

By carefully identifying the relevant aspects of investment patterns in different cyclical episodes, we can identify both theme and variation in the story of boom and bust. We can find both similarities and differences, for instance, in comparing the experience of the 1920s and 1930s with that of the 1980s and 1990s. Further, we can show that the prolonged succession of policy-induced "temporary" effects, which has fundamentally changed the relationship between fiscal and monetary policy, has had permanent effects on the health of the economy.

Variation on a Theme

How strong are the parallels between the boom of the 1920s and the boom of the 1980s? How similar are the economic circumstances of the early 1990s to those of the early 1930s?

It may be tempting to try to account for our current macroeconomic plight by retelling the story of the interwar experience, changing only the dates and a few minor details. But the story doesn't fit that well. Credit conditions as judged by real rates of interest were relatively tight during the 1980s in comparison to credit conditions during the 1920s. And although the overall monetary expansion was actually greater in the more recent episode, the patterns of monetary growth in the two periods differs importantly. In the 1920s, the money growth rate peaked near the end of the decade as the Federal Reserve attempted with increasing resolve to keep the boom going; in the 1980s, the peak growth rate of M1 came at mid-decade, after which monetary growth fell to low single digits while the bull market continued. Adjusting the story by replacing the conventional money or credit aggregates with more narrow ones, such as the monetary base, or with broader ones, such as the Divisia index, does little to improve the fit. And given the intense Fed-watching in recent decades, it would in fact be surprising to learn that the Federal Reserve had nonetheless ignited and sustained an artificial boom for several years by simply repeating its misdeeds of the 1920s. There is, after all, a kernel of truth in the notion of "rational expectations"—as recognized by Ludwig von Mises

years before that term achieved currency in macroeconomic thought.[7]

Parallels can be found not in the strict sense of a replay but in the broader sense of variation on a theme. The story requires a recasting of the characters and some major changes in the plot. The Federal Reserve no longer plays the lead; it plays instead an indispensable supporting role. Banking legislation and fiscal policy are more central to the storyline. In accounts of both periods, however, we can say that unprecedented conditions allowed an artificial boom to go unchecked for a significant period of time. Unprecedented in the 1920s was a strong central bank bent on stimulating growth in a peacetime economy. Unprecedented in the 1980s was a banking industry operating in a dramatically altered regulatory environment and a federal government running deficits measured in the hundreds of billions.

Interest rates in the recent episode play an important role not so much because of considerations of time discount but because of considerations of risk. During the 1920s, the low time discount signaled by artificially depressed interest rates did not accurately reflect people's actual willingness to save; during the 1980s, the low risk premiums built into interest rates did not accurately reflect people's actual willingness to accept the risks of increasingly speculative investments—much less the additional risks attributable to the government's irresponsible fiscal policy. The boom of the 1980s was no less artificial, however, than the one in the 1920s. To see why, we shall have to shift our focus from the easy money provided by the Federal Reserve in the 1920s to the risk-free securities provided by the Treasury in the 1980s. But first let us highlight aspects of the 1920s that have identifiable counterparts in the 1980s.

The Federal Reserve played a leading role in the dramatic boom of the 1920s (and the bust of the 1930s). Artificially cheap credit provided by the Federal Reserve underlay the economic expansion that lasted through mid-1929. This credit expansion, in an economic environment largely devoid of Fed-watchers, drove a wedge between saving and investment. Guided by low rates of interest, investment outstripped saving in aggregate

[7]Ludwig von Mises, *The Theory of Money and Credit* (New Haven: Yale University Press, 1953; originally published in German in 1912). Mises fully recognized the strategic significance of expectations in his 1953 addendum entitled "Monetary Reconstruction." He expressed the limits to—and the short-run nature of—inflationary finance in terms of Lincoln's Law: You can't fool all the people all the time (see p. 419).

terms, and—more importantly—investment projects were excessively long-term. As the boom proceeded, low interest rates lured capital into relatively time-consuming production processes. That is, the timing of the output of these production processes was skewed toward the future in comparison to the intertemporal pattern of demand for output. While the intertemporal distortion of output is the essence of so-called real business cycle theory, it is only a symptom, in the view presented here, of a pervasive distortion in the economy's capital structure. The economywide inconsistencies—attributable to Federal Reserve policy—between investment decisions of the business community and the time preferences of consumers made the bust inevitable. The recovery, hampered by policies aimed at re-igniting the boom, consisted of extensive capital liquidation and a general intertemporal restructuring of capital.

Modern textbook treatments of the recent economic boom in comparison to the interwar boom hinge on a sharp distinction between monetary and fiscal policy. The earlier boom was driven by monetary policy; the later one by fiscal policy. It is true that the 1920s were characterized by (relatively) tight fiscal policy and loose monetary policy as each is conventionally measured, and that the 1980s saw a reversal in the relative strengths of the two policy alternatives. But the strict dichotomization between fiscal and monetary policy is badly overdrawn. In the 1980s, the significance of fiscal policy lay not in its augmentation of aggregate demand but in the private-sector risks and uncertainties that were attributable to chronic and dramatic federal budget deficits. This shift in focus directs attention to the Federal Reserve's critical supporting role throughout the decade and to the banking legislation at its beginning.

While irresponsible fiscal policy created additional risks and uncertainties to be born by the private sector, the Federal Reserve in its capacity to monetize Treasury debt kept the risk premium off Treasury securities. Further, while extensive changes in the regulatory environment faced by the banking industry led banks to take on increasingly riskier portfolios, the Federal Reserve in its capacity of lender of last resort—together with policies of the Federal Deposit Insurance Corporation (FDIC)—kept the risk premium off bank securities and minimized the worries of the banks' depositors. Although the story of the 1980s is institutionally complex, the general nature of the problems in the private sector is relatively simple. The regulatory and policy environment led the business community to take on risks that were

systematically out of line with the risk preferences of private wealth holders. This systematic discrepancy between risks undertaken and risk preferences, which provides the thematic link to the interwar episode, justifies the claim that the 1980s boom was artificial and that the bust was inevitable.

Deficit-Induced Uncertainties

It is not difficult to demonstrate that chronic and dramatic federal budget deficits create uncertainties in the private sector.[8] A numerical example can serve to illustrate. Suppose the government's anticipated rate of spending over the next several years is a trillion dollars per year and that it anticipates collecting $800 billion per year in tax revenues. The difference, the anticipated annual deficit, of $200 billion represents yet-to-be-funded government spending.

The business community understands that the government will appropriate a trillion dollars worth of resources each year. Tax codes stipulate the particular targets of eighty percent of the government's appropriation activities. Production plans can be made in the light of these codified taxing procedures. But there can be no plans that effectively take into account the other twenty percent, the anticipated deficit. In effect, the government is putting the private sector: "We are planning on appropriating another $200 billion worth of resources, but we are not saying just how, just when, and just whose."

The government may continue issuing new Treasury bills while holding the line on the money supply. This would mean continued strains on credit markets, real rates of interest higher than they otherwise would be, and continued trade deficits as the Treasury sells those bills both at home and abroad. Alternatively, the government may rely more heavily on money creation. The Federal Reserve may begin buying Treasury bills at an accelerated rate. This process of debt monetization would take the pressure off credit markets and strengthen export markets. It would reduce the real rate of interest (temporarily) but would build an inflation premium into the entire structure of interest rates. As still another alternative, the government may institute new taxes of some kind or raise tax rates in some yet-to-be-specified way. In

[8]Deficit-induced uncertainties underlie the arguments in Roger W. Garrison, "Public-Sector Deficits and Private-Sector Performance," in *The Crisis in American Banking,* Lawrence H. White, ed. (New York: New York University Press, 1992), pp. 29–54.

the meantime, a $200-billion cloud of "intent to appropriate in some unspecified way" looms large over the private sector.

There is no effective hedge against uncertainty of this kind. There are no probabilistic answers to the question of just how the government will appropriate the additional resources. Should long-term capital be shifted out of export industries because of the currently high foreign-trade deficit and correspondingly weak export markets? Or should it be kept in place by anticipations of—or hopes for—a change in fiscal strategy? Should long-term financial commitments be based on the current credit conditions or on the contingency of some unknown likelihood that the Treasury will borrow more heavily in domestic as opposed to foreign credit markets? Should land, durable assets, and even inventories be bought or sold at prices that reflect current inflation rate? Or should such transactions reflect accelerating inflation based upon some guess about the extent and timing of debt monetization?

Although the government's borrowing at irresponsibly high levels adds to the riskiness of private-sector activities, none of these risks are born by the holders of Treasury securities. This discrepancy between risk created and risk assumed can be directly attributed to the Federal Reserve in its capacity to monetize Treasury debt. Overextended borrowers in the private sector must pay a substantial default-risk premium in order to continue borrowing. Even overextended municipalities pay a default-risk premium as their bonds are downgraded by bond-rating agencies. The power to tax alone is not enough to protect municipal bondholders against default. But the interest rate paid by the federal treasury contains no default-risk premium at all. The Federal Reserve stands ready to monetize the Treasury's debt in circumstances that otherwise would require an outright default. It is true, of course, that *actual* monetization imposes costs in the form of price distortions and a general price inflation, but these costs are imposed on the economy in general—not just the holders of Treasury securities. Since a "monetization risk," unlike a default risk, is born by holders and non-holders alike, there is no monetization-risk premium—separate from the economywide inflation premium—built into the nominal yield on Treasury securities. The very potential for debt monetization is what breaks the link between fiscal irresponsibility and some corresponding risk premium.

The Federal Reserve, then, plays a critical supporting role in the pursuance of fiscal policy. Relieving the holders of Treasury securities of any risk burden increases the attractiveness of those securities and thus eliminates what would otherwise be a binding

market constraint on further Treasury issues. The increasing significance of *potential* debt monetization suggests that the magnitude of the Federal Reserve's influence is not to be detected in *actual* movements of monetary aggregates. The mere fact that the Federal Reserve stands ready to monetize debt gives the Treasury a much longer leash than it would otherwise have.

The Artificial Boom

Textbook treatments of fiscal and monetary policy recognize that the fiscal authority and the Federal Reserve can work together. The Treasury issues debt and the Federal Reserve monetizes it. So long as government borrowing has not been pushed to irresponsible levels, debt issue and monetization have short-run effects on output and incomes that reinforce one another and short-run effects on the interest rate that cancel one another. These effects of policy are derived straightforwardly from standard analysis which focuses on aggregate supply and aggregate demand. But when borrowing becomes excessive, considerations of risk become dominant. Going beyond the circumscribed focus of the textbook, we can recognize that the Treasury creates risk and the Federal Reserve externalizes it.

To say that the Federal Reserve keeps the default-risk premium off Treasury bills is not to say that the risk is actually eliminated. The burden of bearing it is simply shifted from the holders of Treasury securities to others. Borrowing and investing in the private sector becomes more risky than it otherwise would be. Holders of private debt and equity shares must concern themselves not only with all the usual risks and uncertainties of the marketplace but also with the risks and uncertainties attributable to changes in the way the federal deficit is accommodated. Selling Treasury bills in foreign credit markets, in domestic credit markets, or to the Federal Reserve can have major effects on the strength of export markets, on domestic interest rates, and on the inflation rate. The inability of market participants to anticipate the Treasury's borrowing strategy translates into unanticipated changes in the value of private securities.

If the additional risks attributed to federal budget deficits and imposed upon the private sector were allocated in some economically efficient way, there would have been no artificial boom arising from the irresponsible fiscal policy of the 1980s. The willingness to lend and to buy equity shares in the private sector would have been generally reduced, as wealth holders opted for

the artificial security provided by government debt; but the reduction in private-sector activity would have been minimized so long as the additional risks were assumed by those most willing to do so. This result, though, was precluded by institutional factors that hid the private-sector riskiness from those who were (unknowingly) financing risky undertakings. Again, the Federal Reserve plays a strong supporting role, as does the FDIC. Together, they enabled commercial banks and their depositors to finance risky ventures throughout the 1980s while being shielded either permanently or temporarily from the risks. This shield from risk bearing, like the low rate of interest in the 1920s, gave rise to an artificial boom and subsequent bust.

The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) dramatically changed the banking industry's ability and willingness to finance risky undertakings. Increased competition from nonbank financial institutions drove commercial banks to alter their lending policy so as to accept greater risks in order to achieve higher yields. The Federal Reserve in its long-established capacity of lender of last resort diminished the banks' concerns about possible problems of illiquidity while the FDIC absolved the banks' depositors of all worries about illiquidity and even about bankruptcy. Riskier loans, then, were only partially reflected in higher borrowing costs and lower share prices. In substantial measure, specific private-sector risks were transformed by DIDMCA, the Federal Reserve, and the FDIC into (1) the generalized risk of inflation in the event of excessive last-resort lending by the Federal Reserve and (2) the risk of a large and unbudgeted liability in the event of excessive last-resort closings by the FDIC. Thus, economic activity in the private sector was spurred on by the lure of higher yields, yet it was largely unattenuated by considerations of risk, which were effectively externalized and diffused.

The artificially low risk premiums stemming from the risk-externalizing effect of potential debt monetization in the 1980s paralleled the artificially low interest rates created by actual monetary expansion in the 1920s. What was without an earlier parallel, however, was the impact of deposit insurance in the post-DIDMCA period.[9] Throughout the 1980s, the FDIC continued

[9]For a treatment of the effects of FDIC policy, see Roger W. Garrison, Eugenie D. Short, and Gerald P. O'Driscoll, Jr., "Financial Stability and FDIC Insurance," in *The Financial Services Revolution: Policy Directions for the Future*, Catherine England and Thomas Huertas, eds. (Boston: Kluwer Academic Publishers, 1987), pp. 187–207.

to protect depositors while charging the banks a premium that was too low in general and, more significantly, that was unrelated to the riskiness of bank assets. This subsidy to risk-taking may have been significant enough, by itself, to create an artificial boom. There was no difficulty in finding risks to take. Banks could simply lend more heavily to overextended farmers, third-world countries, oil prospectors, and real estate developers; or they could find new risks such as those created by leveraged buyouts and the dramatic growth of the junk-bond market. It was the financial sector's demand for high-risk, high-yield securities, in fact, that gave junk bonds and other highly leveraged securities their buoyancy.

Although it is possible to think of the FDIC as having its own independent effect throughout the 1980s, FDIC policy was actually an integral part of the fiscal, monetary, and regulatory environment that created and externalized risks. The Treasury created risk; the Federal Reserve and the FDIC externalized it. After all, speculative lending such as for commercial real estate development or for highly leveraged financial re-organizations are risky in large part because of possible changes in such things as the inflation rate, interest rate, trade flows, and tax rates—the very things that can undergo substantial and unpredictable change when the federal budget is dramatically out of balance. The 1980s may best be understood, then, as a decade in which the policy-induced externalization of risk gave rise to a substantial but ultimately unsustainable economic boom.

The Bust

Potential debt monetization can keep Treasury bills risk free for the indefinite future; the reimbursement of depositors of failed banks can continue so long as the FDIC can be recapitalized out of general tax revenues. But the banking industry cannot be shielded from the consequences of excessive risk-taking forever. For almost a decade the banking industry and the speculative activities it supported were able to keep the economic expansion going. Although risk aversion normally characterizes sound banking, high-flying banks in the 1980s were able to indulge in risky lending despite the preferences of their depositors and to escape both market-imposed or government-imposed discipline until the cumulative effects of externalizing risk turned the undue risk-taking into a financial crisis. The Federal Reserve's routine functioning as lender of last resort, the FDIC's *de facto*

policy of forbearance in cases of problem banks, and the implicit acceptance of the doctrine of "too big to fail," all help to account for the length of the artificial boom. But neither increased last-resort lending and forbearing nor more overt inflationary finance, such as was pursued in the 1920s, could keep the boom going indefinitely. As with the artificial boom in the interwar period, an eventual bust was inevitable.

Like the time-consuming production processes that were out of line with time preferences, speculative loan portfolios that were out of line with risk preferences generated an artificial boom in the 1980s that belonged to the same general class as that of the 1920s. However, the distinction between economic activities that are excessively future-oriented and economic activities that are excessively speculative—together with some institutional considerations—allows us to see systematic differences between the 1930s and the 1990s.

First, the downturn at the end of the Bullish Eighties came in the form of a bank-led bust. A high rate of bank failures was experienced well before the general economic contraction. At the end of the Roaring Twenties, by contrast, the bank failures came after the economic contraction had begun. This difference in the timing of events is consistent with differences in the nature of the two expansions. Industrial borrowers in the 1920s were using newly created funds for excessively capital-intensive ventures that, in general, were not otherwise excessively speculative. It is true, of course, that there was heavy speculation in securities markets in the 1920s—much more so then than in the 1980s—but the cause-and-effect relationship in the recent episode was the reverse of that in the earlier one. That is, in the 1920s, monetary expansion, which allowed banks to support heavy industry, also fueled speculation in securities markets. However, because the risks of that speculation were born, in the first instance, by the buyers of the securities, there was no policy-induced externalization of risk to weaken banks even as the expansion continued. In the 1980s, policy-induced speculation, on the part of the banks themselves and their industrial borrowers, eroded bank capital, weakening the banks throughout the boom—so much so that the erosion of their capital base eventually turned boom into bust.

Second, while the idleness of plant, equipment, labor, and other resources that characterized the 1930s has its counterpart in the semi-idleness in the 1990s, the disposition of unprofitable assets is different now, largely because the recent bust was

bank-led. During the Great Depression, firms whose revenues did not cover operating costs simply closed their doors. Work on incomplete industrial projects whose present value had turned negative was simply discontinued. Although this form of market discipline was sometimes delayed by policies aimed at rekindling the boom, eventually resource idleness characterized those sectors of the economy that were most out of line with underlying economic realities, and liquidation could proceed apace.[10] In the current slowdown, many failing firms are first identified as nonperforming loans in the portfolios of failed banks. As insolvent banks are closed by the FDIC, the bad loans are transferred to the Resolution Trust Corporation (RTC), which functions as a caretaker until it can sell the assets. In many cases, the physical assets, such as franchised motels or restaurants, are not idled. Instead, the RTC contracts with an operating company to run the business. The contract allows the operating company to earn a profit while minimizing the cost to the RTC of maintaining the assets.

The existence of many such failed-but-still-operating businesses, including firms undergoing bankruptcy proceedings but still operating with the newly evolved debtor-in-possession (DIP) financing, helps to explain why the current recession is a relatively shallow one by conventional measures. What otherwise would be idle capital is partially masked by RTC policy as underemployed capital—analogous to the underemployed labor associated with 1930s-style make-work projects. "Zombie banks," banks that are allowed to continue operations after their net worth has turned negative, have their counterpart in RTC-owned or DIP-financed "zombie firms."[11]

While the underemployed capital in zombie firms limited the depth of the recession, it added to the length. Recovery consists of re-employing resources idled by the bust. As confirmed by

[10]On the role of government in adding to the severity of the Great Depression and delaying recovery, see Gene Smiley, "Can Keynesianism Explain the 1930s?: Reply to Cowen," *Critical Review* 5, no. 1 (Winter 1991): 81–114 and Richard K. Vedder and Lowell E. Gallaway, *Out of Work* (New York: Holmes and Meier, 1993), pp. 74–149.

[11]The term "zombie S&Ls" was coined by Edward J. Kane in the context of the savings-and-loan crisis, which was a precursor to the crisis in the banking industry and subsequent recession. See Edward J. Kane, "Dangers of Capital Forbearance: The Case of the FSLIC and the 'Zombie' S&Ls," *Contemporary Policy Issues* 5, no. 1 (January 1987): 77–83. For a healthy perspective on RTC policy and DIP financing, see Stephen Delos Wilson, *The Bankruptcy of America* (Germantown, Tenn.: Ridge Mills Press, 1992), pp. 81–96 and *passim*.

experience in the early 1990s, it would have been easier to draw resources out of idleness than to draw them away from the RTC. Asset managers of the RTC, trying to avoid spoiling markets that dumping real assets at fire-sale price would entail, stockpiled them instead, creating a huge "overhang" which added significantly to the uncertainties in the private sector. Also, solvent firms and would-be upstarts, who would have to raise their own capital to expand or enter the market, are not eager to compete with bankrupt firms or with privately operated but RTC-owned businesses whose revenues do not have to cover the costs of capital. Considerations of these sorts help to explain why the government's recent recourse to monetary stimulation in the form of exceedingly low discount rates has met with such little success.

Third, the unemployment currently being experienced has a distinctly different composition from that of the 1930s. It is widely reported that white-collar workers are disproportionately affected in the current recession as compared to earlier cyclical downturns. The time-preference/risk-preference frame of analysis makes this composition difference readily understandable. The boom in the 1920s involved resources allocated disproportionately to capital-intensive projects, such as steel mills and manufacturing plants. The labor complement to heavy industry tends to be predominantly blue-collar. The boom in the 1980s involved resources allocated to speculative development, such as commercial real estate and financial services. The labor complement to this kind of capital tends to be predominantly white-collar. In both episodes, the composition of unemployment matches the pattern of capital misallocation.

Finally, macroeconomic policy after the bust reveals a critical difference between the current situation and that of the 1930s. When further monetary expansion, which sustained the boom of the 1920s for nearly a decade, could sustain it no longer, both the monetary expansion and the boom came to an end. The public's increased demand for currency relative to checking-account money, coupled with the increased reluctance on the part of commercial banks to lend, swamped the Federal Reserve's efforts to re-inflate.[12] Despite the further padding of the monetary base, the dynamic of the bust itself was an effective check against continued monetary expansion. By contrast, when further deficit spending and risk externalization, which sustained the boom of

[12]See Smiley, "Can Keynesianism Explain the 1930s?" p. 88.

the 1980s, could sustain it no longer, the boom ended, but the deficit spending and risk externalization escalated. In fact, decreased tax revenues and increased payments of entitlements, both associated with recession, led to still more government borrowing. The dynamic of the bust, then, provided increased scope for the very kind of irresponsible fiscal policy that made the bust inevitable.

How Little "We" Know

The failure at the dawn of the last decade to extend deregulation to the provision of deposit insurance and the absence of any market check against the Treasury's fiscal excesses provide dramatic illustration of the general fallacy of the mixed economy. Privatized profit seeking coupled with socialized risk bearing undergirded both the bull market of the 1980s and the harsher economic realities of the 1990s. The risks assumed by lenders and borrowers, savers and investors, hedgers and leveragers are rendered inconsistent with the actual risk preferences of wealth holders in the marketplace by the FDIC subsidy to risk bearing and by the Fed-backed Treasury, whose power to issue risk-free debt imposes risks on the private sector.

Researchers at the Federal Reserve are just two steps away from recognizing the problem of deficit-induced uncertainties as evidenced by a recent article entitled "How Little We Know About Deficit Policy Effects."[13] Macroeconomic data as illuminated by several sophisticated modeling and econometric techniques have led two economists at the Minneapolis Federal Reserve Bank to conclude with confidence that "Deficit policies may matter, and then again they may not. Existing studies really don't tell us much about their effects."[14] The first step from this disturbingly limp conclusion to a healthy understanding of the deficit problem is to recognize that the "We" in the title of the article, intended to mean "We Economists," can be extended to mean "We Lenders-Borrowers-Savers-Investors-Hedgers-Leveragers" or simply "We Market Participants." Market participants do not know how deficit accommodation will affect future market conditions, so they have to make guesses. And if they guess

[13]Preston J. Miller and William Roberds, "How Little We Know About Deficit Policy Effects," *The Federal Reserve Bank of Minneapolis Quarterly Review* 16, no. 1 (Winter 1992): 1–12.

[14]Ibid., p. 8

wrong, they may lose big. The second step is to recognize that the "We" may also refer to the holders of Treasury securities. Accordingly, the title phrase should be amended to read "How Little We Know *or Care* about Deficit Policy Effects." The potential for debt monetization, as manifested by the Federal Reserve in its standby capacity, has absolved the Treasury's creditors of any inclination to care. Externalizing risk has precluded any possibility that the reluctance of creditors will provide an effective check against the excesses of the Treasury.

The tripling of federal government indebtedness since the beginning of the 1980s' bull market stands as testimony to the capacity of the Treasury to issue its artificially risk-free debt. The banking legislation of 1980 has shown us its capacity for blinding the banking industry and the private sector to the black cloud of debt gathering above it. Together, the actions of the fiscal and monetary authorities have demonstrated once again how public institutions ostensibly devoted to stability and prosperity are, in the end, responsible for crises and decay.