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# Financial Crises in Historical Perspective: Comparing the US and UK Monetary Policy Responses to the Crises of 1929 & 2008

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*The recent crisis of 2008 is often used to illustrate the achievements of the monetary policy since the Great Depression. My paper compares policy responses of the US and the UK monetary authorities during financial crises of 1929 and 2008. On scrutiny of these policy responses, to a large extent it seems indeed to be true that the responses of monetary authorities of the U.S. and Britain were quicker and stronger, with a bigger toolkit applied. Besides aggressive interest rate cuts and liquidity injections, the central banks started extensive asset purchases and other unconventional monetary policy operations. This attitude stays in contrast with rather sluggish responses of the Gold Standard period. Yet, the fact that the crisis took place doubts the ability of the monetary authorities to forecast and prevent the crisis. That might and should be a much more effective skill to have.*

**JEL Codes:** E5, N1, N2.

## 1. Introduction

The financial crisis has been an integral phenomenon of the world economy over the last one hundred years. Albeit in a contemporary, more global and liberal economic system, crises seem to have become more frequent with their severity significantly falling. In this the role of the central bank and monetary policy should be considered.

The parallels between the Great Depression and the Great Recession have been studied by a number of scholars, including renowned economists like Eichengreen, Ben Bernanke, O'Rourke, Paul Krugman to name a few. Most of the studies focus on comparison of the United States in the two crises. However, this does not give us the whole understanding of the crises, as the effect was not limited to the U.S. and the measures taken by the Federal Reserve were not the only ones to fight the recession. While comparing the responses to the crisis of the 1930s to that with 2000s one needs to consider the macro-economic policy environment to be significantly different making implementation of certain measures difficult. In the Depression, money was the principal player, the series of monetary shocks resulting from the recurrent banking crises turning an otherwise severe recession into a debacle of unprecedented proportions. In the recession of 2007/2008 money as an instrument has played a much smaller role.

Nonetheless, my paper compares responses in both the crisis on the grounds of poor regulatory mechanism and absence of safety nets in place across the financial systems during the time of crisis in the UK and the US. The paper highlights the fault lines and some

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gaping loopholes that were responsible for the exacerbation of the crisis in the 1930s and present a critical insight into the kind of policy measures taken. As an economic historian it is pertinent to scrutinize and understand whether policy makers in the 21st century (during the time of the Great Recession) took warranted steps in avoiding a historical repeat of the 1930s crisis spill-over effect.

The main research question that I seek to address through this paper is whether central banks (taking the case of the Federal Reserve and the Bank of England here) over time have become better and more efficient as institutions in managing and preventing an economic crisis? To answer this I compare the monetary policy responses of these banks looking at two critical economic crisis (The Great Depression and the Great Recession). I then see if the mistakes of the 1930s (times of the Great Depression) were reflected upon during the time of the Great Recession (2007 onwards) and whether the policy makers over time became more open- minded and responsive in reacting to crises situations.

In addition to this, my paper reviews the causes and responses that can explain the failure of the US' Federal Reserve to act, especially during the 1930s. The US financial system gets distinctive attention in my analysis of the policies (with respect to discount rate, interest rates etc.) implemented by its own central bank, the Federal Reserve which at that time seemed quite aware of the unsound shape of the banking system and its need for intervention. Why did not the Fed take more intensive measures and did not increase the money supply? Why did the Federal Reserve consider using tools like suspending deposit convertibility at the time of crisis? These are some of the questions that merit scholarly attention while discussing the factual and counterfactual possibilities concerned in the analysis of the Great Depression.

The failure to act effectively and promptly at that time is highlighted in the paper while explaining the Banking Panics that followed the stock market crash (1929) leading to the further exacerbation of the crisis. In case of the UK, the decision to return to the Gold Standard at the pre-war parity emerges as the principal cause that was responsible for the lost decade of the 1920s where Britain faced persistent economic instability in years before and after the crisis.

The Great Recession of 2008 was preceded with the Great Moderation and the crisis of the 21st century definitely offered a wider toolkit for central banks and institutions present. A major difference between the crisis of the 1930s and 2000s for the US is in regards to the new rather unconventional monetary policy tool adopted i.e. Quantitative Easing (QE), the significance of which I highlight in the second half of my paper. The QE package pushed by the Fed aimed at lowering the longer-term rates through pushing reserves into the banking system and increasing the money supply quite contrary to the monetary policy measures the Fed adopted in the 1930s.

In 2008 Britain too experienced a crisis in a number of ways similar to what the country experienced 80 years earlier. However, in my analysis I explain how Britain adopted a more contemporary discretionary monetary policy with no 'golden fetters' attached letting the Bank of England reduce the rate much more aggressively than during the Great Depression.
In the body of the thesis, at first, I give a lucid picture of the two crises i.e. the Great Depression and the Great Recession in the U.S. and Britain. Later (section 2) I offer a review of the literature covering the monetary policy responses to the crises commenting on whether

such measures were apt or necessary to reach the holy grail of macroeconomics. The findings (section 3) offer a detailed assessment of the crises responses, evaluating the policy response of the Federal Reserve and the Bank of England. The conclusion (concluding section 4) sums up the main arguments highlighting the limitations of the study and the unexplored space within the scope of the research on institutions and crisis management.

## 2. Literature Review & Methodology

The critical review of the literature done below divides the two crises as two distinct economic events, the causes of which differed considering the politico-economic factors in play during the time. The monetary policy responses of the USA's Federal Reserve and Britain's Bank of England have been explained in detail while deliberating on what contributes as a better response to the unfolding of the crisis situation.

### 2.1 The Great Depression

Around a decade following the end of the First World War the U.S. economy was flourishing. It was also a time of rapid growth for the U.S. financial market. American stock market capitalization tripled from 1920 to 19281. However, the fundamental reasons for growth were questionable and in the means of calming down the market, the Federal Reserve repeatedly increased the interest rate and slackened the pace of monetary growth from mid-1928 onwards. The result of the tightening monetary policy confirmed some fears of the Federal Reserve Board that this policy '…would be not restrictive enough to halt the bull market yet too restrictive to foster vigorous business expansion'. Indeed, the US stock market that reached its highest level in September 1929 collapsed a month later and reached its bottom in 1932. The stock market crash together with the tough monetary conditions coincided with the general downturn of the U.S. economy.

The post-1919 period witnessed years of boom in Britain too, primarily due to the grand restoration after the war. The immediate goal of the authorities then, was to take the exchange rate under control. The prices were forced to decline by curtailing the government spending, at the same time the Bank rate was gradually increased from 5% to 7%. The deflationary policy strengthened the exchange rate, which in March 1923 reached the level of $4.705.

In 1925 Britain returned to the Gold Standard at the pre-war parity of $4.86. However, in the 1920s with much higher prices and weaker international commercial position of Britain the fundamentals for such parity were rather questionable. Friedman and Schwartz (1963) suggested that at that rate sterling was around 10% overvalued and that would require further deflation. Although, Britain was ready to make sacrifice in the short-term for the benefits in the long-run, which at that time it believed would offset the losses.

### 2.2 The Great Recession of 2008

The years preceding the crisis of 2008 are often referred to as *Great Moderation*, characterized as a period of macroeconomic stability and steady growth in advanced economies. Adam and Vines (2009), Bean (2009) and Eichengreen (2009) emphasize two developments during that period that lead to the crisis of 2007/2008: *global imbalances and* *inadequate regulation in financial markets*. The causes cannot be limited to these per se even though they can be defined as the two most prominent of all in explaining the causes of crisis in the US.

At *first*, on glancing through the decade preceding the Great Recession global imbalances were seen to persistently mount. The export-led growth of the countries of East Asia and China, as well as the economic boom in Japan and commodity producing nations contributed enormously to global net saving and heavy investment in the United States. A third of the gross external liabilities increase in the US can be explained by its current account deficit. The intensive overseas investment flows coupled with the US dot-com bust stimulated easing of the monetary policy, and between 2001 and 2003 the interest rate was reduced from 6.5 to 1.2 per cent, promoting similar actions in the UK and Europe.

The period of cheap money thus, stimulated debt-financing and as a result growth of investment. Bean (2009) observed a significant increase in the debt-to-GDP ratio of households and business within the US and the UK. Furthermore, investors in, what Adam and Vines (2009) call *'search for yield'*, increased their leverage and share of innovative financial instruments, such as structured debt. Leverage provides additional profit in the good times, but can cause significant damage even after a small shock. Structured debt was supposed to be a good diversification tool, however it implied, *valuation risk*, as it was hard to assess the risk of those instruments due to the diverse and sometimes not well-understood collateral. Even the well-known rating agencies and regulators failed to adequately assess the risks. In addition it tied up various investors across the world, thus implying increased systemic risk. As Bean (2009) put it, '[t]he complexity did not seem to matter when markets were steady and defaults low but was fatal once conditions deteriorated…'.

Indeed when the initial shock hit the asset market it was immediately transmitted throughout the global financial system as a snowball, increasing in scale and creating a domino effect. Global stock markets experienced an even faster slump than at the outbreak of the Great Depression.

*'Risk premia have surged, lending standards have been tightened, and in some cases entire credit markets have effectively shut down'*

Furthermore, through reduction of wealth of the asset holders and fall in consumption and demand for exports this shock spread to general global economic system. Almunia et al. (2009) observed that in the first year of the crisis global industrial output was falling at the same pace as in the first year of the Great Depression. Thus, the decline of the global industrial output was steeper in 2008 than in 1929.

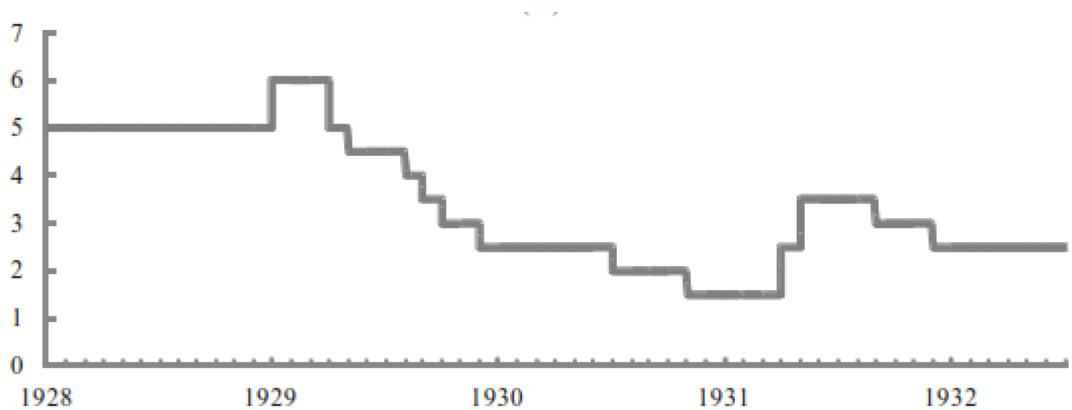
## 3. The Findings

### 3.1 The U.S. Monetary Policy Response to the Economic Crisis of 1929

Although the fact that the Federal Reserve's response to the market boom affected the economy is universally agreed upon, the scale of the affect is debatable. According to Schwartz (1981), the monetary contraction both initiated the recessionary wave in the U.S. economy and further aggravated the crisis thereafter. Gordon and Wilcox (1981) have a less aggressive view on that account, assigning to the monetary policy only the role of deepening the recession. Ritschl (2006), on the other hand, argued that the effect of the Fed's policy seemed too small to explain the slump after 1929 and could only generate a mild recession in 1930. Regardless of whether it was an outcome of the monetary policy or not, the US economic growth slowed down and contracted for the following years.

By October 1930, the country was already in a deep recession with fall in production, prices and personal income by 26, 14 and 16 per cent respectively. Decline in the Fed's discount rate from 6 to 2.5 per cent [Figure 1] could not stop the downfall. In fact, this tool became largely inefficient during that period of time, as together with the decline in the discount rate there was a sharp decline in the demand for discounts. The Federal Reserve discount rate decreased in absolute terms, but increased relative to the market interest rate on short-term securities, thus became less attractive. As Reed (1930) has put it 'the rate reduction had been too gradual and long delayed'. Had the Fed been more proactive and more aggressive in its policy, or used other credit expansion tools in hand, the results might have been of a greater help for the US economy.

**Figure 1: U.S. monetary policy rates, monthly, 1929- March 1933**




Source: Friedman, M., Schwartz A.J., 'A Monetary History of the United States 1867-1960', Princeton University Press, 1963, p. 304

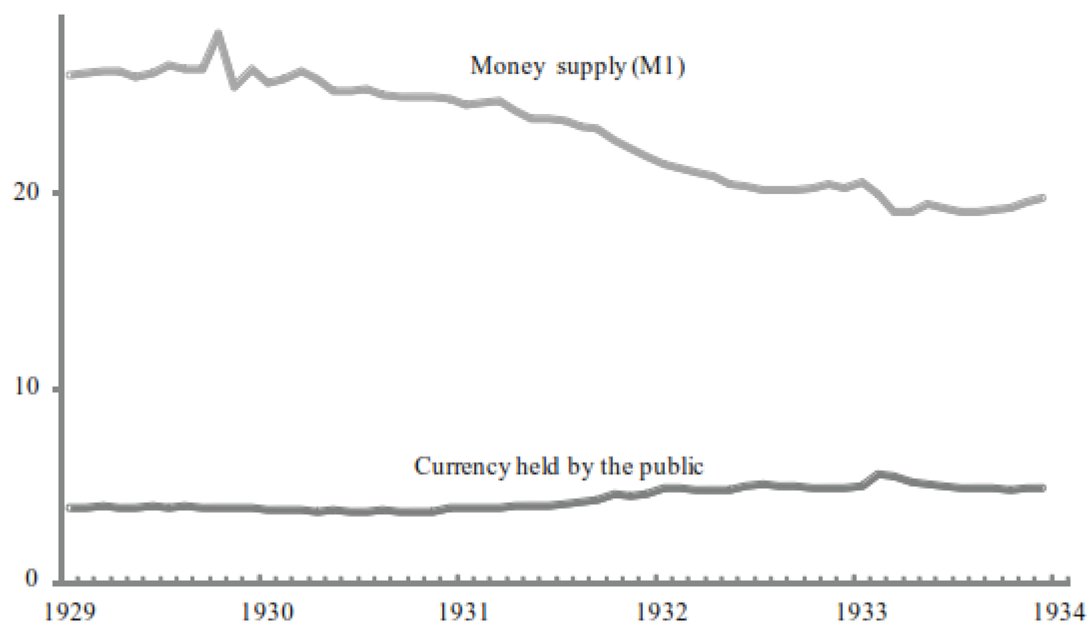
The following period of the crisis was characterized with extreme instability in the U.S. financial system. The falling economic activity and rising concerns about the banks' shape made numerous bank depositors withdraw their money. When the panic started spreading across the public, the deposit withdrawals grew into bank runs, which in a matter of months dried the U.S. banking system. 'The failure of 256 banks with $180 millions of deposits in November 1930 was followed by the failure of 352 with over $370 million of deposits in December, the most dramatic being the failure of the Bank of United States with over $200 million deposits'. Collapse of a bank, with such a distinctive name ended up spreading even more panic around the public.

One cannot say that the Federal Reserve was not aware of the unsound shape of the banking system and the need for its own intervention. In fact, the monetary base rose by 5 per cent from October 1930 through January 1931, partly due to an increase in the Fed's credit outstanding. However, again these attempts were least to say, too modest leading to the continuance of widespread deposit withdrawals and collapse of the banking system. At the beginning of 1931 there was a sign of improvement in some areas of economic activity. However, a short-lived revival of confidence and slight increase in the money supply was soon taken over by the next wave of banking panics. Moreover, failure of numerous banks abroad, especially Austria's Kreditanstalt, intensified the crisis. Ironically, these events abroad had a positive effect as well, since those events invigorated capital flows to the United States.

As in the case of the first banking panic monetary base was increasing, yet it was not enough to offset the effect of reduction in bank deposits. This time the 4 per cent increase in monetary base was almost entirely produced by gold inflows, whereas before it was partially produced by Federal Reserve's measures.

Almost the only Fed's contribution in money supply was further decline in the New York Reserve Bank discount rate in May 1931, which did not stimulate borrowing as expected. Furthermore, as soon as Britain departed from the Gold Standard the gold flows to the U.S. ceased and the Federal Reserve had to increase sharply the discount rate to attract gold. The Federal Reserve's open market purchases of the government bonds in April 1932 could not offset the effect of gold drain that was accompanied with continuous downward trend of deposit ratios.

**Figure 2: U.S. Money Supply (M1) and Currency held by the public, monthly, 1929-March (billion pounds)**




Source: Friedman, M., Schwartz A.J., ‘A Monetary History of the United States 1867-1960’, Princeton University Press, 1993, pp. 712-714

The third banking panic of 1933 was the final attack of the banking system, with extensive deposit withdrawals and gold outflows. The Fed increased the discount rate to stop the drain, but did not extend its open market purchases sufficiently. Throughout the three banking crises the ratio of deposits to currency, as well as the deposit-reserve ratio declined from 11.5 and 12.9 respectively in October 1930 to 4.4 and 8.4 respectively in March 1933. As a result, the stock of money suffered impetuous downfall throughout the period [Figure 2].

So, why did not the Fed take more intensive measures and did not increase the money supply? Friedman and Schwartz (1963) argue that the authorities did not increase the high-powered money component so that it would offset the decrease in the money multiplier because of its unwillingness to engage in open market operations of that scale. In fact they could have produced any desirable growth in money supply. Hetzel (2008) supported this argument quoting Governor Harrison, who believed that the operations conducted by the Fed would be enough to increase confidence and give rise to self-fulfilling recovery. However, according to Eichengreen (2008), the Federal Reserve was prevented from taking more aggressive measures by the priority it attached to the rules of the Gold Standard. In fact, if the System's commitment to the Standard became questionable this might have caused fear among foreign investors and consequential gold outflows, which in turn would further dry up the scarce liquidity in the banking system.

Another tool the Federal Reserve could have used was suspension of deposits convertibility. This practice was used before the establishment of the Federal Reserve, when the '...loose organizations of urban banks called clearing houses...' initiated suspension of convertibility of bank deposits in order to make liquidations unnecessary. However, the Fed did not adopt that practice. According to Friedman and Schwartz (1963), had the authorities suspended the convertibility and stopped the domino effect of asset sales it would almost certainly have prevented the following waves of bank failures.

Although the Fed’s failures seem evident, yet it does not assure us in any way that had the Federal Reserve avoided these failures there would have been no depression. Peter Temin (1989), for example, considered the fall in money supply not as a reason, but as a consequence of the depression, as a result of the falling consumption. Here the real source of the crisis is not the Fed’s inability to keep the money supply stable. However, Temin still recognized that the general policy of the Fed depressed the economy and definitely exacerbated a national crisis into a global crisis. Thus, change in the Fed’s monetary policy response could have helped. Even if the fall in money supply was a response to the fall in consumption, stimulating the economy through money supply increase could have been more effective than inaction.

In the prevailing conditions it was not until mid-1933 that a positive trend in economic indicators took place. To a large extend it was a consequence of monetary expansion. However, according to Romer (1992), it was not Federal Reserve that established this expansion, as the Fed's credit did not increase. Rather the increase in high-powered money was exogenous, as the devalued dollar attracted more gold flows to the U.S. 'The monetary gold stock nearly doubled between December 1933 and July 1934 and then increased at an average annual rate of nearly 15 percent between December 1934 and December 1941.

### 3.2 British Monetary Policy Response to the Crisis of 1929

As in the case of the United States the factors that led the British economy into the depression are still discussed. Broadberry (1986) interpreted British economic downturn as due to aggregate demand fluctuations. Within that Broadberry emphasizes the role of real and monetary forces during 1919-21, real forces during 1929-31, and monetary forces during 1929-1931. Indeed it seems that the role of real forces was significant at the time. However, it seems to be true for the whole period of the restored Gold Standard. The decision to return to the Gold Standard at the pre-war parity determined British economic instability of the next years.

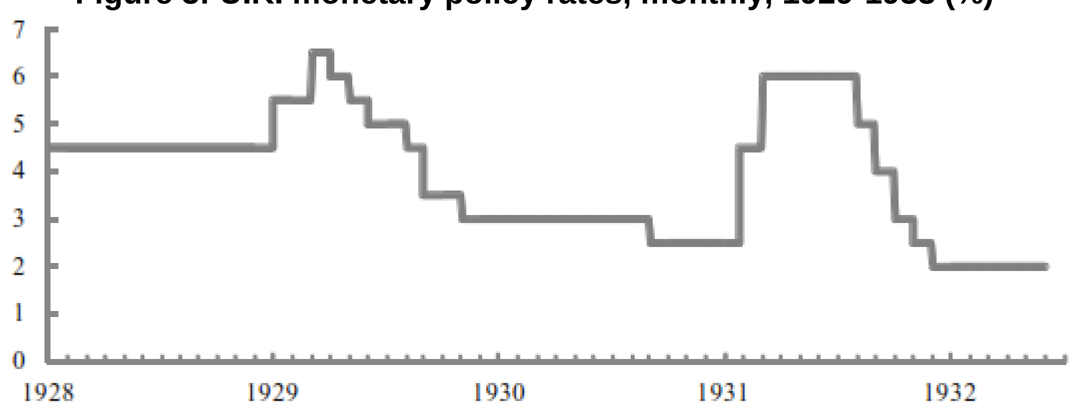
In the words of Moggridge (1972), '[t]he tendency to simplify the decision to one of the gold at a given rate or no gold at all, rather than to consider the possibility of gold at alternative rates of exchange, represents one of the most tragic aspects of the decision making process'. The British balance of payments situation was impetuously deteriorating ever since the measures to re-establish the pre-war parity took place.

According to Maizels, from 1913 to 1929 prices for British manufactured exports overgrew that of competitors by 13 per cent and as a result Britain's share in the world trade dropped from 30.2 to 23.0 per cent. Starting from 1929, this was further aggravated by fall in demand due to spread of the depression to America and other countries. Given the British traditional dependence on export this drove the economy into a deep recession.

On further research one sees that the adjustment to the new Gold Standard for Britain was indeed more painful than it appeared. Although the Bank Rate was reduced to 4 per cent in October 1925, in December it was moved back to 5 percent. Monetary tightening was primarily forced by continuous gold drain. The gold flow to France with the undervalued *franc* was the most prominent reason. As Temin observes, when in 1927 the US reduced the discount rate to support the sterling, France was the principal beneficiary. With the rise of the Federal Reserve discount rate in 1928, Britain faced even more considerable reserve losses and started interest rate hikes [Figure 3].
*Although similar in some symptoms, the British crisis was different from that in the US and the monetary policy response differed as well.*

Quite contrary to the US, the collapse of the stock exchange in Britain did not produce damage of the same magnitude. One of the key reasons for that was that British household portfolios mainly contained government securities. Thus, declining stock prices per se did not deteriorate the economic situation in the country. Antagonistically, it allowed the Bank of England ease its policy and gave the economy a gulp of fresh air.

**Figure 3: U.K. monetary policy rates, monthly, 1929-1933 (%)**




Source: Bank of England

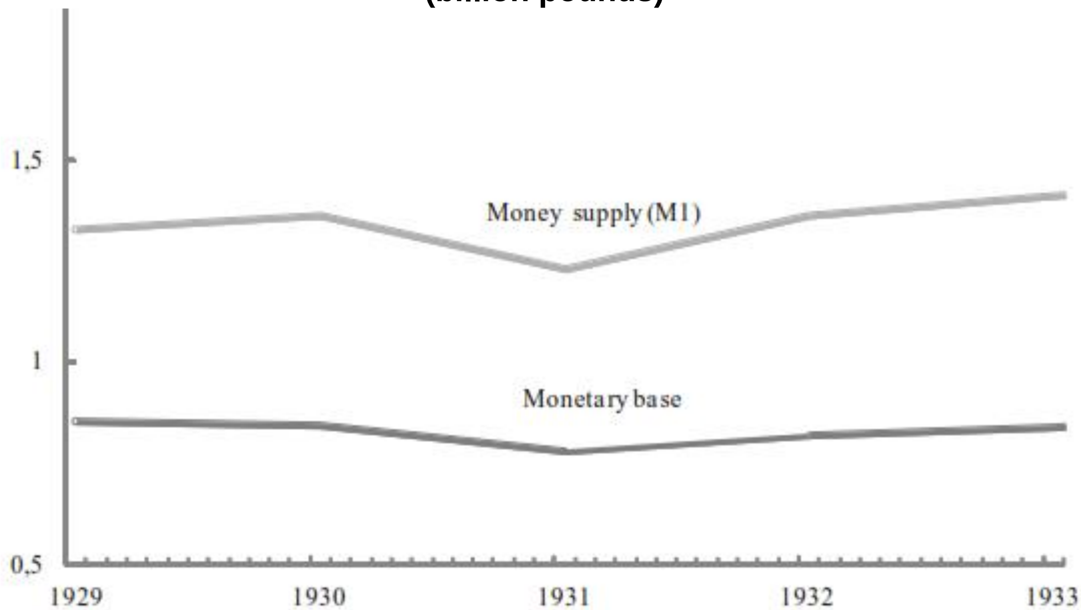
Following the decline in New York rates, the Bank Rate of 6.5 per cent was gradually reduced to 3 per cent by May 1930 [Figure 3]. Surely in the economic environment that prevailed at that time in Britain, further reductions would have been preferable. However, the devotion to the pre-war par substantially limited the Bank's capacity to follow that direction. It was only in March 1931 that the bank further reduced the rate to 2.5 per cent.

The depression in the two countries differed also in the sense that there was no such a massive banking crisis in Britain like in the US. Unlike the US system that consisted of thousands of small, single-unit banks, banks in Britain were usually bigger, with multiple branches over the country. This geographical diversification, according to Roselli, lowered the systemic risk and made it more stable.

Eichengreen in his book *'Globalizaing Capital*' emphasizes the loose connections of British banks within their industry, which made them less vulnerable to industrial slump. In fact, as Roselli showed, from 1929 to 1932 while the industrial output contracted by 20 per cent, the financial sector product grew by 5.8 per cent. Britain did not sink into the US-scale banking panics, and the Bank of England did not have to get involved in large-scale interventions.

However, the Bank did organize liquidity provision for the non-financial sector. As mentioned above, the crisis in Britain mainly depressed the industrial sector of the economy. The drying up of exports after 1929 pulled the enterprises into bankruptcies or reorganization. The Bank of England intervened in 1930 with establishing the Bankers' Industrial Development Corporation. Through this entity the Bank could provide liquidity to enterprises that were on the way of restructuring their businesses. One of the examples of this was the Bank's provision of financing to the armament-maker company, Armstrong, Withworth & Co., which was under way of diversifying its business at the post-war period. As a consequence of the sustainable banking system and the Bank's support of the industry the money multiplier remained stable for the entire period of the depression. Although, the money supply did decrease slightly by 1931 [Figure 4], according to Bernanke, largely due to gold outflow, following British suspension of the Gold Standard it returned to growth. This stays in contrast with the outrageous and prolonged money supply fall in the US.

**Figure 4: U.K. Money Supply (M1) and Monetary base, yearly, 1929-1933 (billion pounds)**




Source: Bernanke, B., 'The macroeconomics of the Great Depression: A Comparative Approach', Journal of Money, Credit and Banking, vol. 27(1), 1995, p. 9

Even though Britain did not witness the catastrophic collapse of its banking and industrial sector like the USA, by mid-1931 the country's economy was still quite shattered. Furthermore, the Bank of England could not control the gold drain any more. It increased the Bank Rate twice during the summer of 1931, which, as Cairncross and Eichengreen (1983) believed, should have more than offset the outflows. However, the outflows continued. By that time, the policy of the Bank of England was more concerned with the domestic needs, rather than with following the *rules of the game*. The interest rate hikes, on account of the worsening economy, further increasing unemployment rates with the increase in the cost of government debt only added more trouble to the existing financial woes for Britain.

Despite the reluctance to lose the 'prestige' and foreign investors, as well as fear of inflation on 20 September 1931 the Bank suspended convertibility of gold and the next day the Gold Standard was abandoned. By the end of the year sterling depreciated by 30 per cent, reaching the point of $3.24 in December. The era of the Gold Standard in Britain was over.

Undoubtedly, the end of the Gold Standard was the major step towards British recovery. As Middleton (2010) puts it, *'[i]n the following 9 months [after devaluation] there then occurred reorientation of economic policy that impacted on each element of the monetary policy tri-lemma'*. The Bank Rate was temporarily increased to 6 per cent in order to attract capital flows and to overcome the anxiety period. Within the next half a year it was reduced to 2 per cent.

The recovery seen in the 1930s did not take place until control over monetary policy moved from the Bank to the Treasury, as 'cheap money' and price level increase were in the interest of the latter. This change was important for two reasons. *First*, it symbolized the onset of independent monetary policy, which was non-existent before. *Second*, cheap money played a very important role in British economic recovery as it stimulated investment. Between 1932 and 1934 non-housing investment and housing investment increased by 15.2 and 47.3 per cent respectively.

### 3.3 The U.S. Monetary Policy Response to the Crisis of 2008

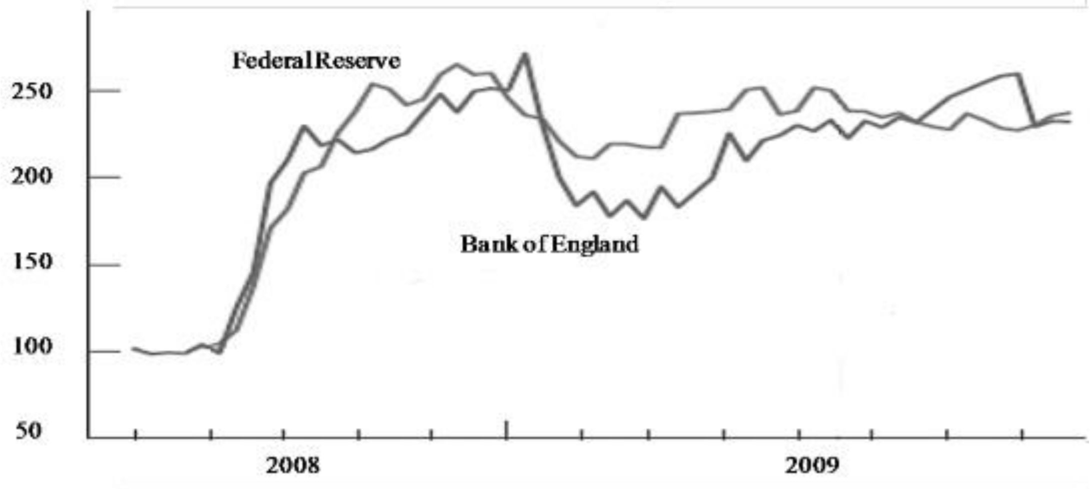
The severity of the crisis and history lessons induced a rather aggressive response by the monetary authorities. The strategy of the Federal Reserve was proactive and better structured than in 1929. First of all, the central bank engaged in profound liquidity provisions and sharp reduction in interest rates to limit the scale of the crisis and cushion the economic downfall. These measures became more pronounced after collapse of Lehman Brothers, which, although did not represent the 1930s banking crisis, created a large-scale panic in the financial system.

Due to earlier and more pronounced symptoms of the upcoming crisis the Federal Reserve discount rate was first reduced in August 2007 and reached the level of 1.75 per cent by October 2008 and a near-zero point by the end of 2008, which is still valid in 2012. This pro-active attitude for sure stayed in contrast with the rather re-active and modest rate cuts during the time of the Depression, during which the discount rate reached the level of 1.5 per cent before it jumped back. Yet the Fed believed that the policy rate was still too high and further reduction of the rate to minus 5 per cent would be helpful. Miller and Stiglitz (2010) pointed two factors that restrain the efficiency of rate cuts: *its limited scale* and *the range of agents benefiting*.

To reduce inefficiency, the central banks went further and expanded the short-term stimulus through liquidity injections. The Fed began unparalleled scale of lending against risky collateral of the banks. However, due to significant share of non-bank financial institutions that were affected by the tough economic conditions, this program was extended to cover a range of other agents. Although it did not finance industrial entities as the Bank of England did in the 1930s, still these actions of the Federal Reserve could be well described in the words of Paul Volcker, as heading to the *'very edge of its lawful and implied powers'*.

All in all, the balance sheets of the central banks doubled in size in a matter of weeks [evident through Figure 5]. If we go in the direction of Friedman and Schwartz and take the monetary base and the money supply as indicators, then this policy seems very efficient. In contrast to the post-1929 period, the US money supply did not fall during the crisis, instead it continued the pre-crisis growth. This rapid and large-scale increase in the monetary base clearly played a crucial role in avoiding the wholesale seizure of the global financial system.

**Figure 5: Central Banks' total liabilities (August 2008=100)**




Source: Bank of England Quarterly Bulletin 2009 Q3

However, as Bean (2009) shows in his research on this, due to de-leveraging of the financial system the monetary policy transmission mechanism was weaker than before the crisis and the conventional monetary instruments did not produce the expected result. Despite the rate cuts taken by the Federal Reserve the interest rate applicable to businesses and households increased as a result of growing credit spreads.

*'Credit spreads went through the roof…with the Treasury Bill-to- Eurodollar rate (TED) spread…going from around 40 basis points…before the crisis to over 450 basis points, highest value in its history'.* In addition, to this a short-term policy rate is not seen as an effective tool in influencing decisions of the private sector. Hence, more stimulus covering longer-term perspective was needed at the time.

To address these issues the Federal Reserve resorted to an unconventional monetary policy tool, ***Quantitative Easing (QE)***, that aimed at lowering the longer-term rates and through pushing reserves into the banking system increase the money supply. The process involved large-scale secondary market purchases of government and private sector bonds with long-term -maturities by the central banks. Purchases of the government assets pushed the bond yields down, whereas purchases of private assets reduced the credit spreads.

In this respect, the US approach is often referred to as Credit Easing, as it focuses on improving functioning of private credit markets through purchases of corporate securities. According to Meier (2009), this strategy improve access to financial markets by the private sector, however it would expose the central bank to significant credit risk. The Quantitative Easing program of the United States was large both, in its scale and its scope. The first round began in March 2009 and consisted of purchases of $1.75 trillion worth securities, including $300 billion of long-term government bonds, $200 billion in government-sponsored enterprises debt and 1.25 trillion in mortgage backed securities. This was to improve general availability of credit in the private market, as well as to provide liquidity to mortgage and housing markets. The following round of the program that took place at the end of 2010 was intended to strengthen general economic recovery in the country. Thus, the Fed extended its portfolio with $600billion worth of long-term Treasury securities driving the volume of the program above $2.3 trillion.

In late 2011 the Fed continued its downward pressure on the long-term interest rate through its Maturity Extension Program. This was to affect discretely the long-term interest rates, leaving the money supply unchanged. In addition to that in early 2012 the Federal Reserve began discussion of a third type of strategy. Known as 'sterilized' QE, this approach involved the Federal Reserve printing money and buying long-term securities, however, effectively locking up the money, as it borrows the money back from investors for a short period of time at low interest. The effect of the program is similar to that of the Maturity Extension Program; they both represent a sterilized purchase of assets that rebalances the private portfolios.

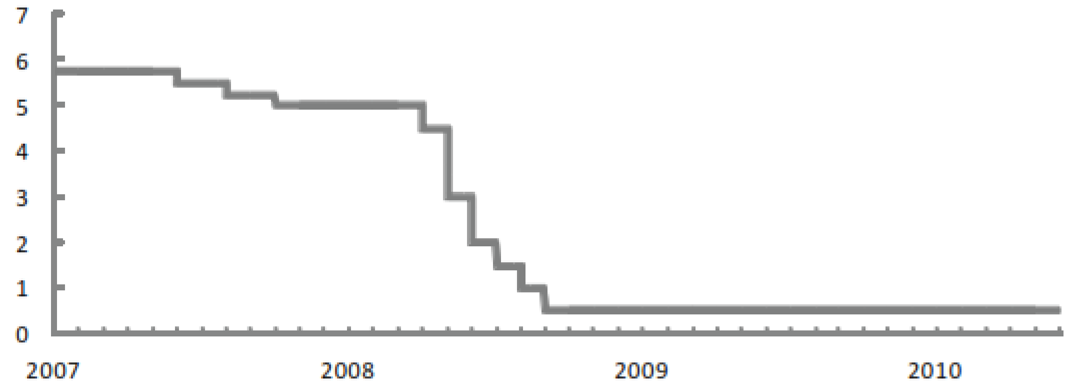
However, is the hope that Quantitative Easing alone could help the U.S. out of the crisis well-grounded? Krugman argued with the opinion of Friedman and others that QE is a panacea in the current conditions. He used the experience of Japan to demonstrate that outstanding increase in monetary base through QE per se does not necessarily lead to rise of the money supply and economic recovery. If this is the case, then the whole idea of the Fed's control over money can become questionable and our expectations of the efficiency of the QE program might be not satisfied. The Quantitative Easing however, was not the only tool in dealing with the longer-term crisis problem. Providing commitment to keep the policy rate low for a prolonged period of time is another one that the Federal Reserve applied. According to Bean (2009),*'The idea behind providing such commitments is that they…pull down market interest rates further out along the yield curve and raise expected future inflation'*. This is supported with the evidence, provided by Bernanke et al. (2004), of a considerable impact of the Fed's communication on expected future policy rate.

### 3.4 British Monetary Policy Response to the Crisis of 2008

In 2008 Britain experienced a crisis in a number of ways similar to what the country experienced 80 years earlier. All over again it was a recession with 7 per cent fall in GDP, fragile growth during recovery and interest rates close to the lower bound. In this the earlier experience did provide useful lessons for dealing with the crisis this time around. But for the British the origin and symptoms of the crisis seemed to be the one that were quite similar to what America was experiencing at the time. As a result, the approach of the two was very similar which allowed history to repeat itself all over again after 80 years.

The Bank of England began its crisis management program by reducing the official interest rate from 5.75 per cent in December 2007 and by the time the US rate bottomed the Bank rate was still around 2 per cent. However, by March 2009 the Bank rate effectively reached the zero bound [Figure 6]. Relative to the period of the Great Depression when the interest rate was gradually reduced by 4 per cent over an 18-month period, in the recent crisis the reduction was more aggressive with a 5.25 per cent cut over 15 months of crisis. Furthermore, the interest rate went effectively to the lowest possible level in March 2009, thus the period of cheap money came much earlier. The contemporary discretionary monetary policy with no 'golden fetters' attached let the Bank reduce the rate much more aggressively than during the Great Depression.

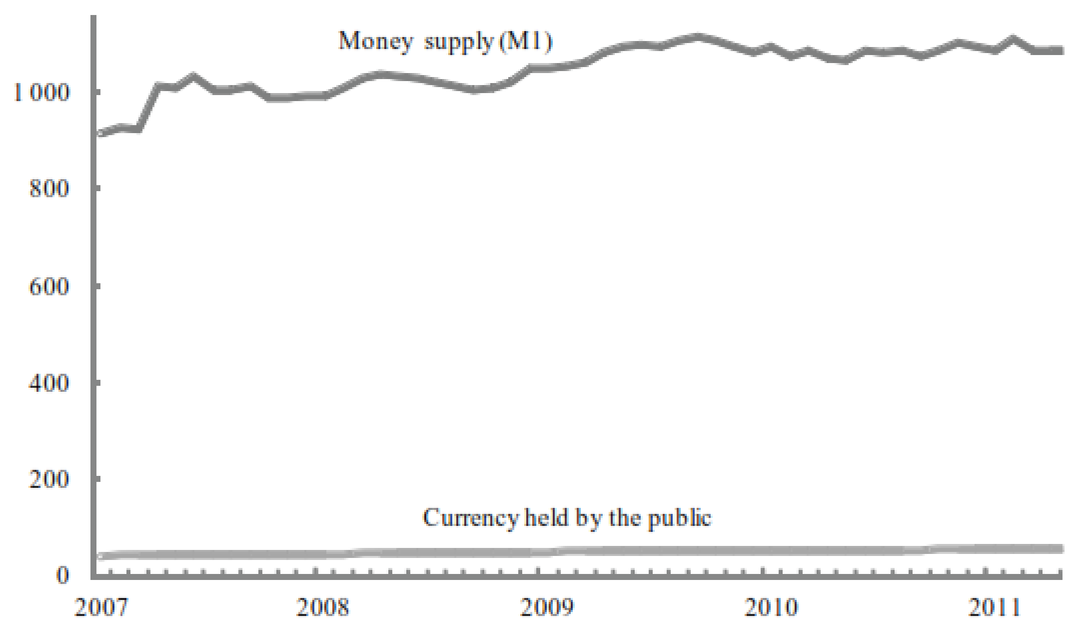
**Figure 6: U.K. monetary policy rates, monthly, 2007-2011 (%)**




Source: Bank of England

Along with the Federal Reserve, the Bank of England began unparalleled scale of lending against risky collateral of the banks [Figure 5]. This was done primarily to reduce the systemic risk through assuring that the central bank stands ready to assist the financial institutions, should they have any problem of meeting their demand for cash, thus '…preserve the well-functioning of the banking system…'80. These measures appeared to be helpful as the UK financial system did not suffer from lack of liquidity, nor did it face large-scale panics of bank depositors or foreign investors. Similar to the US, Britain managed to keep the money supply (M1) growing [Figure 7].

**Figure 7: U.K. Money supply (M1) and Currency held by the public, monthly, 2007-2012 (billion pounds)**




Source: Bank of England

Following interest rate cuts and liquidity injections the Bank of England started its Quantitative Easing, the final target of which, according to the Bank *was '…to stimulate nominal spending and thereby domestically generated inflation'*. The Fed and the Bank of England implemented this strategy with different emphases on private and public sector assets, reflecting different financial market structure, where the former had an increased share of corporate assets relative to the latter. This was often mentioned as a weakness of the Bank's policy, as it was primarily concerned with the safety, thus, waiving an important stimulus for the private sector. Although British monetary policy has used a number of conventional and unconventional instruments to stimulate recovery, the economic growth has still been sluggish. As the money supply declined by 1.4% in December 2011 and households continued deleveraging.

A number of economists expected the Bank to continue the Quantitative Easing program. However, latest data suggests that there is unwillingness to spend in the recent circumstances because of increased fiscal austerity and high unemployment. QE here might not be the most effective measure in the longer run.

In support of this, Crafts (2011) suggested that substituting a modern equivalent of *cheap money policy* (making the real interest rates negative through low nominal rates and high inflation expectations) for further QE with a 2 per cent inflation target would deliver more stimuli. To do this it is essential to create credible expectations of higher inflation, so that the real interest rate would go down. Results of the cheap money policy however, are likely to be smaller than in the 1930s due to smaller output gap and continuing pressure from the Eurozone crisis. Nevertheless, this could be a valuable hint for the policy-makers, especially at the time when the decision on continuing the QE program is to be made.

## 4. Conclusion

So, was *monetary policy* an efficient antidote to the crisis of 1930? So far, from the literature studied and the analysis put forth the most obvious answer that emerges is a negative one. Both the Federal Reserve and the Bank of England contributed to the downfall through some rash measures (especially in the 1930s as compared to the 2000s) and thereby failed in efficiently implementing the role of a crisis preventer and manager. It was a combination of factors, including the problem related to the 'golden fetters', serious policy mistakes and lack of hegemonic experience at the hands of the Fed and Bank of England that led to inadequate monetary response in the 1930s.

Comparing the two authorities, however, it seems that the Bank of England was relatively more efficient, as it seemed to address some of the major problems in hand at the time, in particular to that related to the impact of the crisis on its' overall industry. The Federal Reserve, on the other hand, failed in its major mission of saving the banking system from the panics in both the crises. Had it been more efficient in this respect, the Great Depression could have been reverted or mellowed down in the form of a cyclical downturn at least.

Nonetheless, the monetary authorities seem to have definitely evolved over time with a better crisis tool kit at their disposal. By 2008 they had become experienced and rather prudent as independent institutions. The approaches of the Federal Reserve and the Bank of England converged, as their toolkit was largely similar and the attitude was very proactive in both cases. The measures taken (in case of the recent crisis to say) have been quite effective, since there has been no free-fall of the economies as to what happened in the 1930s and the general deterioration of the conditions has been more or less put at rest.

Yet, a lot needs to be done by central banks and international financial institutions like the IMF (the role of which I have not explored in this paper) in becoming better crisis preventers and act as effective watchdogs in monitoring the fault lines within the global financial system. It is critical to consider application of other tools and strategies, rather than relying only on the same existing ones in dealing with the complex problems related to an economy's financial system.

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