

## Commentary

### The Fed Responds to Crisis.....in 1929

In August 1929, the Federal Reserve raised the New York Fed Discount Rate from 5% to 6%. This Discount Rate was the main Fed policy interest rate. Their reasoning on raising this rate was to curb the “speculative froth” of the stock market. The market had already had a crash scare in March of 1929 and the New York Fed didn’t want another one. The market was making new highs all summer and the Fed wanted to manufacture a “soft landing” and decided raising rates was the right policy. We all know what happened to stocks in October 1929, but in the course of my research, I found what the Fed did in reaction to the 1929 economic crisis incredibly interesting.

The 1929 market crash was just one event in a series of events that started us down the depression path. In 1929 and even well into 1930, within the halls of Washington, the worsening economic events were called the banking crisis. In March, 1930, President Hoover proclaimed “prosperity was just around the corner” and in December, he even proposed raising taxes to help rub out the mushrooming deficit. But by November 1929, the Fed had an inclination that things were bad and they needed to do something. So, they decided to lower the Fed rate. By the start of 1930, the New York Fed rate was down from 6% to 4.5%. The Bank of England decided to coordinate its efforts with the New York Fed and also started lowering its Base Rate. At first, the market reacted favorably as the stock market came off the lows established during the crash and rallied back up 52% and stood only 20% from its all time high. But as the market started to weaken, the Fed reacted again by providing lower interest rates to the economy. By the summer of 1931, the stock market had reestablished brand new lows and the Fed rate was pushed down in a dramatic fashion, standing at 1.50%. The Bank of England’s Base Rate was also at a new low, hitting 2.5%. The financial centers of the world were experiencing a major drop in a major asset class, in

this case the stock market and the Federal Reserves of both countries not only lowered rates to try and stop the declines, but did so in a historic fashion.

In the summer of 1931, the runs on these countries currencies began. Since Britain had the strongest currency, the selling began with the British Pound. The Bank of England’s reluctant response was to increase their interest rates to support their currency. One of the ways a country supports their currency is to raise their interest rates. The theory here is by having higher interest rates in your country more people will buy and hold your currency therefore supporting it. By July 1931, the Bank of England raised rates by 2 full percentage points to 4.5%. The run on the Pound eased for a while but then reaccelerated and by September 1931, their rate had climbed all the way back up to 6%.

In the US, many expected the New York Fed would raise rates to defend its currency as well. And they did. This currency contagion swept through the industrialized world and by October 1931, US rates had more than doubled climbing back up to 3.5%. The summer of 1931 proved to be the real beginning of the great depression.

The reason behind this history lesson should be apparent. The eerie similarities between what we are experiencing today verses 1929, and more important, the Fed’s reactions to the events are interesting cocktail party talk at the least. At the most, they should serve as a blueprint of what not to do. Compare the 1929 stock market crash with the 2007 housing collapse, coupled with the 1929 and 2007 Fed interest rate lowering reactions and you can start to connect some pretty scary dots as to where we may be going next.

The Fed’s solutions to the problems of 1929 are similar to today. Using the 1931 model as a guide, the Fed will keep responding to negative events by continuing to lower rates. As they do, the dollar will

come under renewed pressure, just as the Pound did in 1929. The Fed will have to make the same critical decision that the Bank of England did in 1931. They may have no option but to raise rates to protect the dollar and risk a deeper and longer recession.

The defining moment of the great depression was not the 1929 market crash; it was the run on the banks that started in 1930 and the raising of interest rates

during these runs into 1931. The defining moment of this economic crisis may not be the 2007 real estate collapse, but what decisions the Fed makes in response. And if history is a guide, the defining moment and these decisions still lie ahead.

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