A Lesson from the Great Depression that the Fed Might have Learned: A Comparison of the 1932 Open Market Purchases with Quantitative Easing

Michael Bordo[1]

(Department of Economics, Rutgers University)

Arunima Sinha[2]

(Department of Economics, Fordham University)

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Abstract

Following the financial crisis of 2007-09, there has been considerable debate about the effectiveness of the Quantitative Easing programs of the Federal Reserve, and their significance for the economic recovery. In this analysis, we examine the first QE program through the lens of an open-market operation undertaken by the Federal Reserve in 1932, at the height of the Great Depression. This program entailed large purchases of medium- and long-term securities over a four-month period. There were no prior announcements about the size or composition of the operation, how long it would be put in place, and the program ended abruptly. We first conduct an empirical analysis of the asset purchase programs. To do this, we construct a dataset with weekly-level Treasury holdings of the Federal Reserve in 1932, and the corresponding yields. Results from the event study indicate that the 1932 program significantly lowered medium- and long-term Treasury yields. QE1 has similar effects on Treasury yields, as found by other recent analyses (Krishnamurthy and Vissing-Jorgensen,

[1]Email: bordo@economics.rutgers.edu. Contact: New Jersey Hall, 75 Hamilton Street, New Brunswick, NJ 08901.

[2]Email: asinha3@fordham.edu. Contact: 113 W 60th street, Lowenstein building Rm 924, New York, NY 10024.

2012). Given the similar states of the U.S. economy at the time of implementation of the 1932 and 2008 programs, the former operation is a unique monetary policy experiment for providing insights into the different aspects of QE1: the importance of forward guidance, the significance of debt magnitude and its maturity composition, and the effects of these asset purchases on the economy. To examine the importance of these channels, we use the segmented markets model of Andrés, López-Salido and Nelson (2004), in which unrestricted households face transaction costs while buying long-term bonds. Quarterly data from 1920-32 is used to estimate the model with Bayesian methods, employing the methodology of Chen, Cúrdia and Ferrero (2012). Several results emerge from the analysis including: (a) if the average debt maturity in the economy is medium- instead of long-term, the asset purchase program has a larger positive effect on output; (b) if the program duration is credibly announced to be of a longer duration, the increase in output following the purchase program is larger on impact, and persists for longer.