

# Birth of a Modern Money Market: the Federal Reserve and Interest Rate Determination on the Eve of the Great Depression

Mark Carlson & Chris Hanes

Discussion by Sriya Anbil  
Board of Governors of the Federal Reserve

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# Overview

## Research Question

- ▶ How was monetary policy implemented in the late 1920s–early 1930s?

## Main Claim

- ▶ The interwar money market was already “modern”:
  - ▶ Overnight rate determined by reserve supply and demand
  - ▶ Other rates driven by expected future overnight rates
  - ▶ Early 1930s represent a liquidity trap (ELB)

## Approach

- ▶ Inventory-theoretic model adapted to bank reserve demand
- ▶ Use Treasury payment flows to study reserve shocks and rate responses

# Contribution

## 1. Reinterpretation of how monetary policy was implemented

- ▶ Riefiler–Burgess (borrowing-based transmission)
- ▶ Monetarist interpretations (rates secondary)

Argues policy worked through interest rates, not borrowing

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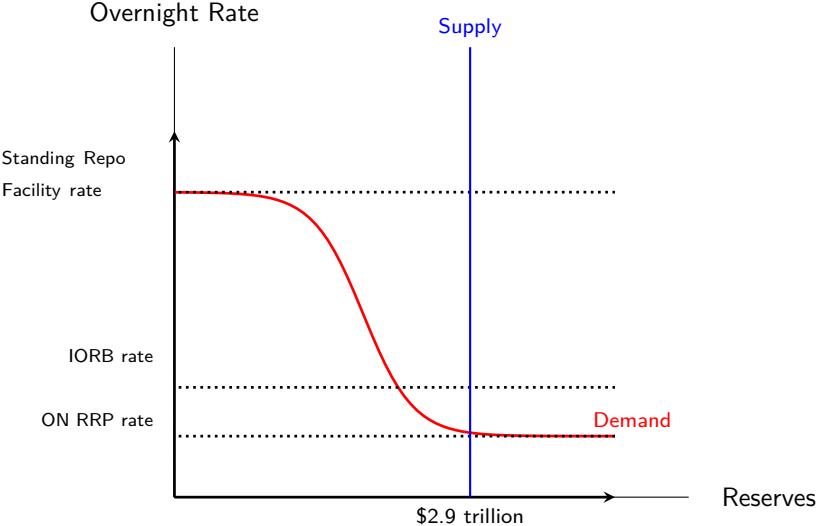
## 2. Implementation was “modern”

- ▶ Maps system into a corridor-style framework
- ▶ Interprets 1932 as a true effective lower bound (ELB) episode

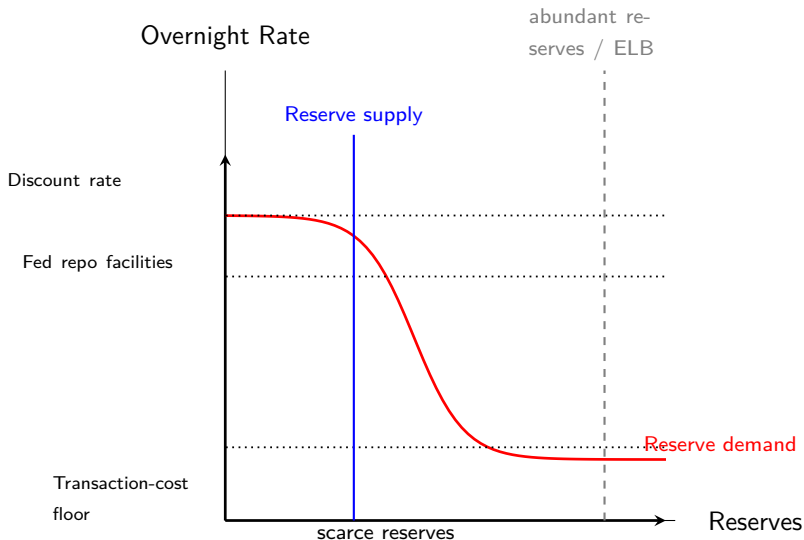
## 3. Empirical Contribution

- ▶ Uses variation in Treasury payment flows as reserve shocks
- ▶ Documents co-movement of reserves and interest rates
- ▶ Provides evidence consistent with lower-bound behavior

# Current Ample Reserves Framework



# 1920s Ceiling Implementation Framework



# Comment 1: What is the Relevant Market Rate?

## Key Tension

- ▶ The paper treats the fed funds rate as the central price of liquidity
- ▶ But in the late 1920s:
  - ▶ Fed funds trading was limited and concentrated in New York
  - ▶ The dominant money market was call money

# Comment 1: What is the Relevant Market Rate?

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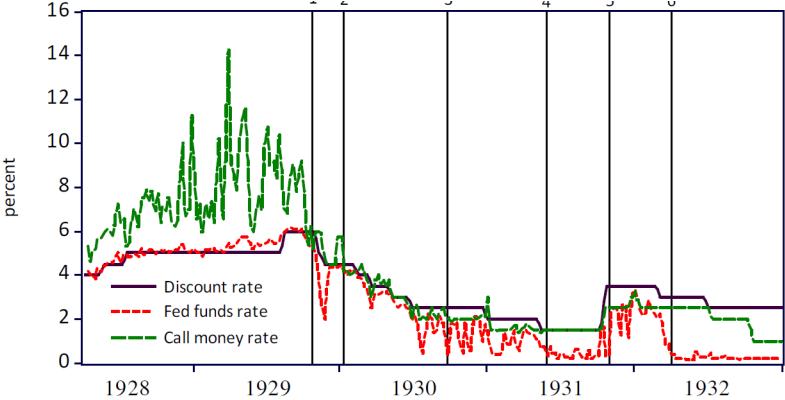
## Measurement Issue

- ▶ We do not observe a clean market-clearing call money rate
  - ▶ NYSE rates were often administered or pegged
  - ▶ “Street” rates are not systematically available

## Implication

- ▶ It is difficult to establish which rate was the marginal price of liquidity
- ▶ Raises the question of whether policymakers were responding to a market-determined rate

# Federal Funds Rate vs. Call Money Rate



## Comment 2: Identification and Treasury Shocks

### Empirical Strategy

- ▶ Uses Treasury payment flows as exogenous variation in reserves
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### Concern

- ▶ How do we distinguish between:
  - ▶ Riefler–Burgess (borrowing-based transmission)
  - ▶ Modern view (rate-based transmission)

### What is Missing?

- ▶ A more explicit IV / 2SLS approach:
  - ▶ Instrument reserves with Treasury shocks
  - ▶ Estimate effect on the relevant market rate

## Comment 3: Interpreting the 1932 Bond Purchases

### Mark & Chris Interpretation

- ▶ Bond purchases begin when the fed funds rate reaches its lower bound
- ▶ Interpreted as evidence of a modern liquidity trap (ELB)

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## Concern: Persistence and Transmission

- ▶ The 1932 program is short-lived
- ▶ In modern frameworks:
  - ▶ Effects on long-term rates rely on expectations (forward guidance)
- ▶ Would we expect a temporary program to affect longer-term rates?

## Alternative Interpretation

- ▶ Bond purchases as *market functioning* intervention
- ▶ Does not require rates to be at the ELB
- ▶ Consistent with Eichengreen: concerns about gold flows out of New York

# Main Takeaways

## 1. Important Reinterpretation

- ▶ Provides a fresh and compelling perspective about monetary policy implementation in the 1920s
- ▶ Connects historical monetary policy to modern implementation frameworks

## 2. New Empirical Evidence

- ▶ Documents patterns in rates and quantities that align with the framework