Rasheed Saleuddin (Cambridge)

‘Shadow credit, the Fed and the Crash of 1929’

The Crash of 1929 (Crash) remains in the minds of the general investing public and academics as the quintessential stock market boom and bust. Several bubbles and corrections in recent years have resulted in tremendous costs to society, yet there are few crashes for economic historians to study. It is, therefore, worth examining the historical case of 1928-9 to determine what, if anything, regulators, supervisors and central banks could have done to avoid the extreme instabilities of the period.

Friedman and Schwartz (1963) and many others fault the U.S. Federal Reserve (Fed), the central bank, for holding its discount rate too high to support a slowing real economy, but not raising rates enough to curb the speculative lending on the NYSE. That is, not only did the Fed contribute to the build-up of speculative credit and therefore the so-called stock market “bubble” but also may have influenced the crash by raising rates “too late”.

Identifying the source of the so-called stock market bubble and its effects is important in that it determines our evaluation of the Fed’s response versus the optimal policy prescription. If the lending market on the NYSE had decoupled from other rates including the Fed discount rate, only macro-prudential regulation, by government or industry, could have controlled the flow of credit to the stock exchange.

In the 18 months leading up to the Crash, up to an unprecedented 40 percent of all share investments in the U.S. were purchased using (non-bank) private “shadow” credit available on the floor of the stock exchange. This paper finds such speculative credit market was fueled by a feedback loop that allowed new private money creation–the first shadow banking market during the lifetime of the Fed, effectively bypassing bank credit markets and therefore Fed control. Beginning around the middle of 1928, speculators invested in new securities of US corporations and trusts, and the treasurers of these companies then lent the proceeds of the new issues back to existing or new speculators to purchase more new issue securities, and so on. This new almost unlimited supply of credit put a damper on rate rises such that demand was not stifled. This shadow banking market involved speculators borrowing in the short-term money markets to invest for the long term, with the collateral used to secure the loans marked to market on a daily basis.

This paper applies quantitative methods, specifically involving structural breaks, and archival research to the market for speculative lending to reveal that this system was uncorrelated to and separated from traditional monetary markets and policies. Though the US Federal Reserve has been blamed for not “leaning against” the 1928-9 bubble in the stock market, it had no effective tools and therefore was irrelevant to the market for speculative credit, rather than apathetic or incompetent.