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The Great Depression is the greatest failure of the United States financial system to date. In a speech in 2002, Ben Bernanke, an expert on the subject and former chairman of the Federal Reserve stated: “Regarding the Great Depression, … we did it. We're very sorry. … We won't do it again”.[1] To assess whether the Federal Reserve did in fact play a large role in causing the Great Depression, we must answer two questions. The first question being: What caused the initial economic contraction which grew into the Great Depression? Second and more importantly: Why did this contraction grow into the elongated recession we have coined “Great”? As we will see, the Federal Reserve made a number of errors in both instigating the initial contraction and failing to provide stability to the financial system as the problem progressed, allowing the issue to grow into one of the greatest disasters in American History.

The Great Depression is a series of events whose effects are unrivaled in the depth and length of their impact on every element of the economy. Ben Bernanke gave a lecture on the history and causes of the Great Depression at Washington and Lee University in 2004. In this speech he highlighted the specific economic elements of the Great Depression, “Between 1929 and 1933, real output fell nearly 30% ..... the unemployment rate rose from about 3% to nearly 25%, and many of those lucky enough to have a job were able to work only part-time”. He went on to add that “Other features of the 1929-33 decline included a sharp deflation – prices fell at a rate of nearly 10% per year during the early 1930s – as well as a plummeting stock market, widespread bank failures, and a rash of defaults and bankruptcies by businesses and

[1] Richardson, Gary. *The Great Depression.* Federal Reserve History (The Federal Reserve Bank of St. Louis). 2013

households".[2] It has long been argued that the blame for much of this chaos and economic hardship falls on the many errors the Federal Reserve made throughout the late 1920s and early 1930s.

In the 1960s, Friedman and Schwartz published the book *A Monetary History of the United States* where they examined changes in the money supply in correlation with other economic factors. Through this examination, they developed a theory, pertaining to the origin of the Great Depression and the various Monetary Policy mistakes, which was different from the leading academic thought at the time. Friedman and Schwartz claimed, "The [economic] contraction is in fact a tragic testimonial to the importance of monetary forces".[3] That is to say, the Monetary Policy decisions made by the Federal Reserve were the core reasons behind the economic contraction experienced during the Great Depression. In their analysis of the Fed's actions between 1928 and 1935, Friedman and Schwartz identify four major mistakes the Federal Reserve made which encouraged much of the contraction and chaos that followed.

The first major error Friedman and Schwarz identify occurred at the start of the Depression. To many, the Great Depression officially began on October 29, 1929 also known as Black Monday. On Black Monday, the Dow Jones declined 13% followed by Black Tuesday when the entire stock market fell 12%. For years prior to this, the stock market had become wildly inflated with investors using debt to fuel their speculative investments. This bubble was despised by the Federal Reserve who rightfully feared the use of debt for investment in overvalued and speculative assets. The Fed initially appealed to the banks, warning against

[2] Bernanke, Ben S. *Money, Gold, and the Great Depression*. The Bank for International Settlements. 2004. 1
[3] Friedman, Milton and Anna Jacobson Schwartz. *A Monetary History of the United States, 1867-1960*. Princeton University Press. 1963. 300

loaning to investors and brokers for these types of investments. When this failed, the Fed raised its Federal Funds rate in the Spring of 1928, to further discourage bank loans towards speculation.[4] They continued to raise rates over the next year, raising the policy interest rate a final time in August of 1929 to 6%. While the speculative investing was a valid concern, the economy at the time was not nearly strong enough to handle such steep policy rate increases. In his lecture, Bernanke attributed the slowdown that resulted from this monetary policy mistake to the start of the recession, "The market crash, rather than being the cause of the Depression, as popular legend has it, was in fact largely the result of an economic slowdown and the inappropriate monetary policies that preceded it".[5] Unfortunately, this was not the only time the Federal Reserve errantly raised interest rates in pursuit of an alternate objective without regard for the health of the overarching economy.

The beginning of the Great Depression, 1929 through 1931, were defined by monetary instability and loss of confidence banking system. For the greater part of 1929 and 1930, the Federal reserve failed to stimulate the economy despite a progressively worsening economic situation. A storm of asset price deflation, rising unemployment, and a cloudy global economic outlook caused depositors to loose confidence in the strength of the Dollar. In steps the Federal Reserve with what Friedman and Schwartz identify as the second major error the Fed made in contributing to the Great Depression. In October of 1931, the Fed opted to raise their policy interest rate twice from 1.5% to 3% to encourage investors to keep their money in banks for

[4] Bernanke, Ben S. *Money, Gold, and the Great Depression*. 3
[5] Bernanke, Ben S. *Money, Gold, and the Great Depression*. 3

the higher interest money accrued.[6] The thought was that this would both stabilize the value of the Dollar and reduce the number of Bank runs even though they were imposing a restrictive monetary policy in an already negative economy.[7] Federal Reserve's solution only worked briefly until the further lack of investment, growth, and monetary tightness caught up with the economy. Bank runs and suspensions persisted and even grew in 1932 and 1933, as shown in Figure 1 on the right. As we will see later, the collapse of financial institutions through loss of confidence and insolvency are some of the most impactful and elongating events that can occur during a recession making the Federal Reserve's second mistake, identified by Friedman and Schwartz, dire.

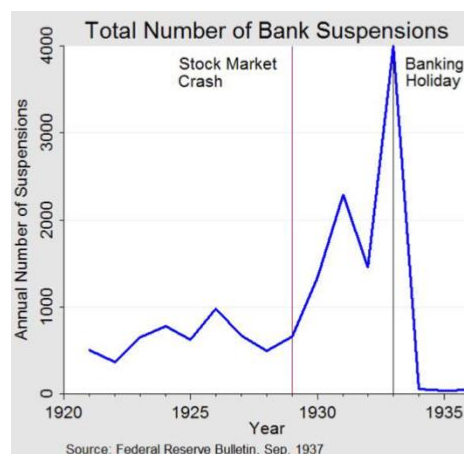

Figure 1: Total Number of Bank Suspensions (Source: Federal Reserve History)

Unfortunately, the Federal Reserve continued to make mistakes which further elongated the already severe recession. Friedman and Schwartz argue that the Fed's third policy mistake was made in 1932. The Fed maintained a belief that loosening monetary policy was not the right move despite the state of the economy. In spite of this, the Fed received pressure from Congress and changed its policy stance to conduct open market operations between April and June of 1932 before reversing its policy in July.[8] This caused public sentiment to further loose trust in the Federal Reserve and the United States economy, negatively

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[6] Romer, Christina D and David H Romar. *Does Monetary Policy Matter? A New Test in the Spirit of Friedman and Schwartz*. NBER 1989. 126

[7] Bernanke, Ben S. *Money, Gold, and the Great Depression*. 4

[8] Bernanke, Ben S. *Money, Gold, and the Great Depression*. 4

affecting growth the rest of the year. The fourth and final mistake Friedman and Schwartz identify the Federal Reserve making occurred throughout the entirety of this depression. That mistake being, their failure to assist the banking sector. As mentioned briefly, the banking sector took tremendous hits throughout the Great Depression adding to the contractions severity and longevity. Bernanke claims that, "Between December 1930 and March 1933, ….., about half U.S. banks either closed or merged with other banks".[9] This fourth mistake by the Fed and the affect it had on the banking industry was by far the Fed's most costly mistake.

The attributes that put the "Great" in Great Recession were its unique length and depth, both of which can be attributed to the financial crises that resulted from the fourth mistake made by the Federal Reserve. During the Great Depression, all three forms of financial crises (banking crises, currency crises, and sovereign debt crises) were experienced in what is referred to as a triple crises event. This is the most severe form of financial crises which happens to be the worst type of shock an economy can face. Friedman and Schwartz identify two core reasons financial crises impact the economy so negatively. The first being the wealth shareholders loose when a bank fails.[10] This was made much worse in the Great Depression due to how inflated the stock market had become in the "Roaring twenties" and because much of the investments into the stock market had been financed through debt further harming the banking system. The second reason financial crises are so detrimental is the dramatic reduction in the money supply which occurs when banks fail.[11] Ben Bernanke won the 2022 Economics Nobel Prize with a third

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[9] Bernanke, Ben S. *Money, Gold, and the Great Depression*. 4
[10] Bernanke, Ben S. *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*. The American Economic Review Vol 73. 1983. 257
[11] Bernanke, Ben S. *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*. 257

reason he added to Friedman and Schwartz's examination of the major impacts financial crises have. This third negative affect being the impact the bankruptcy of debtors has on the Cost of Credit and Intermediation (CCI) and subsequently the effectiveness of the financial system as a whole.[12] Bernanke's argument is essentially that the bankruptcies, defaults, and mass bank closures that occurred between 1930 and 1933, the cost of borrowing rose substantially making it very difficult for many smaller sized lenders (like households, farms, and small businesses) to acquire credit. Bernanke states that the "Effects of this credit squeeze on aggregate demand helped convert the severe but not unprecedented downturn of 1929-30 into a protracted depression".[13] So we have now seen that the four mistakes made by the Federal Reserve both initiated the contraction and elevated its severity, encouraging it to eventually grow into the depression we still remember one hundred years later.

There exists a very well-known phrase "Hindsight is 20/20" which reminds us that it's very easy to critique history with knowledge of its consequences. The Federal Reserve was ill equipped and too divided in the early 1900's to manage a crisis of this magnitude effectivity. With that said, the Fed made four critical mistakes which directly initiated and prolonged the Great Depression. While there are a lot of factors in an economic downturn, there is no denying the Federal Reserve, the U.S. economy's keeper, failed in upholding its commitment to the American people.

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[12] Bernanke, Ben S. *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*. 257

[13] Bernanke, Ben S. *Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression*. 257

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