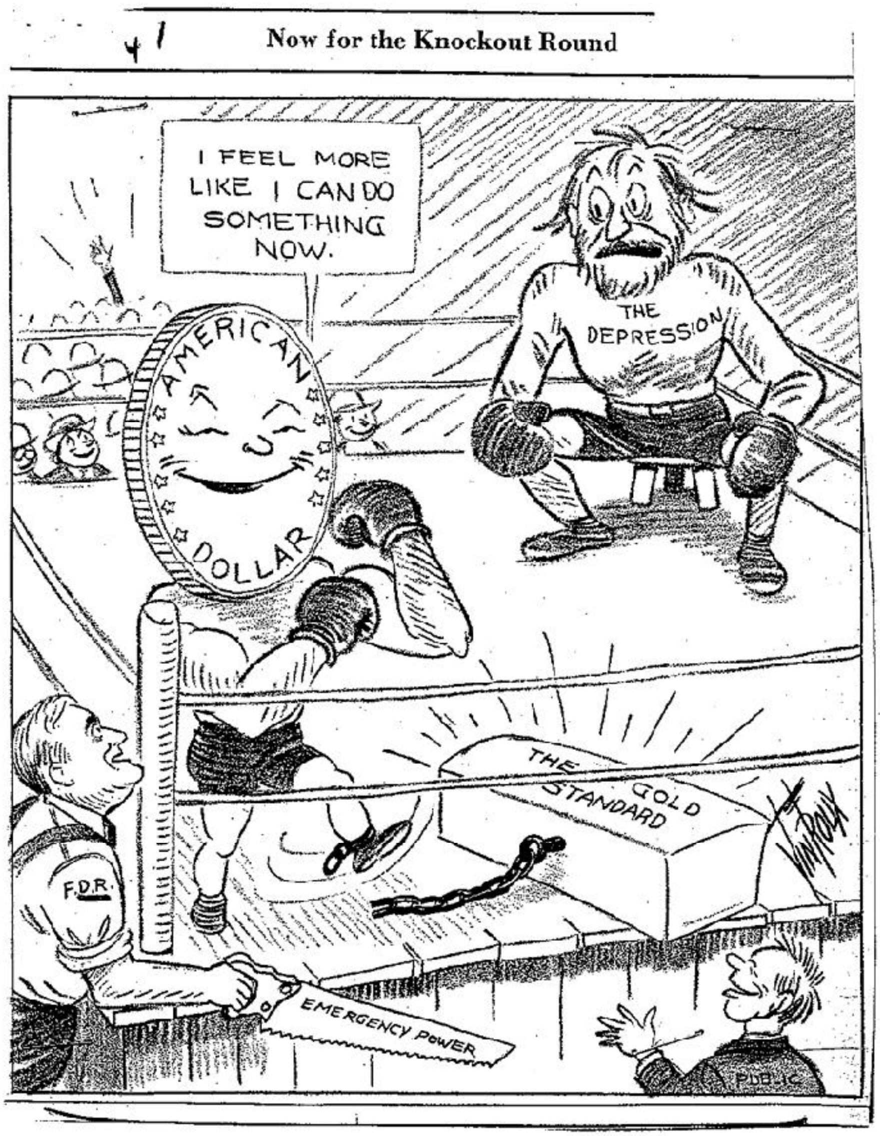
Resource 3 (1 of 5)

The Federal Reserve and the Great Depression



by Kendall Vintroux, April 23, 1933. *The Charleston (W.Va.) Gazette*

Questions to Consider:

- What do you notice about this cartoon?
- What story does it tell about the Great Depression and the role of the Federal Reserve?

Resource 3 (2 of 5)

The Federal Reserve and the Great Depression

The Sower (after Millet)

by Gregor Duncan, April 1934, *Life*

Questions to Consider:

- What do you notice about this cartoon?
- What fiscal policy does it depict?
- How might this complement or contradict the monetary policy recommended by former chairman of the Federal Reserve Ben Bernanke (next reading)?

Resource 3 (3 of 5)

The Federal Reserve and the Great Depression

Remarks by Governor Ben S. Bernanke

At the H. Parker Willis Lecture in Economic Policy, Washington and Lee University, Lexington, Virginia
March 2, 2004

Money, Gold, and the Great Depression

. . . I was a professor myself before coming to the Federal Reserve Board. One topic of particular interest to me as a researcher was the performance of the Federal Reserve in its early days, particularly the part played by the young U.S. central bank in the Great Depression of the 1930s. . . .

The number of people with personal memory of the Great Depression is fast shrinking with the years, and to most of us the Depression is conveyed by grainy, black-and-white images of men in hats and long coats standing in bread lines. However, although the Depression was long ago—October this year will mark the seventy-fifth anniversary of the famous 1929 stock market crash—its influence is still very much with us. In particular, the experience of the Depression helped forge a consensus that the government bears the important responsibility of trying to stabilize the economy and the financial system, as well as of assisting people affected by economic downturns. Dozens of our most important government agencies and programs, ranging from social security (to assist the elderly and disabled) to federal deposit insurance (to eliminate banking panics) to the Securities and Exchange Commission (to regulate financial activities) were created in the 1930s, each a legacy of the Depression.

. . .

What caused the Depression? This question is a difficult one, but answering it is important if we are to draw the right lessons from the experience for economic policy. Solving the puzzle of the Depression is also crucial to the field of economics itself because of the light the solution would shed on our basic understanding of how the economy works.

. . .

While the fact that money, prices, and output all declined rapidly in the early years of the Depression is undeniable, the interpretation of that fact has been the subject of much controversy. Indeed, historically, much of the debate on the causes of the Great Depression has centered on the role of monetary factors, including both monetary policy and other influences on the national money supply, such as the condition of the banking system. Views have changed over time. During the Depression itself, and in several decades following, most economists argued that monetary factors were not an important cause of the Depression. For example, many observers pointed to the fact that nominal interest rates were close to zero during much of the Depression, concluding that monetary policy had been about as easy as possible yet had produced no tangible benefits to the economy. The attempt to use monetary policy to extricate an economy from a deep depression was often compared to “pushing on a string.”

Resource 3 (4 of 5)

The Federal Reserve and the Great Depression

During the first decades after the Depression, most economists looked to developments on the real side of the economy for explanations, rather than to monetary factors. Some argued, for example, that overinvestment and overbuilding had taken place during the ebullient 1920s, leading to a crash when the returns on those investments proved to be less than expected. Another once-popular theory was that a chronic problem of "under-consumption"—the inability of households to purchase enough goods and services to utilize the economy's productive capacity—had precipitated the slump.

. . .

The economy was only just emerging from a recession, commodity prices were declining sharply, and there was little hint of inflation. Why then did the Federal Reserve raise interest rates in 1928? The principal reason was the Fed's ongoing concern about speculation on Wall Street. . . .

The market crash of October 1929 showed, if anyone doubted it, that a concerted effort by the Fed can bring down stock prices. But the cost of this "victory" was very high.

. . .

new research found that a complete understanding of the Depression requires attention to the operation of the international gold standard, the international monetary system of the time.

. . . the gold standard is a monetary system in which each participating country defines its monetary unit in terms of a certain amount of gold. The setting of each currency's value in terms of gold defines a system of fixed exchange rates, in which the relative value of (say) the U.S. dollar and the British pound are fixed at a rate determined by the relative gold content of each currency. To maintain the gold standard, central banks had to promise to exchange actual gold for their paper currencies at the legal rate.

. . .

The finding that leaving the gold standard was the key to recovery from the Great Depression was certainly confirmed by the U.S. experience. One of the first actions of President Roosevelt was to eliminate the constraint on U.S. monetary policy created by the gold standard, first by allowing the dollar to float and then by resetting its value at a significantly lower level. The new President also addressed another major source of monetary contraction, the ongoing banking crisis. Within days of his inauguration, Roosevelt declared a "bank holiday," shutting down all the banks in the country. Banks were allowed to reopen only when certified to be in sound financial condition. Roosevelt pursued other measures to stabilize the banking system as well, such as the creation of a deposit insurance program. With the gold standard constraint removed and the banking system stabilized, the money supply and the price level began to rise. Between Roosevelt's coming to power in 1933 and the recession of 1937–38, the economy grew strongly.

. . .

Resource 3 (5 of 5)

The Federal Reserve and the Great Depression

> Some important lessons emerge from the story. One lesson is that ideas are critical. The gold standard orthodoxy. . . led policymakers astray, with disastrous consequences. . . . Another lesson is that central banks and other governmental agencies have an important responsibility to maintain financial stability. . . . Finally, perhaps the most important lesson of all is that price stability should be a key objective of monetary policy. By allowing persistent declines in the money supply and in the price level, the Federal Reserve of the late 1920s and 1930s greatly destabilized the U.S. economy and, through the workings of the gold standard, the economies of many other nations as well.
>
> **Source:** Federal Reserve Board. (2004, March 2). Remarks by governor Ben S. Bernanke. Retrieved from http://www.federalreserve.gov/boarddocs/speeches/2004/200403022/default.htm

Questions to Consider:

- Who is Ben Bernanke?
- What more would you need to know to evaluate his view of the Great Depression and its causes?
- Consider the date of this selection. What significance does Bernanke's view of the Great Depression have for the role the Federal Reserve in response to the financial crisis of 2008?