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Then and Now: Fed Policy Actions During the Great Depression and Great Recession

November 2011

Classroom Edition

An informative and accessible economic essay with a classroom application.

Includes the full version of the Liber8 Newsletter, *plus questions for students and an answer key for classroom use.*

Prepared by the Economic Education Group of the Federal Reserve Bank of St. Louis

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Then and Now: Fed Policy Actions During the Great Depression and Great Recession

"Regarding the Great Depression. You're right, we did it. We're very sorry…we won't do it again."
—Federal Reserve Chairman Ben S. Bernanke, November 8, 2002

Any mention of the Great Depression conjures up images of unemployed masses queuing in bread lines and frantic crowds trying to withdraw money from banks. And yet these illustrations tell only part of the story. The Great Depression was undoubtedly the most severe economic downturn in the United States and caused untold suffering among millions. To contextualize it, national output fell by about 33 percent and consumer prices plummeted by over 25 percent between 1929 and 1933; one in four workers was unemployed by 1933. The resulting protracted slump only ended at the onset of World War II.[1] In contrast, during the Great Recession of 2007-09, national output fell by only 5 percent, consumer prices increased by 1 percent, and unemployment peaked at 10.1 percent.[2]

Scholars have posited a variety of causes for the Great Depression, and the role of central banks in exacerbating the crisis has emerged as a key point. This article thus considers (i) how Federal Reserve policies during the Great Depression weakened economic conditions and (ii) how policymakers used the lessons learned from the Depression to stabilize the economy during the Great Recession.

Federal Reserve actions in the run-up to the Great Depression were important in hastening the decline in economic conditions. The speculative effects of the stock market boom in 1928-29 caused the Fed to increase interest rates to curtail the bullish trend.[3] While this policy action dampened excessive borrowing to finance stock purchases, it also brought unintended consequences. Capital spending (e.g., for equipment and infrastructure) slowed dramatically in many sectors of the economy, leading to a drop in industrial production and output growth. The infamous stock market collapse in October 1929 finally ground the economy to a halt, and the Depression hit with full force soon after.

In the early 1930s, continued policy missteps by the Fed significantly lengthened the Depression. Specifically, the Fed failed to prevent four massive banking panics from battering the economy in 1930-33. On each occasion, anxious depositors descended on banks to withdraw cash because the public had lost confidence in the ability of financial institutions to service deposit obligations. Due to fractional banking procedures,[4] banks did not have enough cash on hand to meet this increased demand. The Federal Reserve, as the lender of last resort, was in a prime position to limit the fallout by providing emergency funds to banks under distress. However, Fed policy at that time dictated that only banks with sufficient collateral or member banks of the Federal Reserve System were eligible for these funds. Consequently, cash-starved banks failed in large numbers.

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[1] As determined by the National Bureau of Economic Research, the Great Depression officially lasted from August 1929 to March 1933. Although output rebounded significantly from 1934-37, the effects of the Depression lingered throughout the 1930s and the economy only returned to full employment when the United States entered World War II.

[2] As determined by the National Bureau of Economic Research, the Great Recession lasted from December 2007 to June 2009.

[3] Prior to this, the Fed reduced the discount rate on loans made to banks from 4 percent to 3.5 percent between July and September 1927. Some observers contend that this prolonged an unsustainable boom in the stock market and that the Fed should have tightened monetary conditions sooner.

[4] Fractional-reserve banking is a system where banks hold a portion of their deposits (cash) in vaults or at the Federal Reserve and use the remaining cash for lending activities.

The effects of the banking panics were catastrophic: The money supply[5] fell precipitously and a prolonged bout of deflation set in. As the institution directed to maintain price stability, the Fed should have flooded the economy with additional liquidity[6] to stop consumer prices from falling. However, policymakers dithered and hampered the prospects of a quick recovery. With a decline in the price level, real (or inflation-adjusted) interest rates soared.[7] As a result, borrowers became saddled with higher debt burdens, contributing to widespread defaults and bankruptcies. In addition, the increase in real borrowing costs depressed consumer and business investment, further slowing economic activity.

By 1933, government policy actions (e.g., provision of deposit insurance) helped stabilize the banking system and the economy improved significantly in the mid-1930s. As investor confidence grew, gold and other funds began to flow into the United States once again, expanding the money supply. Fed officials, though, became increasingly alarmed at the prospect of high inflation and increased reserve requirements for banks (the percentage of deposits that banks must hold in reserve). Some experts suggest that this increase caused a decrease in lending, which in turn caused the money supply to decrease once again.[8] The recession that followed in 1937-38 temporarily derailed the recovery. Although the economy rebounded again in 1939, the nation's unemployment rate returned to its pre-crisis level only after the United States entered the war in late 1941.

By contrast, Fed policies implemented during the 2007-09 Great Recession were markedly different from those during the Great Depression. When the Recession began, the Fed acted decisively to stave off the collapse of the financial sector. Specific policies included decreasing the federal funds rate to nearly zero percent and establishing programs that lent money to banks on a short-term basis. The latter was especially significant in providing stopgap funding to American International Group (AIG), whose failure could have plunged the financial sector into further chaos. Through an expansion of its balance sheet, the Fed also facilitated the sale of distressed investment bank Bear Stearns to a commercial bank (JPMorgan Chase). In addition, to reduce the risk of deflation that devastated the economy during the Depression, the Fed made large-scale purchases of Treasury bonds in two rounds of quantitative easing.

Philosopher George Santayana (1863-1952) said that "those who cannot remember the past are condemned to repeat it." Recent experience shows that the Federal Reserve avoided the policy pitfalls of the Great Depression. During the 1930s, inadequate Fed policy compounded the downward slide in the economy. This experience served as a wake-up call for the Fed, however, resulting in more assured policy measures that prevented the meltdown of financial markets during the Great Recession.

—By David A. Lopez, Research Associate

[5] The two most common measures of money supply are called M1 and M2. Further information can be found here.

[6] In this case, liquidity refers to the ease of obtaining credit and meeting the demand for money. The Fed increases liquidity by purchasing Treasury securities, which increases bank reserves and, all else equal, lowers nominal interest rates.

[7] The real interest rate is the difference between the nominal interest rate and the inflation rate. During the Depression, nominal rates were close to zero percent and the inflation rate was negative, leading to very high real interest rates. For further information, see Carlstrom, Charles T. and Fuerst, Timothy S. "Perils of Price Deflations: An Analysis of the Great Depression." Federal Reserve Bank of Cleveland *Economic Commentary*, February 2001.

[8] More recent research, however, finds that an increase in the reserve requirement did not significantly affect the supply of money at that time; see Calomiris, Charles C.; Mason, Joseph R. and Wheelock, David C. "Did Doubling Reserve Requirements Cause the Recession of 1937-1938? A Microeconomic Approach." Working Paper No. WP2011-0021, Federal Reserve Bank of St. Louis, January 2011.

Additional Articles and Further Reading on the Great Depression

"Closed for the Holiday: The Bank Holiday of 1933," by the Federal Reserve Bank of Boston, 1996.

Recaps the stock market crash of 1929 and the bank holiday of 1933 and resulting political resolutions.

"Remarks on Milton Friedman's Ninetieth Birthday," by Ben S. Bernanke at the Conference to Honor Milton Friedman, University of Chicago, November 8, 2002.

A speech providing detailed information on (i) the four key monetary policy episodes during the Great Depression and (ii) the impact of the gold standard and bank failures on the economy during 1929-33.

"Great Depression," by Richard H. Pells and Christina D. Romer, *Encyclopædia Britannica*.

Provides an overview of the factors that caused the Great Depression and the sources of recovery from it.

Free Data Sources and Reports

Resource: The Financial Crisis: A Timeline of Events and Policy Actions
Description: Provides data, reports, and news releases related to the 2007-09 financial crisis.
Published by: Federal Reserve Bank of St. Louis
Location: http://timeline.stlouisfed.org/index.cfm?p=home

Resource: FRASER: Depressions & Panics
Description: Historical documents, charts, and data regarding the Panic of 1907 and the Great Depression.
Published by: Federal Reserve Bank of St. Louis
Location: http://fraser.stlouisfed.org/cbt/browse.php?collection_id=5

Resource: *The Great Depression Curriculum*
Description: Six classroom lessons on the Great Depression. Includes a reference list of additional print and audio sources.
Published by: Economic Education, Federal Reserve Bank of St. Louis
Location: www.stlouisfed.org/greatdepression/

Resource: Timeline of the Great Depression
Description: Provides an in-depth chronology of key economic and political events from 1929 to 1940.
Published by: American Experience, Minnesota Public Broadcasting Service (PBS)
Location: www.pbs.org/wgbh/americanexperience/features/timeline/rails-timeline/

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Name___________________________________ Period_______

Federal Reserve Bank of St. Louis *Liber8*:
"Then and Now: Fed Policy Actions During the Great Depression and Great Recession"

After reading the article, enter the specified information and answer the following questions.

	Great Depression	Great Recession
Length of recession (in months)		
National output decrease (percent)	From 1929-33:	From 2007-09:
Consumer prices decrease or increase (percent)	1933: _____ decrease	2007-09: _____ increase
Unemployment at peak (percent)	1933:	October 2009:

1. How does the Great Recession compare with the Great Depression in terms of severity?

2. Consider the noted policy mistakes made by the Federal Reserve during the Depression and explain how each may have contributed to economic decline.

a. "The speculative effects of the stock market boom in 1928-29 caused the Fed to increase interest rates to curtail the boom."

b. "[O]nly banks with sufficient collateral or member banks of the Federal Reserve System were eligible for these [emergency] funds."

c. "Fed officials…became increasingly alarmed at the prospect of high inflation and increased reserve requirements for banks."

3. How have Federal Reserve policies implemented during the Great Recession differed from those implemented during the Great Depression?

Teacher's Guide

Federal Reserve Bank of St. Louis *Liber8*:
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After reading the article, enter the specified information and answer the following questions.

	Great Depression	Great Recession
Length of recession (in months)	43	18
National output decrease (percent)	From 1929-33: 33%	From 2007-09: 5%
Consumer prices decrease or increase (percent)	1933: 25% decrease	2007-09: 1% increase
Unemployment at peak (percent)	1933: 25%	October 2009: 10.1%

1. How does the Great Recession compare with the Great Depression in terms of severity?

The Great Depression was longer in duration and more severe in terms of economic indicators.

2. Consider the noted policy mistakes made by the Federal Reserve during the Depression and explain how each may have contributed to economic decline.

a. "The speculative effects of the stock market boom in 1928-29 caused the Fed to increase interest rates to curtail the boom."

Increased interest rates caused capital spending (e.g., for equipment and infrastructure) by businesses and households to slow dramatically in many sectors of the economy, leading to a drop in industrial production and output growth.

b. "[O]nly banks with sufficient collateral or member banks of the Federal Reserve System were eligible for these [emergency] funds."

Cash-starved banks failed in large numbers.

c. "Fed officials…became increasingly alarmed at the prospect of high inflation and increased reserve requirements for banks."

Because higher reserve requirements meant banks had fewer funds available for lending, the supply of money in circulation declined once again.

3. How have Federal Reserve policies implemented during the Great Recession differed from those implemented during the Great Depression?

When the Great Recession began, the Fed acted decisively to stave off the collapse of the financial sector. Specific policies included decreasing the federal funds rate to nearly zero percent and establishing programs that lent money to banks on a short-term basis. Credit provision by the Fed also helped facilitate the mergers of distressed firms with healthier banks. In addition, to reduce the risk of deflation that devastated the economy during the Depression, the Fed made large-scale purchases of Treasury bonds in two rounds of quantitative easing.

For Further Discussion

Read the following to your students.

In a fractional reserve banking system, such as our own, banks are subject to a reserve requirement. This requirement specifies that banks must hold a given percentage of their customers' deposits in reserve *at all times*, either in their vaults or at the central bank. The central bank in the United States is the Federal Reserve. Banks may use the remaining funds not held as required reserves to make loans. Much of what economists call "money creation" is the result of this system. Let's see how this works using a $1,000 deposit and a 10 percent reserve requirement.

Display or distribute the included (blank) chart and use the following questions to guide the discussion.

Money Creation: An Example

	Deposits	**Reserve Requirement (10%)**	**Loans**
1. George	$1,000	$100	$900
2. Lydia	$900	$90	$810
3. Judy	$810	$81	$729
Total	**$2,710**	**$271**	**$2,439**

1. George deposits $1,000 at his local bank.
   a. How much of George's deposit must the bank hold in reserve? $100
   b. How much may the bank loan out? $900
2. George's bank loans $900 to Lydia, which Lydia deposits in her checking account.
   a. How much of Lydia's deposit must the bank hold in reserve? $ 90
   b. How much may the bank loan out? $810
3. Lydia's bank loans $810 to Judy, which Judy deposits in her checking account.
   a. How much of Judy's deposit must the bank hold in reserve? $ 81
   b. How much may the bank loan out? $729
4. The process could continue, but let's see what's happened so far:
   a. How much money is on the books as deposits? $2,710
   b. How much money is held in reserve? $271
   c. How much money has been loaned? $2,439
   d. From the initial $1,000 deposit, how much money is available for people to spend in the economy (including the initial $1,000)? $3,439 = $1,000 (the amount of the original deposit) + $2,439 (the amount of the three loans: $900 + $810 + $729).

5. **Given what you now know, how does the process of money creation help fuel spending by businesses and households in a growing economy?**

   The process of money creation provides banks with money to lend to businesses and households. Without this process families would find it more difficult to borrow to buy homes, firms would find it more difficult to borrow to invest in tools and equipment, and students would find it more difficult borrow for college.

6. **What if people no longer trusted banks and withdrew their deposits from the banking system?**

   If people withdrew their deposits from the banking system, the system of money creation would slow considerably. In fact, the decrease in the growth of the money supply could contribute to deflationary fears.

Read the following.

During the Great Depression, the failure of many banks and the fear of financial loss of deposits before the existence of deposit insurance caused many people to withdraw their funds from the banking system, reducing the money available for lending. This contributed to the deflationary cycle and helps explain the depth of the Great Depression. During the most recent financial crisis, the Federal Reserve took several measures to stabilize the banking system to ensure that a similar situation did not occur.

Money Creation: An Example

	Deposits	**Reserve Requirement (10%)**	**Loans**
1. George	$1,000		
2. Lydia			
3. Judy			
Total			