Monetary Factors and the Great Depression

- Friedman and Schwartz – Money Stock ↓ > 1/3
- MV = PQ
- Works through interest rates and investment
- Collapse of money stock was:
  - Due to inept Federal Reserve
  - Entirely preventable
The Federal Reserve System

- since 1919 - 12 Districts with an autonomous Federal Reserve Bank
- Federal Reserve Board (Board of Governors of the Federal reserve from 1935) coordinating the system powers
  - Regulate banking system
  - Rediscounting – buying commercial paper from member banks
  - Supervision of the banking system
  - Ensure an elastic supply of currency – open market operations
Goals of the Federal Reserve – the early 1930s

- Maintaining the gold standard
- Preventing excess speculation – stock boom of the 1920s bust of 1929 – tightened money supply
- Some purge is healthy
1. Bank Failures
   - Unit-banking laws
   - “Contagion of fear” – bank holidays

   Effects
   - Wealth of depositors, stock holders
   - Demand for narrow money - Substitution of currency for deposits
   - Further bank failure
   - Run on bank → sells assets → asset price ↓
   - → further runs
   - Credit contraction – unwillingness to make loans, tie up capital

2. Effect on Investment – 89% decline
   - High real interest rates - deflation
   - Credit rationing
   - Effect on confidence
The International Gold Standard

- **Characteristics**
  1. Free flow of gold – mandatory convertibility
  2. Fixed exchange rates
  3. No international co-ordination mechanism

- **If gold stocks are too low ⇒ reduce imports ⇒ deflate**

- **Advantages**
  1. Price Stability
  2. Exchange rate stability
  3. Policy constraint

- **Disadvantages**
  1. Asymmetry in obligation – no penalty for hoarding
  2. May prevent counter-cyclical policy
  3. Difficult to maintain convertibility in crises
GS Suspended in WWI

Resumption in 1920s at pre-war rates £1 = $4.86

Changes in world economy

- UK exported gold from 1925

“Golden Fetters”

- France hoarded gold

US - Fed defended gold standard above all else

- Deflate in Nov 1931 & in early 1933

Germany – Quasi-Defended gold standard

- Effect on external debts
- Forced to deflate

Britain off gold in Nov 1931

- Mild recovery
- No banking panics
Monetary Policy in a nutshell

1. Oct 29-Sept 31: allowed Ms to fall by 10%
2. Oct 31-Jan 32: raised discount rate; Ms fell another 12%
   - Defending the dollar and prevent gold outflow
   - Believed Ms was sufficient: banks held excess reserves
3. Feb 32-Jan 33: mildly expansionary but banks opted for excess reserves
4. Jan 33-March 33: Fed raised discount rate

Like fiscal policy, monetary policy was never tried: allowed Ms to fall 25% from 1929-1933
Why?

1. belief in gold standard

2. belief that excess reserves signaled sufficient liquidity