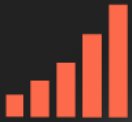


# The Federal Reserve and the Banking Crisis of 1931



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## *Overview*

- The emergence of the Federal Reserve and its founding principles and Laws
- Talk through the Fed's tactics before the Crash, After, and during the Crises of 1930 and 1931
- The Banking Crises/Panics and their connection to Wray's concepts of Financial Fragility
- Ben Bernanke's thoughts about Credit Intermediation, Aggregate Demand, The Great Depression, and the 2008 Crisis.



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## *The Federal Reserve*

- Real Bills Doctrine
- Seasonal Fluctuations
- The National Banking Acts
  - Prohibition of notes in excess of 90%
  - Double Liability
- Greenbacks
- The Federal Reserve Act
  - Creation of Federal Reserve System
  - "An act to provide for the established of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.
- Discount Rate
- Lender of last resort
- The Federal Reserve in action
- Pressure Builds

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## *The Fed's Policies in the 1920s*

- Economic Boom!
- Throughout 1921-1928 the Us was relatively free of any major banking panics

### The Fed...

- Was helping nations of Europe recommit to the Gold Standard.
- Used the discount rate to effect changes in the money stock. By lowering rates and committing open market purchases, the Fed effectively shortened the recessions of 1923 and 1926



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*Freidman and Schwartz*

"The close synchronism between the American economy during the 1920s and the confidence of the system that offered (was) a delicate effect on economic fluctuations, and that it towards the end."

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*The Fed's Crusade Against Speculation*

The Fed  
- "Qualitative expansion"  
- They had  
- Interest  
- The Fed

### Fed's Tactic #2: Liquidationism Good or Bad?

- Liquidationism: The belief that rather than propping up failing banks with loans, it is best to just let them die off
- Many Fed officials were reluctant to bail banks
- Lessor of Louis Brandeis was for illiquid banks, not insolvent
- Banks should blame themselves for getting into trouble

George Horner  
"Governor of the  
Federal Reserve"  
"The Fed's  
Crusade Against  
Speculation"

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*Freidman and Schwartz*

" The close synchronism (between the Fed's actions and the American economy during the 1920's) produced much confidence.. The System that the new monetary machinery offered (was) a delicate effective means of smoothing economic fluctuations, and that is operators knew how to use it towards the end."

**Exhibit 6** Number and Assets of Member and Nonmember Banks of the Federal Reserve System, 1913-1930

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	Member Banks of the Federal Reserve System						Nonmember Banks (State Banks)	
	Total Banks		National Banks		State Banks		Banks (count)	Assets (billions of dollars)
	Banks (count)	Assets (billions of dollars)	Banks (count)	Assets (billions of dollars)	Banks (count)	Assets (billions of dollars)		
1913	7,467	11.0	7,467	11.0			19,197	11.0
1914	7,518	11.5	7,518	11.4			19,718	11.7
1915	7,614	11.9	7,597	11.8	17	0.1	19,776	12.2
1916	7,605	14.2	7,571	13.9	34	0.3	20,134	14.0
1917	7,652	17.0	7,599	16.2	53	0.8	20,646	15.8
1918	8,212	24.4	7,699	18.2	513	6.1	20,644	12.0
1919	8,821	29.7	7,779	21.1	1,042	8.6	20,326	12.7
1920	9,398	33.6	8,024	23.3	1,374	10.4	20,893	13.9
1921	9,745	30.9	8,150	20.5	1,595	10.4	20,711	12.8
1922	9,892	31.6	8,244	20.6	1,648	11.0	20,228	12.5
1923	9,856	33.7	8,236	21.5	1,620	12.2	19,973	13.7
1924	9,650	35.7	8,080	22.5	1,570	13.2	19,338	14.4
1925	9,538	38.9	8,066	24.3	1,472	14.7	18,904	15.5
1926	9,375	40.6	7,972	25.2	1,403	15.4	18,367	16.1
1927	9,099	42.6	7,790	26.5	1,309	16.1	17,551	16.4
1928	8,929	44.7	7,685	28.3	1,244	16.4	16,869	16.9
1929	8,707	45.5	7,530	27.3	1,177	18.2	16,263	17.0
1930	8,315	47.3	7,247	28.8	1,068	18.5	15,364	16.8

Source: Adapted from Howard Bodenhorn and Eugene N. White, "Commercial banks—number and assets, by Federal Reserve membership and type of bank: 1896-1998," in *Historical Statistics of the United States, Earliest Times to the Present: Millennial Edition*, eds. Susan B. Carter et al. (New York: Cambridge University Press, 2006), tables Cj289, Cj290, Cj292, Cj293, Cj295, Cj296.

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## *The Fed's Crusade Against Speculation*

- Wanted lending for 'productive' means rather than speculative purposes
- Used "direct pressure" tactic
- Contacted banks to which it lend and attempted to dissuade them from further borrowing
- Curb Security Speculation by denying rediscounts to member banks making loans on securities



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## *Fed's Tactic #1: Direct Pressure Good or Bad?*

- "Qualitative" technique for controlling lending were not embraced by reserve banks
- They had no legal right to deny rediscount of securities
- Interest hikes could have curbed speculation loans!
- The Fed put banks in an awkward position.

### *1930: The First Banking Crisis*

- Distrust of banks grew almost a year after the Stock Market Crash.
- Banks Suffered.
  - Deflated value of securities
  - Mortgage defaults and bad collateral
- And... The panic of 1930! Dun Dunnnnnnn!

