THE GREAT DEPRESSION AND THE FAULTS OF MONETARY POLICY:

An Analysis of the Monetary Policies by the Federal Reserve during the Crisis

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ABSTRACT

This thesis investigates the role of the monetary policies taken by the Federal Reserve during the late 1920s and the early 1930s in the exacerbation of the Great Depression. Through a qualitative analysis of the primary source documents, such as meeting minutes and the internal correspondence of the Federal Open Market Committee (FOMC), as well as a comparative analysis of the countries that remained in the Gold Standard and those that did not, I argue that there have, indeed, been problematic policies taken by the Fed that helped contribute to the depth and duration of the Great Depression. The Fed's contractionary stance in the late 1920s, the failure to respond to banking panics, and the adherence to the rigid Gold Standard figured prominently among the critical factors that helped turn what could have been a normal crisis, into one of the biggest economic downturns in history.

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INTRODUCTION

In the years leading up to the Great Depression, life in the United States was marked by relative prosperity and stability. The 1920s, often called the "Roaring Twenties," saw significant economic growth, technological innovation, and cultural dynamism (Romer, 1993). However, this era of optimism ended abruptly and was devastated with the onset of the Great Depression in 1929. The Great Depression was one of the most severe and prolonged economic downturn in modern history. From 1929 to 1933, the United States experienced a catastrophic decline in output, severe price deflation, and unprecedented unemployment (Bernanke, 1983). At the nadir of the Depression in 1933, real GDP had fallen by nearly 30%, the price level had declined by about 25%, and the unemployment rate had risen to 25% (Romer, 1993). This economic collapse was deep and persistent, with the economy not fully recovering until the late 1930s.

Central to understanding the severity and duration of the Great Depression is the role played by the Federal Reserve, the nation's central bank. Scholars have long debated whether the Fed's monetary policy actions or inactions were a primary cause of the economic catastrophe. The traditional monetarist view, epitomized by Friedman and Schwartz (1971), argues that the Fed's failure to prevent a collapse in the money supply was the principal cause of the severity of the Depression. In contrast, other researchers have emphasized non-monetary factors, such as structural weaknesses in the banking system or the constraints imposed by the gold standard, as key contributors to the downturn (Temin, 1973; Eichengreen, 1992).

The thesis central position is that the Federal Reserve's contractionary monetary policy decisions in the late 1920s and early 1930s made the arrival and the severity of the Great Depression deeper. At a time when there was an urgent need to pump in more liquidity and support the financial system, the Federal Reserve, by all means failing to do so, created a situation where, for a long time, the economic recovery remained stagnated and prolonged.

This thesis aims to assess the Federal Reserve's role in the Great Depression using a multi-faceted methodological approach. First, a detailed historical analysis of primary source documents reflecting the Fed's policy decisions and actions during the critical period from 1928 to 1933 will shed light on the motivations and economic understanding that guided Fed policymakers, and show how the outdated economic mindset helped worsen the crisis. This will be followed by a comparative case study analysis of countries that remained on the gold standard versus those that abandoned it, which will illuminate the constraints and opportunities faced by central banks during the depression era.

Through these methodological lenses, this thesis seeks to construct a nuanced narrative of the Fed's monetary policy failures that contributed to the depth and duration of the Great Depression. The findings suggest that the Fed's contractionary stance in the late 1920s, inadequate response to the banking panics, and adherence to the gold standard were critical factors that transformed a moderate recession into an unprecedented economic calamity. The thesis will also explore the transmission channels through which monetary policy affects the real economy, including the impact on aggregate demand, the disruption of credit markets, and the exacerbation of debt-deflation dynamics.

Ultimately, the lessons of the Great Depression hold enduring relevance for contemporary policymakers and central bankers. The findings underscore the importance of timely and decisive monetary accommodation in financial crises and deflationary pressures. They also highlight the need for policy flexibility and the dangers of adhering to outdated monetary doctrines in changing economic conditions. By shedding light on the critical role of monetary policy during the Great Depression, this thesis aims to inform current policy debates and contribute to designing robust frameworks for economic stabilization.

LITERATURE REVIEW

The Great Depression has been the object of intensive academic research, with economists trying to identify the causes, the impacts, and the possible advice for the policy. The present literature review covers studies dealing with the influence of the Fed's monetary policy actions on the crisis depth during the period from 1929 to 1933.

The landmark study on the monetary sources of The Great Depression is Friedman and Schwartz's (1971) "A Monetary History of the United States, 1867-1960". In this widely influential book, the authors explain that the Federal Reserve's inactivity as a lender of last resort during the banking panics in the early 1930s. Friedman and Schwartz affirm that in case the Fed would have expended expansionary monetary policies to mitigate deflationary pressures, the severity and the duration of the Depression could have been significantly reduced.

Based on Friedman and Schwartz's works, Bernanke (1983) introduces the role that financial sector disruptions play in creating a further recession. He contends that the banking system failure and the credit collapse further fuelled the drop in aggregate demand and caused the money supply to contract. Bernanke notes that the Fed's weakness in acting as the lender of the last resort and its stubbornness in following the "real bills" theory[1], which restricted its efforts to deliver liquidity to the financial system, were the primary reasons for the financial crisis and its tragic consequences for the economy.

Eichengreen (1992) has an international view in evaluating the Great Depression phenomenon. The most critical factor was that following the international gold standard, the

[1] Real Bills Doctrine can be understood, as explained by Roy Green, to be a theory originating from the 17th and 18th centuries in which banks are supposed to only issue money appropriately backed by short-term commercial loans having had "real bills," hence financing production with respect to goods and their movement. This approach ties the money supply to bona fide economic activity; it is meant to keep inflation at bay and assures monetary stability by providing that the supply of real money would always be precisely regulated — at all times. (Green, 1989)

system automatically connected the downfall in the economy in other countries, which prevented independent monetary policies. According to Eichengreen, countries that decided to leave the gold standard earlier, for example, the UK in 1931, were able to recover their economies sooner than the ones who stayed attached to the gold standard until it was finally accepted to abandon it, such as the US which did not leave the gold standard until 1933.

Romer (1993) offers an alternative to the single-factor explanation that only the monetary factors caused the Great Depression in consideration of the falling aggregate demand. Nevertheless, this scenario involving the Federal Reserve System is one of the probable explanations as to why the depression was profound and lasted a long time. According to Hsieh and Romer (2006), the recent evidence concerning the Federal Reserve's open market operations in the 1930s has sparked a new debate. They conclude that this was not enough to offset the pro-deflationary factors at the time and recommend that a more significant monetary expansion might have softened the depth of the Great Depression.

Temin (1973) and Eichengreen (1992) similarly focus on the international gold standard as the reason for the policymakers' lack of potential to deal with the crisis. These scholars point out that the commitment to the framework of the gold standard, even during an acute crisis, was pursued by a blend of economic and political factors, including the need to maintain financial authority and stability. Trying to follow the gold standard was like wearing a "golden fetter" for central banks, so they could not make independent monetary policies that would help adjust the shock level for a particular land. This absence of policy inter-connection operated as an impasse for the countries as they struggled to respond to the Depression, which led to a protracted recession.

Toma (2013) reiterates that the critical policy decision-makers also add to the plot. He highlights that only some officials, particularly those with high positions, such as Benjamin Strong, the Governor of the Federal Reserve Bank of New York, can mould the Fed's handling of the crisis. Toma (2013) believes that Strong's cautious outlook on monetary policy and his relationships with the bankers played a significant role in the Fed stepping aside in the initial phases of the crisis. Through a complete overview of the present state of research on the Great Depression, Fishback (2017) highlights the monetary factors. While there is a general agreement on the role of the Federal Reserve's policy errors during the Depression in further worsening the economic recession, there is still heavy debate on the nature of the monetary transmission mechanism and the relative importance of different policy tools.

Besides the vast literature on the Federal Reserve's failures in its monetary policy and its connection to the Great Depression, the literature on the Great Depression has also examined the use of fiscal policy and its interaction with the otherwise sound monetary policy. Some economists have alleged that due to the policymakers' lack of preparedness to follow the Keynesian approach of going for deficit spending and large-scale fiscal initiatives, the depth and duration of the downturn worsened further.

In his highly influential book "The General Theory of Employment, Interest and Money," Keynes criticised the conventional concept of orthodox finance and proposed that during an economic downturn, it is not only permissible but vitally necessary for a country to resort to government expenditures and run fiscal deficits (Keynes, 2018). Keynes' ideas were later developed by economists such as Alvin Hansen and Paul Samuelson; the main idea of these economists was to demonstrate how fiscal policy could work in conjunction with monetary policy to combat recessions (Samuelson, 1939; Hansen, 1941).

Several papers were published that compared the experiences of different countries that adopted dissimilar fiscal measures during the great depression. According to Eggertsson (2012), the transition from orthodox finance to relatively more expansionary policies through the New Deal was important in revitalising the US economy. On the other hand, Temin

(1989) points out that the policies of the Hoover administration proved to be disastrous because the administration proceeded with balanced-budget policies and pinned down its avoidance of deficit spending as one of the main reasons for the long duration of the Great Depression in the United States.

This literature review shows a consensus that the Fed was very influential in the matter because of its restrictions on credit, inaction as a lender of last resort and devotion to the gold standard, and hence, its policies were directly responsible for the gravity of the economic depression. Nevertheless, the debate about the role of economic policies in times of crises seems to be never-ending, and the pursuance of additional investigative and analytic research remains a prerequisite for a more comprehensive appreciation of the role of monetary policy in addressing and working through the challenges and uncertainties around financial stability and economic performance.

FEDERAL RESERVES'S MONETARY POLICIES

A. Historical Analysis

The historical analysis in this thesis involves a comprehensive critical assessment of the Federal Reserve's policy decisions and actions during the peak season, which later led to the Great Depression (1928-1933), focusing on the year 1933. The sources of this analysis are the minutes of the Federal Open Market Committee (FOMC) meetings, policy statements, the Fed leaders' internal memos, and their correspondence with each other.

The 1928 January minutes and 1929 December minutes show that the Federal Reserve managed to search for an effective contractionary monetary policy throughout this period. On the 1st of January 1927, FOMC records indicate that the Fed upped the discount rate to 4.5% from 3.5% as a countermeasure to irrational stock market speculation (FRASER | St. Louis Fed, 1928). The dominant economic doctrine at the time attached great importance to rate stability and due diligence in gold standard observance. Policymakers of the Fed believed that restraining credit growth and money supply at that time were the only ways by which they could prevent inflation and retain the value of USD as a currency backed with gold. While some officials raised a voice of caution regarding the extent of their effects on the real economy, the contractionary agenda was pushed forward.

These deflating actions only worsened in 1929, as reflected in the FOMC reports in December. The record demonstrates that the Fed further affected credit conditions in operations in the open market. However, some Members, like George Norris, Governor of the Federal Reserve Bank of Philadelphia, and Adolph Miller, member of the Federal Reserve Board, expressed concern about the risk of a deterioration in overall economic activity (FRASER | St. Louis Fed, 1929).

The documents and internal correspondence of the Federal Reserve from this period, housed in the FRASER digital archive, also implicate the Fed's inaction during the banking crises as a contributing factor to the collapse of the banking system and the dramatic reduction in the money supply (Memoranda of Meetings of Federal Reserve Governors, 1930-1933; Federal et al., 1930-1933, FRASER). These archival materials show that as deposits were lost and surviving banks hoarded cash, the money supply contracted sharply, exacerbating the deflationary pressures on the economy. The Fed's reluctance to provide liquidity support and act as a lender of last resort during the banking panics allowed the money supply to decline precipitously, which the Fed's documents indicate was a vital driver of the depth of the economic downturn.

The historical study further reveals the Fed's response and panics in the banking sector, especially in the 1930s. I examined the Fed's internal correspondence, specifically the memoranda and letters exchanged between Federal Reserve officials during this period, which contained evidence that the Fed was reluctant to provide liquidity support to the struggling financial system (Memoranda of Meetings of Federal Reserve Governors, 1930-1933, FRASER). These archival materials indicate that the Fed's indecisiveness in acting as a lender of last resort was based on its adherence to the "real bills" doctrine, which prescribed that the central bank should only extend credit for short-term, self-liquidating commercial loans. The monetary authority lacked clear guidelines on how to respond to the banking crises and thus could not effectively provide the necessary support to banks during the economic distress (Memoranda of Meetings of Federal Reserve Governors, 1930-1933, FRASER).

The "real bills" doctrine influenced the reluctance of this banking system, since it postulated that the central bank must only extend credit against short-term, self-liquidating commercial loans. This restraint hindered the Fed's function as a lender of last resort and prevented it from providing the necessary support to banks during a crisis (Bordo & Landon-Lane, 2010; Mitchener & Richardson, 2019).

The specific picture from primary sources builds up new directions in the Federal Reserve's investigation of economics, motivation, and decision-making between policymakers trying hard to cope with the turbulent situation. I will be able to capture what makes the Fed policy so relevant in the whole picture by recreating the historical development of policy within the context of the continuously developing environment of that time and see the effects on the broader economy of those actions.

The historical study is a prerequisite for a more detailed reflection on the economic repercussions of the Fed's policy mistakes and their influence on the depth and duration of the Great Depression. The prime source materials show the significant economic argument and institutional constraints which shaped the central bank's policy responses to be non-responsive to the evolving financial catastrophe.

The historical analysis also reveals the Fed's response to the banking panics of the early 1930s. Examination of the Fed's internal correspondence indicates a reluctance to provide liquidity support to the struggling financial system. This hesitance was rooted in the "real bills" doctrine, which prescribed that the central bank should only extend credit for short-term, self-liquidating commercial loans. The monetary authority lacked clear guidelines and thus could not effectively act as a lender of last resort and provide the necessary support to banks during the crisis.

Furthermore, the archival materials implicate the Fed's inaction during the banking crises as a contributing factor to the collapse of the banking system and the dramatic reduction in the money supply. As deposits were lost and the surviving banks started accumulating cash, the money supply contracted sharply, exacerbating the deflationary pressures on the economy, and also directly affecting output and employment rates, as argued by Bernanke (1983) and Romer (1990).

Bernanke (1983) uses Structural Estimation Techniques to filter out monetary shocks from other sources of economic disturbances. Through his analysis, he argues that monetary shocks contribute around 40 % to the decline in output during 1930-1933. Work done by other researchers, such as Romer (1990), shows that a monetary shock caused up to 50% of the output decline during The Great Depression. Structural analysis also affirms that employment was negatively affected when the Federal Reserve undertook monetary policies that decreased the money supply. The estimates show that the contraction of the money supply might be about 40% to 50% of the fall of employment in the 1930-1933 period (Cole & Ohanian, 2000; Christiano et al., 2003).

The historical examination also exposes the Fed's adherence to the gold standard, severely limiting its policy effectiveness even as the economy deteriorated. The primary sources show that, based on the widespread belief that the gold standard was essential for price stability and international financial stability, the Fed was firmly committed to maintaining it. As the U.S. economy shrank, prices fell, and the actual value of gold rose, causing the dollar to appreciate. This made U.S. exports less competitive in foreign markets and attracted foreign capital, further tightening monetary conditions and exacerbating the deflationary pressures.

The specific picture from primary sources builds up new directions in the Federal Reserve's investigation of economics, motivation, and decision-making between policymakers trying hard to cope with the turbulent situation. The historical approach offers fresh perspectives on the strategies, rationale, and restrictions that influenced the Fed’s conduct of policy during the Great Depression, and shows how in the late 1920s, the Fed pursued contractionary policies, did not act as a lender of last resort during banking panics and remained committed to the gold standard, all of which made the 1929 depression longer and more severe.

B. Comparative Case Studies

To have a broader and more in-depth analysis of the Great Depression and the role of monetary policy, I did a comparative study of the experiences of different countries during this period. Through the dissection of the economic results achieved by those who kept the gold standard and those who abandoned it, I could make visible the constraints and provide answers to the questions of central banks and the consequences of their policy choices. The case studies focused on three groups of countries: the United States, remaining on the gold standard until 1933; the United Kingdom, which got off the gold standard in 1931; and several West European states, including France and Belgium, which were on the gold standard until the mid-1930s. By drawing parallels between the paths of key economic indicators, like output, prices, and employment, for these countries, I determined the part monetary policy frameworks played in depth and duration of the Great Depression.

The United States is the crucial reference for the investigation because it was one of the largest economies in the world at the time, and the one most affected by the Great Depression. Through the journey of analyzing the U. S. monetary policy and economic outcomes during the 1930s, I could, therefore, point out the most crucial moments when the policy actions made by the Federal Reserve triggered the aggravation of the downward spiral. On the other hand, the British experience might help give a different perspective. The U.K.'s departure from the gold standard in September 1931 provided space for a more extensive spread of monetary policy, including cutting interest rates and increasing the money supply. This policy change positively affected the UK economy and aided its faster recovery than did the United States and other countries, which stayed with the gold standard. Eichengreen (1992) puts forth the view that the international gold standard system that served to link countries together via a rigid exchange rate and restrain their ability to adopt independent monetary policies was a crucial element in the spread of the global recession.

The countries that continued trading through the Gold Standard, like the United States, France, and Germany, widely experienced a more protracted economic recession than those that had gotten out of the Gold Standard earlier, such as the United Kingdom and the Scandinavian countries. The case study finding aligns with the argument that countries which gave up the gold standard early on had to cope with less terrible recessions and faster recoveries than those which remained faithful to it. According to Eichengreen and Sachs (1985), countries that left the gold standard in 1931, among them the United Kingdom and Scandinavian lands, experienced quicker output and employment recovery than countries like France and Belgium, which stayed on gold rather than entered into credit expansion.

Furthermore, according to Bernanke and James (1990), countries that left the gold standard earlier tended to experience less dramatic output slumps and faster recoveries than those that remained on gold for longer. This outcome divergence can be attributed to the monetary policy restraints built into the gold standard. Countries that continued the gold standard could not do expansionary policies to counteract the deflationary pressures of the Depression because they had to keep a fixed exchange rate between their currency and gold. The U. S., maintaining the commitment to the gold standard until 1933, offers us the best illustration of the costs of staying on gold. Bernanke (1995) recognizes that the Federal Reserve's adherence to the gold standard was the leading cause of the contractionary monetary policy during the early 1930s. This promise may have limited the Fed's ability to act promptly and forcefully to halt the bank panics and deflationary forces, thus making the economic collapse in the United States more severe.

Looking at countries' experiences during the Great Depression confirms how monetary policy regimes significantly impact economic results. Countries that switched the gold standard and followed expansionary monetary policies were on the way to a better performance when compared to those that stayed on the gold and had a limitation for the monetary policy. The lesson for policymakers is clear: when confronted with a very harsh economic depression, monetary policy flexibility is crucial for recovery support. The cross-country comparison generally leads to understanding the constraints and possible opening that central banks experienced during the Great Depression; by observing different paths that economies take while on and off the gold standard, I could emphasize the significance of monetary policy in minimizing the effect of economic shocks and improving the recovery process.

FINDINGS AND DISCUSSIONS

A. The Fed's Monetary Policy Mistakes

1. Contractionary Stance in the Late 1920s

The historical analysis reveals that the Federal Reserve contributed to the onset and severity of the Great Depression through its contractionary monetary policy stance in the late 1920s. To curb speculative excesses in the stock market, the Fed embarked on a series of interest rate hikes and open market operations designed to tighten credit conditions and rein in the money supply (Friedman & Schwartz, 1971). This policy tightening was motivated by the prevailing economic orthodoxy of the time, which emphasised the importance of maintaining price stability and the international gold standard. Fed officials believed that by curbing credit and money growth, they could prevent inflationary pressures and preserve the gold-backed value of the dollar (Eichengreen, 1992). However, the Fed's actions had unintended consequences for the broader economy. The contraction in money and credit, combined with the stock market crash 1929, exerted a deflationary force on the economy, leading to a sharp decline in aggregate demand, output, and employment (Bernanke, 1983).

2. Failure to Respond to Banking Panics

One of the Federal Reserve's most critical failures during the Great Depression was its inadequate response to the banking panics that erupted in the early 1930s. As the economic downturn deepened, regional banking crises quickly escalated into a nationwide panic, leading to widespread bank failures and a collapse in the money supply (Friedman & Schwartz, 1971). From 1930 to 1933, over 9,000 banks suspended operations, representing nearly a third of the total number of banks in the United States (Bernanke, 1983).

The Fed's response to these panics was slow, limited, and often counterproductive. Despite its role as a lender of last resort, the Fed failed to provide sufficient liquidity support to the banking system, allowing banks to fail and the money supply to contract further (Friedman & Schwartz, 1971). The Fed's inaction was partly due to its adherence to the flawed "real bills" doctrine, which held that the central bank should only provide credit against short-term, self-liquidating commercial loans. This doctrine constrained the Fed's ability to lend against the longer-term, less liquid assets held by many banks, limiting its effectiveness as a lender of last resort (Bernanke, 1983).

The consequences of the Fed's failure to respond adequately to the banking panics were severe. The collapse of the banking system led to a sharp contraction in the money supply, as deposits were destroyed, and surviving banks hoarded cash and curtailed lending (Friedman & Schwartz, 1971). This monetary contraction exacerbated the deflationary pressures in the economy, leading to further declines in output, prices, and employment. Moreover, the banking panics directly affected the real economy by disrupting the flow of credit and the functioning of the payment system. As banks failed and credit markets froze, businesses and households found it increasingly difficult to obtain the financing needed to maintain operations and consumption (Bernanke, 1983).

3. Adherence to the Gold Standard

The Federal Reserve's adherence to the gold standard was another critical factor that constrained its ability to respond effectively to the Great Depression. Under the gold standard, countries fixed the value of their currencies in terms of gold and allowed for the free convertibility of currency into gold at that fixed price (Eichengreen, 1992). This system limited the flexibility of monetary policy, as central banks were required to maintain a fixed ratio of gold reserves to currency in circulation.

The Fed's commitment to the gold standard was based on the prevailing economic orthodoxy of the time, which viewed the gold standard as a necessary anchor for price stability and international financial stability (Bernanke, 1995). However, as the U.S. economy contracted, prices fell during the Depression, and the actual value of gold increased, putting upward pressure on the dollar's exchange rate. This dollar appreciation made U.S. exports less competitive and encouraged capital inflows, further tightening monetary conditions and exacerbating the deflationary pressures (Eichengreen, 1992). The Fed's adherence to the gold standard also made it more challenging to respond to the banking panics and the contraction of the money supply. Under the gold standard, the Fed was required to maintain a fixed ratio of gold reserves to currency in circulation. This constraint limited the Fed's ability to expand the money supply and provide liquidity to the banking system, as doing so would have threatened the gold-backing of the dollar (Bernanke, 1995).

Additionally, the Fed's adherence to the gold standard also had significant implications for international economic stability. The gold standard transmitted deflationary pressures across countries, as nations were forced to maintain tight monetary policies to defend their gold reserves. This led to a synchronised global downturn, as countries simultaneously pursued contractionary policies (Eichengreen, 1992). Moreover, the gold standard constrained the ability of countries to pursue independent monetary policies and adjust to country-specific shocks. This lack of policy flexibility made it more difficult for countries to respond to the Depression and recover from the downturn (Bernanke & James, 1990).

Finally, the Fed's commitment to the gold standard also reflected a broader set of economic and political factors. The gold standard was seen as a symbol of financial rectitude and a bulwark against inflation. Central bankers and policymakers were reluctant to abandon the gold standard for fear of losing credibility and unleashing inflationary pressures (Eichengreen, 1992). These factors contributed to the Fed's unwillingness to pursue a more accommodative monetary policy, even in the face of a severe economic contraction.

B. Economic Impact of Fed's Policy Mistakes

1· Effects on Output and Prices

The Federal Reserve's monetary policy mistakes significantly contributed to the severity and persistence of the Great Depression. The Fed's contractionary stance in the late 1920s, its failure to respond adequately to the banking panics, and its adherence to the gold standard all combined to exert a powerful deflationary force on the U.S. economy (Bernanke, 1983). From 1929 to 1933, the U.S. price level fell by nearly 25%, as measured by the Consumer Price Index (Romer, 1993). This steep deflation was driven by the contraction in the money supply, as the Fed failed to offset the impact of bank failures and the public's hoarding of currency (Friedman & Schwartz, 1971).

The deflationary spiral had severe real economic consequences. The real debt burden increased as prices fell, leading to defaults and bankruptcies (Bernanke, 1983). The deflationary pressures also led to a decline in nominal wages and incomes, further depressing aggregate demand and economic activity. The impact on output was equally devastating. From 1929 to 1933, the real Gross Domestic Product (GDP) in the United States fell by nearly 30%, the most significant contraction in the nation's history (Romer, 1993). Industrial production declined sharply, falling nearly 50% over the same period (Bernanke, 1995).

The contraction in output was driven by a combination of factors, including the decline in aggregate demand, the disruption of credit markets, and the increased real burden of debt (Bernanke, 1983). The Fed's monetary policy failures played a central role in each channel, amplifying the downturn's severity. Econometric analysis confirms the significant impact of monetary shocks on output and prices during the Great Depression. Bernanke (1983) estimates that the contraction in the money supply can explain between 30% and 40% of the decline in output during the 1930-1933 period. Other studies, such as Romer (1990), find that monetary shocks can account for an even larger share of the decline in output, up to 50%.

The Fed's policy mistakes also had long-lasting effects on the U.S. economy. The deflationary shock of the early 1930s left a legacy of debt and financial fragility that took years to unwind (Bernanke, 1983). The economy did not fully recover to its pre-Depression output level until the late 1930s, and even then, it was operating well below its potential (Romer, 1993).

2. Effects on Employment

The Federal Reserve's monetary policy failures during the Great Depression also devastated employment in the United States. As the economy contracted sharply in the early 1930s, millions of workers lost their jobs, and the unemployment rate soared to unprecedented levels (Bernanke, 1983). From 1929 to 1933, the unemployment rate in the United States rose from 3.2% to 25.2%, the highest level in the nation's history (Romer, 1993). At its peak in 1933, over 13 million workers were unemployed, representing nearly one-quarter of the total labour force (Bernanke, 1995).

The sharp rise in unemployment was driven by the contraction in output and the deflationary pressures caused by the Fed's monetary policy mistakes. As firms faced declining demand and falling prices, they responded by cutting production and laying off workers (Bernanke, 1983). The deflation also put downward pressure on nominal wages, making it more difficult for workers to find employment at their previous wage levels. The rise in unemployment had severe social and economic consequences. The loss of income and the inability to find work led to widespread poverty and hardship (Bernanke, 1995). The psychological toll of prolonged unemployment was also severe, leading to increased rates of depression, malnutrition, and even suicide (Eichengreen, 1992).

The Fed's monetary policy failures contributed to high unemployment throughout the 1930s. By failing to offset the deflationary pressures and the contraction of the money supply, the Fed allowed the economy to remain mired in a deep recession for an extended period

(Bernanke, 1983). This prolonged downturn made it more difficult for workers to find employment and the economy to recover. Econometric analysis confirms the significant impact of monetary shocks on employment during the Great Depression. Bernanke (1983) estimates that the contraction in the money supply can explain between 40% and 50% of the decline in employment during the 1930-1933 period. Other studies, such as Eichengreen and Sachs (1985), find that countries that abandoned the gold standard and pursued expansionary monetary policies experienced a faster recovery in employment than those that remained committed to the gold standard.

Some of the consequences of high unemployment endured not only during the initial contraction in the early 1930s but extended even beyond this phase. Though the economy started growing in the mid-1930s, the unemployment rate failed to reach normal levels. It averaged 14% for the whole decade (Romer, 1993). Economic policy in the post-war period was influenced in a lasting way by the outcome of the Great Depression concerning the labour markets.

3· Comparison of Countries on and Off Gold

The Great Depression was a global phenomenon, but the experiences of individual countries varied significantly depending on their monetary policy regimes. Countries that remained on the gold standard longer, such as the United States, France, and Germany, experienced more severe economic contractions than those that abandoned the gold standard earlier, such as the United Kingdom and the Scandinavian countries (Eichengreen, 1992). This outcome divergence can be attributed to the constraints imposed by the gold standard on monetary policy. Countries that remained on the gold standard could not pursue expansionary monetary policies to counter the deflationary pressures of the Depression, as they were required to maintain a fixed exchange rate between their currency and gold (Bernanke & James, 1990). This commitment to the gold standard limited the ability of central banks to expand the money supply and lower interest rates, which could have helped to stimulate economic activity and mitigate the impact of the downturn.

In contrast, countries abandoning the gold standard could pursue more accommodative monetary policies, including currency depreciation and expansion (Eichengreen, 1992). These countries could boost their export competitiveness and stimulate domestic demand by allowing their currencies to depreciate. Expanding the money supply and lowering interest rates could counter deflationary pressures and encourage economic recovery.

Case study evidence confirms that countries that abandoned the gold standard earlier experienced less severe economic downturns and faster recoveries than those that remained committed to gold. Eichengreen and Sachs (1985) find that countries that left the gold standard in 1931, such as the United Kingdom and the Scandinavian countries, experienced a faster recovery in output and employment than countries that remained on gold, such as France and Belgium (Bernanke, 1995). Similarly, Bernanke and James (1990) show that countries that left the gold standard earlier tended to experience less severe declines in output and faster recoveries than countries that stayed on gold longer.

The United States, with its adherence to the gold standard until 1933, is a prime example of the costs of remaining on gold. Bernanke (1995) argues that the Fed's commitment to maintaining the gold standard was one of the key reasons for its contractionary monetary policy during the early 1930s. This commitment constrained the Fed's ability to respond aggressively to the banking panics and the deflationary pressures, contributing to the severity of the economic collapse in the United States.

The United Kingdom, on the other hand, provides a valuable counterfactual. The U.K.'s decision to leave the gold standard in September 1931 allowed for a more expansionary monetary policy, including a reduction in interest rates and an increase in the money supply (Eichengreen, 1992). This policy shift provided a much-needed stimulus to the U.K.

economy. It facilitated a faster recovery than in the United States and other countries that remained on the gold standard.

The comparative experiences of countries during the Great Depression highlight the critical role of monetary policy regimes in shaping economic outcomes. Countries that abandoned the gold standard and pursued expansionary monetary policies generally fared better than those that remained committed to gold and were constrained in their policy responses. The lesson for policymakers is clear: In the face of a severe economic downturn, monetary policy flexibility is essential for supporting recovery.

C. Other Contributing Factors

While the Federal Reserve's monetary policy mistakes were a critical factor in the severity of the Great Depression, it is important to note that this thesis acknowledges that there have also been other elements of structural weakness in the U.S. economy that played a significant role. One crucial vulnerability was the fragility of the U.S. banking system. In the 1920s, the U.S. banking system was highly fragmented and poorly regulated, with thousands of small, undercapitalised, and poorly managed banks (Friedman & Schwartz, 1971). These banks were highly vulnerable to economic shocks and banking panics, lacking the resources and diversification to withstand significant losses.

The structure of the banking system also made it susceptible to contagion and systemic risk. Banks were interconnected through an extensive network of correspondent relationships and interbank deposits, meaning the failure of one bank could quickly spread to others (Bernanke, 1983). The absence of deposit insurance also encouraged depositors to withdraw funds at the first sign of trouble, leading to runs even on solvent banks. These vulnerabilities were laid bare during the banking panics of the early 1930s. As the economy contracted, borrowers defaulted, and banks began to fail in large numbers (Friedman & Schwartz, 1971). Bank failures triggered further runs. The money supply contracted sharply as deposits were destroyed. Surviving banks hoarded cash (Bernanke, 1983). This monetary contraction amplified the deflationary pressures and contributed to the downward spiral of economic activity.

The banking panics also directly disrupted the flow of credit, as banks failed, and credit markets froze. Businesses and households found it increasingly difficult to obtain financing, further amplifying the contractionary effects (Bernanke, 1983). The fragility of the U.S. banking system was thus a critical factor in the depth and persistence of the Great Depression, as its fragmented and poorly regulated structure made it vulnerable to panic and contagion. Another critical factor was the debt-deflation dynamic described by Irving Fisher (1933). High debt levels in the 1920s, combined with steep price declines during the Depression, led to a vicious cycle of defaults, bankruptcies, and further contractions in economic activity (Bernanke, 1983). This dynamic made it more difficult for the Federal Reserve to stimulate the economy through monetary expansion, as the deflationary pressures offset the effects of policy interventions.

The debt-deflation spiral was particularly severe in the agricultural sector, where falling crop prices and heavy mortgage debt led to widespread farm foreclosures (Friedman & Schwartz, 1971). The lesson from the Great Depression is that preventing deflation and maintaining price stability is critical, especially in high-debt environments. Finally, the presence of nominal wage rigidities in the U.S. labour market may have also contributed to the severity and persistence of the Depression. As prices fell, but nominal wages remained sticky, the real wage increased, leading to higher unemployment and further declines in aggregate demand (Bernanke, 1983; Eichengreen, 1992).

Evidence suggests that countries with more rigid nominal wages experienced more profound and prolonged economic contractions during the Depression (Bernanke & Carey, 1996). In the U.S., nominal wages were slow to adjust downward despite the sharp fall in prices and economic activity (Eichengreen, 1992). These rigidities may have been due to factors such as the power of labour unions, long-term contracts, and employer reluctance to cut wages. Nominal wage rigidities had significant implications for monetary policy. As Bernanke (1995) noted, in the presence of such rigidities, a deflationary shock can reduce the effectiveness of monetary policy in stimulating economic activity. Even if the Federal Reserve had pursued more expansionary policies, the rigidity of nominal wages would have limited the boost to employment and output.

In conclusion, while the Federal Reserve's monetary policy failures were a central driver of the Great Depression, other structural weaknesses in the U.S. economy, such as the fragile banking system, debt-deflation dynamics, and nominal wage rigidities, also significantly amplified the severity of the downturn. Addressing these vulnerabilities became a key priority for policymakers after the Depression.

CONCLUSION

A. Summary of Key Findings

The Great Depression was certainly one of the most severe economic downturn in modern history, and understanding its causes and consequences remains a central concern for economists and policymakers. This thesis has employed a multi-faceted methodological approach, combining historical analysis and cross-country comparisons to assess the role of the Federal Reserve's monetary policy in contributing to the depth and persistence of the Great Depression.

The key findings of this thesis can be summarized as follows:

1. The Federal Reserve's monetary policy mistakes were a critical factor in the onset and severity of the Great Depression. The Fed's contractionary stance in the late 1920s, its failure to act as a lender of last resort during the banking panics of the early 1930s, and its adherence to the gold standard all contributed to the deflationary forces that turned a moderate recession into a severe economic collapse (Friedman & Schwartz, 1971; Bernanke, 1983).

2. The Fed's monetary policy failures devastated the real economy, contributing to sharp declines in output, prices, and employment. Econometric analysis suggests that the contraction in the money supply can explain a significant portion of the decline in economic activity during the early 1930s (Bernanke, 1983; Romer, 1990).

3. Countries that abandoned the gold standard and pursued expansionary monetary policies experienced less severe economic downturns and faster recoveries than countries that remained committed to it. The contrasting experiences of countries such as the United States, which stayed on gold until 1933, and the United Kingdom, which left gold in 1931, highlight the importance of monetary policy flexibility in mitigating the impact of economic shocks (Eichengreen & Sachs, 1985).

4. Although monetary factors were vital in triggering the Great Depression, structural weaknesses accompanying the macroeconomy also contributed to the depth and persistence of the recession (Bernanke, 1983; Fisher, 1933).

5. Learning from the great depression was very relevant for contemporary policymakers, particularly the need for monetary stability, the coordination of policies, and the dangers of out-of-date monetary theories (Bernanke, 1995).

B. Implications for Understanding the Great Depression

The findings of this thesis have important implications for our understanding of the Great Depression. First, they suggest that the Depression was not an inevitable outcome of underlying economic weaknesses but rather the product of policy failures and institutional flaws. The Fed's monetary policy mistakes played a critical role in transforming what might have been a moderate recession into a severe and prolonged economic collapse.

Second, the thesis highlights the complex interplay between monetary, financial, and natural factors in shaping the course of the Depression. While monetary forces were central to the downturn, the Fed's policy failures' impact was amplified by the banking system's fragility, the debt-deflation dynamics, and the rigidities in the labour market. Understanding the Depression thus requires a holistic perspective that considers the interactions between these different dimensions of the economy.

Finally, the thesis underscores the importance of international factors, particularly the role of the gold standard, in the propagation of the Depression. The countries' adherence to the gold standard and the lack of international policy coordination made it more difficult for individual countries to pursue expansionary policies and recover from the downturn. The lesson is that domestic monetary policy cannot be conducted in an interconnected global economy in isolation from international considerations.

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