

## Why did the Federal Reserve Fail?



## Why?

- Why did the Federal Reserve System allow the money supply to fall?

## The Failure of the Federal Reserve System

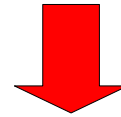
- Set up after 1908 Panic to be Bank of Last Resort to provide liquidity in *exactly* the conditions of 1929-1933.

$$M_2 \text{ Multiplier} = \frac{M_2}{M_B}$$

$$M_2 = M_2 \text{ Multiplier} * M_B$$

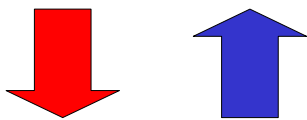
## The Failure of the Federal Reserve System

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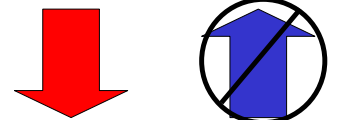
## The Failure of the Federal Reserve System

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## Why?

- Concerned about defending Gold Standard
- Failure of Leadership
- Bank of England abandoned Gold Standard and provided liquidity. Decline was milder.

## Benjamin Strong

Powerful leader of  
Federal Reserve  
Bank of New York,  
who died just  
before crash. Left  
a power vacuum.



## British Influence

Walter Bagehot  
left rule about  
expanding  
Monetary Base.



## British Influence

*A bank lives on  
credit. Till it is  
trusted it is nothing;  
and when it ceases  
to be trusted it turns  
to nothing.*



*Nothing, therefore, can be more certain than that the Bank of England has in this respect no peculiar privilege; that it is simply in the position of a Bank keeping the Banking reserve of the country; that it must in time of panic do what all other similar banks must do; that in time of panic it must advance freely and vigorously to the public out of the reserve.*



## Phase III-The Collapse of 1933

- In early 1933, bank after bank collapsed in the United States. Real implosion of economic conditions.
- FDR took over as President in March 1933.
  - Proclaimed bank holiday, restructured banks
  - Started New Deal

## Phase III-The Collapse of 1933

- In early 1933, bank after bank collapsed in the U.S. as a result of the depression of the economy.
- FDR's M<sub>2</sub> multiplier began to rise in March 1933.
  - Proclaimed bank holiday, restructured banks
  - Started New Deal

## Phase IV-1933-1940

- Recovery was long in coming and economists still debate why.
  - Next Lecture

End

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