

Lecture 13: The Great Depression, Part I

ECON 43370: Financial Crises

Prof. Eric Sims

University of Notre Dame

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The Great Depression

The Great Depression began in 1929 and persisted through the 1930s. It became a worldwide crisis and the most severe economic downturn in modern U.S. history.

The economic collapse was enormous: Between 1929 and 1933, U.S. real GDP fell nearly 30 percent, and unemployment reached approximately 25 percent.

From Crash to Panics

The October 1929 crash was an important early event, but repeated waves of banking panics followed

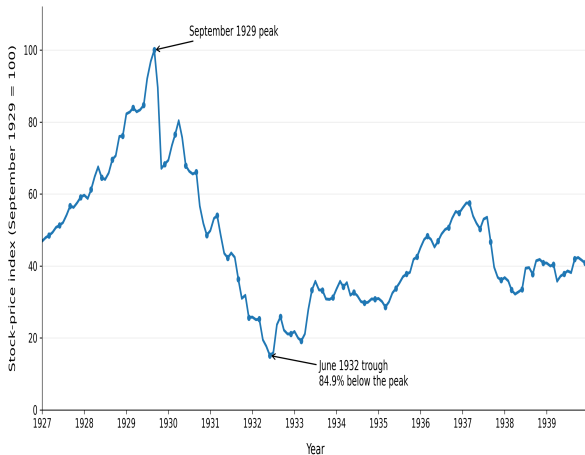
Loan losses and bank runs reinforced each other. Losses weakened banks, which heightened incentives to run

The banking system approached collapse: approximately 9000 banks suspended operations between 1930 and 1933!

Stock Market Crash

S&P Stock Price Index, 1927-1939

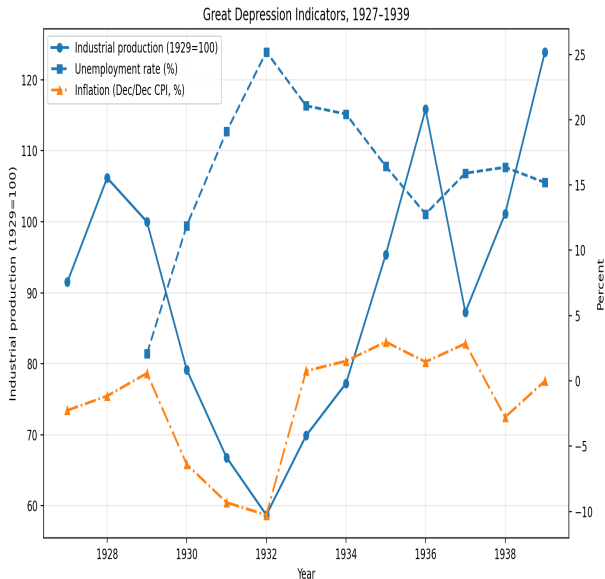
Historical composite series | Monthly observations, with quarterly markers



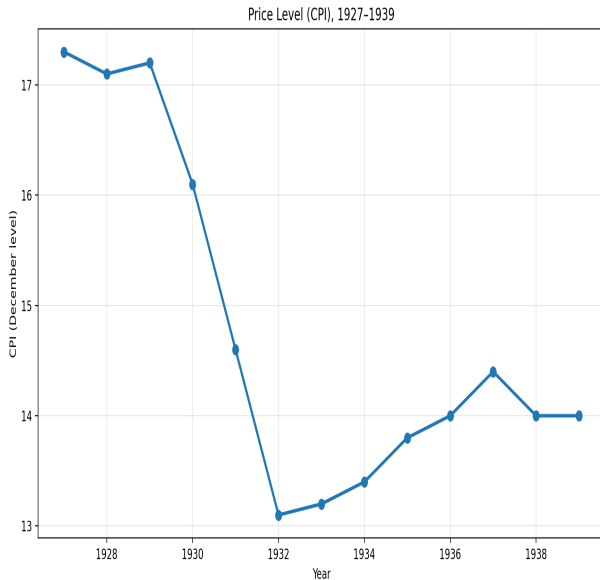
Source: NBER Macrohistory / FRED, M1125AUSM343NNBR (Cowles / Standard & Poor's historical series).

Nominal stock prices; dividends excluded. Historical series predates the S&P 500, introduced in 1957.

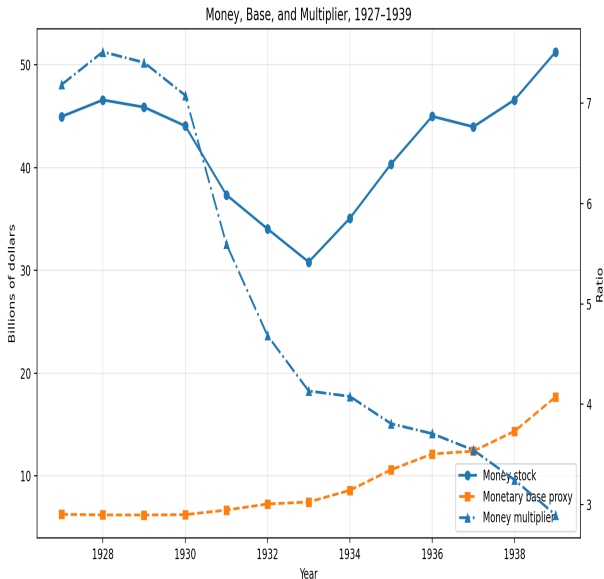
Macro Indicators



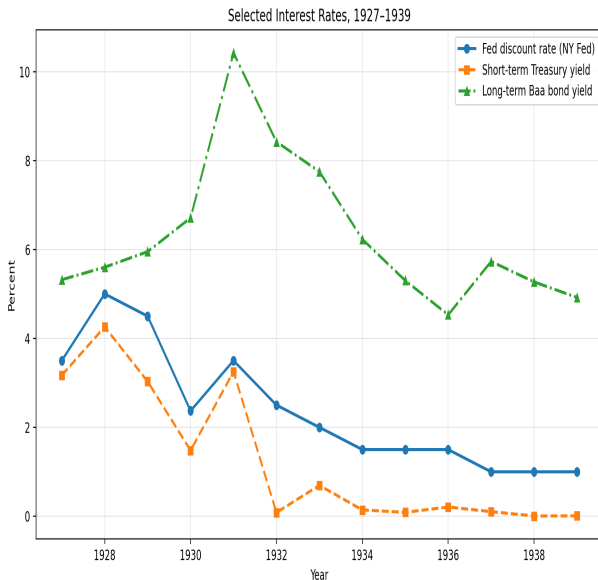
Price Level



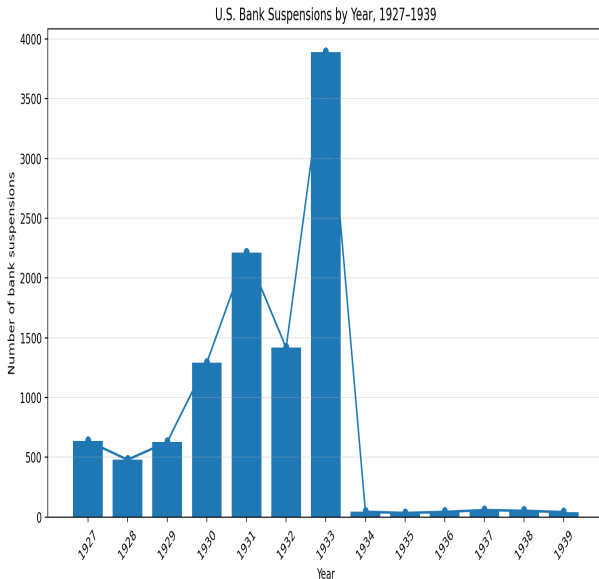
Monetary Indicators



Interest Rates



Bank Failures



A Monetary Event

The money supply contracted sharply. Depositors hoarded cash and banks accumulated reserves, shrinking bank deposits and contributing to lower spending and falling prices

This led to large reduction in aggregate demand: output and prices both fell

Bank failures disrupted the supply of credit. Lending relationships and information about borrowers were lost, making it harder for businesses to borrow, invest, and finance everyday operations.

Friedman and Schwartz Quote

“The monetary collapse was not the inescapable consequence of other forces, but rather a largely independent factor which exerted a powerful influence on the course of events. The failure of the Federal Reserve System to prevent the collapsed reflected not the impotence of monetary policy but rather the particular policies followed by the monetary authorities and, in smaller degree, the particular monetary arrangements in existence.” (pg. 13)

Friedman and Schwartz: Monetary collapse a cause, not just a symptom

Currency plus deposits fell by approximately 1/3

Runs and failures accelerated the contraction of bank deposits, transmitting financial distress to the broader economy through the money supply.

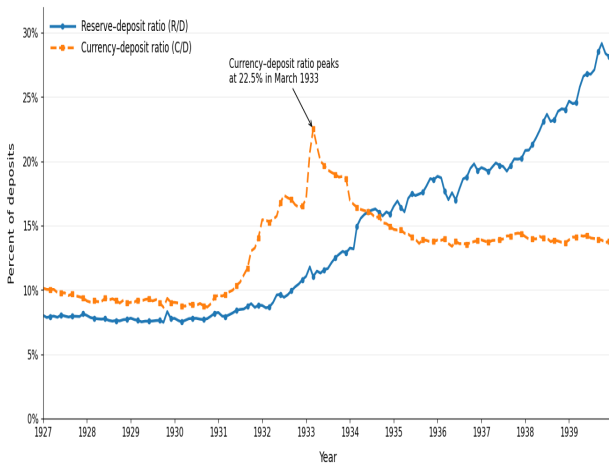
$$M = mm \times MB$$

$$mm = \frac{1 + c}{c + r}$$

The Money Multiplier

Reserve-Deposit and Currency-Deposit Ratios, 1927-1939

United States | Historical monthly estimates | Markers every quarter



D = adjusted demand + time deposits at commercial banks. C = currency held by the public.

R = bank vault cash + member-bank reserve balances at the Fed. Currency, deposits and vault cash are seasonally adjusted; Fed balances are not.

Source: NBER Macroeconomy / FRED: M1445AUSM1445NBR, M1425AUSM1445NBR, M1426AUSM0275NBR, M14064USM144NNBR.

The Fed Failed as Lender of Last Resort

More aggressive emergency lending could have helped solvent but illiquid banks meet withdrawals and prevented runs from spreading.

In 1931, the Fed raised interest rates to defend the dollar's gold convertibility, worsening domestic banking and monetary conditions.

Large-scale securities purchases in 1932 slowed the monetary contraction and were followed by signs of recovery, but the Fed ended the program.

Officials interpreted low nominal rates as evidence of easy money, despite monetary contraction and deflation that made real borrowing costs high.

The Clearing House (or lack thereof)

"We have already expressed the view that under the pre-Federal Reserve banking system, the final months of 1930 would probably have seen a restriction of the kind that occurred in 1907, of convertibility of deposits into currency. By cutting the vicious cycle set in train by the search for liquidity, restriction would almost certainly have prevented the subsequent waves of bank failures that were destined to come in 1931, 1932, and 1933 . . ." (pg. 28)

The Existence of the Fed Hampered Action

“The existence of the Reserve System prevented concerted restriction, both directly and indirectly: directly, by reduces the concern of stronger banks, which had in the past typically taken the lead in such a concerted move, since the System provided them with an escape mechanism in the form of discounting; and indirectly, by supporting the general assumption that such a move was made unnecessary by the establishment of the System. The private moves taken to shore up the banking system were therefore extremely limited.” (pg. 30)

Why did the Fed Fail?

Benjamin Strong's death in 1928; NY Fed President, experienced 1907 panic

Fragmentation: power struggle between the NY Fed and the Board of Governors in DC

Outdated thinking: "liquidationist" thought we needed to let weak banks fail

Narrow vision: not all banks were (or are) members of the Federal Reserve System (only about one third). Disagreements about whether they should be aided or not

The Role of the Gold Standard

Bernanke emphasizes that adherence to the gold standard both worsened the recession and helped it spread internationally

Importantly, he also emphasizes how cross-country comparisons provide evidence in support of the monetary nature of the Great Depression:

- Focusing only on data within a country (e.g., the US) it is easy to say causality is reversed (e.g., decline in the money supply is a symptom rather than a cause)
- Cross-country comparisons make it easier to make a causal claim

Stylized facts: countries that left the Gold Standard sooner (e.g., Great Britain) recovered sooner and more strongly than those who left later (e.g., France)

How the Gold Standard Worked

Each country promised to exchange its currency for gold at a fixed price

This implied, in essence, a system of fixed exchange rates between currencies

Central banks held gold reserves to back their issued money

Just like a regular bank needs some reserve to support its deposits (though not one-to-one), under a gold standard a central bank needs the quantity of money to gold reserves to not be too large

Defending the Gold Standard

If investors fear a devaluation, they could exchange currency for gold, threatening the viability of the standard

To discourage gold outflows, central banks often raised interest rates to make domestic assets attractive

In 1931 (in response to Great Britain leaving the gold standard), the Fed explicitly raised interest rates to defend the dollar's gold value

There was a conflict here: defending the gold standard necessitated tight policy. Being lender of last resort and stopping the economic free-fall necessitated looser monetary policy

Potential for contagion/spillover: one country enacting tight policy to protect the gold standard would trigger other countries doing the same!

Debt Deflation

The price level in the US (and other countries) contracted significantly

Most debt contracts are in nominal terms

Falling prices raise the real value of debt

Even without bankruptcies, this reallocates resources from debtors to savers

Debtors often have higher marginal propensities to consume (MPC). This reallocation can dampen aggregate demand, worsening the deflationary spiral

Borrower net worth important factor in credit supply: falling prices raises the value of outstanding debt, worsening borrower net worth

Financial Frictions and Persistence

The Bernanke article essentially asks: what kind of supply restrictions allowed a monetary demand contraction have such large and persistent effects?

Part of the role of banks is to overcome information asymmetries: screening and monitoring

When you destroy a bank, you do more than destroy deposits. You destroy information capital

That information cannot be easily or quickly rebuilt

This destruction of information capital can help make sense of the persist economic impacts of a financial crisis