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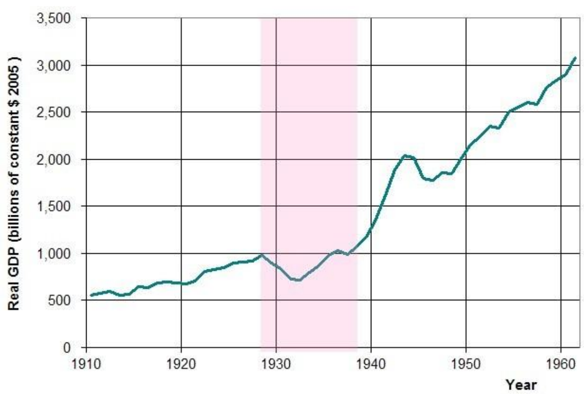
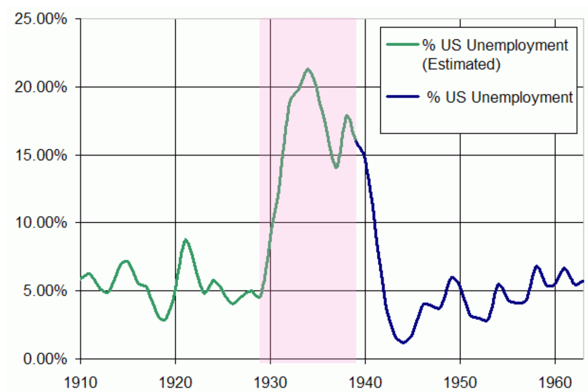
LECTURE 21: BANKS AND THE GREAT DEPRESSION

I. Fractional reserve system
  a. Banks are *financial intermediaries*: they connect savers with borrowers. They make money by turning their liabilities (debts) into assets, such as lending out a deposit.
    i. *Reserve requirements* refer to a regulation requiring the bank to hold a certain percent of deposits (typically 10%).
    ii. *Required reserves* are those deposits.
    iii. *Excess reserves* are holdings beyond the required reserves and are often used for lending.
    iv. This system is called the *fractional reserve system*; banks keep a fraction of what's deposited and the rest is lent out.
  b. A house of cards?
    i. So banks get money from depositors and then lend most of it out to others. But you can still stake a claim 100% of the money you deposited. How? It's not there anymore!!!
    ii. If you close your bank account, you'll be taking other people's deposits. This isn't a big deal—these individuals still have a claim to their money. People only want a fraction of the money in their checking account at any one time.
    iii. Every day, the bank brings in money from people paying back loans and from new deposits in accounts. Every day, money flows out in the form of loans and withdraws. On average, it balances out just fine.
    iv. The problem occurs when people take more out than what is there. This is called a bank run and when it happens, it becomes a disaster very quickly.
  c. FDIC
    i. Stopping a bank run is very hard. The more people try to take money out, the more urgent it is to withdraw money. In emergencies, the government might declare a "holiday" and close the banks, but that doesn't really solve the problem.
    ii. The Federal Deposit Insurance Corporation insures all deposits under $250,000. If the bank fails, you'll still get your money. Just make sure your bank is a member of FDIC (it's a really shady bank if it's not).

d. Money creation
   i. If a bank gets new deposits, most of that money is lent out; that's the point of the system.
   ii. But that means that a single dollar is counted twice as part of the money supply. Once as deposit—fulfilling the role as an asset of the depositor—and once as a loan—fulfilling the role as an asset of the bank.
   iii. Resist the temptation to freak out. Unlike GDP, where we hate counting things twice, this isn't a big deal. The money *should* be counted twice; the same dollar is doing two things; it's just like the velocity of money. The same money is involved in multiple transactions.
   iv. Though no money was printed, this is money creation. Loans count as money.

II. Basics
   a. Understanding money and banking is fundamental to understanding the cause of the Great Depression.
   b. The Great Depression was the longest, deepest economic downturn in U.S. history. The unemployment rate went over 20% and GDP fell as much as 24% in the first few years.[1]
   c. There was also massive deflation; prices fell by about one-third in the first few years of the Depression.
   d. Nor was it a uniquely American problem; it was worldwide and its devastating effect helped give rise to Adolf Hitler and World War II.
   e. It began in 1929 (or 1928 for some countries like Germany and Brazil) and lasted until 1939, though some argue it lasted until the end of WWII.





[1] http://www.multpl.com/us-gdp-inflation-adjusted/table

III. The Cause

a. Economic historians agree the main cause of the Great Depression was a fall in the money supply.[2] It came about due to concerns of inflation during the 1920s and inept Fed policy.
b. The effects of the GD were worldwide because most of the world was on the gold standard. Currencies, and thus economies, were linked through the price of gold. The more gold a country held, the more valuable its currency became.
c. As the U.S. and France attracted investors to park their gold in those countries, done by lowering the money supply to raise interest rates, other countries fought back. Economic activity slowed and prices fell.
d. Banks began to fail.[3] A lot of them. In 1929, there were 25,000 banks in the U.S. By 1933, there were 15,000.[4] Bank runs were common.
e. Mysteriously, the Fed did not act as lender of last resort; this turned a recession into a depression.
    i. More panic set in as banks failed. (Remember: this destroyed money.) And people hoarded money, effectively taking it out of the economy. Deflation deepened. Consumption plummeted.

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[2] Milton Friedman would win the Nobel Prize in Economics for his work in area. See the landmark book he wrote with Anna Schwartz, *A Monetary History of the United States*.

[3] Banks were failing for a lot of reasons at this time. Part is due to the above effects relating to gold. Part is due to stock market bubbles bursting (though this is a normal economic event). Part of it is due to poor bank diversification. But a big part of it was the banks that failed because of other banks that failed.

[4] https://fee.org/articles/the-great-depression-according-to-milton-friedman/