LESSON 1: THE FEDERAL RESERVE, 1928–1932

Vocabulary

- The "Fed"—Nickname for the Board of Governors of the Federal Reserve System, the central banking system in the United States; sets monetary policy for the nation
- Interest rates—What banks charge for loans and what they pay to depositors
- GDP (gross domestic product)—The measure of all goods and services an economy produces in a year
- Depression—A decline in GDP coupled with an increase in unemployment over 10%
- Recession—A downturn in the economy; milder than a depression
- Gold standard—Monetary system in which currency in circulation can be redeemed for an equivalent amount of gold
- Money—Currency (dollar bills and coins), plus checking accounts
- Bank run—When most or all depositors lose confidence in their bank at the same time and rush to withdraw their deposits (also called a "run on a bank")

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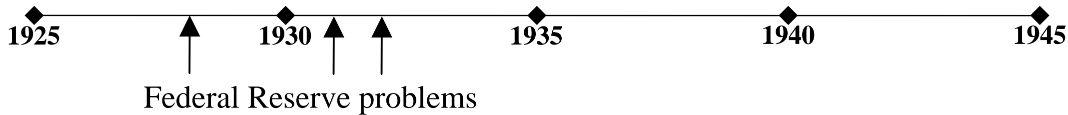
Student Handout 1



PROBLEM 1—INTEREST RATES IN 1928

You are the chairman of the Federal Reserve System (popularly known as "the Fed") in 1928. It is your job to maintain the health and stability of the U.S. banking system by regulating banking institutions and setting monetary policy (such as interest rates). The 1920s have witnessed a rapidly expanding economy, but signs of trouble have cropped up. The nation's wealth is concentrated in the hands of a very small percentage of people. Also, most Americans have no savings at all and buy goods on credit. Due to new technologies and increased efficiency, farms and industries produce more goods than ever before, but because most people can't afford them, demand has decreased. This in turn has led to a decline in prices, which will hurt businesses.

The Federal Reserve Building in Washington D.C.

There is also a great deal of speculation in the stock market. Following the "get rich quick" mentality of the 1920s, people have borrowed money in order to buy overvalued stocks. Increasing interest rates will make it harder for banks to loan money for this type of speculation. This in turn should slow down the huge increases in stock prices, but it may also hurt investments and slow economic growth.

Another problem is that the U.S. currency operates on the gold standard, which means that the money in circulation can be redeemed for an equivalent amount of gold. However, economic instability worldwide has caused foreigners to buy gold, thus decreasing the U.S. supply. Raising interest rates will make American investments more attractive to foreigners; some will invest in American businesses rather than buy gold. Higher interest rates will therefore help stop the flow of gold out of the U.S.

Will you raise interest rates to slow stock speculation and stop the loss of gold? Explain your choice.

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PROBLEM 2—INTEREST RATES IN 1931

You are the chairman of the Federal Reserve System in October 1931. The stock market has crashed and the economy has started to plummet into a depression. Unemployment has increased to about 10% of the workforce, businesses are declaring bankruptcy in alarming numbers, and the size of the economy (as measured by GDP) has decreased. Prices have also declined further as demand for products has dropped: average Americans have lost their jobs and no longer have the money to buy goods, and even the wealthy are nervous and have stopped buying luxury items.

You have also taken note of ominous events in Britain, which is experiencing a similar economic downturn. Investors there have decided that the British currency, the pound, is too unstable, so they have exchanged their pounds for gold. This has depleted the gold reserves of the Bank of London, so Britain has gone off the gold standard (meaning that Britain no longer backs its currency with gold).

Now, many U.S. investors have begun exchanging their dollars for gold. The gold supply is shrinking fast, which may force the U.S. to abandon the gold standard—something it's reluctant to do. The gold standard has traditionally been used to inspire confidence in the economy because it reassures people that the government won't begin printing large sums of money and devalue the currency. People want to know their money is backed by something solid. Increasing interest rates may offer a way to save the gold standard: Higher interest rates will encourage investors to keep their dollars since they can gain a higher rate of return on them, rather than cashing them in for gold.

Meanwhile, prices have dropped rapidly—about 10% this year. Declining prices make people reluctant to take out loans because the amount of the loan stays fixed while the amount of money earned from business or work will keep dropping—even for the same number of goods sold or the same amount of work. Declining prices make loans a bad risk.

As chairman of the Fed, you could take several actions regarding interest rates and the money supply. Remember that the money supply consists of both currency (dollar bills) and checking accounts. Each of the proposals below is followed by an argument made by a proponent of that proposal. Keep in mind that you can't implement all the proposals, since they contradict each other. Consider the arguments carefully and decide which you will choose:

A. Increase interest rates and shrink the money supply a little. This should prevent inflation and stop the loss of gold. If you keep the value of the dollar strong, investors will probably have more confidence that inflation will not erode their profits. That should then motivate them to start investing more, which will expand the economy.

B. Keep interest rates and the money supply at current levels. This will keep the amount of borrowing stable and the value of the dollar steady.

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C. Decrease interest rates and expand the supply of money a little. Lower interest rates should lead to more business borrowing and investment as well as more consumer borrowing, which will help the economy expand. Increasing the money supply should stop prices from dropping, which will motivate more people to take out loans, which will help the economy expand.

Which will you do? Increase, maintain, or lower interest rates? Explain your choice.

PROBLEM 3—LOANS TO WEAK BANKS IN 1932

Thousands of banks have gone out of business due to "bank runs," which occur when depositors lose confidence in their bank and all rush to withdraw their money at the same time. Since the bank only has a fraction of the deposits on reserve at any one time, it quickly runs out of cash and is unable to give depositors their money. The bank is then forced to close. Depositors lose their savings, and people lose faith in the banking system and choose to keep their money out of banks. For this reason, over one-third of banks nationwide have gone out of business. Most are small banks; banks in rural areas have been hit especially hard.

A crowd of depositors gathers outside a bank

As chairman of the Fed, you need to decide if you will help weak banks by lending them money to survive bank runs. If you choose to help the weak banks, you risk losing the money you lend to them if the banks don't recover, which in turn would weaken the Federal Reserve System itself. However, one of the main purposes of the Federal Reserve System is to preserve the stability of the banking system.

Will you lend money to banks in order to keep them in business? Explain your choice.

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