JUNIOR RESEARCH PROJECT

Field of Study n. 16: History

Was the Great Depression in the US the result of a bad credit boom?

Adrian Vlna

Jihočeský kraj

Soběslav, 24.1.2025

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Autor: Adrian Vlna

Škola: Česko-anglické gymnázium s.r.o., Třebízského 1010/9, 370 06 České Budějovice 5

Kraj: Jihočeský kraj

Konzultant: Mgr. Štěpánka Kloudová

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Annotation

This document dives into the role of debt and margin lending in exacerbating the financial collapse during the Great Depression. It highlights how excessive private credit, fueled by speculative borrowing in the stock market, created a fragile economic environment. Margin lending, which allowed investors to borrow up to 80-90% of a stock's value, amplified risks by encouraging unsustainable speculation. The subsequent stock market crash triggered widespread defaults, leading to a contraction in private credit and further destabilizing the banking system. The text also explores how systemic debt issues, compounded by deflation and reduced lending capacity, contributed to the economic downturn. Reforms introduced during the Depression aimed to address these vulnerabilities, showcasing the dangers of unchecked debt expansion and the need for regulatory safeguards.

Keywords

Great Depression, Gold Standard, Monetary Policy, Bank Failures, New Deal

Obsah

Introduction

Studying history throughout our lifetimes has been crucial for determining the potential outcomes of possible scenarios in the future. This can be especially implemented in the financial sector and economic principles. While there have been decades of prosperity among nations and individuals, there has always been some depression or an economic downturn afterward. When things seemed like everything was prospering, doing great and people were starting to spend unconsciously there has always been some correction. We can see the exact thing when we look at the Roaring Twenties in the US, which took place just after the First World War. The economy was recovering and prospering after the war, wealthy people were squandering money everywhere, the stock market was soaring, people were borrowing money and no one was paying attention to the actual problems the US economy had. Among the biggest ones were: consumer and institutional debts that were created due to credit borrowings, inflated and uncontrolled stock market with money that never existed, job losses due to mechanization of factories, overproduction and underconsumption of goods, high wealth concentration among the top 1%, they controlled about 40% of the total wealth in the US, low wages amid workers, and many more. All of the negligence on the actual things that mattered led to what we now know as the Great Depression.

Since I was fifteen years old, I have started to be interested in topics around business and finance. I was eager to learn about the stock market and a potential way to retirement, and I was fascinated by what can compound interest do, if we start investing early. Furthermore, I was determined to learn how the banking system works and what are the connections between banks, the stock market, institutions, and the public. Once I had done some research, I frequently came across recessions and problems the financial system faced or is facing. This is where I came across The Great Depression. The biggest and most devastating recession in the US. I thought to myself that it would be beneficial to study what happened and what were the reasons that had made it possible. While I have been analyzing the depression, many of the reasons rose questions in my head. One of the questions I wanted to know was: How it was possible that banks did not have enough gold to back up the currency? It was very surprising to me, because at that time the US had been on the gold standard and came off the gold standard in 1933. This meant that all of the money in circulation, including the money that was borrowed, should have been backed up by gold. I will explain further in one of the upcoming chapters how the borrowings and the gold standard actually worked, thus explaining why they did not have the required amount of gold. This is also the time when I have stumbled upon Mike Maloney, one of the leading speakers, teachers and publishers about gold, silver and history of money. He is a public speaker that tries to educate people around the topics of money policies and the investment assets such as gold and silver. He published many books and has free and accessible content on the internet. With the current condition the world economy is in and US debt rising, I wanted to deeply understand how credit and the money supply work, and he can provide me with that information. Additionally, the Great Depression is a perfect example of money borrowings and the collapse of the banking system.

This is where it all started. That is why I am going to focus my Junior Research Project on the banking and financial system in the Great Depression. I am going to touch upon credit borrowings, how the US banking system works, what went wrong and what was the impact of it on the US stock market and the banking system, and what preventive measures were thereafter adopted. Moreover, I will also add some interesting facts, and I will go over why the US had to come off the gold standard. I will try to show the huge spike in credit borrowings and the structure of the contract between the banks and the borrowers. I find the things included in the contract quite interesting, and I think many will too. I will also try to show how big of an influence credit had on the stock market and how "easy" it was to collapse it.

Throughout my work, I will use professional literature from universities and professionals like: Mike Maloney, Milton Friedman, and Anna Schwartz. I will use the information they provided in their books and articles to make a statement about credit borrowings and the collapse of the market. I will also try to extract important graphs that will help us to better understand the whole concept of credit borrowing. The graphs will also help us to understand the correlation between different assets and between credits, banks, and the stock market, and how all of the assets and things that have happened, have effects on each other. Furthermore, I will try to explain most of the professional terms so that even someone who has no idea what I am talking about will be able to understand it.

The US banking system before the Great Depression

Introduction

The US banking system has always played a crucial role in shaping the nation's economy and influencing its financial stability. Understanding the structure and practices of the banks in the pre-Great Depression era is essential for grasping how economic systems can evolve or collapse under stress. During this period, banking practices were often loosely regulated and susceptible to instability, setting the stage for the financial turmoil[1] of the Great Depression. This chapter examines the key aspects of the U.S. banking system before the Great Depression, including the historical development of banks, the dual banking system, banking operations, and how financial crises foreshadowed the economic collapse of the 1930s.

1. Historical Context of Banking in the United States

A. Early Banking Institutions

The US banking system can be traced back to the late 1700s. Prior to the first U.S. bank, it was up to the individuals to provide credit to each other or to rely on credit from banks in Great Britain. This changed in 1781 when the Bank of North America became the first financial institution chartered by the US Congress and opened in 1782 in Philadelphia. Shortly after, Alexander Hamilton founded the Bank of New York in 1784, which still operates today as BNY Mellon and is the oldest continuously operating bank in the US. Additionally, the Bank of Massachusetts was also founded in 1784 and, through mergers, is a part of Bank of America today. When George Washington became the first President in 1789, he chose Hamilton to serve as the first Secretary of the Treasury, who worked to provide the U.S. with a modern banking system. The creation of banks was inevitable and they were very much needed to facilitate trade and manage public funds[2]. These banks had the power to issue their own banknotes and accept deposits, and they played a crucial role in local economies by providing much-needed credit to businesses and individuals.

State-chartered banks, banks created and regulated by the state government, operated with minimal regulation, which often led to a proliferation of unstable institutions. The system allowed for a wide range of variation in how banks were managed and operated, with little

[1] Financial turmoil refers to a state of severe instability or disruption in the financial system, often characterized by rapid declines in asset (anything of value owned by an individual, business, or organization that can be converted into cash or used to generate economic benefits, they can include physical items, financial instruments, or non-physical resources) values, loss of confidents among investors, businesses, and consumers, ext.

[2] A public fund is money collected and managed by a government or public authority, primarily sourced from taxes, or other public income streams. It is allocated to finance public services, infrastructure projects, welfare programs, and other initiatives aimed at benefiting the community or nation as a whole.

standardization across states. This contributed to frequent issues of trust[3] and liquidity[4], primarily the ability of the bank to provide cash to depositors when they want to withdraw their funds, which would later become key factors in financial instability.

B. The First Bank of the United States

The first bank of the United States was established under the leadership of Alexander Hamilton by the Congress in 1791 to deal with war debt from the Revolutionary War; a conflict between the American colonies and Great Britain, in which the colonies fought for and won their independence, leading to the creation of the United States; and to create firm financial footing for the government and private enterprises. The bank had eight branches spread across the East Coast and it was headquartered in Philadelphia. This was the first vision of Hamilton, the first Secretary of the Treasure, of a central bank, one that could act as a source of capital to develop new businesses and grow the economy. The impact of the First Bank of the United States was profound, as it helped regulate the money supply and offered a measure of financial order. However, its charter, which was set to last for 20 years, was not renewed in 1811 due to the opposition from political parties who feared that it gave too much power to a centralized financial institution. The absence of a central bank in the following decades left the U.S. banking system decentralized and vulnerable to crises. [5]

2. The Dual Banking System

A. Federal vs State Banks

By the mid-19th century, the U.S. banking system had developed into what is known as the dual banking system. The birth of this system is closely tied up to the 1913 Federal Reserve Act, in which Congress created the Federal Reserve System to serve as the central bank of the United States and guide the nation's modern policy. This system is characterized by the coexistence of both state-chartered and nationally chartered banks. The nationally chartered banks are regulated on the federal level and state banks are regulated by each state. There is an overlap between those two systems, with certain state banks subject to regulation on both levels, as national and state banks have different regulations. While this system maintains two crucial pros: that national banks benefit from their greater scale, while state banks can be more innovative and accustomed to the needs of their communities, and that the two types

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[3] Trust is a legal setup where one person (the trustee) manages assets for someone else (the beneficiary) based on the instructions of the person who created the trust (the grantor)

[4] Liquidity refers to how easily and quickly an asset can be converted into cash without affecting its price.

[5] WEBER WE. Early State Banks in the United States: How Many Were There and When Did They Exist? *The Journal of Economic History*. 2006;66(2):433-455. doi:10.1017/S0022050706000180

complement each other; it adds a certain level of complexity for bankers and consumers that wouldn't exist in a single banking system.

While there had been significant differences in regulations, oversight, and operations, state banks continued to operate under changeable state laws, often issuing their own currency and operating without a unified standard. In contrast, federally chartered banks adhered to national laws and standards, which provided a more consistent framework for banking practices. Additionally, this duality created competition between federal and state banks, often leading to tensions over-regulation and control.

B. The Role of The National Banking Act of 1863

The National Banking Act took place during the Civil War and was created in 1863, with its main objective being to raise money for the North to defeat the South. The act established a system of nationally chartered banks and introduced a national currency, the official money issued by a country's government, backed by federal bonds, a government-issued debt security where investors lend money in exchange for interest payments and repayment after a set time.

The act created competition for state banks, and legislators went a step further the next year by passing an amendment to tax the issuance of state banknotes, a "bill" or a form of currency that one party can use to pay another party. The number of state banks substantially dropped, but a key innovation by them – demand deposits, which allowed depositors to withdraw their money anytime – led to a strong comeback in the number of state banks. However, today the Federal Reserve is the only bank that can issue banknotes and mint money, the process of producing coins.

The transition to federally chartered banks under the National Banking Act marked the beginning of a more standardized banking system. Banks that chose to operate under a federal charter were subject to stricter regulations, which helped infuse greater confidence in the banking system. [6]

3. Banking Practices and Operations

A. Deposit and Loan Practices

In the early years of the U.S. banking system, banks primarily operated by accepting deposits from individuals and businesses and then loaning those funds to borrowers at interest.

[6] Barret Ridgely, W. (1904). Government Control of Banks and Trust Companies. The ANNALS of the American Academy of Political and Social Science, 24(1), 17-26

This process of lending was essential for economic growth, as it allowed businesses to expand and individuals to invest in property and enterprises. However, the banking system's reliance on short-term deposits to finance long-term loans often created liquidity issues, making banks vulnerable to runs when depositors demanded their money back.

The Great Depression is a perfect example of this, where thousands of banks collapsed due to bank runs. Initially, in 1929, many banks lost money gambling on the stock market, leading to a loss of capital and people's money. The public quickly learned about those losses, causing panic and loss of trust in banks. Additionally, the lack of confidence forced people to flood the banks and demand their money back. This was fatal as people demanded their money at once, leading many banks to collapse. By 1933, more than four thousand banks closed, leaving many people homeless and destitute.

The significance of fractional reserve banking, a practice in which banks only kept a fraction of their deposits in reserve and loaned out the rest, became increasingly apparent. While fractional reserve banking allowed banks to maximize the funds they could loan out, it also made them susceptible to liquidity crises when they were unable to meet the withdrawal demands of their customers. This practice was a major factor contributing to the instability of many banks during financial panics, as addressed in the paragraph above. I would like to point out that under normal circumstances the banks would be fine. The crucial thing that led banks to collapse is: almost an immediate stop of inflows, in this case, deposits, and sudden requests for withdrawals at once.

B. Currency and Monetary Policy

Before the establishment of the Federal Reserve in 1913, the issuance of currency in the U.S. was largely decentralized[7]. State-chartered banks and, later. Nationally chartered banks issued their banknotes, which circulated as currency. These banknotes were often backed by a combination of gold, silver, and government bonds[8], but their value and acceptance varied widely, leading to a fragmented monetary system.

The role of gold and silver standards was central to monetary policy during this period. The U.S. operated on a bimetallic[9] standard for much of the 19th century, with currency backed by both gold and silver. This created tension between supporters of hard money (those who favored the gold standard) and soft money (those who supported inflationary policies[10] using silver). The eventual move toward the gold standard in the late 19th century helped bring more stability to the currency but also limited the money supply, which had economic repercussions, particularly during times of financial crisis.

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[7] In finance, it often refers to a system, like decentralized finance (DeFi), where decisions and operations are distributed among multiple participants instead of being managed by a central authority.

[8] A bond is a fixed-income investment where an investor lends money to a government, corporation, or organization in exchange for periodic interest payments and the return of the principal amount at maturity. They are used to raise capital and are considered less risky then stocks.

[9] Bimetallic standard was a system in which a government recognizes coins composed of gold and silver as legal tender (coins or banknotes that must be accepted if offered in a payment of debt)

[10] Inflationary policy refers to government or central bank actions that increase the money supply or boost demand, leading to higher inflation.

If the US had chosen to move toward inflationary policies using silver, it would have allowed them to mint more silver coins or more currency to be backed by silver. While this would be highly beneficial during times of financial crisis, it would have a significant impact on the daily lives of regular people. Why? Implementing these measures would automatically allow the FED to inject more money into circulation, leading to a devaluation of the current currency, while also supporting inflation. [11]

4. The Impact of Financial Panics and Crises

A. The Financial Panics of the 19th Century

The 19th century was marked by several significant financial panics, including the Panic of 1837, the Panic of 1873, and the Panic of 1893. These events were characterized by widespread bank failures, a collapse in confidence, and severe economic downturns.

The Panic of 1837, for instance, was triggered by speculative lending practices and the collapse of land values, leading to widespread bank runs and failures. Similarly, the Panic of 1873 was caused by the collapse of major investment bank and the subsequent crash of the railroad industry, which had been heavily financed by speculative investments. In response to these crises, the government often took limited action, with banks bearing the brunt of the responsibility for stabilizing the economy.

B. The Role of Speculation

Speculation played a significant role in the stability of the banking system during this period. Banks often engaged in speculative investments, particularly inland and railroads, which were seen as lucrative, money-making, opportunities for rapid financial gains. However, when these speculative bubbles burst, banks were left with large amounts of bad debt, which eroded public confidence in the banking system.

Notable speculative bubbles, such as the railroad boom of the 1870s, serve as case studies in the dangers of unchecked speculation. As banks became more heavily involved in financing risky ventures, combined with loose regulatory oversight, contributed to the financial instability that would later culminate in the Great Depression.

[11] WHEELOCK, David C. Monetary policy in the Great Depression: What the Fed did, and why. *Federal Reserve Bank of St. Louis Review*, 1992, 74.2: 3-28.

5. Prelude to the Great Depression

A. Economic Conditions Leading up to the Depression

The 1920s, often referred to as the "Roaring Twenties," were a period of rapid economic growth and prosperity in the United States. The stock market boomed, and consumer confidence was high. However, beneath the surface, there were significant issues that foreshadowed the coming economic collapse. Over-leverage and reckless lending practices became widespread, as banks extended credit to businesses and individuals without sufficient regard for risk. This created a fragile financial system that was highly susceptible to shocks.

The over-extension of credit was particularly problematic in the agriculture sector, where farmers borrowed heavily to expand production. When crop prices fell, many farmers were unable to repay their loans, leading to widespread defaults[12] and bank failures, particularly in rural areas.

B. The Stock Market Crash of 1929

The stock market crash of 1929 marked the beginning of the Great Depression and had a devastating impact on the banking system. Many banks had invested heavily in the stock market, and when the market crashed, they faced enormous losses. At the same time, panicked depositors rushed to withdraw their savings, leading to a wave of bank runs and failures.

The connection between banking practice and the crash is clear: banks had become deeply entangled in speculative investments, and their failure to maintain adequate reserves made them vulnerable to financial shocks. The immediate effects on banks were catastrophic, as hundreds of institutions collapsed in the aftermath of the crash, leaving millions of Americans without access to their savings and fueling a deeper economic depression.[13]

What Went Wrong?

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[12] In finance, default refers to the failure to meet a financial obligation, such as not making a loan payment or failing to repay bonds.

[13] BERNANKE, Ben S.; JAMES, Harold. The gold standard, deflation, and financial crisis in the Great Depression: An international comparison. 1990.

Introduction

The Great Depression was marked by a catastrophic collapse of financial systems and severe economic contractions. Its roots lay in excessive credit expansion, speculative bubbles, rigid monetary policies tied to the gold standard, and systemic structural weaknesses in banking. To understand the scale and intensity of the Depression, it is essential to examine the role of borrowing on credit, the mechanics of speculative investing, and the limitations imposed by the gold standard, including the volume of gold in circulation and its backing of the monetary supply.

1. The Overextension of Credit and Borrowing on Margin

The 1920s saw an unprecedent expansion of credit in the United States. Banks and financial institutions, driven by optimism and loose regulations, extended credit liberally to consumers and investors. For many Americans, purchasing stocks, real estate, and consumer goods on credit became a commonplace practice, enabling a consumption-driven economy. However, this widespread borrowing created significant vulnerabilities when asset prices began to fall.

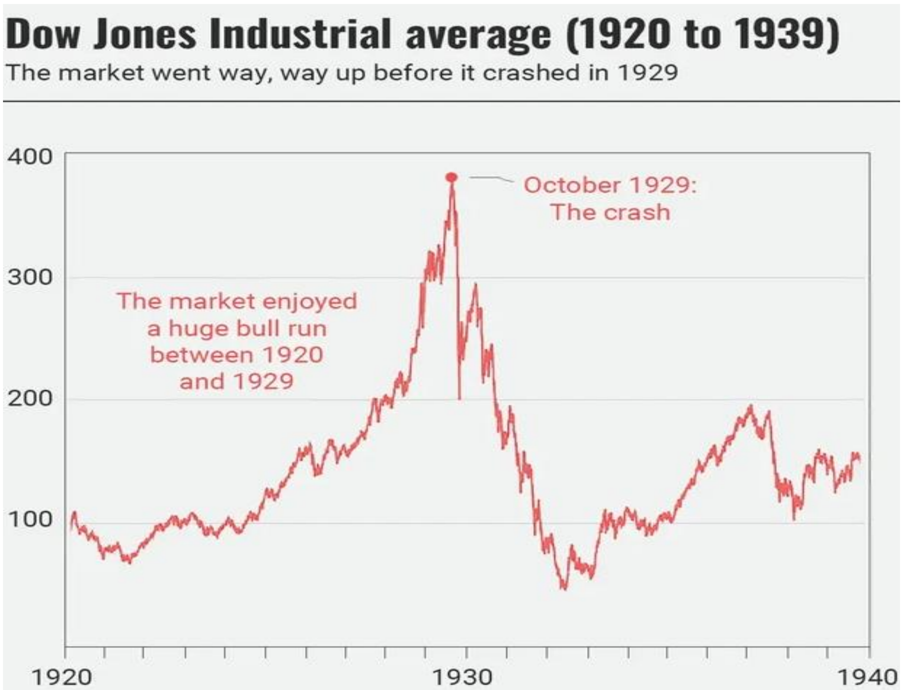
Margin lending[14] in the stock market showed how excessive speculation dominated the decade. Investors could buy stocks with only 10-20% of their own money while borrowing the remaining 80-90% from brokers or banks. This practice, known as buying on margin, allowed investors to leverage small amounts of capital to control large amounts of stock. Such extreme leverage meant that even minor declines in stock prices could trigger margin calls[15], forcing investors to repay their loans or liquidate their holdings at a loss. As stock prices collapsed in late 1929, the wave of margin calls spiraled into a full-scale market beating. We can examine this behavior in Figure 1. Just over the span of two years, the assets bought on margin doubled and reached its peak at the end of October 1929. Promptly after, the spiral of margin calls kicked in and the stock market plummeted. When we observe Figure 2, we can see how the stock market drop correlates exactly with the margin call triggers. The stocks' market sharp drop bottomed in 1933 after the U.S. government implemented several key measures. Those key measures such as: The Emergency Banking Act of 1933, The Banking Act of 1933, and the

[14] Margin lending is a type of loan where an investor borrows money from a broker to buy securities, using their existing investments as collateral. This allows for greater purchasing power but also increases risk, as losses can exceed the initial investment if the market moves unfavorably.
[15] Margin call is a demand from a broker or financial institution requiring an investor to deposit additional funds or securities into their margin account to meet the maintenance margin requirement. This occurs when the value of the investor's account falls below a specified threshold due to declines in the value of securities/assets purchased on margin. Simply said, if your position declines in value by a substantial amount, you will be required to add funds into your account, if you want to stay in your position. If the price doesn't turn back up and keep going down, your position will be closed automatically, to protect your capital, so that you won't lose all of your capital.

Securities Act of 1933, gave a strong foundation for the stock market's slow recovery. You'll learn more about these Acts in Chapter 3.

Figure 1: Margin debt as a percentage of GDP

Figure 2: The stock market drop of 1929



Public institutions and wealthy individuals were not immune to speculative risks. Many large financial institutions engaged in aggressive borrowing and stock market speculation, believing that the economic boom would continue indefinitely. When the bubble burst, these institutions faced insolvency, spreading financial instability throughout the banking system. The combination of overextended credit and speculative excesses left businesses, households, and banks heavily exposed when economic conditions worsened.

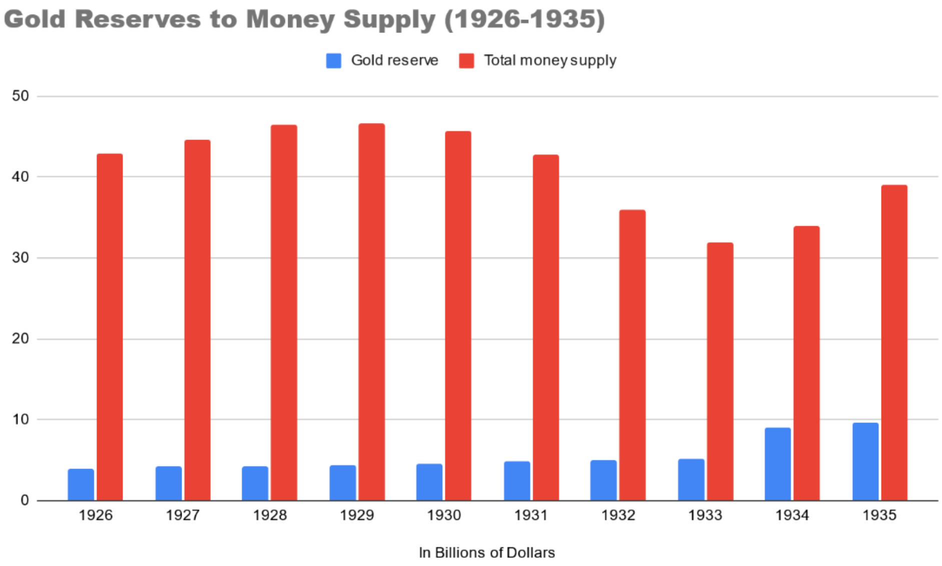
2. Monetary Policy Missteps and the Gold Standard

At the outbreak of the Depression, the total amount of gold in the U.S. circulation was approximately $4 billion. This gold backed the entire U.S. money supply, which was significantly larger, creating a reserve ratio of around 10-15%. This means that for every dollar in circulation, 10-15 cents were effectively backed by gold reserves. While this system provided a degree of confidence in the dollar's stability, it also imposed significant constraints on monetary policy.

When the Great Depression began, deflationary pressures captivated the U.S. economy. Under the gold standard, the Federal Reserve's ability to expand the money supply was severely restricted, as increasing currency issuance required proportional increases in gold reserves. This limitation forced the Federal Reserve to prioritize defending the gold reserves rather than addressing the domestic economic crisis. Consequently, interest rates were kept high, intensifying deflation and reducing investment at a time when economic stimulation was desperately needed. When we look at Figure 3, we can observe the significant drop in the money supply during the period from 1929-1933, followed by a rise, after abandoning the gold standard in 1933. The most significant action in this chart is the gold reserve supply increase between 1933 and 1934. This was the time when the U.S. revalued gold from $20.67 to $35 per ounce through the Gold Reserve Act. This was the time when the government centralized gold ownership by requiring individuals to sell their gold to the Treasury[16]. The higher gold price increased the value of U.S. gold reserves, enabling more currency issuance and attracting global gold inflows. These actions boosted liquidity, reduced debt burdens, and made U.S. exports more competitive. While criticized internationally, the revaluation strengthened government control over monetary policy, helping to pave the way for economic recovery and positioning the U.S. as a dominant financial power.

[16] The Treasury refers to the United States Department of the Treasury, a federal government agency responsible for managing the nation's finances.

Figure 3:



Internationally, the gold standard created a ripple effect of deflationary policies. Countries with trade deficits or gold outflows tightened monetary policy to protect their reserves, further reducing global demand and worsening the economic contraction. The interconnected nature of the gold standard meant that a crisis in one country could easily spread to others, intensifying the global downturn.

3. The Abandonment of the Gold Standard

The U.S. departure from the gold standard in 1933 marked a pivotal moment in the fight against the Depression. President Franklin D. Roosevelt's decision to suspend the gold convertibility allowed the dollar to devalue and freed monetary policy from the constraints of gold backing. This policy shift had several transformative effects.

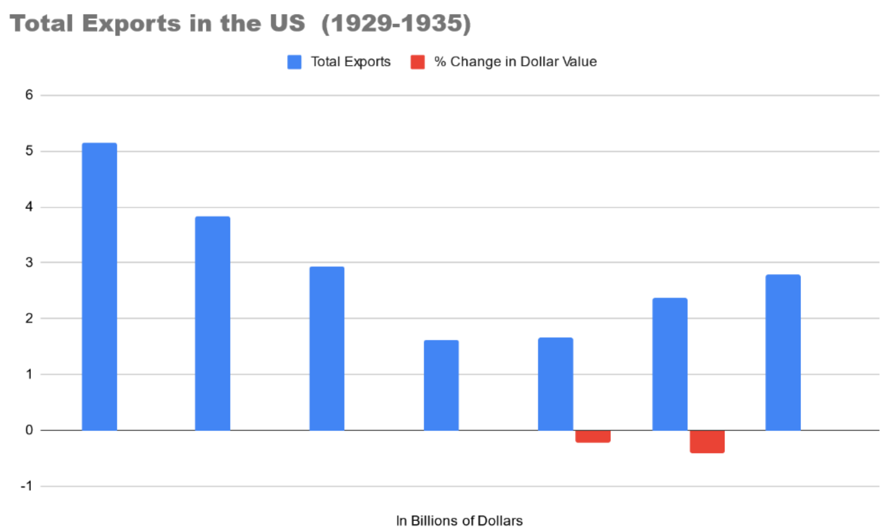
a. Expansion of the Money Supply

Abandoning the gold standard enabled the Federal Reserve to expand the money supply without fear of depleting gold reserves. As clearly shown in Figure 3. This monetary expansion helped to counter deflation, stabilize prices, and restore confidence in the economy. By increasing the money supply, the government could inject liquidity into the banking system, easing credit flows to businesses and consumers. While looking at Figure 3, we can also catch up on the fact, that not only the money supply is expanding, but the gold reserves are too. Why? By accumulating gold, the U.S. positioned itself as a global economic leader, boosted its monetary flexibility, and most importantly laid the foundation for the dollar's dominance in international finance. It also strengthened the confidence in dollar, as gold reserves remained as a symbol of financial stability and strength.

b. Boost to Exports

The devaluation of the dollar made American goods more competitive in international markets, spurring exports and supporting domestic industries. Look at Figure 4. We can see the clear downtrend of exports right from the start of the Depression, finally settling in 1933. The red bar shows us the percentage change of the dollar's value, in this case, the devaluation. We can see that the dollar lost almost 45% of its value in 1934, right after losing around 22% the year prior. This was right at the time of the implementation of the Gold Reserve Act. The Act made American goods cheaper for foreign buyers, enhancing their competitiveness in international markets, as we can see in the rising exports following. By allowing the currency to float, the U.S. could adjust to global economic conditions, promoting recovery in key sectors like manufacturing and agriculture.

Figure 4:



c. Debt Relief

Deflation during the early years of the Depression increased the real burden of debt for businesses and households, as they had to repay loans in dollars that were gaining value. The abandonment of the gold standard, coupled with controlled inflation, reduced the real value of debts, easing financial pressures on borrowers and promoting economic activity. [17]

[17] BERNANKE, Ben S.; JAMES, Harold. The gold standard, deflation, and financial crisis in the Great Depression: An international comparison. 1990.

4. Positive Outcomes of Abandoning the Gold Standard

The decision to leave the gold standard yielded significant economic and policy benefits, providing a foundation for recovery and long-term reforms.

a. Increased Policy Flexibility

Without the gold standard, the Federal Reserve and Treasury could implement countercyclical monetary policies. This flexibility allowed the government to respond more effectively to economic fluctuations, setting the stage for Keynesian approaches[18] to fiscal and monetary policy.

b. Prevention of Future Crises

The gold standard's rigidity contributed to the spread and severity of the Great Depression. Its abandonment illustrated the importance of adaptable monetary systems in managing modern economies. Future crises, such as the 2008 financial collapse, were met with aggressive monetary expansion, a strategy enabled by the lessons learned from abandoning the gold standard.

c. Global Recovery

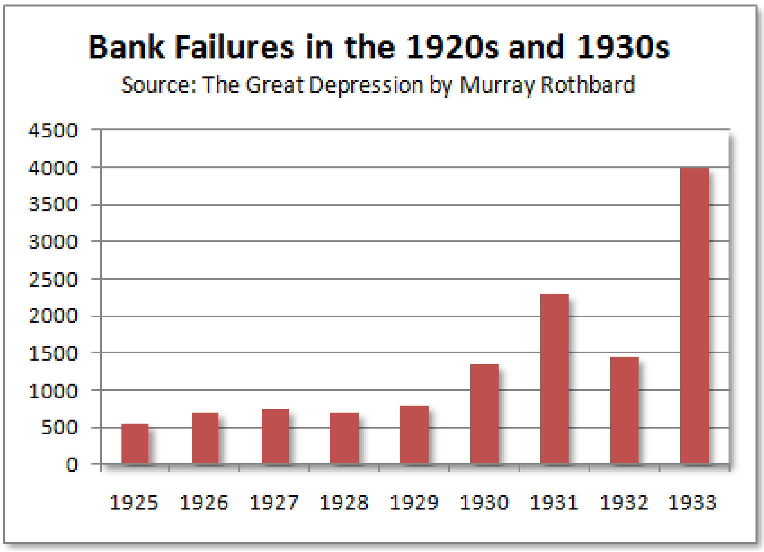
Countries that abandoned the gold standard earlier, such as the United Kingdom in 1931, experienced quicker recoveries compared to those that maintained it. By freeing themselves from gold's constraints, these nations could pursue stimulative policies, demonstrating the benefits of monetary independence.

5. Bank Failures and Financial Instability

The collapse of the banking system during the Great Depression was a devastating blow to the U.S. economy, both cause and an effect of the crisis. By 1933, more than 9,000 banks had failed, wiping out the life savings of millions of Americans and plunging the economy into deeper turmoil. The roots of this collapse lay in the speculative excesses of the 1920s, the structural weaknesses of the banking system, and the inflexibility of monetary policy under the gold standard. Figure 5 shows us the start of the banking crisis and its peak in 1933. The number of banks, which failed in 1933 climbed up to 4000, making it one of the worst years in the banking history. We can see, how it perfectly correlates with the stock market crash and margin bubble.

[18] Keynesian approaches refer to economic theories based on the ideas of John Maynard Keynes, emphasizing government intervention to manage economic cycles. These approaches advocate for increased government spending and lower taxes during recessions to boost demand and reduce unemployment, and reduced spending or higher taxes during booms to control inflation.

Figure 5:



Banks had been heavily involved in speculative lending during the economic boom of the 1920s, providing loans for businesses and individuals engaging in high-risk investments, particularly in the stock market. Investors often borrowed on margin, purchasing stocks with as little as 10-20% of their own money while financing the rest through bank loans. When the stock market crashed in 1929, the value of these investments plummeted, and borrowers were unable to repay their debts. As a result, banks faced mounting losses and a wave of insolvencies, which escalated in 1933, just before all of the banking reforms were implemented.

The structure of the U.S. banking system intensified its fragility. Many banks were small, independent institutions with limited reserves, serving only local markets. These smaller banks were less diversified and more vulnerable to regional economic shocks. Furthermore, they often relied on short-term deposits to finance long-term loans, leaving them highly exposed to sudden withdrawals. This mismatch became catastrophic during the widespread bank runs of the early 1930s when depositors, fearing for their savings, rushed to withdraw funds. These runs drained banks of their liquidity, forcing many to close their doors permanently.

The Federal Reserve's commitment to the gold standard further constrained its ability to provide emergency liquidity to struggling banks. Under the gold standard, the dollar was tied to a fixed amount of gold, which meant that any significant expansion of the money supply risked depleting gold reserves and undermining confidence in the currency. This rigid monetary policy left the Federal Reserve unable to act as an effective lender of last resort[19]. Instead of increasing liquidity to stabilize the banking system, the Federal Reserve often raised interest rates to protect gold reserves, intensifying deflationary pressures and deepening the economic downturn.

[19] A lender of last resort (LoR) is an institution, usually a country's central bank, that offers loans to banks or other eligible institutions that are experiencing financial difficulty or are considered highly risky or near collapse. In the U.S., the Federal Reserve acts as the lender of last resort to institutions that do not have any other means of borrowing, and whose failure to obtain credit would dramatically affect the economy.

Adding to the crisis was the absence of deposit insurance. In the early 1930s, depositors had no guarantees of recovering their savings if a bank failed. This lack of protection heightened the public's fear and accelerated the pace of withdrawals during bank runs, even from solvent institutions. Without a safety net, the financial system spiraled into instability.

The collapse of the banking system had far-reaching economic consequences. The loss of savings among millions of Americans reduced consumer spending, while the contraction of credit paralyzed businesses, leading to widespread bankruptcies and layoffs. Deflation intensified the crisis as the value of money increased, raising the real burden of debt for borrowers and discouraging new investments.

The failures of the U.S. banking system during the Great Depression exposed deep vulnerabilities in the nation's financial framework. The lessons learned during this period shaped reforms that strengthened the system's resilience, including the creation of deposit insurance and the adoption of more adaptable monetary policies. These changes would help ensure greater stability in the face of future economic challenges.[20]

What Preventive Measures were thereafter adopted?

The Great Depression revealed deep structural flaws in the financial system, prompting sweeping reforms[21] to prevent future economic catastrophes. These changes targeted banking regulations, monetary policy, and broader economic stability mechanisms.

1. Banking Reforms

To restore trust in the banking system, legislation was introduced to stabilize financial institutions and protect depositors. In response to the financial catastrophe, sweeping reforms were introduced to stabilize the banking system. The Banking Act of 1933 established the Federal Deposit Insurance Corporation (FDIC), which provided government-backed insurance for bank deposits, restoring public confidence. The FDIC initially insured deposits up to $2,500 per account, which was later increased over time.

In addition to deposit insurance, the Glass-Steagall Act imposed a clear separation between commercial banking, which dealt with depositors and loans, and investment banking, which was involved in securities trading and speculation. By preventing banks from engaging in both commercial and speculative activities, the Act aimed to reduce the risky speculative

[20] POSTEL-VINAY, Natacha. Was the US Great Depression a credit boom gone wrong? *Postel-Vinay, N.(forthcoming)." Was the US Great Depression a Credit Boom Gone Wrong*, 2021.

[21] The term sweeping reforms refers to extensive and significant changes introduced to reshape economic policies, financial regulations, and institutions. These reforms aim to address systemic failures, prevent future crisis, and create more stable, equitable, and sustainable financial systems.

practices that had contributed to the financial collapse. This separation was crucial preventing banks from using depositors' money for high-risk investment ventures, which had been a significant cause of the stock market crash.

The Act also required banks to maintain a certain level of reserve funds, thus ensuring that they could meet the withdrawal demands of customers during periods of financial instability. It also established the Federal Reserve Board's role in overseeing these new regulations and ensuring that banks adhered to them.

2. Broader Economic Reforms

To address systemic vulnerabilities, the government introduced two critical pieces of legislation during the New Deal[22]: the Social Security Act of 1935 and the Wagner Act of 1935.

The Social Security Act provided long-term financial security through unemployment insurance and retirement benefits. It established a federal safety net for workers, ensuring that those who lost their jobs or reached retirement age could receive assistance, significantly reducing poverty among the elderly and vulnerable populations.

The Wagner Act empowered workers to organize and bargain collectively, aiming to stabilize wages and demand. It also created the National Labor Relations Board to protect workers' rights and investigate unfair labor practices. This Act helped strengthen labor unions and improve the position of workers in negotiations with employers.

3. Post-Depression Financial Reforms

On the international front, the Bretton Woods system restructured global monetary relations, tying major currencies to the U.S. dollar while fostering international cooperation through institutions like the International Monetary Fund (IMF) and the World Bank. Domestically, governments adopted Keynesian economic principles, using fiscal policies to stabilize economic cycles and prevent deep recessions. Enhanced consumer protections ensured greater transparency in credit markets and safeguarded borrowers from predatory practices.

These reforms collectively strengthened the financial system, creating mechanisms to mitigate future risks and stabilize the economy during crises. The changes established frameworks that remain influential in modern and economic policy. [23]

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[22] The New Deal was a series of economic and social programs introduced by U.S. President Franklin D. Roosevelt in the 1930s to help the country recover from the Great Depression. It focused on relief for the unemployed, recovery for the economy, and reform of the financial system. Key programs included Social Security, public work projects, and banking regulations.

[23] EICHENGREEN, Barry; MITCHENER, Kris James. The Great Depression as a credit boom gone wrong. 2003.

Conclusion

The Great Depression was a defining moment in U.S. economic history, resulting from a combination of speculative credit practices, systemic banking weaknesses, and restrictive monetary policies tied to the gold standard. The unprecedented collapse of the banking system and the financial chaos of the 1930s exposed critical flaws in the economic framework of the time. As millions of Americans lost their savings and livelihoods, the crisis reshaped the financial landscape and necessitated sweeping reforms.

The era underscored the dangers of unchecked speculation and inadequate banking regulation, as well as the limitations of the gold standard, which constrained monetary policy during times of crisis. The abandonment of this rigid system marked a turning point, enabling the U.S. government to stabilize the economy through monetary expansion and currency devaluation. These measures, along with legislative reforms such as the Glass-Steagall Act and the establishment of the FDIC, created the foundation for a more stable and resilient financial system.

The study of the Great Depression is crucial because it illuminates how speculative credit practices, such as excessive margin lending, amplified financial instability. Investors leveraged as much as 80-90% of stock purchases on borrowed money, creating a fragile economic bubble that burst catastrophically during the stock market crash. This period also highlights the perils of relying on restrictive monetary systems like the gold standard, which limited the FED's ability to respond to deflation and liquidity crises. By examining how private credit reached unsustainable levels and the resulting feedback loops of defaults and bank collapses, we can better understand the systemic vulnerabilities that led to the crisis.

The lessons learned from the Great Depression extend beyond its immediate economic aftermath. They continue to inform modern approaches to financial regulation, monetary policy, and crisis management. By studying this period, policymakers and financial institutions are better equipped to anticipate and mitigate the risks of future economic crises. The Great Depression remains a powerful reminder of the importance of vigilance, adaptability, and proactive measures in maintaining financial and economic stability.

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List of Pictures

Figure 1: Margin Debt to GDP. (n.d.-b). https://substackcdn.com/image/fetch/f_auto,q_auto:good,fl_progressive:steep/https%3A%2F%2Fbucketeer-e05bbc84-baa3-437e-9518-adb32be77984.s3.amazonaws.com%2Fpublic%2Fimages%2F94bb24b8-1329-4eb5-bb57-a9a11fbaaeb0_594x380.png. Accessed 18 January 2025

Figure 2: *The Dow Jones Industrial Average*. (n.d.). Retrieved from https://thehustle.co/the-banker-who-caused-the-1929-stock-crash. Accessed 18 January 2025

Figure 3: Bank Failures. (n.d.). https://seekingalpha.com/article/186864-some-interesting-facts-about-great-depression-bank-failures. Accessed 21 January 2025