4-2010

# Groupthink Theory and the Great Crash of 1929

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by

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Undergraduate honors thesis under the direction of

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Submitted to the LSU Honors College in partial fulfillment of
the Upper Division Honors Program.

[April, 2010]

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## Introduction

One of the most prevalent theories in the study of small group decision-making is groupthink. Irving Janis, who originally developed the concept defines groupthink as "a mode of thinking that people engage in when they are deeply involved in a cohesive in-group, when the members' striving for unanimity override their motivation to realistically appraise alternate courses of action" (Janis 1982, p.9). While this definition could be used with any form of small group decision-making, Janis's body of work largely focused on foreign policy decision-making[1]. However, the study of groupthink did not end with Janis's work. Janis himself argued in his original book that groupthink could affect various governmental and nongovernmental groups, and he called for additional research into such situations. In fact, since Janis's initial publications on groupthink, the theory has continued to evolve beyond foreign policy decisions and is used to better understand various areas of group decision-making.

In this study I intend to apply the groupthink theory, as it was proposed and modified by Janis, to the decision-making process of the Federal Reserve Board during the stock market crash of 1929 and its aftermath (commonly referred to as the "Great Contraction"). By analyzing groupthink as it relates to this instance of monetary decision-making, I intend to show how the presence of groupthink contributed to the poor monetary policy decisions exhibited during and following the market crash of 1929.

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[1] Most of Janis's work focused on foreign policy decision-making during foreign policy events such as Pearl Harbor, the invasion of North Korea, the Bay of Pigs invasion, and the Vietnam involvement. The only non-foreign policy instance in which Janis examined groupthink in a different political context is limited to the Watergate cover-up.

## Groupthink Literature Review

As I alluded to in the introduction, previous studies concerning groupthink have largely centered on foreign policy decision-making. However, some more recent papers have taken groupthink out of the foreign policy realm to evaluate other governmental and non-governmental small group decision-making processes (Bantel and Jackson 1989, Hensley and Griffin 1986, Thies 2004). Within these papers, the authors take groupthink ideas developed by political psychology and international relations scholars and apply them to groups that have no involvement with foreign affairs. The success of these applications vary, but they are nonetheless insightful as to the applicability of groupthink to various institutions. Indeed, the ideas present in foreign policy literature that precede these studies still serves as an important basis for the use of groupthink theory in any arena.

In Janis's initial research, groupthink is identified as a detailed conceptual framework with various antecedent conditions that give rise to a concurrence-seeking need in the group. This concurrence-seeking need then leads to symptoms of groupthink, which in turn produce various symptoms of poor decision-making. All of this combined leads to a low probability of a successful outcome. In short, the groupthink theory attempts to address the adverse effects of the consensus building tendencies in a cohesive small group under a large degree of stress (Janis 1982). As scholars such as Longley and Pruitt have pointed out, Janis's initial characterization of groupthink is rather confusing because it "incorporates not only the process itself (a certain mode of collective thinking), but also some of the antecedents (a cohesive in-group, personal involvement in it by individual members), as well as some of its effects (a reduced capacity to realistically appraise alternative courses of action)" (Hart 1991, p.256).

However, in later versions of Janis's work he does clarify the operational formulation of his theory. The causal connections between antecedents as well as indicators and effects are made explicit in the following flow chart (see figure 1).

Looking at the flow chart, the observer can see that there are three types of "causes" of groupthink that Janis refers to as antecedent conditions. These conditions are: high cohesiveness of the decision-making group, specific structural characteristics or faults of the organizational context in which the group operates, and stressful internal and external characteristics of the situation. Then, as a result of the antecedents being met, Janis identifies characteristics or symptoms of groupthink that fall into three categories.[2] The symptoms are: those producing an overestimation of the group, those producing closed-mindedness, and those producing pressures toward uniformity. When these concurrence-seeking traits become excessively evident, the probability of finding a desired outcome is reduced. As Paul't Hart explained in his review of Janis's work, "closed-minded, stereotyped, overconfident and morally exempt decision-makers are highly unlikely to strike the right, or at least satisfactory, key" (Hart 1991).

Since Janis's publications, several other analysts have moved forward in developing the groupthink theory. In the mid 1970's, after the Watergate scandal broke, scholars tried to determine if Nixon and his advisors exhibited any groupthink tendencies. Their work was met with various levels of success. In Raven's work (Raven 1974), the author found many conditions and symptoms of groupthink present, but he did not find some of the most important characteristics of groupthink within his analysis. Using sociometric techniques to analyze Nixon's political team, Raven found a high level of conflict within a highly competitive group.

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[2] Throughout groupthink literature, indicators of groupthink are referred to by many different terms. In order to remain consistent, I will refer to groupthink indicators as symptoms from this point forward.

Figure 1

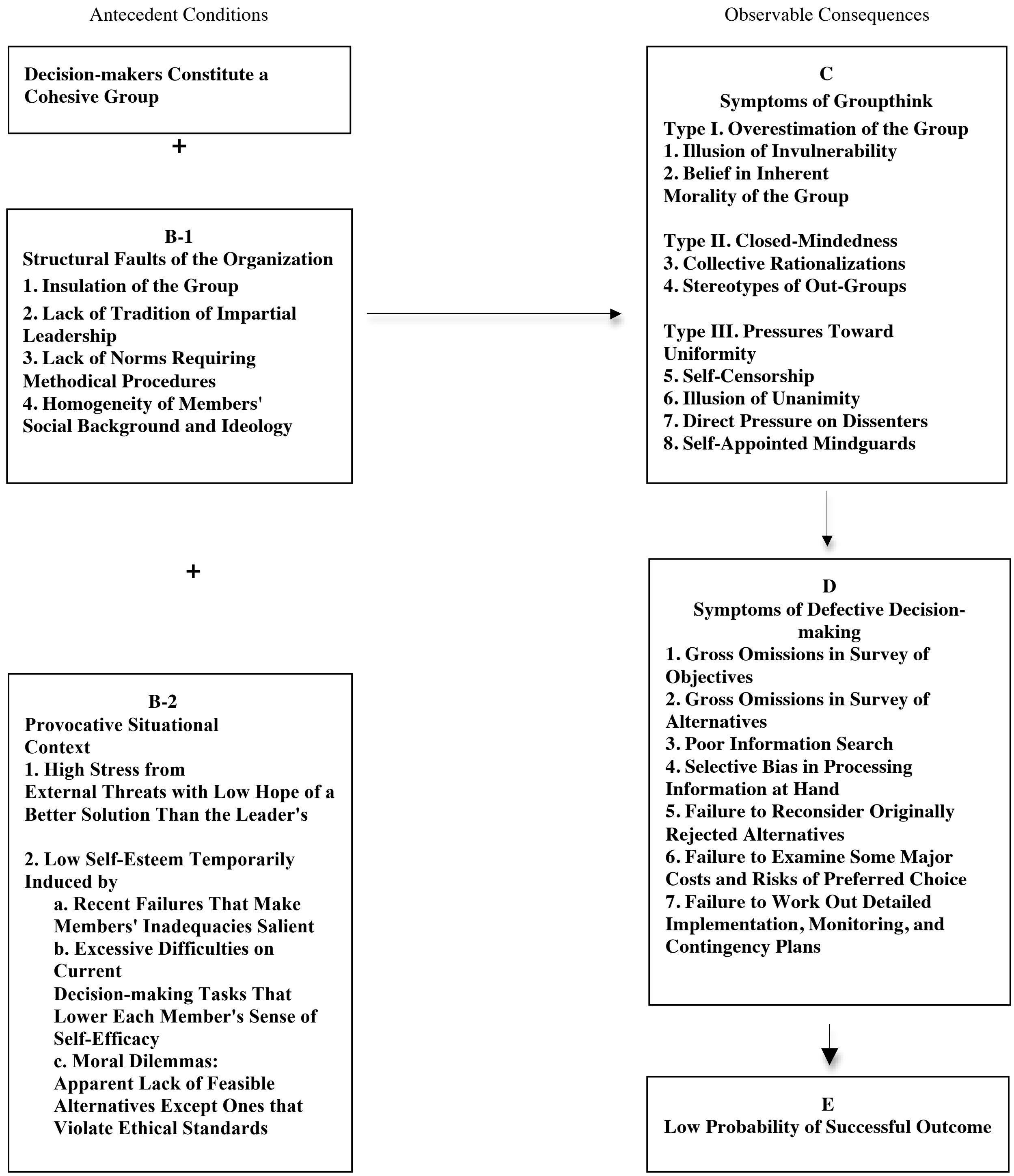


Fig. 1: Groupthink theory: A Model. (Janis 1982)

Thus, groupthink was exceedingly unlikely. On the other hand, however, various other works did in fact establish the presence of groupthink symptoms in the Nixon group during the Watergate scandal (Green and Connolly 1974). Janis even went on to study the Watergate affair and use groupthink explanations for evaluation purposes.

Further studies concerning groupthink inside and outside the foreign policy arena have brought mixed results with respect to the implications of the theory based on what case was being studied and the methodology used. Using the technique of integrative complexity[3], Philip Tetlock found that relative to groups not exhibiting groupthink, decision-makers hindered by groupthink had more simplistic perceptions of policy issues and viewed their own country's (United States) policy decisions more positively (Tetlock 1979). However, Tetlock also found some inconsistencies with Janis's theory; an example being groupthink decision-makers did not perpetrate a greater degree of negative references to their opponent (Soviet Union) (Tetlock 1979). In an article by Schafer and Crichlow, the authors also use a quantitative approach to address Janis's prescribed antecedents of groupthink. Their work finds faulty decision-making rooted in leadership style, traditional group procedures, and patterns of group behavior. However, their work also found that various external factors such as a short time constraint, high personal stress, or a recent failure are in fact not as important as once thought (Schafer and Crichlow 1996).

Moving past evaluations of Janis's work, the groupthink theory has been expanded upon and modified over the past few decades. McCauley uses the cases in Janis's original work to argue the assertion that groupthink arises from mere compliance (individual public agreement

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[3] Integrative complexity refers to the degree by which thinking and reasoning involves recognizing and integrating multiple perspectives and possibilities and the resulting interrelated contingencies (Tetlock 1979)

that is not actually accompanied by private acceptance of the prevalent perspective). Therefore, according to McCauley, groupthink does not come about only from the internalization of group norms and opinions (McCauley, 1990). Another paper attempting to expand on Janis's original theory uses groupthink to explain choice shifts in the context of crisis decision-making. According to Minix, decision quality under stress is an important issue in crisis decision-making. Moreover, groupthink as a syndrome was not likely to appear in crisis decision-making by small groups, but when present was detrimental to the quality of decision-making. In other words, excessive risk-taking is regarded as the important factor (Minix 1982).

With the plethora of research on groupthink, much of it conflicting with each other, it is impossible to identify exactly what is the complete definition of the phenomenon. Since Janis's initial research on the subject, the study of groupthink has grown and evolved a great deal. What remains constant, however, is the important role groupthink has played over the last few decades in political psychology and international relations. Thus, I believe it is beneficial to apply groupthink, as Janis proposed it, to the study of a "different" small group decision-making body: the Federal Reserve Board.

## Methodology

To study the impact of concurrence seeking behavior on the Federal Reserve Board decision-making process during the times surrounding the market crash of 1929, I intend to qualitatively test for the existence of groupthink. Using biographies, memoires, Federal Reserve Board minutes, historical newspaper articles, and various other economic publications, I will piece together the relationships on the Federal Reserve Board and throughout the entire system to examine the context in which they were working. Due to the large quantities of reliable information available concerning the Federal Reserve in the wake of the Great Crash, I am confident in the results an observational groupthink study can produce.

A methodological concern that may arise from undertaking a qualitative investigation of groupthink during the time surrounding the Great Crash of 1929 is a problem of objectivity. More specifically, the concern arises from the requirements used to accept or reject various aspects of the theory. Obviously, it is not in the vein of quality academic research to select a theory and then use hindsight to look for precisely those data that prove such theory, while ignoring or manipulating the data that violate the theory. Therefore, I will try to alleviate this concern by following a procedure for collecting data used in Griffin and Hensley's 1986 study entitled, "Victims of Groupthink: The Kent State University Board of Trustees and the 1977 Gymnasium Controversy." Their methodology proceeds by first requiring more than one type of evidence before concluding that any specific condition or symptom has occurred, and if only one example of the symptom or condition is cited, then I will not conclude that the factor was present. Second, in examining the antecedent conditions, symptoms of groupthink, and

symptoms of defective decision-making, I will only apply a piece of evidence to one specific condition or symptom within each of the categories. For example, one piece of evidence cannot be used to establish the presence of all the symptoms of groupthink. Finally, I have attempted to accumulate the largest and most diverse data in testing the components of the theory, and I will not use hard evidence from any source that has had its validity challenged by another source.

The model I will primarily use for my analysis will be Janis's groupthink model. However, I will not solely rely on Janis's work, but instead I will supplement his material with additional conditions and consequences found in subsequent research. While I understand many reviews of Janis's groupthink theory have called into questions the accuracy of his work, his core principles of groupthink are still used to achieve a greater understanding of decision-making groups. Furthermore, Janis's groupthink theory has never been applied to monetary decision-making specifically, so there is no precedent concerning how well groupthink as defined by Janis can apply to such a situation.

Finally, I will define each component of groupthink I will be testing. My discussion of these components will proceed chronologically depending on what point in the decision-making process each one occurs. Therefore, I will first address antecedent conditions, followed by symptoms of groupthink and ending with symptoms of defective decision-making.

## Antecedent Conditions

As seen in figure 1, Janis's study of groupthink is split into two major parts: antecedent conditions and observable consequences. The antecedent conditions are the "causes" of groupthink and without these conditions groupthink is less likely to arise. Furthermore, this point in the decision-making process is very important because this is when "precedents are set, group

norms are established, leadership style emerges, and situational constraints materialize"[4] (Schafer and Crichlow 1996, p.417). Hence, in my analysis of Federal Reserve decision-making during the Great Contraction, I will first evaluate how prevalent each of the three causes were in the decision-making body prior to the Great Crash beginning in October 1929. These three causes are discussed next.

*High cohesiveness of the decision-making group*

According to Janis, group cohesiveness arises from members' own valuation of the group in which they belong and their motivation to continue their membership in the group. "Cohesiveness is thus determined by the attractiveness of the group to its members, resulting from such factors as friendship, prestige, and mutual support" (Hensley and Griffin 1986, p.507). Thus, group cohesiveness is a central component to the development of groupthink because a highly cohesive group develops methods of unspoken understanding and a way to work together without in depth explanations for their actions (Hart 1991).

*Structural Faults of the Organization*

According to Janis there are many structural faults that can plague a decision-making body. These are: insulation of the group, lack of traditional impartial leadership, lack of norms requiring methodical procedures, and homogeneity of members' social background and ideology. Group insulation presents itself when decision makers detach themselves from those outside the group; therefore isolating themselves from outside sources of information and opinions. This

[4] Additionally, it is important to note that by definition all antecedent conditions must precede the occurrence of the symptoms of groupthink or the symptoms of defective decision-making. This dimension of time is explicit in the theoretical framework of groupthink.

then leads to a lack of procedures set for easy communication with non-group members of the organization.

Lack of tradition of impartial leadership takes shape when a leader has a history of failing to conduct impartial decision-making processes. A leader who is generally biased will make his or her positions clear throughout the decision-making process, limiting open discussion among members. Furthermore, the leader does not feel constrained by general traditions to avoid pushing for his or her own preferred agenda and does not encourage unbiased inquiry into other alternatives (Schafer and Crichlow 1996, see also Schafer and Crichlow 2001).

A lack of norms requiring methodical procedures concerns the ability of a group itself to get reliable and complete information and to deliberate on that information and options available. By traditionally ignoring methodical information searches, failing to hold systematic group meetings, and avoiding analysis of pros and cons the decision-making body proves to lack methodical procedures. With no methodology set to obtain information it becomes very easy for a group to only obtain partial information even when complete information is available (Schafer and Crichlow 1996).

Lastly, the homogeneity of members' social background and ideology refers to how alike group members are to begin with. Generally, it is believed that a group whose members are similar to start with is more likely to develop a strong in-group bias, shutting out other opinions and perspectives (Hart 1991).

*Provocative Situational Context*

It is hard to imagine that a phenomenon such as groupthink could easily occur in times of calm. Instead, Janis insists that stressful internal and external characteristics of a situation are

precursors to groupthink. When decision-makers are under a great deal of stress and dealing with a crisis, the likelihood of groupthink arising dramatically increases. The provocative situational components are: high stress from external threats with low hope of a better solution than the leader's, and low self esteem temporarily induced by recent failures, excessive difficulties in current decision-making tasks, or apparent lack of feasible alternatives except ones that violate ethical standards (Janis 1982). High stress from external threats refers to a large amount of anxiety caused by the magnitude of the crisis at hand. High stress from external threats with low hope of a better solution than the leader's becomes important in regards to groupthink because it is thought to increase group cohesiveness and concurrence-seeking tendencies. When groups are under a lot of stress, they may band together and rely on one another for moral support throughout the trying time. Additionally, having low self-esteem caused by recent failures, excessive difficulties in current making-tasks, or apparent lack of feasible alternatives except ones that violate ethical standards are believed to hinder the effectiveness of a decision-making body because recent failures effect the attitudes of the decision-making group and affect current decisions.

As addressed earlier, Schafer and Crichlow's analysis concerning the antecedent conditions of groupthink states the most problematic factors for group decision-making to fall most specifically into the categories of leadership style, traditional group procedures, and patterns of group behavior. On the other hand, they argued that a short time constraint, high personal stress and a recent failure do not seem to be a factor in poor decision-making (Schafer and Crichlow, 1996). Therefore, in building off both this work and Janis's, I will examine all the antecedent conditions I have previously mentioned, while adding extra weight to the three problematic factors identified by Schafer and Crichlow.

## Symptoms of Groupthink

If the antecedent conditions of groupthink are witnessed within a group and if a concurrence-seeking tendency exists, then it is possible for symptoms of groupthink to follow. Janis identifies eight symptoms, but groups them into three groups. These groups are as follows:

### *Overestimation of the Group*

According to Janis, there are two ways in which a group can overestimate itself. First there could be an illusion of invulnerability, creating excessive optimism and encouraging risk taking. Moreover, groups that perceive themselves as having control over events that they actually have little to no control over are less likely to thoroughly analyze the situation they are in, take unnecessary risks and make more overall mistakes (Ahlfinger and Esser 2001, Schafer and Crichlow 1996). Second, if members of a group view their motives and actions as being of high morality, they are more likely to ignore ethical consequences of their decisions.

### *Closed-mindedness*

Under this category stands collective rationalization and stereotyping out-groups. With collective rationalization, the group tries to rationalize warnings or other information that might lead them to reconsidering past assumptions or past policy decisions. "These rationalizations reflect the group's desire not to question and possibly destroy the consensus they have established around their decision" (Hensley and Griffin 1986, p.516). When a group stereotypes the out-group they rely on cursory, often negative, judgments instead of learning more about the other group's true nature or intentions. By relying upon stereotypes, a group may ignore information or signals that could lead to more efficient dealings with an out-group.

*Pressure Toward Uniformity*

Lastly, Janis identifies four types of pressures towards uniformity as symptoms of groupthink. First, self-censorship of ideas that deviate from the understood beliefs of the group can manifest when a group wants to maintain a consensus. I would like to note that this symptom is a particularly hard one to analyze because individuals, by nature, are not likely to admit to this even if it occurred. In addition, public statements and actions are indirect indicators at best of this symptom. Second, an illusion of unanimity can persist due to the presence of groupthink. At large, groupthink literature contends this illusion of unanimity may be due in part to self-censorship of deviations as well as from incorrect assumptions that silence indicates consent. Direct pressure on dissenting group members also falls under the category of pressures toward uniformity. Many times members of a group are labeled as disloyal for expressing dissent, proving a strong incentive for them to withdraw any dissenting opinions from the task at hand. Finally, the last symptom of pressure towards uniformity is emergence of self-appointed "mind guards". These "mind guards"[5] serve to protect the group from hearing adverse information that might ruin their shared understanding concerning the effectiveness and morality of the decision. On many occasions, the person who acts a the mind guard is trying to block a policy that he or she personally oppose from gaining support or to prevent a policy that he or she favors from being undermined. Mind guards are a symptom of groupthink because they keep members unaware of pertinent information and they may signal that a decision-making body is more concerned with adhering to an ideological agenda than pursing helpful information, carefully analyzing various arguments, and adequately thinking through actions (Schafer and Crichlow 2010).

[5] Also sometimes referred to as "gatekeepers" in groupthink literature

While it is possible for all these symptoms to be present in a decision-making process, not all eight symptoms are required to say groupthink has occurred. As I have noted some symptoms are harder to test for then others and I will move forward in my analysis with these difficulties in mind.

## Symptoms of Defective Decision-Making

Now that the antecedent conditions and the symptoms of groupthink have been indentified it is important to briefly identify what the consequences of groupthink may be. In Janis's work he identified seven different ways a group's decision-making can be impaired. It is important to note, however, that these instances of defective decision-making are not exclusively linked to groupthink. While groupthink can explain various aspects of defective decision-making, there could also be exogenous variables that actually lead to factors of poor decision-making. In spite of this, by undertaking a thorough examination of groupthink in any context, a strong case can be made that the occurrence of any of the symptoms of defective decision-making are related to the presence of groupthink.

### *Gross Omissions in Survey of Alternative*

The first type of defective decision-making occurs when a group fails to systematically evaluate a variety of alternate plans of action. Some ways in which a group can engage in this type of gross omissions is by failing to consider the likely risks, costs, and prospects of success for alternative courses of action.

### *Gross Omissions in Survey of Objectives*

Another aspect of defective decision-making that stems from symptoms of groupthink is the incomplete survey of objectives. When a group fails to review, discuss, or carefully consider its objectives and the nature of its situational goals before deciding on a course of action to embark on, defective decision-making is probable.

*Poor Information Search*

This symptom refers to the failure of a group to pursue information that may be available and necessary to engage in critically evaluating decision options. This can be a result of many problems including, but not limited to: "arrogance, ignorance, misguided deference, or even a conscious decision to not contact someone who has relevant information and is available to talk. Decision-makers who make their choices off of necessarily incomplete information stand a greater risk of seeing their plans fail" (Schafer and Crichlow 2010).

*Selective Bias in Processing Information at Hand*

The fourth symptom of defective decision-making is a selective bias in processing information. Usually, this means that a group will screen out information that does not support the group's decision or might threaten the cohesion of the group. Moreover, the group will only accept new information when it supports a preferred alternative or to refute other information that they are exposed to. This can lead to decision-makers using poor, incomplete or largely inaccurate information to make a decision.

*Failure to Reconsider Originally Rejected Alternatives*

This facet of defective decision-making involves the refusal of the group to reexamine a course of action that was initially rejected for good or bad reasons at the prior time. This

symptom is "a likely result of groupthink, for such an appraisal could strike at the heart of concurrence established by the group" (Hensley and Griffin 1986).

*Failure to Examine Some Major Costs and Risks of Preferred Choice*

The sixth symptom of defective decision-making is largely self-explanatory. When a group fails to adequately examine the costs and risks associated with a choice they plan to pursue, their decision may bring about unwanted consequences. Thus, the intended outcome is not achieved.

*Failure to Work out Detailed Implementation, Monitoring, and Contingency Plans*

The final symptom Janis identifies in defective decision-making is the failure to work out contingency plans due to the little time spent considering how the previously chosen plan might not succeed. Groups tend to believe that the choices they are making are the right ones and do not want to consider what they might do if they are wrong. Hence, a group may hold on to a decision they make although it has obviously failed because they have no other possible plans of action.

Now that I have provided my operational definitions of the antecedent conditions, symptoms of groupthink, and symptoms of defective decision-making that constitute groupthink theory, I am prepared to examine the quality of decision-making at the Federal Reserve during the time surrounding the Great Crash of 1929. Keeping my requirements for accepting or rejecting various components of the theory in mind, I will move forward in my evaluation.

## Federal Reserve Decision-Making During the Great Crash of 1929

To begin my analysis I will summarize the history of the Federal Reserve and the economic situation of the United States prior to the Great Crash of 1929. I believe this is important in order to provide a foundation for analyzing the specific components of groupthink.

### Evolution of Federal Reserve Power Prior to the Great Crash

On December 23, 1913 the United States Congress passed the Federal Reserve Act. This piece of legislation serves as the basis for the influential central banking system the United States has today. However, at the time of inception the Federal Reserve had no broad statement of purpose or policy objective. The price level (real purchasing power of the dollar) was to be controlled mainly by gold movements and changes in the foreign exchange. Additionally, the founders of the Federal Reserve believed seasonal and cyclical movements in the demand for credit would increase or decrease the demand for rediscounts at Federal Reserve banks. The only active role the founders intended the Federal Reserve to have was in regards to raising or lowering the discount rate in ordinary times and providing emergency credit in times of a financial panic (Meltzer 2003).

Additionally, at the time of inception the founders of the Federal Reserve expected the regional reserve banks to function in cooperation, but also independently of the Federal Reserve Board in Washington to achieve the benefits of central banking without becoming a monopolistic central bank.[6] Due to fear of the central bank in Washington or one particular region of the

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[6] The plan adopted in the original Federal Reserve Act called for the creation of both private and public entities. There were to be at least eight, and no more than 12, private regional Federal Reserve banks (12 were established). Each was to have its own branches, board of directors, and district boundaries. In Washington, the System was to be headed by a seven member Federal Reserve Board made up of public officials appointed by the President and confirmed by the Senate. Also created as part of the Federal Reserve System was a 12 member Federal Advisory Committee.

country becoming too powerful, Congress attempted to distribute power throughout the system. This, as I will explain later, would lead to decision-hindering power struggles between the New York regional bank and Washington.

Although the intent of the founders was not to invest a great deal of economic power into the Federal Reserve, the actual influence of the Federal Reserve would quickly broaden, but without any form of increasing legal power. A short time after the Federal Reserve System was established, the United States entered World War I and the Federal Reserve was reshaped in many ways. The number of state chartered banks voluntarily joining the Federal Reserve System rose to more than a thousand and the influence of the Federal Reserve increased. In this time of war, the Federal Reserve System began its transformation into a more unified central bank, and the decision-makers within the Federal Reserve System started to become more powerful.

After the war, two decisive groups emerged as powerful players within the Federal Reserve System. The Federal Reserve Board in Washington intended to serve as the head of the regional banks, providing guidance and direction in all monetary policy. The New York Federal Reserve bank, under the resounding leadership of Benjamin Strong, saw the structure of power a little differently. Although never chairman of the Board, Governor Strong became arguably the most influential person in the Federal Reserve System before his death in 1928.[7] According to Federal Reserve Board member Adolph C. Miller, Strong was "brilliant of mind, engaging of personality, fertile of source, strong of will, ambitious of spirit, and he had extraordinary skill in impressing his views and purpose on his associates in the federal reserve system" (Miller, 1935). Furthermore, as open market operations increased in importance and discount policy declined,

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[7] Under the leadership of Governor Strong, the New York Federal Reserve Bank independently engaged in open market operations without consulting the Federal Reserve Board. Open market operations can be used as a powerful monetary tool to expand or contract an economy's monetary base through the respective purchase or sale of government securities.

Strong maintained control of the most influential dealings of the Federal Reserve System until his death.

Moreover, at the crux of the differences between New York and Washington was the "real bills doctrine"[8]. The Board favored the real bills doctrine, thus emphasizing control over the quality of credit by discounting real bills. The New York bank, and more specifically Governor Strong, believed the System had to control the quantity of credit available (largely through open market operations) to be effective. Largely due to Strong's lack of formal education in the field of economics, members of the Board despised Strong for his views and pushed to take power away from him.[9] As long as Governor Strong was in charge he could push his ideas about the quantity of credit into policy discussions. Upon his death, however, there was a major power shift away from the New York bank to the Federal Reserve Board in Washington and the real bills doctrine became the driving force of monetary policy.

In the spring of 1927, Governor Strong proposed expansionary policies in light of recessionary indicators in the economy.[10] His proposal consisted of purchasing securities in the open market and reducing discount rates, therby cheapening the cost of credit to borrowing banks. Almost unanimously, this policy was approved and implemented system-wide. Although the new availability of cheap credit did stimulate business and production, the use of credit in the stock market drastically increased as well. Therefore, an already speculative stock market was

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8 The real bills doctrine contends that the Federal Reserve was to "accommodate the needs of trade and agriculture by only (or mainly) commercial paper… This principle largely prevented purchases of government securities, mortgages, other long-term debt and the use of these instruments or equities as collateral for borrowing from the Federal Reserve" (Meltzer 2003, p.22).

9 Adolph C. Miller was one of the most ardent detractors of Strong's power and deeply desired to strip him of power because Strong did not exclusively adhere to the real bills doctrine.

10 In the summer of 1927, both the physical volume of industrial production and wholesale prices were declining and had been doing so since the autumn of 1925. These indicators are commonly thought to foreshadow a depression. (Meltzer 2003)

being fueled by further speculation. In fact, bank loans to security brokers in New York increased during 1927 by about $600 million (Meltzer 2003).

Seeing a speculative bubble developing after the spring of 1927, the Federal Reserve System engaged in restrictive monetary policy to check the further expansion of bank credit in the first half of 1928. However, seeing that their selling of government securities and increases in the discount rate were not working to decrease speculation as they expected, the Federal Reserve Board essentially gave up. In fact, no further measure of restraint was put forth by the Federal Reserve Board until February 1929, even as the New York Reserve bank, recognizing the ill effect of their previous recommendation, requested further action. Brokers' loans by both banks and others increased rapidly and stock prices rose rapidly. Despite all of this however, the Federal Reserve Board failed to pursue any policies of restraint. The passive policy the Federal Reserve found itself pursuing was "lacking in strong conviction with regard to current developments profoundly affecting the Federal Reserve System, the banking system, and the economic and financial condition of the country" (Miller 1935, p.452).

By the middle of 1929, a new issue was on hand for the Federal Reserve System to deal with. In June, the Board, after a conference with representatives from the New York bank, realized that the stock market was reaching a point where it would collapse under its own weight. The new principle concern would now have to be how was the Federal Reserve System going to handle a collapse when it did happen.

## Antecedent Conditions

Now I turn to a methodical analysis of the effect of groupthink on the decision-making process of the Federal Reserve in light of every antecedent condition, symptom of groupthink, and symptom of defective decision-making I previously described.

### Decisionmakers Constitute a Cohesive Group

The degree of cohesiveness on the Federal Reserve Board prior to and during the Great Crash of 1929 was particularly high. The Board of the Federal Reserve banded together in trying to wrestle power away from the "disobedient" regional banks, most specifically the New York bank after Governor Strong died in 1928. Federal Reserve Historian Allan H. Meltzer contends, "The conflict over policy in 1928 and 1929 was part of the continuing struggle between the Board and the reserve banks and mainly between New York and Washington" (Meltzer 2003, p.263). With the death of Governor Strong in 1928, the board was in a better position to shift power from New York and the other banks to Washington and they did just that. This shift in power strengthened ties between Miller, Young and the real bills faction that constituted the Board. Thus, in 1929 the Federal Reserve Board may have formed a cohesive group due to their disdain for the regional banks and the power they proved to exert over monetary policy in their regions. Furthermore, in finding a common "enemy" of sorts, the members of the Board viewed the New York bank and the other regional banks as an out-group even though the Board and the regional banks were supposed to be working together as part of the same central banking system.

### Structural Faults of the Organization

*Lack of Tradition of Impartial Leadership*. Throughout the Great Crash of 1929 there is no doubt that leadership on the Federal Reserve Board was *not* impartial. Roy A. Young, the

Chairman of the Board at the time, as described by New York bank Governor Harrison was "extremely stubborn and very vocal" (Meltzer 2003, p.195). In addition, Young did not make it a secret that he strongly supported the gold standard and remained a supporter of the real bills doctrine throughout his chairmanship. He had a good understanding of banking, but did not believe the role of Federal Reserve was to alleviate the depression by preventing deflation. Because of Young's affinity for the real bills doctrine, it is highly unlikely that he legitimately listened to arguments asking for the Federal Reserve to engage in anti-deflationary policies or any other policy that would violate his economic beliefs concerning the importance of maintaining the quality of money over quantity of credit.

*Lack of norms requiring methodical procedures.* One of the most apparent and cited reasons for the failure of the Federal Reserve Board in dealing with the Great Crash of 1929 concerns the way in which the Federal Reserve Board viewed their own duties and responsibilities. "Weaknesses of the Federal Reserve Act and the inconsistent objectives…hindered the System in choosing and maintaining policies" (Meltzer 2003, p. 215). In essence, the Federal Reserve Board was unsure of what power they actually had and how they could employ tools they had at their disposal to affect the market.[11] Unlike the Federal Reserve Board of today, which sees itself primarily as the guardian against a rising rate of inflation, the Federal Reserve Board of the 1920s did not have a clear mandate addressing their objectives. In the 1920s the Federal Reserve Board simply adhered to the real bills doctrine which focused on what the Federal Reserve described as "the needs of trade" rather then economic growth, the foreign exchange rate of the dollar, or the expected rate of inflation (or deflation).

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[11] Today, the general consensus throughout the economic community states that a central bank is most effective when they are given operational independence from elected government, without goal (objective) independence (Fischer 1994). The Federal Reserve Bank did not have any objective guidelines in their mandate.

Friedman and Schwartz described this insurmountable lack of direction in the Federal Reserve credit policy as a reason the Federal Reserve failed to act in the face of the Great Crash of 1929. "Despite the skill and acuity with which this section of the [real bills doctrine] is written, it is yet most unsatisfactory as a guide to credit policy. The requisite 'judgment' cannot be based on factual evidence alone. The evidence must be interpreted and the likely effects of alternative courses of action predicted. On all of this, the [real bills doctrine] offers little beyond glimmering generalities instructing the men exercising the judgment to do the right thing at the right time with only the vaguest indications of what is the right thing to do" (Friedman and Schwartz 1963, p.256).

In addition to the inadequacies of the real bills doctrine, the Federal Reserve as a whole did not maintain an understanding of the division of power between the regional banks and Washington. As stated earlier, prior to 1929, the New York Federal Reserve Bank was led by the decisive leadership of Benjamin Strong. Strong designated himself the de facto leader of the Federal Reserve and executed policies that quantitatively controlled credit without consulting with the Federal Reserve Board in Washington. However, with Strong's death at the end of 1928, the relationship between New York and Washington became more unclear. Harrison, Strong's replacement, was not as influential as Strong and a power struggle between Washington and New York ensued over whom had the final say in controlling monetary policy. Could the Federal Reserve Bank in New York raise their discount rate without asking the Federal Reserve Board? What was the procedure for the New York bank to request open market operations? No one truly knew the answer to these questions in the fall of 1929, forcing everyone in the Federal Reserve to work in the unknown. The governors of the various banks complained that the Board was not well organized, delayed decisions, failed to answer questions and lost communication.

Obviously, there were no norms or objectives set for the Federal Reserve in dealing with their regional banks, especially during a financial crisis.

*Homogeneity of members' social background and ideology*. The Federal Reserve Board during the 1920s did not fit the role of a homogeneous group in many ways. The members of the Board came from a plethora of backgrounds and professions. Edward H. Cunningham was a farmer from Iowa and was active in the American Farm Bureau. Charles S. Hamlin was lawyer, George R. James was a small merchant and manufacturer from Tennessee and Edmund Platt was a teacher from Tennessee. Arthur C. Miller was the only academic economist on the Board, and the Chairman, Roy A. Young, was a banker who started in banking as a bank messenger and rose quickly through the ranks. The two de facto members of the Board were Treasury Secretary Andrew W. Mellon and Commerce Secretary J.W. Pole[12]. By design, the demographic make-up of the Federal Reserve Board in 1929 was very diverse with members hailing from all over the country.

The ideology of the group, on the other hand, was similar at times and different at other times. All the members of the Board supported the real bills doctrine in its totality, but may have disagreed on different parts or methods to control the quality of money (type of credit outstanding). For example, J.W. Pole was apparently the only supporter of a bank reform measure calling for banking to be limited to "trade areas" or regions around important cities (Meltzer 2003). Conversely, Adolph Miller argued that the Federal Reserve had no control over the volume of money in circulation because the quantity of money was determined by the

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[12] In the Federal Reserve Act of 1913, there were five public officials solely appointed to the Federal Reserve Board with the Secretary of the Treasury and the Comptroller of the Currency serving in both the executive branch and on the Federal Reserve Board as the sixth and seventh members. In subsequent amendments to the Federal Reserve Act, the Secretary of the Treasury and the Comptroller of the Currency were removed from the Board due to the conflict of interest arising from putting political appointees on a monetary decision-making board.

community. The Federal Reserve System could provide economic and price stability through preventing the use of credit in speculation. Therefore, I believe the evidence as a whole supports a lack of homogeneity in the Board Members' social background and ideology.

*Insulation of the group*. Even in 1929 without many of the technological marvels of today (computers, faxes, e-mail, etc.), the Federal Reserve Board had access to information about the state of the economy and current happenings on Wall Street. As Meltzer explains, "knowledge of events was not a problem at the time or later. Misinterpretation, incorrect analysis, lack of agreement, and concern about letting the discount rate rise without limit – not ignorance of events – prevented the action" (Meltzer 2003, p. 245). Therefore, it is apparent that the Board was not insulated from outside sources of information and opinions. In fact, the Federal Reserve Board had many economists on staff whose jobs were solely to create reports on the current state of the economy and provide them to the decision-makers on the Board.

## Provocative Situational Context

*High stress from external threats with low hope of a better solution than the leader's.* During the time leading up to the Great Crash of 1929, there is no doubt the Federal Reserve Board members and the Federal Reserve System as a whole realized a speculative bubble was growing on Wall Street. This "bubble" posed a danger to the Federal Reserve Board because they perceived it as threatening the economy they were charged with monitoring. This speculative bubble can be viewed as an "external threat" to the healthy economy and the Federal Reserve. If the words or actions of the Federal Reserve were not analyzed for deeper meaning by the general public, but rather taken simply at face value, the Federal Reserve Board would have eased the

speculation on Wall Street through discounting and the bubble would have deflated proportionately. However, such guarantees that the public would react calmly to any Federal Reserve action are not possible in the real world and the Board was paralyzed in the face of the unknown. Most members of the Board felt any policy action they took would exacerbate a rapid decline of prices. Therefore, instead of insisting on contractionary monetary policy before the fall of 1929, the other members of the Board conceded to the policy of inaction advocated by their Chairman.

Galbraith sums up the Board's low degree of hope or desire to find a better solution than the one favored by Chairman Young by saying, "Young… was undoubtedly aware of what was going on. However, he was a man of caution who sought no fame as a martyr to the broken boom. Also, his colleagues were among the more commonplace of Harding-Coolidge appointees" (Galbraith 1954, p.28). Obviously, Young, as the institutional leader of the Federal Reserve, did not want to engage in proactive action to quell the speculative bubble and no one else on the board saw a need to challenge his views.[13]

Low Self-Esteem

*Recent failures that make members' inadequacies salient.* Some academics cite the recession of 1920-1921 and the failures of the Federal Reserve during that recession as one of the reasons the Federal Reserve Board was so unsure of taking action during the Great Crash of 1929. However, I am not going to use this as an example of a recent failure that made members' inadequacies salient. I cannot in good faith consider a recession that ended eight years before the market crash

[13] It was this complacency exemplified by Young that would play a large roll in the severity of the market crash in 1929. As H. Park Willis argued the Federal Reserve Board was "fundamentally and primarily a cause of the panic of 1929 by permitting the use of banking funds in an unduly large degree and without adequate protection, in promoting speculation" (Willis, p.177).

of 1929 recent. Especially in an economic time span, eight years is considerable amount of time. Therefore, I do not believe this antecedent condition was present in the decision-making process of the Board.

*Excessive difficulties on current decision-making tasks that lower each member's sense of self-efficacy.* Although Roy A. Young was the Chairman of the Board, his leadership was considered to be weak by many. While his views on monetary policy were well known, his leadership style was not decisive. Additionally, none of the other full-time members of the Board or full-time staff had the standing within the System to exercise the required leadership.[14] Without strong leadership or dominating personalities driving the decision-making process, making decisions was extremely difficult for the Board. Subsequent experiences in Federal Reserve Board decision-making has proven that having a strong Chairman is crucial to facilitating a good decision-making environment (Bernanke 1995 and Theis 2004). Given the financial system that existed and the far-reaching implications any decision the Board would have on that financial system, the members of the Board found themselves questioning their own abilities on a regular basis. The evidence therefore suggests that the magnitude of the financial situation, paired with little to no leadership coming from Young led to a lower sense of self-efficiency among all the Board members.

*Moral dilemmas: apparent lack of feasible alternatives except ones that violate ethical standards.* During the Great Crash of 1929, the Federal Reserve Board believed there were certain economic doctrines that they had to adhere to at all costs. For an economist, violating your own school of thought when deciding on policy is virtually a moral dilemma. As mentioned

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[14] See Friedman and Schwartz, *The Great Contraction*, p.204n

earlier, the Board supported the real bills doctrine, but they also believed in maintaining the gold standard and they believed in Andrew Mellon's now infamous "liquidationist" thesis.[15] Various economists have argued that blind adherence to any of the above policies (or blind adherence to any policy) can explain why the Federal Reserve Board failed to act in the fall of 1929 (Eichengreen 1992 and Wicker 1966). In particular, the adherence to the liquidationist thesis represents a moral dilemma faced by the Board that caused them to believe all feasible alternatives to the banking crisis violated ethical standards. In the first half of 1929, 346 banks failed in various parts of the country with aggregate deposits totaling about $120 million (Galbraith, 1954). After the stock market crash, this number grew exponentially.

Seeing mass bank failures starting in 1929 did not alarm the Board at first because, according to their liquidationist doctrine, this was a good thing for the banking system. The Board saw no need to stem the panic. What they failed to consider, however, was that the large banks, which would have intervened before the Federal Reserve was created, felt that they no longer had the responsibility of protecting other banks. In other words, by coming in to existence, the Federal Reserve became the bank that was supposed to protect against massive bank failures. The liquidationist doctrine stood in the way of the Federal Reserve serving this purpose. Thus, any action to ease the banking panic was viewed as an infeasible alternative to the economic standards laid out in the liquidationist doctrine.

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[15] This theory proposed weeding out "weak" banks as a harsh, but necessary prerequisite for the recovery of the entire banking system.

## Symptoms of Groupthink

### Type I. Overestimation of the Group

*Illusion of Invulnerability.* Based on the actions and statements of the Board during the Great Crash of 1929, it seems as though the Board did not see itself as invulnerable. In fact, much of the complacent policy of the Federal Reserve Board in 1929 seems to stem from the fear of making mistakes. Although current policy was not working in the fall of 1929, the Board did not want to engage in new policy in any way because they feared making things worse throughout the economy.

*Belief in the inherent morality of the group*. Because of their role as head of the Federal Reserve System, the Board believed that any action they took was in the greater interest of the country. When the Federal Reserve Board made a decision, especially when it was in contrast with a regional bank, they justified it in saying that they were doing what was best for the overall economy. In the Board's eyes, the regional banks thought about policy through a regional lens without regard to what their policies meant for other regions, while the Board was looking out for all regions collectively. Whether this belief is true or not is outside the scope of this symptom of groupthink, but the fact remains that the Federal Reserve Board believed they were a moral decision-making body.

### Type II. Closed-Mindedness

*Collective Rationalization.* With an abundance of information on the state of the domestic and foreign economies presenting itself to the Federal Reserve Board throughout the speculative bubble and market crash of 1929, one might ask him or herself how the Board justified passive

monetary policy. One way the Board ignored such dire economic indicators was through collective rationalization.

In the third quarter of 1928, the GNP deflator decreased for the first time in the last year. Additionally, the GNP deflator fell continuously for the next eighteen quarters with only one exception. The twelve-month percentage change in the consumer price index is negative from July 1926 to May 1929. Between June 1929 and January 1930 the annual change is between 0 and 1 percent and then becomes negative for more then three years (Balke and Gordon 1986). Any economist looking at these commonly available indicators would obviously recognize the economy is in a state of deflation. At this time, however, the Federal Reserve Board believed policy was expansive and sought to either *restrain* speculation through contractionary policy or do nothing at all.

Analysis of the decision to ignore the deflationary signals of the economy by the Federal Reserve Board, suggests the Board used other less telling economic indicators to rationalize their policy of inaction. Based on a 43 percent increase in stock prices in 1928, the use of credit to support leveraged positions, faster credit growth than output, and the large volume of member bank borrowing, the Board asserted the economy was not facing deflationary times. In other words, by suggesting the price of stock was an adequate indicator of economic health, instead of focusing on solid indicators such as the monetary base, the Federal Reserve rationalized their ill-fated policy of inaction. "Misled by the level of discounts and the growth of borrowing, the System forced further deflation instead of moderating policy to prevent deflation. The evidence suggests that a less restrictive policy that avoided deflation would have ameliorated or possibly prevented the 1929 recession" (Meltzer 2003, p.265).

*Stereotypes of Out-Groups.* Although it is not conventional to view a subsidiary of a decision-making group as an "out-group", the Federal Reserve Board acted as if the New York bank was an out-group and treated it as such. Therefore I will analyze this symptom of groupthink with the New York bank playing the role of out-group. Because of the New York bank's power to affect monetary policy through complete control of their discount rate and open market operations under Governor Strong, the Federal Reserve Board resented the New York bank. The Board saw itself as the leader of the Federal Reserve, believing any policy action should be approved by its members. Hence, the Board stereotyped the New York Bank as overreaching and disobedient.

Evidence suggests that the Board would go out of their way to reject New York policy proposals simply because the New York bank proposed it.[16] The content of the New York proposals was not considered as thoroughly as it should have been. In fact, after proposing further rate increases to the Board in the beginning of 1928, Governor Harrison (Strong's replacement) appealed to Treasury Secretary Mellon to intervene. Mellon, understanding that New York's repeated rejections were solely due to the stalemate between the Board and New York Bank, pleaded with the Board to allow the increase of the discount rate, but they still refused. It would not be until August, when the Board could no longer rationalize denying the New York bank an increase in the discount rate, that the Board allowed the increase. Little did they know it was already too late (Friedman and Schwartz 1963, Galbraith 1954, Meltzer 2003).

By forming stereotypes about the New York bank, the Board kept itself from effectively working with their most prominent regional bank. Subsequent analysis by Temin, Friedman and

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[16] On one occasion in early 1929 the Board voted seven to one to reject the request of the New York bank to raise the discount rate a percentage point to 6 percent because New York made the request by telephone and they did not give adequate reason for the increase. The Board viewed making such a request by telephone as a sign of disrespect (Meltzer 2003)

Schwartz, and others note the validity of New York's request for a rate increase in the face of such rampant speculation in the beginning of 1928 (Friedman and Schwartz 1963, Temin 1976). Obviously, the policies New York was advocating were not outlandish. Yet, the Board refused to consider them because of their unfavorable view of the New York bank.

Type III. Pressures Towards Uniformity

*Self-Censorship.* During the time surrounding the Market Crash of 1929, self-censorship was prevalent on the Board. In John Kenneth Galbraith's historical account of the market crash entitled *The Great Crash of 1929,* he described the attitude of complacency on the Board and the desire for the members to keep quiet when discussing future policy choices. "Of all the weapons in the Federal Reserve arsenal, words were the most unpredictable in their consequences. Their effect might be sudden and terrible. Moreover, these consequences could be attributed with the greatest of precision to the person or persons who uttered the words. Retribution would follow" (Galbraith, p. 33). No one person wanted to serve as the face of a policy that further hindered the economy, even if the opposite could be true as well. Therefore, the evidence suggests all the Board members engaged in self-censorship.

*Illusions of unanimity*. Without a doubt, the decisions made within the Federal Reserve during the time surrounding the Great Crash were perverted by an illusion of unanimity. With the Board members remaining silent on many issues, they were essentially giving their consent for a policy of inaction. In the absence of strong leadership of any kind, the tendencies of drift and indecision had full scope. If the silence among Board members had not been unanimous, then maybe something would have been done.

*Direct pressure on dissenters.* Throughout my research I noticed little dissent among Board members. Some economic historians point to the presence of the Secretary of the Treasury and the Comptroller of Currency on the Board as a source of political pressure on the Board, but I do not believe this pressure, if any, translated to pressure on dissenters. Prior to the 1930s, the Secretary of the Treasury and the Comptroller of Currency rarely participated actively in Board meetings. Also, the views of the Board were very much in line with the politicians (Carter Glass and Robert Latham Owen were the leading advocates of the Federal Reserve System) that granted their charter in 1913. Hence, I do not have enough evidence to say one way or another whether there was direct pressure on dissenters during the decision-making process surrounding the Great Crash of 1929.

*Self-Appointed Mindguards.* I found no evidence of self-appointed mindguards on the Federal Reserve Board. If one person on the Board saw a piece of economic information, the remaining Board members did as well.

## Symptoms of Defective Decision Making

*Gross omissions in survey of objectives.* As noted earlier, during the time surrounding the Great Crash of 1929, the Federal Reserve Board held their primary objectives as maintaining the "quality of money" by discounting real bills. By solely focusing on the quality of money during this time of speculation on Wall Street, the Federal Reserve saw reasons to continue with deflationary monetary policy. The Federal Reserve Board did not believe it was their responsibility to take direct action in providing liquidity to the market in light of deflationary indicators. This was a drastic mistake.

Largely influenced by the feud between the New York bank and Washington, the Board willingly neglected to view their mandate to include perpetrating a monetary policy based on the state of current output and prices. Many economic scholars have since commented that the Board should have based their actions on current output and prices,[17] and their duties prescribed to them as central bankers in the Federal Reserve Act were based on such objectives. As argued by our current Federal Reserve Chairman, Ben Bernanke, the principle reason the Federal Reserve tightened credit in 1928 through 1929 was due to the ongoing concern about speculation on Wall Street (Bernanke, 2002). Hence, this period represents an omission in the survey of objectives because the Federal Reserve Board incorrectly viewed their objective to be controlling speculation on Wall Street instead of supporting current output and prices.

*Gross omissions in the survey of alternatives*. Although it may seem logical that the Federal Reserve Board did not consider alternative courses of action in fall 1929, it is highly unlikely that they actually did not. With the New York Bank consistently presenting quantitative approaches to easing the financial crisis and the Federal Reserve Board having to continuously turn down such proposals with reason, it was not possible for the Board to have altogether ignored the alternative ideas present in the requests. Therefore, there is no evidence that this symptom of defective decision-making was present.

*Poor information search.* Although the Federal Reserve Board did seek out information relating to the current state of the economy and the dire financial situation it found itself in, they did so in an incomplete and inadequate way. I would like to note that much of the evidence pertaining to

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[17] In fact, the system's holdings of government securities had reduced from a level of $600 million in 1927 to $210 million in 1928 despite an outflow of gold (Friedman and Schwartz 1963).

the antecedent conditions and symptoms of groupthink could also relate to this symptom[18], but my methodology does not allow me to use previously stated evidence in support of various symptoms, so I will cite yet another example of poor information search present within the decision-making process of the Board.

In the fall of 1929, the Federal Reserve Board contended that the rise in stock prices was solely due to speculation in the market. Therefore, the Board only concerned themselves with policies aimed at bringing prices down because the real bills doctrine led them to believe such large increases in stock prices hindered the quality of money. What the Board failed to notice was that real GNP rose consistently between 4 and 12 percent between 1924 and 1929, yet annual rates of inflation (consumer price index) remained negative between July 1926 and May 1929. Additionally, in 1929 corporate profits increased about 30 percent over the first nine months (Meltzer 2003). This type of data (which was available to the Board) suggests that the optimistic projections underlying the rise in stock prices had a factual base and Federal Reserve policy remained deflationary throughout the 1920s when judged by the nominal monetary base. There is no denying that the practice of buying stock on credit is not a good economic practice, but the rising prices of the stock market were not solely due to investors buying stock on credit. If the Federal Reserve Board had actively sought out this information about actual deflation already present in the economy, it would have been much more difficult for them to justify further deflationary policy during the time leading up to and during the 1929 market crash. The Board, however, contended that the rising prices were solely due to speculation and inflation in

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[18] The previous discussions dealing with the antecedent condition of moral dilemmas and the groupthink symptom of collective rationalization offer evidence that suggests the Board sought information in an incomplete or inadequate manner.

the market[19]. Fully understanding all the indicators of the economy is important when making far reaching monetary decisions, and it is obvious the Board chose to stay ignorant in making decisions in the fall of 1929.

*Selective bias in processing information at hand.* Several examples of selective bias in processing information at hand are evident in the Federal Reserve Board decision-making process. Many of these examples were already explained under other parts of the groupthink model[20], but due to my methodology concerns I will not address them in regards to this symptom of defective decision-making. Instead, I will explain how the Board's negative views of open market operations affected how they viewed the effectiveness of using them.

According to the Board in the fall of 1929, to buy government securities as a means of increasing the quantity of money in the economy would lead to a delay in the natural liquidation and recovery of the economy (Friedman and Schwartz 1963). These assumptions were not based on experience because the Board had never controlled open market operations prior to Governor Strong's death. Nevertheless, in late 1929 and early 1930 whenever there was a proposal made to engage in open market purchases by one of the regional banks or other countries[21], the Board almost always refused due to their preconceived notions about the implications of such purchases. In explaining why the Board had refused to allow the effective purchase of

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[19] "Growth of the monetary base or the money stock tells a different story. These indicators implied that policy was deflationary…In 1927-1929 the Federal Reserve followed an activist policy by sterilizing gold inflows to prevent monetary expansion. Misled by the level of discounts and the growth of borrowing, the System forced further deflation instead of moderating policy to prevent deflation. The evidence suggests that a less restrictive policy that avoided deflation would have ameliorated or possibly prevented the 1929 recession" (Meltzer 2003, p.265).

[20] Previous examples of selective bias in processing information are due to the Board's desire to adhere to various theories such as the real bills doctrine and the liquidationist theory as explained under lack of impartial leadership, collective rationalization, and poor information search.

[21] In July 1930 a monthly letter from the Royal Bank of Canada pleaded for the immediate and decisive action of the Federal Reserve Banks in putting a large volume of new funds into the market in order to arrest the serious and protracted decline in prices.

government securities throughout late 1929 and early 1930, Governor Harrison wrote, “from a System standpoint it is a practical impossibility to embark on such a program at the present time – to do so would mean an active division in System policy” (Harrison 1930). No matter the argument provided by the New York bank to the Board concerning government purchases, it was almost always turned down because of their negative bias towards government purchases on credit.

*Failure to reconsider originally rejected alternatives*. While the Federal Reserve Board may have adequately surveyed alternatives during their decision-making process, it appears that the Board did not reconsider those alternatives once they were rejected. An excellent illustration of this point involves the gold standard. Throughout the time surrounding the Great Crash of 1929 the Board refused to consider moving away from the gold standard. Therefore, maintaining gold reserves relative to currency was always at the forefront of the Board member’s minds when making monetary decisions. On various occasions, the Board used the possible shortage of gold to continue to reject alternate policies such as open market purchases and discounting. Furthermore, in a paper written by Ben Bernanke (1995) he showed how adherence to the gold standard predicted deeper and more extended depression. If the United States had moved away from the gold standard (like Britain did in 1931) the range of policies the Board would have felt comfortable pursuing probably would have increased.

*Failure to examine some major costs and risks of preferred choice.* When the Federal Reserve Board decided to hold the discount rate constant in the face of the market crash of 1929, they essentially made the decision to allow the borrowing of member banks from the Federal Reserve to decline. Additionally, the Board decided to not replace the decline in discounts by other credit outstanding, leading the stock of money to fall by 2.6 percent. From the period from August

1929 to October 1930, Federal Reserve private claims decreased by $1.2 billion, $100 million in bills bought and $920 million in bills discounted and other claims (Friedman and Schwartz 1963). With the decline in the money supply continuing for years to come[22], this rapid and harsh decrease in the stock of money would become a major factor in the banking panics that define the beginning of the Great Depression.

It can be assumed that it was not the intent of the Federal Reserve Board to cause a drastic decrease in the stock of money and indirectly a future run on the banks. However, if they had thoroughly examined the major costs and risks of this decision they probably would have seen that such an outcome was possible. Indeed, the New York bank advocated leaving the discount window open while letting it be known the member banks could borrow freely to establish reserves required against the large increase in deposits that resulted from taking over loans called by others, but for a plethora of reasons (many of which had to do with the power struggle between the New York bank and the Board) the Board decided against this suggestion. In other words, people within the Federal Reserve System had questioned the consequences of maintaining the discount rate, but those people were not on the Board. The Board, on the other hand, failed to examine the costs and risks of their choice.

*Failure to work out detailed implementation, monitoring, and contingency plans*. The decision-making process on the Federal Reserve Board was hindered because of a failure to work out monitoring and contingency plans. When the Board was met with failure after implementing a policy, they were extremely slow to act again, instead making up excuses for their inaction. The Board explained economic decline and failures as occurring despite its own actions and due to

[22] By 1933 the stock of money had decreased by a third. In other words, for every $100 in existence in 1929, by the time you got to 1933 there was only about $65 or $66 left.

forces beyond their control. Therefore, as the Great Crash of 1929 turned into the beginning of the Great Depression, the Board became increasingly likely to hope that matters would right themselves or to simply accept the view that the crisis developed due to the private business community beyond their control. When the Board failed they did not have a contingency plan, leading to countless delays in policy formation.

## Conclusion

Were the members of the Federal Reserve Board victims of groupthink? My analysis leads me to answer "yes". In the prior sections I argued that the decision makers on the Board constituted a cohesive group, the organization had extreme structural faults, and there were attributes of a provocative situation context.[23] All of these antecedent conditions contributed to a concurrence-seeking tendency in the actions of the Federal Reserve Board. Additionally, I found convincing evidence suggesting the Board engaged in at least five symptoms of groupthink and six out of the seven symptoms of defective decision-making.

In order to compare this case of groupthink to prior documented cases of groupthink, I used comparable quantitative measurements developed by Schafer and Crichlow (2010) to scale my results and compare them to other cases studied through a groupthink lens[24]. In my case, there were seven structural faults (out of eleven possible) and six decision-processing faults (out of eight possible). With a sample mean of 3.79 and a standard deviation of 2.87 for structural

[23] Recall the findings of Schafer and Crichlow that suggested that some of Janis's antecedent conditions are less problematic for decision-making than previously thought. Their data contends that situational factors such as: a short time constraint, high personal stress and a recent failure, as well as group homogeneity do no lead to poor decision-making on average (Schafer and Crichlow 1996). Of the few antecedent condition I failed to find on the Federal Reserve Board, three of them fall under these findings. Therefore, my data also suggests that situational factors did not lend much weight to the development of groupthink on the Federal Reserve Board in 1929.

[24] For additional explanation of the quantitative measures used to compare my case to other groupthink cases see appendix sections B and C in *Groupthink versus High-quality Decision Making in International Relations* (Schafer and Crichlow 2010).

faults, my data produced a z score of 1.12. Looking at decision-processing faults, my data presented a z score of 1.29 with a sample mean of 2.97 and a standard deviation of 2.34. This means that my case presented twice as many structural faults as averaged in the Schafer and Crichlow dataset, and more than twice as many decision-processing faults as compared to their average. Furthermore, both of these z scores support the conclusion that the Federal Reserve Board exhibited a significant level of groupthink faults in their decision-making process. As Benjamin Friedman contends, "accidents of personality" and institutional characteristics have had an "extraordinary" impact on monetary policy (Friedman 1962, p.235).

Furthermore, I would like to briefly note the changes the Federal Reserve System has undergone due to the decision-making failures in 1929. Without any knowledge of the implications of groupthink (the theory was not invented yet), the United States Government changed the structure of the Federal Reserve System in order to make it less likely to engage in groupthink behaviors. The Banking Acts of 1933 and 1935 permanently changed the Federal Reserve's structure and shifted power wholly to Washington. This power shift alleviated the power struggles seen within the Federal Reserve System in 1929. Additionally, the Secretary of the Treasury and the Comptroller of Currency were removed from serving on the Federal Reserve Board, allowing more independence in the Federal Reserve System. The important implications of monetary policy were finally realized and numerous policy tools were explicitly made available to decision-makers on the Board in times of financial panic (Meltzer 2003). These subsequent changes, many of which were unknowingly designed to address the causes of groupthink, provide further evidence that groupthink adversely affected the decision-making of the Federal Reserve Board in the wake of the Great Crash of 1929.

I would like to note, however, that my conclusion concerning the presence of groupthink does not imply that I have completely explained the decision-making process of the Federal Reserve Board during the time surrounding the market crash of 1929. It is impossible to assert that one theory can fully explain the faulty decision-making in such a complex situation. What I am proposing is that the evidence strongly suggests the occurrence of groupthink and that it contributed in important ways to defective decision-making in the fall of 1929.

Nonetheless, with these encouraging findings in regards to the applicability of the groupthink theory to Federal Reserve System decision-making, I would support continued research into additional Federal Reserve responses in times of financial panic. Specifically, it would be optimal to study a Federal Reserve System decision that turned out favorably (possibly the monetary response to the market crash of 1987) to see if groupthink was still present in the decision-making process. Other future research projects could also analyze the response of foreign central banks to a particular financial crisis in order to see if their structures and methods facilitate the development of groupthink. Indeed, understanding the decision-making process of the most important financial institutions in the world is important in order to achieve financial stability.

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