From Prosperity to Poverty: The Story of American Economic Decline During the 1920s

Marcus M. Witcher
University of Alabama

Joseph Horton
University of Central Arkansas

This paper engages the historiography on the causes of the Great Depression, especially significant events leading up to the collapse of the banking system in 1933. Many historians label the stock market crash of 1929 as the catalyst to the economic downturn that began in late 1929, and continued well into the thirties. This paper, however, argues that the Federal Reserve's policies throughout the twenties caused the Depression. Easy money created malinvestment and poor monetary policies in 1928 along with legislative restrictions on branch banking led to monetary contractions, bank failures and ultimately the depression.

INTRODUCTION

During the twenties, a vast cultural dived existed between the urban and rural sections of the United States. The country was experiencing rapid modernization with the spread of electricity and the widespread usage of the automobile. In cities, modernity had taken hold but conveniences such as indoor plumbing and electricity were still foreign to the rural regions. The two elements of society had different visions for what it meant to be American and what morals and principles should govern the emerging superpower (Ahamed, 2009, pp. 29). The nation, however, proved to be unwilling to accept worldwide power and prominence.

RURAL AMERICA, URBAN AMERICA AND THE McFADDEN ACT

With the election of Warren G. Harding in 1920, the nation rejected the progressive vision for America and instead embraced a return to "normalcy." In fact, Harding received almost 61 per cent of the popular vote, the greatest victory in American history. The newly elected vice-president, Calvin Coolidge, said the election marked "the end of a period which has seemed to substitute words for things." (Leuchtenburg, 1958, pp. 88-89) After the horrors of the First World War and the Spanish Flu epidemic, voters determined that the U.S. should not be continually involved in foreign affairs. With the Versailles Treaty defeated and the reemergence of the Grand Old Party to political prominence, the nation prepared itself for a return to prewar governance.

The Republican leadership attempted to scale back the massive growth of government that came with World War I. The Harding Administration did not seek to return the U.S. to nineteenth century Cleveland

America but they did desire to cut taxes and reduce the scope of government. In his inaugural address, President Harding outlined the way out of war and towards prosperity: "I speak for administrative efficiency, for lightened tax burdens… for the omission of unnecessary interference of government with business, for an end to government's experiment in business, and for more efficient business in government administration." (Warren G. Harding, Inaugural Address, March 4, 1921)

Andrew Mellon, who had connections to Harding in Ohio, became the Secretary of the Treasury and was fully in line with the president's vision. Mellon believed whole-heartedly that private initiative and productivity were most effective when they were free from intervention and was opposed to taxation beyond what was needed to insure liberty and peace for the nation. Mellon had a unique view of taxation; he held that if rates were high, people were more likely to avoid paying and were unlikely to be as productive as they might otherwise be with lower tax rates. According to Mellon, it was probable that lower tax rates would lead to prosperity and more government revenue (Leuchtenburg, 1958, pp. 98). Republicans cut federal income taxes three times, slashing the top rate from seventy-seven per cent to twenty-five per cent. Lower rates resulted in two outcomes: first, revenue from federal income tax increased and second, the income tax became more progressive. The percentage of the federal revenues paid by citizens making less than ten thousand dollars a year declined from twenty-one per cent in 1921 to five per cent in 1926 (Gordon, 2010, pp. 98, 104).

As the decade progressed, the economy began to boom with new technological advances increasing production and a tax code that encouraged expansion by business American gross national product (GNP) shot up. From 1921 to 1929, it increased by fifty-nine per cent, GNP per person rose by forty-two per cent and personal income by thirty-eight per cent. The private sector succeeded in accomplishing prosperity during the twenties without government spending. Republicans slashed Federal spending in half from 1920 to 1927, and as a percentage of GNP by one-third. They also decreased the national debt by thirty-three per cent. Business prospered under the Harding and Coolidge Administrations, as did workers – with unemployment averaging 4.8 per cent from 1923 to 1929 (Romer, 1986, pp. 31). In 1924, U.S. workers earned nearly six dollars a day, almost three times more than those in Europe. This higher standard of living for workers came despite plummeting union membership (Smiley "The U.S. Economy in the 1920s" EH-Net Encyclopedia). New technologies produced new products and Americans, enjoying new disposable incomes, purchased radios and automobiles. Classically liberal policies had been implemented and the twenties were demonstrating the success of those policies.

Throughout the decade, however, the American financial system experienced incredible strains. In 1922, Congressman Louis T. McFadden, a representative from Pennsylvania and one of the most influential lawmakers concerning banking legislation, introduced what came to be known as the McFadden Banking Act. This legislation aimed to restrict branch banking and create more parity between the national and state banking systems. The McFadden bill, to a large extent, catered to the age-old fear in America of centralized money centers. To protect small unit banks from competition of larger city banks, it restricted branching of Federal Reserve members. McFadden assured the House of Representatives that the American unitary banking system had ensured "a vitality and adaptability unparalleled in the financial history of any other country." (U.S. Congressional Record, 1925 vol 67, pp. 2832)

McFadden claimed that this system was the envy of the world despite the fact that from 1921 to 1925 almost 3,000 U.S. banks failed. With an average of 582 banks failing a year – most of them the unitary banks in small communities his legislation aimed to protect. Bank failures in the U.S. increased 500 per cent from 1922 to 1927 while Congressman McFadden drafted his legislation (Spahr, 1932, pp. 237). Most of these failures were in agricultural areas and especially in states where unit bank lobbies had successfully prohibited branch banking.

Lagging farm income contributed to the high rate of bank failures. At the urging of the government and the prospect of great profits during World War I, farmers incurred debts in order that they might increase production, and as such, fill the global demand for American commodities, which came at the outbreak of World War I (Leuchtenburg, 1958, pp. 100). Farmers increasingly relied on tractors to increase output. This had the dual effect of increasing productivity and freeing up millions of acres for planting that had previously been used to provide fodder for work animals. During the war, farm income increased drastically, but the prosperity enjoyed by American farmers dissipated quickly, their share of national income dropping from sixteen per cent in 1919, to only nine percent in 1929 (Recent Social Trends, 1970, pp. xviii).

America endured a short depression in 1921, which was largely agricultural. Demand decreased for U.S. commodities – due to European farmers returning to work – leading to a general decline in prices. Cotton, which had sold for thirty-five cents per pound during World War I declined in 1920 to a mere sixteen cents. Likewise, corn declined from one dollar fifty cents per bushel to fifty-two cents and wool fell from eighty cents per pound to twenty cents. David M. Kennedy, in his Pulitzer Prize winning tome on America during the Great Depression and World War II, expresses the situation in this way: "Farmers suffocated under their own mountainous surpluses and under the weight of the debts they had assumed to expand and to mechanize." (Kennedy, 1999, pp. 17) Encouraged by the government, farmers, believing that commodity prices would remain high for an extended period, overextend financially. The overextension, however, would not have been possible if rural banking institutions had not extended the farmers' credit.

THE ROLE OF THE FEDERAL RESERVE SYSTEM

Throughout the early Twentieth Century, there had been a growing fear of the "money trust" and their control of the U.S. economy. Many Congressmen saw the need for a central bank to regulate the economy, resulting in the Federal Reserve Act of 1913. The Act created regional Federal Reserve Banks and the Federal Reserve Board. The Board members – who were appointed by the President and confirmed by the Senate – were mainly political appointees with little understanding of the basics of commercial banking, let alone any understanding of central banking (Gordon, 2010, pp. 106-107). As a result of the Board's inability and unwillingness to take effective control, the New York branch – the largest and most experienced of the regional banks – came to dominate the system. As a result, the Governor of that branch, Benjamin Strong, became probably the most powerful man in the U.S. economy (Ahamed, 2009, pp. 56, 59).

The Federal Reserve Act enabled all banks, both national and state, branch and unit, to operate with "an amazingly small amount of cash on hand, under the assurance that an adequate supply of currency [could] be obtained when and as needed." (*Papers of Carter Glass*, Memo by George J. Seay dated Dec 31 1923, Box 7) The result of banks feeling secure in maintaining lower reserve rates meant that more credit could be created and more loans could be made. Rural unit banks participated in the credit expansion and from 1921 to 1927, the increase in loans to real estate skyrocketed from 560 million to 2.9 billion, an increase of 2.3 billion or four hundred per cent. Indeed, the percentage of gross deposits held in reserve by U.S. banks decreased from 7.9 per cent from 1909-13 to only 2.7 per cent from 1922-23 (*PCG*, Memo by George J. Seay, close of 1927, 5, Box 7).

Credit expansion on its own is a byproduct of a healthy and prosperous economy, but this was not to be the case in the 1920s as government, and allied institutions, such as the Federal Reserve, drove down interest rates. Expansion of credit, during the period, led to malinvestment as investors became less and less prudent with their funds and their investments became less conservative. By the last half of the decade, government officials were beginning to worry about the rate of America's credit expansion. In a 1927 memo, George J. Seay, the Governor of the Federal Reserve Bank in Richmond, Virginia wrote: "For the past six years, the volume of bank credit has been progressively expanding, the pace having quickened in the last two years, until, at the present time, the degree and nature of the expansion may be considered as bordering upon imprudent." (*PCG*, Memo by George J. Seay close of 1927, 1, Box 7)

The dip in farmland declined and commodity values left rural unit banks with many poorly performing loans. Due to federal and state regulations and branching restrictions, these banks' portfolios were not diverse, consisting primarily of agricultural loans or loans to local businessmen whose ability to pay were also linked to agricultural conditions. As a result, these banks were especially susceptible to failure if a drought occurred or if the economy experienced monetary contraction (White, 1984, pp. 126).

The establishment of the Federal Reserve System enabled all the different classes of banks to maintain less cash on hand due to the large holdings of currency in the Regional Federal Reserve Banks. Lower reserves enabled the banks to loan more and expand credit. According to Governor Seay, "[t]he crowning achievement of the Federal Reserve System is… the tremendous credit power which it has given to the banks of the country, which follows from the concentration of reserves in Federal Reserve Banks and its vivifying effect when coupled with the note-issuing power; the assurance of adequate credit and abundant supply of sound and elastic currency." (*PCG*, Memo by George J. Seay, Dec 31 1923, Box 7) When Governor Seay referred to the need for "adequate credit", it is unclear how the Federal Reserve would come to a conclusion as to what was adequate. What is clear is that the Federal Reserve encouraged credit expansion. Lower reserve requirements allowed unit banks to make more loans to farmers who were in dire economic straits. The establishment of the System served as something of a moral hazard for banks. If a bank believed that the Federal Reserve would bail it out if it is about to fail, that institution had no reason to make sound loans.

Beyond allowing banks to operate with fewer reserves on hand, the Federal Reserve Act also created a differentiation between time deposits and demand deposits in respect to what percentage of the deposit must be kept in the bank. The Federal Reserve lowered the percentage of money deposited on time that was – by law – required to be kept in the bank from ten per cent to three per cent. The requirement on demand loans remained at ten per cent. This move also effectively lowered the amount of reserves a bank was required to maintain and as such encouraged credit expansion. Due to the incentive of a bank to take time deposits over demand deposits, banks throughout the twenties increased their lending capabilities by accepting more time deposits. From 1921 to 1929, time deposits skyrocketed almost seventy per cent compared to thirty-one for demand deposits (Rothbard, 2008, pp. 92-93).

Throughout the twenties, the Federal Reserve used the tools at their disposal to increase bank reserves. From 1921 to 1929, uncontrollable reserves declined by 1.04 billion dollars. In contrast, the factors controlled by the Federal Reserve and the Treasury department increased by 1.79 billion dollars. The net result of the two forces was an increase in reserves of seven-hundred and fifty million dollars. Some historians have argued that the inflation of the twenties was a "gold inflation" and that the Federal Reserve and the Treasury Department simply did not respond properly to the increase in the monetary gold stocks. This view does not withstand scrutiny. The top three causal factors in the increase in reserves were all controllable: Government securities account for 2.24 billion dollars, bills bought account for 2.16 billion dollars, and new discounts account for 1.54 billion dollars. It is clear that the increase of bank reserves from 1.604 billion in 1921, to 2.356 billion in 1929, was due primarily to the actions of the Federal Reserve and the subsidiary actions of the Treasury Department. This increase led to credit expansion as banks made loans in order to capitalize on the flow of easy money (Rothbard, 2008, pp. 100-101).

Two economists, Milton Friedman and Murray Rothbard, arrived at the conclusion that the money supply during the twenties was increasing. Friedman claimed the money supply rose forty-five per cent from 1921 to 1929, while Rothbard claimed an increase of almost sixty-two per cent. That marked the average yearly increase between 4.6 per cent and 7.7 per cent (Friedman and Schwartz, 1963, pp. 274; Rothbard, 2008, pp. 86). Despite this inflation in the money supply, prices remained relatively constant throughout the period. Such consistency can be attributed to the increased efficiency of producing goods that offset the inflationary trends in the money supply.

The Republican administrations encouraged the Federal Reserve to maintain low interest rates and undoubtedly, the administrations benefited at the polls from the expansion of credit during the period. Secretary Mellon during the depression of 1921 was urging the Federal Reserve to stimulate the economy by creating cheap money. Furthermore, Herbert Hoover, the Secretary of Commerce at the time, strongly supported foreign lending and even made the comment that "even bad loans helped American exports and thus provided a cheap form of relief and employment." (Rothbard, 2008, pp. 127, 129-130) Many of these private loans, which were encouraged by the government, resulted in expensive defaults and contributed to the economic downturn that began in 1929.

GOLD AND THE DISCOUNT RATE

Despite the easy credit market and the inflation of the money supply, in 1926 the United States slipped into a recession. The recession was largely the byproduct of the bottom falling out of the real estate market in Florida and the temporary closing of Henry Ford's automobile factories to transition to the production of the Model A. In 1927, economic downturns in industrial production and commodity prices led some to believe that the recession would lead to a depression. In that same year, Benjamin Strong – who believed wholeheartedly that the revival of world trade depended on Britain's return to the Gold Standard – invited bankers from Great Britain, France and Germany to discuss Europe's return to the Gold Standard. They urged Strong to lower the discount rate to stop gold from flowing to the United States, which was preventing the return of Britain to the Gold Standard. Both the looming recession and Europe's requests led Strong to lower the discount rate. This move had the effect Strong anticipated; gold flowed across the Atlantic to aid Britain and domestic activity increased in the United States warding off a depression (Miller, 1935, pp. 444-445; Ahamed, 2008, pp. 226; Galbraith, 1954 pp. 14-15; Wicker, 1969, pp. 321; Gordon, 2010, pp. 107; Chandler, 1958, pp. 377).

The decline in the discount rate was accompanied by an increase in the stock market. What had been a strong market throughout the twenties became a bull market in 1927. By lowering the discount rate, the Federal Reserve created a bubble of speculation. According to economist John Kenneth Galbraith, "the funds that the Federal Reserve made available [in 1927] were either invested in common stocks or they became available to help finance the purchase of common stocks by others." (Galbraith, 1954, pp. 15) In 1927 alone, bank loans to security brokers increased by six hundred thousand dollars (Miller, 1935, pp. 440). Upon learning of the Federal Reserve's decrease in discount rates, Herbert Hoover warned prophetically, "inflation of credit is not the answer to European difficulties….this speculation….can only lead us to the shores of depression." (Ahamed, 2009, pp. 299) It is unfortunate that Hoover was not of this opinion earlier in the decade when he encouraged easy credit for foreign borrowers.

Throughout the twenties, the stock market had seen steady increases. These increases reflected the realization by investors that America had become the predominant economic power after World War I. The recession of 1926 interrupted the steady increase in stocks, but in 1927, after the Federal Reserve enacted easy-money policies, the market jolted to unprecedented heights. In 1927, the stock market registered a spectacular thirty-nine per cent rise over the previous year (Sobel, 1968, pp. 12; Galbrath, 1954, pp. 14).

In 1928, members of the Federal Reserve blamed the easy money policies of 1927 for the stock market boom. Due to his failing health, Benjamin Strong resigned as the governor of the New York branch in 1927, and died in 1928 (Friedman and Schwartz, 1963, pp. 289; Cargill, 1992, pp. 1275). The Federal Reserve Board took control of the economy after Strong's death. The Board, concerned with the emerging bubble in the stock market, raised discount rates from 3.5 per cent to 5 per cent (Friedman and Schwartz, 1963, pp. 288; Powell, 2003, pp. 29; Sobel, 1968, pp. 115; Parker, "An Overview" EH-Net Encyclopedia). This increase in the discount rate brought the rate to its highest level since the recession of 1921. The increasing and decreasing of discount rates is usually utilized when the economy is in substantial danger. According to Ben Bernanke, the current chairperson of the Federal Reserve, the economic conditions in 1928 did not justify the contractionary policy of the Federal Reserve (Bernanke, 2004). Just a year earlier, in 1927, the economy had been in the throes of a recession. The increase of the discount rate by two-thirds, a year following a recession was substantial. The contraction sent a shock wave through the economy, and all the investors who had overextended while credit was easy, found their economic position troubling.

THE END OF PROSPERITY

In late 1928, the bad decisions that businesspersons and bankers made throughout the decade began to become apparent. In the summer of 1929, the price of unnatural credit expansion illustrated as output began to decline. In October of that year the stock market crashed. Ben Bernanke, in a lecture given in

2004, commented on the Federal Reserve's increase of the discount rate: "The slowdown in economic activity, together with high interest rates, was in all likelihood the most important source of the stock market crash in October. In other words, the market crash, rather than being the cause of the Depression, as popular legend has it, was in fact largely the result of an economic slowdown and inappropriate monetary policies that preceded it" (Bernanke, 2004). Bernanke, like Friedman, realizes that the contractionary policies the Federal Reserve pursued in 1928 were the catalyst of the Great Depression, but does not identify the ultimate cause: the credit expansion pursued by the Federal Reserve throughout the twenties.

The stock market made gains in the spring of 1930, after the first group of bank failures were over and the financial system seemed as if it might have righted itself. Prospects for business, while still dismal, were beginning to look up. In fact, a group urging more public works from the White House received this rebuke from President Hoover that spring, "You have come sixty days too late. The depression is over." (Gordon, 2004, pp. 320) Unfortunately, for Hoover and the country, just a couple of months later he fulfilled a campaign promise by signing into law the highest tariff in American history – Smoot-Hawley.

Thousands of economists wrote Hoover, urging him to veto the Smoot-Hawley tariff claiming that it would lead to the complete destruction of world trade. A tariff war ensued and global trade which had totaled around thirty-six million dollars in 1929, fell to a mere twelve million in 1932 (Gordon, 2004, pp. 320, 321). American exports also fell. Totaling a little over five billion dollars in 1929, they were decreased to 1.6 billion in 1932 (Gordon, 2010, pp. 110). The tariff had its most severe effects on farmers and merchants in small communities. With foreign demand for American commodities almost completely gone, farmers began to struggle to honor their debt obligations.

Undiverse rural unit banks buckled under credit contraction and the implementation of the Smoot-Hawley tariff. Deceived by the mirage of prosperity created by easy money, they had made many questionable loans – almost all connected to the agricultural sector of the economy. On top of being undiverse, many of these banks had been admitted to the state banking system with very low levels of capital and likewise had low levels of cash on hand to cover their deposits.

The McFadden bill of 1927 had the effect of halting the spread of interstate, and in many states the spread of intrastate branching, and achieved its stated goal of making national charters more appealing to state banks. From 1884 to 1926, the amount of commercial bank resources in the hands of national banks had decreased from seventy-five per cent to forty-six per cent (Robertson, 1968, pp. 97; Chapman and Westerfield, 1942, pp. 108; Meltzer, 2003, pp. 217). The McFadden bill restored the national banking system, which was described by the New York Times as a "sinking ship" in 1922, to virtual parity with the state system (*PCG*, New York Times, "National Banking System Rapidly Disintegrating" March 7, 1922). For its success, however, the McFadden bill did little to tackle the causes of bank failures that were occurring at a rapid and alarming pace throughout the twenties. Chapman and Westerfield note that it ignored "entirely the condition of the country banks and not only did nothing whatever to relieve the situation which had resulted in an increasing number of failures of small banks… but tended to make the situation worse by preventing within the Federal Reserve System further consolidations outside of city limits in branch banking states." (Chapman and Westerfield, 1942, pp. 108) The years leading up to the banking panics of the late twenties were lawmakers' last chance to free banks and allow the market to provide the diversify through competition that would enable American banks to survive monetary contraction. They failed.

The Federal Reserve raised the discount rate in 1928, and again in 1929, doubling it from 1927 to 1929. These higher rates caused contraction in the economy and led to a downturn in business. Unit banks that had been shielded from competition by bills that restricted branching were undiverse and contained limited portfolios – primarily consisting of agricultural loans (Wicker, 1996, pp. 3). When contraction occurred, and the easy credit that had marked the twenties disappeared, all the malinvestment of the period was exposed. The Smoot-Hawley tariff, the Hoover tax hikes and his administration's efforts to keep prices from falling further worsened the hardships.

From 1929 to 1933, almost ten thousand banks failed, the majority being small unit banks that served rural areas. Thirty-nine per cent of all banks in existence in 1928 had failed by 1933. Most of the bank failures were regional and there is not clear evidence that points to panic causing the widespread collapse of the entire structure (Wicker, 1996, pp. 2). What is clear from economic research is that states with some sort of state deposit insurance experienced higher rates of bank failures than other states (Grossman, 1994, pp. 655). Economic research has also found that states that allowed branch banking suffered fewer bank failures than states that restricted branching. Furthermore, Canada, the country that many Congressmen touted as being monopolistic during the debate on the McFadden bill, experienced zero bank failures during the Depression despite having a similar decline in production and overall economic performance (Friedman and Schwartz, 1963, pp. 352).

Once Americans lost confidence in the banking system, the Great Depression began, with depositors' funds becoming unavailable for years. As deflation set in and unemployment increased, millions of Americans went without necessities. Naturally, people looked for a distinct group to blame – the rich bankers and the financiers who had speculated in Wall Street were an easy target. The failure of the economy became linked to the greed inherent in capitalism and many began to question if the system itself had failed. In a speech given to a Chicago audience in 1931, John Maynard Keynes lamented, "We are today in the middle of the greatest catastrophe–the greatest catastrophe due almost to entirely economic causes – of the modern world. I am told that the view is held in Moscow that this is the last, the culminating crises of capitalism, and that our existing order of society will not survive it." (Ahamed, 2009, pp. 4)

CONCLUSION

While free enterprise did survive the Great Depression, it continues to be blamed for the crises. Free enterprise did not fail in 1929, in fact outside forces, mainly the Federal Reserve, were involved in manipulating markets throughout the twenties. These policies prevented the market from liquidating and establishing a new equilibrium condition. In some instances, government intervention can improve on market conditions, but in the late 1920s government interference in the economy led to the longest business cycle downturn in United States history.

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