

Werner Troesken

POSTWAR ECONOMIC STABILIZATION:  
A STYLIZED HALF-TRUTH

*ABSTRACT: Conventional wisdom maintains that without government intervention, capitalism is prone to collapse, as it did during the 1930s, and that only Keynesian policies have stabilized post-World War II capitalism. But recent research suggests that postwar economic stabilization is largely a statistical artifact, the result of poor prewar data, and that the Great Depression was caused, not by the inherent instability of capitalism, but by policy errors made by government agencies. Thus, we should not be so quick to credit the economic successes of the last 70 years to enlightened intervention.*

There is a well-known story that goes like this. Before World War II, the U.S. economy was highly unstable, forever cycling between boom and bust. To see this, look no further than the Great Depression: a staggering economic boom during the 1920s was followed by an even more staggering economic collapse during the 1930s. After World War II, the economy stabilized with the ascendancy of Keynesian economics and a more activist government. Many conclude from this story that activist fiscal and monetary policies and government regulation of financial markets are desirable, mitigating the vagaries of unfettered capitalism. Without such policies, they say, the free market is prone to collapse.

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Werner Troesken, Associate Professor of History and Economics, Department of History, University of Pittsburgh, Pittsburgh, PA 15260-7403, e-mail troesken+@pitt.edu, thanks Dave DeJong, Jeffrey Friedman, John Murray, and Rick Tannery for helpful comments and discussions. The usual disclaimer applies.

Economists refer to the stabilization of the postwar economy as a "stylized fact." Stylized facts are compact and simplified abstractions of larger, more complex realities. As such, they are intended to communicate basic truths without the distraction of unimportant details and messy caveats. Of course, by eliminating the details and caveats, stylized facts communicate little lies along with larger truths. Unfortunately, so many details and caveats are sometimes omitted that the remaining abstractions are closer to stylized half-truths than stylized facts.

The story about postwar stabilization with which I began is more a stylized half-truth than a stylized fact. Two parts of the story are accurate, however. The postwar economy is more stable than the prewar economy, and part of this stabilization can undoubtedly be attributed to government policy. But three other things need to be said.

First, the Great Depression was caused by a government-engineered monetary contraction and by a wave of bank panics that would not have occurred, or would have been much less severe, without ill-advised government policies. The lesson that emerges from a correct understanding of the Great Depression is not that activist government is needed to stabilize the economy. To the contrary, activist government can be a source of instability. Indeed, it was government policy that turned a moderate economic downturn into the worst depression Americans have ever seen.

Second, the usual story probably overstates the degree of economic stabilization that has occurred in the postwar era. Christina Romer has shown that postwar economic stabilization is largely a statistical artifact, the result of poor prewar data. Once the data are corrected, the prewar economy appears to be about half as volatile as it otherwise would, and only slightly more volatile than the postwar economy. Although later research has challenged Romer's findings, her work raises serious questions about the robustness of the data used to demonstrate the increased stability of the postwar economy.

Third, postwar government stabilization policies have hardly been a complete success. A wide range of policies has proved destabilizing. For example, deposit insurance and the Glass-Steagall Act—policies ostensibly designed to make the economy more stable—have undermined the stability and health of the banking industry. There is even evidence that antitrust regulation, which one might think irrelevant to economic stability, has reduced real economic output and generated financial panics.

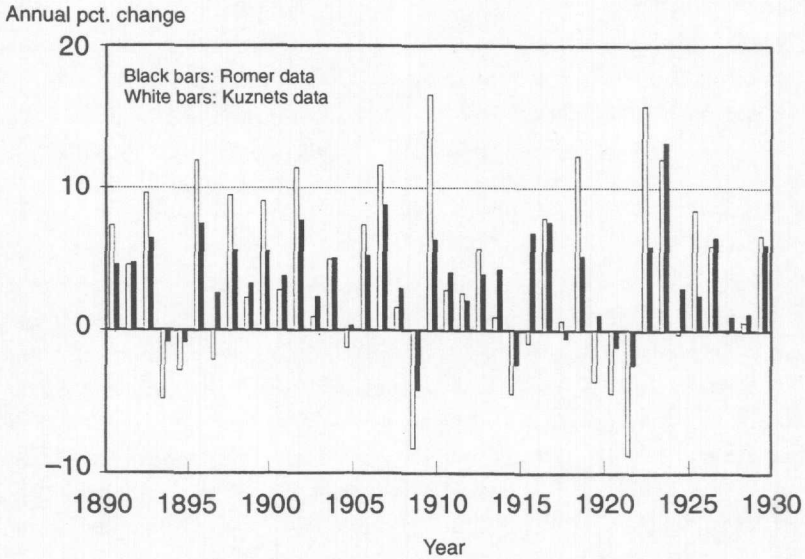
### Romer's Revised Data on the Pre- and Postwar Economies

When researchers want to compare the stability of the post-World War II economy with that of the prewar economy, they typically reach for the *Historical Statistics of the United States*. This source allows researchers to compare the volatility of GNP and unemployment rates before and after World War II. Such comparisons invariably show that GNP and unemployment are more stable after the war than before. For many, this pattern establishes a correlation between government activism and economic stability. It seems that when the government does not pursue stabilization policies, as in the prewar era, the economy has been highly volatile. In contrast, when the government pursues stabilization policies, as it has since World War II, the economy has been much less volatile. This reasoning, however, depends critically on the nature of the GNP and unemployment data found in the *Historical Statistics* and other widely used sources. Since the prewar data are constructed using different methods than the postwar data, one might question how appropriate it is to use these data series to reach conclusions about comparative economic volatility.

Consider first estimates of GNP. The prewar GNP estimates found in the *Historical Statistics* are built on the pioneering work of Simon Kuznets, who relied primarily on data about commodity output. He assumed that noncommodity output, such as transportation and services, moved in proportion with commodity output. While this procedure portrays long-term trends in economic growth accurately, it exaggerates the magnitude of cyclical fluctuations because, as suggested by both economic theory and modern experience, the noncommodity components of GNP are less volatile than the commodity components. Transportation and services, contrary to Kuznets's assumption, move less than commodity output (Romer 1989).

This presents a problem. Ideally, one would like to go back in time and construct an actual data series on noncommodity output. With these data one could then estimate the exact relationship between commodity and noncommodity output. But this is not possible. In lieu of estimating the relationship between commodity and noncommodity output using the actual historical data, Romer (1989) uses data from the interwar and postwar periods—periods for which the necessary data are available—to identify the relationship between commodity and noncommodity output during the late nineteenth

Figure 1. Change in GNP, 1890-1930



Sources: Romer 1989; *Historical Statistics of the United States* (1976), 228, Series F32.

and early twentieth century. Assuming that the relationship between noncommodity output and commodity output was the same earlier that it was in the interwar and postwar periods, Romer has argued that the prewar economy was about 30 percent more volatile than the postwar economy, about half as much as previously estimated. Figure 1 plots the annual percentage change in real GNP using the Romer and Kuznets data series and illustrates the effects of correcting the data. In terms of absolute value, the annual percentage changes in the Romer series are much smaller than the annual percentage changes in the Kuznets (*Historical Statistics*) series.

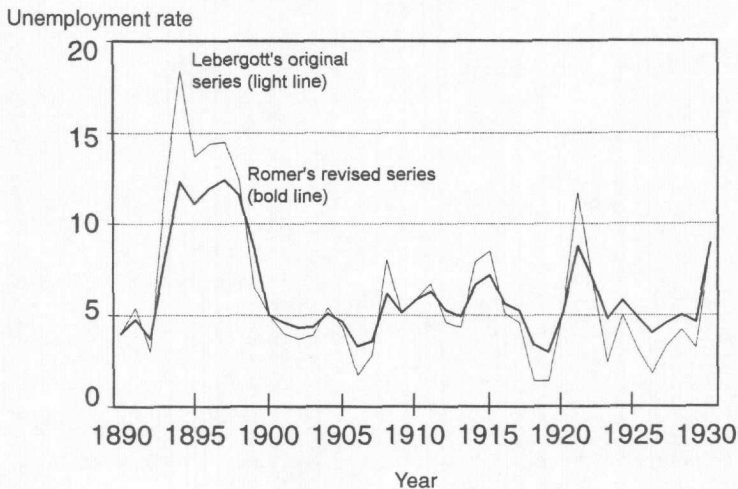
Similarly, for the years after 1940, the unemployment rate series is based on the Current Population Survey. For the years before 1940, unemployment rates are estimates constructed by Stanley Lebergott. To construct these estimates, Lebergott culled information from the decennial census, industry records, and state reports. The census data provided Lebergott with benchmarks for ten-year intervals. He then used a complicated interpolation procedure to estimate unemployment rates for the intervening years (Romer 1986).

Like early estimates of GNP, Lebergott's estimates of unemploy-

ment accurately portray long-run trends but overstate the variability of short-run cycles. In particular, they do not reflect the movement of discouraged workers into and out of the labor force. During boom periods, discouraged workers—workers who are not actively seeking employment, and are therefore not counted as part of the labor force—return to the labor force and begin looking for employment. This should increase the unemployment rate. During recessions, many of these workers get disheartened and leave the labor force. This should reduce the unemployment rate. Because he ignores the countercyclical movements of discouraged workers, Lebergott overstates unemployment during recessions and understates unemployment during expansions (Romer 1986).

The ideal solution to this problem would be to get actual data on the behavior of discouraged workers during the prewar era. But again this is not possible, so Romer follows the same basic procedure to re-estimate prewar unemployment rates that she used to revise prewar GNP. She uses information about the movement of discouraged workers during the postwar era to estimate movements during the prewar era. Romer's revised estimates are much less volatile than Lebergott's. This can be seen in Figure 2, which plots both series.

Figure 2. Unemployment Rates, 1890–1930



Sources: Romer 1989; *Historical Statistics of the United States* (1976), 135, Series D86.

The uncorrected data suggest, for example, that the depression of the 1890s rivaled the Great Depression. The corrected data show that the earlier downturn was no worse than the Reagan recession of 1982.

Romer's work has generated a vast literature—the *Social Science Citation Index* lists over 250 references to her research. Among the most prominent critiques and reconsiderations of Romer's work is that of Nathan Balke and Robert Gordon (1989), who use different procedures to estimate prewar GNP and conclude that prewar GNP was nearly twice as volatile as postwar GNP. David Weir (1986) suggests that Romer's revised estimates can be undone by minor changes in estimating procedures. Weir's own estimates of unemployment before 1900 are actually lower than Romer's, but are higher and more volatile than Romer's estimates for the 1900–1930 period (Weir 1992). And Lebergott (1986; also see *idem*, 1992) argues, among other things, that it is not appropriate to impose postwar relationships on the prewar economy.

Exploring the length of economic recessions and expansions in the pre- and postwar eras, however, Mark Watson (1994) finds evidence that supports Romer. Other researchers have claimed that during the postwar era, recessions have become shorter while expansions have become longer (Diebold and Rudebusch 1992). This, they claim, attests to the efficacy of stabilization policies in the postwar era. Watson (1994), however, shows that postwar recessions merely appear shorter, and expansions longer, because of poor prewar data. The net result of the controversy is that Romer's estimates substantially change the standard story about postwar economic stabilization. The postwar economy now appears, at best, only slightly more stable than the prewar economy (Romer 1986).

### *Reconsidering the Great Depression*

Campaigning for president in the summer of 1928, Herbert Hoover alluded to the Republican policies of the previous eight years and proclaimed:

We in America today are nearer to the final triumph over poverty than ever before in the history of any land. The poorhouse is vanishing from among us. We have not yet reached our goal, but, given the chance to go forward with the policies of the last eight years, we shall

soon, with the help of God, be in sight of the day when poverty will be banished from this nation.

History has not been kind to Hoover and his optimism. A few years after he said these words, America was in the midst of the worst economic downturn it had ever seen and people were living in shantytowns derisively called Hoovervilles. Yet in 1928 Americans had good reason to be optimistic about the economy. Between 1920 and 1928, the unemployment rate averaged between 2 and 3 percent; earnings for nonfarm employees rose by 30 percent; and the average share of stock more than doubled in value. No wonder 58 percent the electorate cast its ballots for Hoover in the 1928 election, a large margin of victory by historical standards.<sup>1</sup> Weeks before the stock market crash, America's most prominent economist, Irving Fisher, notoriously declared that "stock prices have reached what looks like a permanently high plateau. . . . There might be a recession in stock prices but nothing in the nature of a crash" (Walton and Rockoff 1994, 512).

The current view of postwar economic stabilization is reminiscent of Hoover's and Fisher's optimism. Both our gloating and theirs imply that contemporary policy makers are wiser than those of the past. And there is some warrant for such complacency. The economy did in fact grow rapidly during the 1920s, and the policies of Hoover's fellow Republicans, Harding and Coolidge, may well have contributed to that growth. Similarly, the postwar economy is more stable than the prewar economy, and much of this stability probably stems from the fact that policy makers and economists have learned from the mistakes of the past. For example, in response to the stock market crash of 1987, the Fed avoided making the mistakes it had made during the Great Depression.<sup>2</sup> But the unbridled optimism of the 1920s blinded politicians and prominent economists to the conditions that ultimately generated the Great Depression. Gloating about how much smarter economists and policy makers are today than they were in the past can have the same blinding effect.

Alan Brinkley (1997, 682–83) identifies five factors as contributing to the Depression:

One factor . . . was a lack of diversification in the American economy in the 1920s. Prosperity had depended excessively on a few basic industries, notably construction and automobiles. . . . A second important factor was the maldistribution of purchasing power and, as a re-

sult, a weakness in consumer demand. . . . Demand was not keeping up with supply. A third major problem was the credit structure of the economy. Farmers were deeply debt . . . . A fourth factor was America's position in international trade. Late in the 1920s, European demand for American goods began to decline . . . . The international debt structure . . . was a fifth contributing factor to the Great Depression . . . . The collapse of the international credit structure was one of the reasons the Depression spread to Europe (and grew much worse in America) after 1931.

Although many historians share Brinkley's views, few economists do. Brinkley argues that the economy was not sufficiently diversified in 1929, yet it was producing a much greater variety of goods than it had, say, in 1840, when it was based mostly on agricultural production. If diversification were important, then the economy of the early 1800s should have exhibited downturns as severe as the Great Depression. It did not.

As for income inequality, if this contributed to the Great Depression, it seems that economic downturns should generally follow periods of increasing inequality. It is far from clear, however, that such a correlation exists. Moreover, although income inequality did rise during the 1920s, economists have shown that the economic boom of the 1920s benefitted a broad cross-section of the American population (Lebergott 1962, 248-99; Smiley 1983). As mentioned above, income for the average nonfarm worker rose by nearly a third during the 1920s.

Brinkley's third cause—the nation's credit structure—contains a kernel of truth. The collapse of the American banking system did play a role in the Great Depression. This role is considered below. Brinkley's fourth and fifth causes, which concern international forces, also contain some truth. Recent research suggests that trade restrictions and exchange rate policies might have helped push the United States into a downturn (Eichengreen 1989; Temin 1989). But changes in international trade accounted for only a tiny portion of changes in GNP during the Great Depression, suggesting that the role of international trade was minor (Romer 1993).

Most economists believe that the Great Depression started off as a moderate economic downturn after the stock market crash prompted a drop in consumption, especially the consumption of durable goods such as cars and large household appliances (Romer 1990). The crash

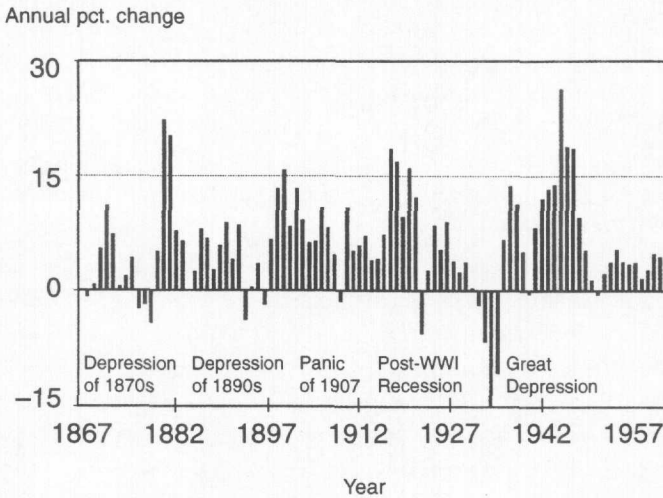


caused people to cut back on spending for two reasons. First, it reduced wealth, leading people to buy less. Second, to the degree that people used the stock market as a barometer of future economic activity, the crash raised concerns about an economic slowdown and encouraged people to put off buying big-ticket items. The economy, however, would have quickly recovered from the crash-induced slowdown had the Federal Reserve not pursued policies that led to the collapse of the nation's monetary and banking system.

The Fed sinned twice, once when it engineered a huge reduction in the money supply, and again when it contributed to the banking crisis. Between 1929 and 1932, the Fed reduced the nation's real money stock by a third, by far the largest monetary contraction in American history (Friedman and Schwartz 1963, 299). By driving up real interest rates, this massive reduction in the money supply made it more expensive for businesses to borrow money to maintain and expand their capital stocks (Romer 1993). At the peak of the Depression, the nation's net capital stock was shrinking; because it was so costly to service existing and future debt, business owners could not afford to buy new equipment or even maintain their existing stock. They had to let their factories and machines fall into disrepair. In the face of nominal wage rigidities, the monetary contraction also caused real wages to rise above their market-clearing levels. Widespread unemployment followed (O'Brien 1990).

When Milton Friedman and Anna Schwartz first argued that monetary forces caused the Great Depression, their thesis was greeted with much skepticism. Thirty years later, though, most economists have been persuaded that the Federal Reserve played a fundamental role in propagating the Depression.<sup>3</sup> Three pieces of evidence have proven especially compelling. First, countries that clung to the gold standard and pursued tight monetary policies, such as the United States, experienced severe downturns, while countries that abandoned the gold standard and pursued loose monetary policies, like Great Britain and Japan, experienced much more mild downturns (Bernanke 1995; Temin 1989). Second, Friedman and Schwartz (1963) establish an historical correlation between monetary shocks and economic output; throughout American history, periods of monetary contraction have been associated with economic slumps. Figure 3, which plots the average annual change in M2 (one measure of the money supply), highlights this correlation. Third, just as a massive monetary contraction ushered in the Depression, monetary expan-

Figure 3. Change in Money Supply (M2), 1867-1960



Sources: *Historical Statistics of the United States* (1976), 992-93, Series X415.

sions brought about recoveries in the United States and elsewhere (Bernanke 1995; Romer 1992; Temin 1989).

Why did the Fed contract the money supply in the midst of an economic downturn? Friedman and Schwartz argue that a critical event was the death in 1928 of Benjamin Strong, governor of the Federal Reserve Bank of New York. Strong's personal correspondence, as well as comments by Irving Fisher and various members of the Fed, suggest that had he survived, he would have known how to address the liquidity crisis that caused the Depression (Friedman and Schwartz 1963, 412-14). Peter Temin takes issue with this view, arguing that Strong's death was a "minor event in the history of the Great Depression." Temin believes instead that rigid adherence to the gold standard drove policy makers to pursue deflationary policies (Temin 1989, 34-35). More recently, David Wheelock has attributed the Fed's poor policy decisions to the method it used to monitor the money supply during the 1920s and 30s. As Wheelock explains, the Fed measured monetary tightness or ease by looking at the borrowing habits of banks that were members of the Federal Reserve System: "heavy borrowing indicated tight money and little borrowing indi-

cated monetary ease.” This policy “resulted in procyclical changes in the supply of money” and “permitted greater declines in the money supply during severe recessions than during minor ones” (Wheelock 1991, 114–15).

The Fed’s other big mistake was how it responded to the collapse of the nation’s banking system. At the peak of the Great Depression, thousands of banks were failing every year. In 1933 alone, roughly 4,000 banks failed. Concerned that their bank would be the next to fail, depositors grew nervous and withdrew their money from the system. Money that had been used to make loans to businesses and homeowners now sat idle in shoeboxes or stuffed under mattresses. Moreover, like the stock-market crash, bank panics eroded business and consumer confidence, further slowing business investment and spending on consumer durables (Bernanke 1983; Telser 1996).

The Fed could have prevented many bank failures and mitigated the severity of the bank panics by acting as a lender of last resort. However, believing that bank failures were caused by poor management and loan decisions, the Fed usually chose not to bail out failing banks (Friedman and Schwartz 1963, 357–59). During the nineteenth century, interbank clearing houses—private institutions created by banks to facilitate check clearing—had often acted as lenders of last resort in times of panic (Gorton and Mullineaux 1987). This prevented isolated bank runs from having the contagion effects they had during the Great Depression. If the Fed had done the same during the 1930s, the crisis in the nation’s banking system would not have been as severe. Beyond this, George Selgin (1994) has argued that bank failures throughout the 1920s and 1930s stemmed, in large part, from government restrictions that prevented small banks in agricultural regions from diversifying by opening branches in other regions, which would have diminished the risks unique to agriculture.

Another possible culprit, ironically, was the Reconstruction Finance Corporation (RFC), which was designed to prevent bank panics and failures. Established in January of 1932, the RFC made low-interest loans to failing banks and railroads. Friedman and Schwartz (1963, 320–21 and 330–31) suggest that net effect of the RFC was minimal. James Butkiewicz has presented econometric evidence that RFC loans reduced the number of bank failures (Butkiewicz 1995). Lester Telser, however, argues that the bumbblings of the RFC contributed to bank panics in Illinois and Michigan (Telser 1996).

In the midst of the Great Depression, Rexford Tugwell, a key advisor to President Roosevelt, proclaimed:

The cat is out of the bag. There is no invisible hand. There never was. If the depression has not taught us that, we are incapable of education. . . . We must now supply a real and visible guiding hand to do the task which that mythical, nonexistent, invisible agency was supposed to perform, but never did. (In Walton and Rockoff 1994, 53.)

Tugwell's view is now widely shared, despite the alleged triumph of *laissez-faire* ideas. Without government policies, it is thought, the market is prone to collapse. This is the wrong lesson to draw from the Great Depression. If anything, this disastrous episode illustrates what can happen when government agencies have too much regulatory discretion. Bennett McCallum has shown that if the Federal Reserve had followed a simple monetary base rule—the type of rule long advocated by such economists as Milton Friedman—the Great Depression would have been much less severe (McCallum 1990; see also Friedman and Schwartz 1963, 301).

### *The Destabilizing Effects of Some Stabilization Policies*

Deposit insurance is typically justified on the grounds that it stabilizes the banking industry and prevents panics like those observed during the Great Depression. In the short run, this is certainly correct. With deposit insurance, depositors know that whatever happens to the bank, their money is safe. This reduces their tendency to start a run on their bank. The Great Depression provides a case in point; shortly after the creation of federal deposit insurance, the bank panics stopped. However, in the long run, deposit insurance can have the opposite effect, gradually eroding the quality of banks' asset sheets and the stability of the banking industry. This is because deposit insurance creates a moral hazard problem. Knowing that their deposits are insured, depositors (or their agents) have little incentive to monitor the prudence of their banks' investment decisions.

Richard Grossman's (1992) study of the thrift industry during the 1930s presents especially strong evidence of moral hazard. Federal deposit insurance for savings and loan companies began in 1934, with

the establishment of the Federal Savings and Loan Insurance Corporation (FSLIC). According to Grossman, the FSLIC initially granted deposit insurance to thrift companies with the highest-quality asset sheets—those that took the least risks. Over time, though, insured thrifts that were not closely monitored and regulated engaged in increasingly risky lending activity. In a study of a state-run deposit insurance program in Kansas during the 1920s, Wheelock and Subal Kumbhakar show that banks that belonged to the state insurance program maintained lower-quality asset sheets and failed at a higher rate than banks that did not (Wheelock and Kumbhakar 1994). Other studies have uncovered similar evidence for state-run insurance programs during the late nineteenth and early twentieth centuries.<sup>4</sup> Moreover, while it is typically believed that federal deposit insurance was created to protect individual investors, the historical record suggests a much different story. In fact, the strongest lobbyists for the creation of deposit insurance programs, at both the state and federal levels, were small banks with low-quality asset sheets. Large, well-run banks opposed insurance because they believed (correctly) that mandatory insurance programs would effectively subsidize poorly run banks (Calomiris and White 1994; Economides, Hubbard, and Palia 1996; White 1983, 200).<sup>5</sup>

Other banking regulations have proven equally unsound. Selgin's point about the effects of branch-banking prohibitions during the Great Depression is made more generally by studies showing that laws limiting interstate banking and laws prohibiting banks from performing brokerage services made it difficult for banks to diversify and avoid region-specific risk (Calomiris and White 1994; White 1993). Selgin (1994) also shows that countries with free banking systems—systems that allowed banks to issue currency rather than reserving this power to the government—have been much less likely to experience bank panics than countries (like the United States) with unfree systems.<sup>6</sup> Even in areas far removed from finance, there is evidence that regulations ostensibly designed to promote economic efficiency have undermined stability. For example, George Bittlingmayer (1993) presents evidence that periods of unusually stringent antitrust enforcement are correlated with slumps in the stock market and reduced economic output. The mechanisms through which antitrust regulation could lower stock prices and slowed real economic activity are many. But the basic idea is this: antitrust enforcement generates un-

certainty about the future and discourages firms from making long-term commitments .

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The notion that postwar government intervention has been responsible for economic stability is, therefore, more a stylized half-truth than a stylized fact. The postwar economy is not, in truth, that much more stable than the prewar economy. The prewar Depression appears to have been caused by interventionism, not laissez-faire. And many of the policies now thought to debar future crashes may actually make them more likely. We would do well not to let pride in our enlightened interventionism lead us to exaggerate the health of the economy and our ability to regulate and maintain that health. Herbert Hoover and Irving Fisher indulged such exaggerations, and we know what history held in store for them.

#### NOTES

1. By contrast, FDR won the elections of 1932, 1936, 1940, and 1944 with 57, 61, 55, and 54 percent of the popular vote, respectively.
2. After the 1987 crash, the Federal Reserve promised to maintain liquidity and intervene as a lender of last resort. After the 1929 crash, the Fed did just the opposite: it reduced the money supply and refused to act as a lender of last resort. This is discussed in detail below.
3. See Romer's 1993 review essay, "The Nation in Depression."
4. See, for example, Calomiris 1990; Wheelock 1992; Wheelock and Kumbhakar 1995; and White 1983.
5. Consider what would happen if insurance companies were not allowed to charge different rates to good and bad drivers, or were forced to insure truly awful drivers. In such a case, insurance companies would have to increase the premiums for good drivers to compensate for the increased claims they would have to pay to poor drivers. In effect, good drivers would be subsidizing poor drivers.
6. Selgin (1994) argues that the positive correlation between increased government regulation and bank panics demonstrates that government restrictions undermine the health of the banking system. Critics of this view might argue that Selgin has the causality backwards. It could be that nations with frequent bank panics are more likely to pass laws regulating the banking industry. History, however, seems to suggest that Selgin has, by and large, identified the correct line of causality. See, for example, his discussion of bank panics during the Great Depression.

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