

### 3. The Final Crisis Winter 1933; the Banking System Collapses and Brings Down All Markets<sup>5</sup>

The governor of Nevada declared a state-wide bank holiday in November 1932. Bank holidays were a legal device for temporarily closing all the banks in a state. Some governors of smaller states followed his example. Apart from suppressing the symptoms of trouble, a state bank holiday has nothing in its favor although it became increasingly used. Friedman and Schwartz (1963) minimize the importance of bank failures and bank holidays in their explanation for the depth of the Great Depression. They describe bank holidays in Nevada, Iowa, Louisiana and Michigan in the same paragraph (p. 325) ignoring crucial aspects of the Michigan crisis.

Bank closures paralyze a modern economy. To focus on the money stock alone fails to grasp how markets work and how much they depend on an acceptable medium of exchange. Even the threat of a bank holiday would heighten fears about survival of all banks. Of course, anyone with a deposit in a failed bank loses all of it. But serious as this is, it is the least of the effects. Greater damage to the economy results when bank failures and bank holidays impel resort to cash, to barter, to private money and to a myriad of other expedients that people contrive to circumvent the breakdown of the banking system. Almost every transaction in a modern economy relies on money. Closing all banks, not saying when they will re-open, is a costly blunder. Once it happens, people fear it will recur. The fear persists and retards economic recovery. Bolstering, not closing, the banks in trouble should have led the list of remedies.

The U.S. economy was in depression before January 1933. It is the collapse of the banking system in the winter of 1933 that transformed depression into the Great Depression.

The lame duck Congress began its final session in December 1932. The final crisis began in the last week of January 1933. It was to be the herald of disaster that arrived 5 weeks later. The governors of Iowa, Tennessee and Kansas had declared bank holidays in their states. Political attacks on the RFC by influential Senators and Representatives mounted. However, there was still no official public list of the banks that had been in debt to the RFC before August 1932. Now Garner, still Speaker of the House, in violation of the July amendment to the RFC Law, ordered Trimble, the aptly named Clerk of the House, to publish the names of all banks that had obtained RFC loans between February 2 and July 31, 1932. This list was published January 26, 1933 in both the *Congressional Record* and in the *New York Times*. The identity of some of these banks, especially the larger ones, including Union Guardian Trust Company of Detroit, and the amounts of their loans had appeared before in an article by John T. Flynn in the November 1932 issue of *Harper's Magazine*. This article was republished in the *Congressional Record* of the Senate on December 22, 1932 at the insistence of Senator Norris. Union Guardian, a group that involved 178 banks, had borrowed more than \$16 million from the RFC six months before, an amount equal to about 25 percent of the bank's resources. It still owed the RFC more than \$9 million in January 1933. This stale news cannot explain the large withdrawals from Union

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<sup>5</sup> The detailed empirical study of panics and bank distress during the Great Depression by Calomiris and Mason (2003b) concludes with the statement "We do find, however, that in January and February 1933 there is a significant increase in bank failure hazard that is not explained by our model of fundamentals." (p. 1638). My narrative fills their lacuna.

Guardian that were threatening its survival. On January 26, 1933, Union Guardian requested a new loan of \$65 million from the RFC which refused the request. The reasons for the refusal are in dispute. Some claim it was because Union Guardian did not have enough collateral to satisfy the legal requirements for such a loan by the RFC. Others claim that the refusal was due to pressure from James Couzens, U.S. Senator from Michigan and a bitter enemy of Henry Ford. Union Guardian was a Ford bank. It had deposits from the Ford Motor Company, its president was a former Ford lawyer. Edsel Ford, the son of Henry Ford, was one of its directors and Henry Ford's son-in-law was chairman of Union Guardian. Henry Ford had been asked to keep his deposits in the bank so that they could be used as collateral for an RFC loan. Although Ford had helped the bank in December, he refused to continue his efforts unless other large depositors joined him. Couzens threatened to embarrass the RFC and Ford by using the floor of the Senate as his forum to reveal details of any RFC attempts to save the bank. Additional attempts during the next 19 days by various officials including President Hoover to extricate Union Guardian from its difficulties were all unsuccessful. All attempts to save Union Guardian came to an end on Monday night, February 13.

The public uproar about the Dawes loan 10 months earlier could not have stiffened the backbones of the RFC bureaucrats in Detroit. Moreover, what was presumably not widely known was that by January 15, 1933, Union Guardian "had reached the point where board chairman Kanzler said, 'We have got to get considerably more money, or the whole group is going to collapse.'" (Kennedy, 1973, p. 82). On January 25 the day before the list was published, Kanzler traveled to Washington seeking an RFC loan. By then, according to Kennedy (1973, p. 83), the RFC had agreed to an additional loan of over \$37 million if Union Guardian could obtain an additional \$3.457 million. On January 27 the chief RFC examiner was in Detroit to help Union Guardian obtain the additional amount required by the RFC. However, despite the RFC's agreement to the plan proposed by these representatives of Union Guardian, on February 6, the RFC representative in Detroit rejected this plan. Meanwhile, President Hoover, cognizant of the perilous nature of the banking crisis in Detroit and of its repercussions on the country, had met privately several times with key participants, Senator Couzens, the senior Senator from Michigan and Henry Ford (Jones, 1951, pp. 59-60). On February 9 in a meeting at the White House attended by both Senators from Michigan, Couzens and Vandenberg, high-ranking cabinet officers and the president of the RFC, Hoover tried to obtain an agreement that would save the Detroit banks. His effort failed largely because of the opposition of Senator Couzens and, perhaps, Henry Ford. On February 10 Commerce Secretary Chapin, a native of Detroit and Assistant Secretary of the Treasury Ballantine, who both had been present at the White House meeting, journeyed to Detroit for yet another rescue attempt. February 11 was a Saturday, Lincoln's birthday fell on Sunday so that Monday would be the Michigan state holiday to celebrate Lincoln's birthday. This gave three days in which the banks would be closed and a plan to save them might be fashioned. Bank failure loomed in Detroit, according to Sullivan (1936, p. 86), but in Washington, thanks to pressure from Hoover, by the late afternoon of Monday, the 13th, Treasury Secretary Mills and RFC Chairman Pomerene were ready to act immediately to stop impending disaster in Detroit. Hoover left Washington for New York to deliver the traditional Lincoln day speech that evening. Calling from

New York later that evening, he was told that Henry Ford was the obstacle. Hoover phoned Ford at 9 P.M. and "the President went to bed believing he had 'got Henry Ford back on the track.'" (Jones, 1951, p. 65). Later "in the early morning of February 14th Governor Comstock [of Michigan] was asked by the Detroit Clearing House Association to declare a bank holiday in Michigan." (Wigmore, 1985, p. 439) and did so. The state-wide bank holiday took effect on the 14th. Some of these details were revealed in the sensational lead story in the Detroit Free Press on February 15, 1933, the day after the declaration of a state-wide 8 day bank holiday. Can it be that no one knew the facts or, even worse, rumors, before the story was published in Detroit's leading newspaper?

On the same day the Detroit story broke, there was a failed attempt to assassinate President-Elect Roosevelt while he was in Miami, Florida. The assassin shot the mayor of Chicago, Anton J. Cermak, who died of his wounds. One should not under-estimate the effects of this attentat on public morale at this critical time.

Meanwhile soon after January 26, 1933, the biggest Detroit bank, First Wayne National (also referred to as First National Bank of Detroit by some writers)<sup>6</sup>, though not in debt to the RFC, faced the same crisis as Union Guardian, huge net withdrawals. Because both banks were holding companies. had many correspondent banks, and owing to their close ties to the auto industry, their struggles were catastrophic.<sup>7</sup> The Federal Reserve Bank of Chicago, since Detroit was in its District, tried to save First Wayne under Section 10 of the Glass-Steagall Act of 1932 that allowed special loans to a member bank that lacked acceptable collateral. For reasons never satisfactorily explained, these efforts came to naught (Wicker, 1996, pp. 118, 121-24). Neither Detroit bank reopened after the Michigan bank holiday ended.<sup>8</sup> In three weeks panic spread throughout the nation like wild fire. By the first week of March, the entire U.S. banking system stood on the brink of total collapse. Adding to the pressure were runs on gold at the New York Federal Reserve Bank mostly by foreign depositors. By March 4 its gold reserves had dropped to \$381 million from \$965 million on February 1 (Wigmore 1987, Table 1). Fear that the U.S. would devalue the dollar helped spur these withdrawals. Although gold at the other Federal Reserve Banks was available in principle to assist New York, most of these Banks turned a blind eye to their sister Reserve Bank. According to Wigmore (1987, p. 749), the decision to declare a bank holiday in the state of New York was primarily at the request of the Federal Reserve Bank of New York and was not due to the perilous condition of the member banks in that state.

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<sup>6</sup>Since Detroit was in the Federal Reserve District of Chicago and since one of the largest banks in the country was the First National Bank of Chicago, it avoids confusion to use First Wayne National instead of First National Bank of Detroit.

<sup>7</sup>Klebaner (1974) gives details of the holding company of banks that included First Wayne.

<sup>8</sup>Einzig (1933, pp. 67-8) gives a nearly contemporary account of this but asserts the Senate decided to make RFC loans public. In fact it was the House that was decisive. Hodson's (1938, pp. 208-9) more accurate and detailed history describes how the House revelations planted the seeds of panic in Detroit that spread throughout the nation. See also Friedman and Schwartz (1963, p. 329).

An intriguing area of research is the effect of this US banking crisis on Hitler's rise to power in Germany. The Reichstag fire occurred on the evening of February 27, 1933. The last democratic election in Germany before the Nazi regime took over was on Sunday, March 5, 1933. In this election, the Nazis got only 44 percent of the popular vote and were able to assume power nevertheless owing to the divided opposition. Shirer describes how during January 1933 leading German businessmen threw their support to the Nazis (Shirer, 1960, pp. 188-96). I am indebted to J. A. Telser for pointing out this connection.

On March 4, Inauguration Day in Washington, the governors of New York, New Jersey, Illinois, Massachusetts and Pennsylvania had declared bank holidays in their states. Neither President Hoover nor Senator Carter Glass wished to close the banks. Smith and Beasley (1939, pp. 340-2) give an interesting account of the discussion a few days before the end of Hoover's term conducted by Glass as an intermediary between President Hoover and President-elect Roosevelt on the economic arguments for and against closing the banks. Whether a President had the legal authority to declare a national bank holiday was in doubt. Because the United States was still legally in a state of war, not having signed the Versailles Treaty, Roosevelt relied on the Trading with the Enemy Act to proclaim a national bank holiday to begin on the morning of the 6th, but Congress passed emergency legislation that day putting a firmer legal justification on FDR's action. Nobody can read contemporary newspaper stories written before and during the bank holidays without dismay at its terrible consequences. For the Federal government to stand ready to pay cash to all bank depositors would seem to have been much better than closing the banks. It would have had at least as much legality as the national bank holiday.

President Roosevelt in his inaugural address that morning famously said, "The only thing we have to fear is fear itself" to a nation in which nearly all the states had already closed their banks. At 11 PM Sunday, March 5, one of FDR's first official acts was to declare a national bank holiday to take effect the next day<sup>9</sup>. It was only 5 weeks, January 26 to March 5, from the revelations in the House to this unprecedented proclamation. More than 17 percent of all the national banks closed their doors that March never to reopen. Interest rates, which had been falling, rose from 0.44 percent in February to 2.38 percent in March. The cash-to-time deposit ratio reached its apogee in March, over 61 percent.

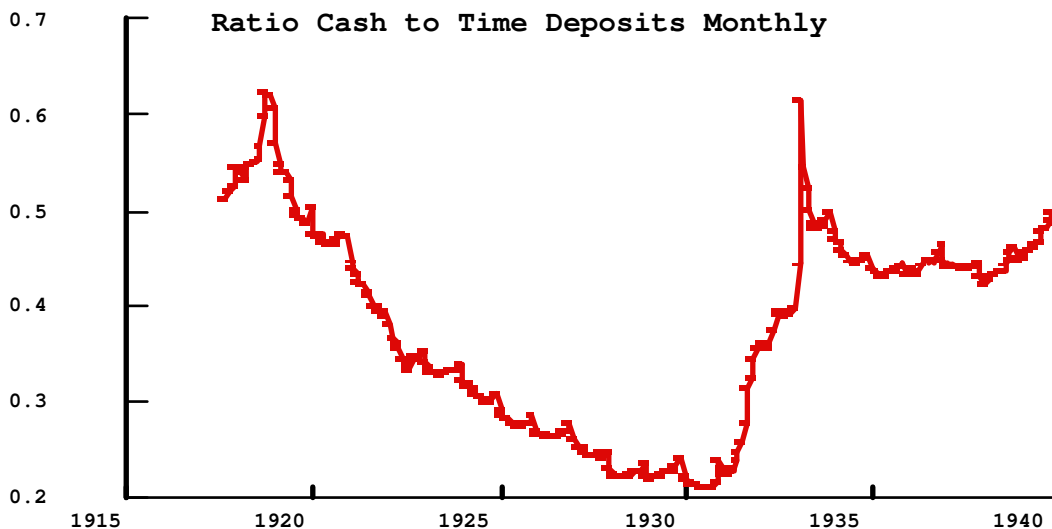


Figure 2

<sup>9</sup> Interestingly, writers differ on the date and time of President Roosevelt's proclamation of a national bank holiday. Smith and Beasley (1939, p. 342) give 11 P.M. Others give times ranging from 10:30 P.M. to "after midnight" (Friedman and Schwartz, 1963, p. 328), Sunday and some say Saturday.

As Figure 2 shows so vividly, the sharp peak of this ratio in March was followed by a sharp drop albeit still far above the levels of the 1920's. During the second collapse of the economy in 1937, it climbed again to well over 50 percent. Another clear expression of the public's anxiety is the rise in postal savings accounts (Friedman & Schwartz, 1963, Table A-1). These savings accounts were at least as safe as the Federal debt. From only \$161 million in October 1929, postal savings accounts rose to nearly \$1 billion by January 1933.

The proposition that a banking panic transformed an 'ordinary' depression into the Great Depression faces an objection raised by Friedman and Schwartz who point to Canada that had no bank failures, that had a huge decrease of its money supply and that also suffered from the Great Depression (Friedman & Schwartz, p.352 ff.). Since the common factor for Canada and the U.S. is the drop in the stock of money, Friedman and Schwartz conclude that this drop in the money stock is the main factor, not the collapse of the U.S. banking system. Obviously, the fate of Canada is not independent evidence of the primacy of the drop in the money supply. Canada is a major exporter to the U.S., hard hit by the deepening slump in the economy of its main customer. It is more plausible to regard the Canadian evidence as showing how much the money supply itself is a creature of the level of bank credit. No better support for this view can be found than in an article by Haubrich (1990, p. 233) His article begins with this abstract. "It [the study] exploits the special nature of the Great Depression in Canada to test propositions linking financial structure and aggregate economic activity. Canada's large domestic debt and shrinking banking system had little impact on the course of the Depression. In comparison with the results for the United States, this implicates bank failures as a prime factor in the real effects of financial crises."

The argument that the collapse of the banking system caused the Great Depression could be refuted by showing an instance where a similar collapse in an advanced economy did not have a similar effect. I know of none. On the contrary, the depression of 1837, the most severe U.S. depression in the 19th century, supports my argument that financial panic and subsequent collapse of the banking system is the key factor. Collapse of the banking system causes severe depression because markets in a modern economy cannot function without banks. The precipitating element then as in 1932-33 was political. The closing of the Second Bank of the United States owing to a political battle between President Andrew Jackson and Francis Biddle, head of the bank, caused widespread bank failures.

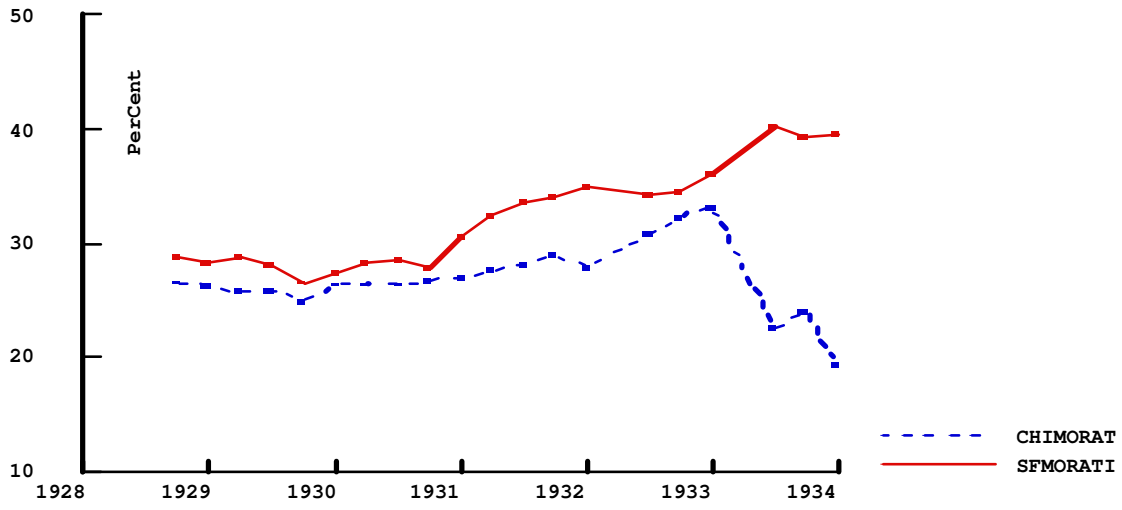
The claim that politics was the driving force behind the collapse of the banking system becomes more convincing if we examine an alternative explanation rooted in the great expansion of urban construction. The point is that the panic began in Detroit, but Detroit was not the city with the biggest growth during the 1920's. From 1920 to 1930, the population of Los Angeles county grew nearly 135 percent while Wayne county in Michigan (Detroit) grew 60 percent. The population increase in Los Angeles was nearly 1.3 million but was 0.7 million in Wayne county. During the same period the population of Cook county (Chicago) grew by nearly 1 million, an increase of more than 30 percent. New York city and environs increased 1.5 million, almost 25 percent. Excluding these 4 places, the population of the U.S. rose from 95 to 108 million, a 13.5 percent

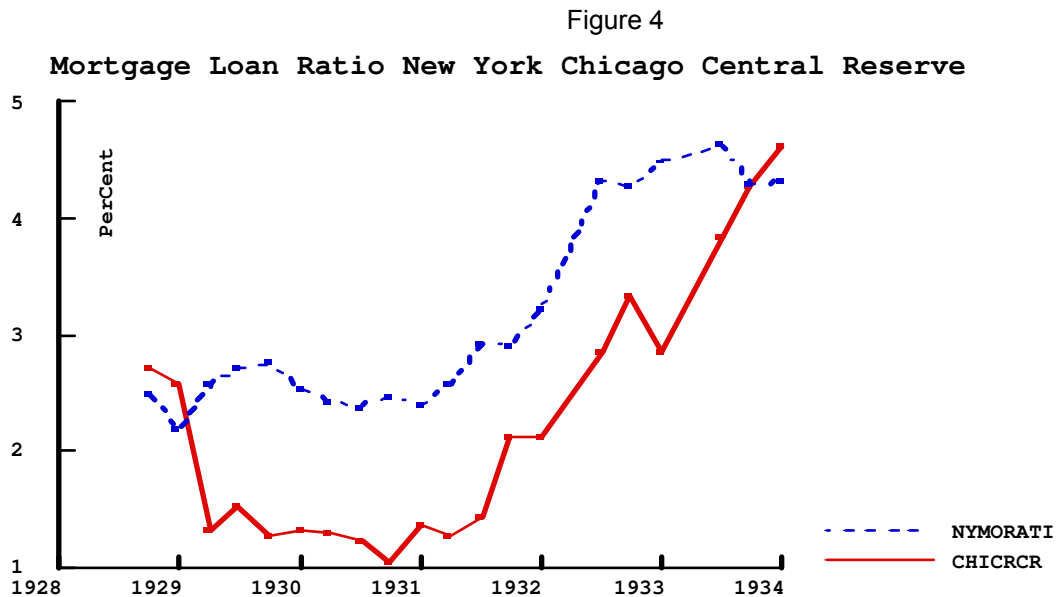
increase. Given the prosperity of the 1920's, it is easy to understand why there was so much urban construction.

More direct evidence for this proposition about the importance of politics derives from the balance sheets of Federal Reserve member banks. We can calculate the ratio of nonfarm real estate loans to total loans in the Reserve Cities of the San Francisco and Chicago Federal Reserve Districts shown in Figure 3. (The latter District includes Detroit. Los Angeles was a Reserve City in the San Francisco District that had no Central Reserve Cities at that time). Figure 3 shows the ratios for the Central Reserve Cities of the New York and Chicago Districts that include the largest banks in the cities of New York and Chicago. Nonfarm real estate loans for San Francisco Reserve City member banks were a bigger fraction of total loans than they were for Reserve City member banks in the Chicago Federal Reserve district. The San Francisco ratio climbed to nearly 40 percent in 1932 and 1933 while the ratio was dropping in the Chicago District (see fig. 3). The ratio in the New York City member banks were usually above those for the Chicago member banks and both were below 5 percent (fig. 4). Nor is this all. As Flynn reports in his Harper's article, Giannini got a \$65 million loan for his California banks at the same time that the \$90 million RFC loan went to the Dawes bank in Chicago. Moreover, Giannini's Bank of America was a large network of branch banks that apparently could not have survived without the large RFC loan. Despite the bigger population growth in California and the greater exposure of the California banks to the risks of real estate loans, California was not the scene of the banking debacle although California's banks did not escape unscathed. Between 1928 and the end of 1932, the number of member banks in the San Francisco reserve cities fell from 58 to 37 and total loans fell by \$400 million (22 percent). However, in the Chicago Federal Reserve District, while the number of Central Reserve City Banks fell from 22 to 11 in the same period, total loans fell from \$1.5 billion to \$630 million, a decrease of more than 58 percent. Although California had branch banking, banks in Michigan had nearly as close ties among themselves in the form of correspondent banking. It is not the exposure to the risks of real estate loans that explains the difference between Chicago and Detroit on the one hand and Los Angeles on the other. It is the political forces impelling the collapse of Union Guardian that explain the difference.

Figure 3

Mortgage Loan Ratio San Francisco Chicago Reserve Cities





Looking back more than three score years after these events we may ask whether the Federal Reserve could have prevented this banking crisis. By flooding the economy with cash could the Fed have stopped bank runs? Thanks to the Glass-Steagall Act of 1932, gold reserve constraints would not have barred the Fed from buying masses of Treasury paper thereby ballooning the money supply. However, this would not have helped an individual bank facing a mob of fearful depositors who wished to close their accounts. Only a direct infusion of cash to an individual bank in such a perilous condition would have had any chance of helping it survive. The Fed had only two tools at its disposal to help an individual member bank -- it could rediscount the bank's commercial paper or it could lend directly to the bank on a banker's acceptance. These tools were encumbered with legal restrictions on the quality of the eligible collateral. Recall that when the Bank of the United States, a member of the Federal Reserve System, faced a crisis in December 1930, the Fed did not help it directly. Instead the Fed tried to persuade the New York Clearing House to rescue the distressed bank. This Clearing House first promised to do so and then reneged. Moreover whatever help the Fed could give to an individual bank was confined to its *member* banks even under the provisions of Section 10 of the Glass-Steagall Act of 1932 that endowed Federal Reserve Banks with more latitude to aid members. More than half the commercial banks were not members of the Federal Reserve System. The Fed could do nothing directly for them.

Only short-term commercial paper was eligible for rediscount by a member bank but such paper comprised about half the assets of a typical member bank. It would seem that overcoming a temporary loss of confidence in a member manifested by a wave of withdrawals was within the Fed's power but the Fed could not rediscount nonperforming loans. The seeds of crisis were sown as soon as bank loans went into default. This happened before a bank had to face the prospect of massive withdrawals. Even good real estate loans of a

member bank were not eligible for rediscounting at the Fed, but they were acceptable as collateral by the RFC. Unfortunately, the RFC, created as a second line of defense, crumbled.

After the national bank holiday the banking system partially recovered. Wigmore (1987, pp. 750-55) offers convincing evidence that the restoration of confidence in the banks can be attributed primarily to suspending the gold standard, to stopping publication of the identity of borrowers from the RFC, to controlling private deals in foreign exchange and to the public's confidence in FDR. He places little weight on the newly formed Federal Deposit Insurance Corporation (FDIC) as an additional factor contributing to the return of some degree of confidence in the banks, pointing out that it would not go into effect until the beginning of 1934.

At the apogee of the financial panic in the U.S., currency was the only unquestionably acceptable form of payment. Table 2 shows the magnitude of the flight to cash. (See also the vivid description in the April 1933 issue of the Federal Reserve Bulletin.) The size of these increases can be judged by noting that the average amount of cash in circulation in 1932 was \$5.3 billion and average M1 was \$20.6 billion. The increase in currency on a single day, March 3, 1933, the day before FDR's inauguration, was 2.2 percent of the average M1 during the whole year 1932!

**Table 2. Daily Increase in U.S. Currency in Millions**

Week Ended	Average Daily Increase
February 1, 1933	\$5.8
February 8	7.6
February 15	20.1
February 22	19.1
Date	Currency Increase
February 23	38.9
February 24	51.0
February 25	65.0
February 27	187.0
February 28	207.0
March 1	174.0
March 2	241.0
March 3	454.0

Sources: Sullivan (1936, p. 82) and the Table: Demand for Currency and Sources of Funds Used by Banks in Meeting the Demand, Federal Reserve Bulletin April, 1933, p.215

Table 3 bears on the view that the depression starting in 1929 turned into the Great Depression after the collapse of the banking system in early 1933. It summarizes figures about the state of the economy from its peak in June 1929 to January 1932 when the RFC began. Most pertinent is the effect of the RFC via the banking crisis it engendered on the behavior of various components of the money supply after the RFC began operating in January 1932. Time and demand deposits fell more rapidly during the 15 months from January

1932 to April 1933 than during the preceding 31 months beginning in June 1929. That currency holdings of the public rose twice as much before than after the RFC began should be seen in conjunction with the falling price level. The price level fell 43 percent more rapidly during the pre-RFC than the post-RFC period. Hence holding cash was more remunerative in the 31 month pre-RFC period than the following 15 month RFC period. The record supports the conclusion that the RFC precipitated the banking crisis.

Table 3 shows remarkable but brief recovery of the economy from April 1933 to July 1933. The FRB Index of Production rose by more than 51 percent, from 66 to 100 (it was 125 in June 1929), stock prices rose even more, from 50.2 to 85.0, a rise of more than 69 percent while the money supply, M1, was nearly constant. One may hardly claim that this recovery was a lagged response to a bigger money supply. No other 4 month period in U.S. history shows as large increases in output and stock prices. The economy then faltered and relapsed into depression. I know of no acceptable explanation for this relapse that began in the summer of 1933. The next section examines in detail the deleterious effect on recovery of the RFC's preferred stock program during the New Deal era. The economy was not to attain as high a level of production until the second half of 1936.

**Table 3: Summary of Salient Statistics on the Great Depression <sup>a</sup>**

	Member Bank Reserves <sup>b</sup>	Demand Deposits	Currency	Time (Savings) Deposits	Market Value of Stocks	Wholesale Price Index	FRB Production Index
June 1929	3327	22278	3911	19729	84659	96.4	125
Jan 1932	2808	16611	4896	15059	23844	67.3	72
Total and (Mean) change June 1929-Jan 1932, 31 months	-15.6 % (-0.55 %)	-25.44% (-0.95%)	25.18% (0.72 %)	-23.67% (-0.87 %)	-71.83% (-4.09 %)	-30.19 % (-1.16 %)	-42.4% (-1.78 %)
April 1933	2872	13 837	5202	10708	17466	60.4	66
Total and (Mean) Change Jan 1932-April 1933, 15 months	2.28 % (0.15%)	-16.70 % (-1.22 %)	6.25% (0.40 %)	-28.89% (-2.27%)	-26.75% (-2.07 %)	-10.25 % (-0.72 %)	-8.33 % (-0.58 %)
July 1933	3005	14201	4886	11073	29635	68.9	100
Total and (Mean) Change April- July 1933, 3 months	4.63 % (1.51 %)	2.63% (0.86 %)	-6.07% (-2.09 %)	3.41% (1.12%)	69.66 % (17.62 %)	14.07 % (4.39 %)	51.52 % (13.85 %)

a. All monetary figures are in millions of dollars b. includes vault cash.