

Corporate Financial Decisions: Have They Changed During a History of Stressful Economic Events?

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Abstract

In the United States, there have been several events that have shaped the way that our economy is currently functioning. Events such as the Great Depression in 1929 and the more recent Great Recession of 2008 have led to financial stress on large, important industries. In these difficult economic times, executive officers and policy makers must make difficult decisions about how to combat this financial stress. In particular, the banking industry in the 1920's and 1930's and the automotive industry in 2008 were struggling to stay afloat.

In this thesis, I research the decisions that have been made in these, sometimes controversial, events. I seek to understand the different approaches that have been taken to mitigate these situations. As a result, I am able to explore the effects of the decisions that were made and how the firms fared during these economic crises. With this information, I can determine if executives and policy makers have been making similar decisions, or if our current leaders have learned from past decisions.

Introduction

According to our constitution, the federal government is in place to “promote the general welfare”(Constitution). Based off of this principle, the federal government is given the power to enact changes that will better the citizens. What the clause doesn’t specifically state is the limitations. When looking at the interaction between the government and markets in the United States, it is important to understand when the government is providing for the general welfare and when they are overstepping their authority. This concept has been a topic of debate in recent elections and finding the line of adequate government intervention is the ultimate goal.

In this paper I look at two examples of economic downturns that have drastically influenced the way our economy functions today, the Great Depression of the 1920s and 1930s and the Great Recession of 2008. I focus on two industries that were greatly impacted by these two events, particularly the banking industry during the Great Depression and the automotive industry during the Great Recession. It is with this information that I can see how decisions were made to create viable solutions to these problems. The major theme in this paper specifically, is analyzing the influence that the federal government had on these decisions and compare throughout the past century if we have evolved in our decision making to create better solutions.

After analyzing both cases there are two distinct findings. The first is that since the Great Depression, the federal government has been involved in economic

decisions that have proved to be viable solutions to the problem. However, the way in which the government has approached these problems has changed over time. In the case of the Great Depression, it was a policy change that impacted the way that the banking institution was operated then and is ultimately still the way they are ran today. This is different than the Great Recession, in which the federal government provided more of a financial backing to get these automakers through these difficult times. The government's purpose was not to change the way that auto companies worked because they knew that once consumer spending bounced back, the auto industry could perform on its own again.

While the outcomes of these two events have been relatively successful in the aspect that we still have a banking industry and automotive industry, it must be noted that government's intervention isn't always the best solution. This is because of a phenomenon known as too big too fail (Hetzel). Essentially what the federal government has created is a sense that if you become a large enough player in your industry, that you are impervious to economic downfall. For businesses that aren't of this size, it makes them angry that these companies can take higher risk knowing that if they fail there will be a bailout waiting for them. Most commonly this type of behavior is described by moral hazard. While federal officials recognize the problem that they have created, the implications that would come as result of no intervention could have been far worse based off of projections.

While we might not ever know what an economy without government intervention is like, it has been shown through history that the decisions made thus far have provided a positive benefit. Without these policy changes and financial support from our government, it is unlikely that we could have made it through these times with the same result.

The Role of Government

The Federal Government has been instrumental to the policies and laws that have shaped the way our country runs. While some may think that there is too much or too little intervention, the Government has played an instrumental part in keeping our country performing during these difficult economic times. In order to fully understand the scope of what the Government has done, it is important that we understand what the United States Government can or cannot do when intervening in corporate and economic policies.

Generally, when an economic crisis ensues there is a panic felt among the country regarding all of the negative outcomes that could have result from this event. More times that not, there is the inclination of going straight to the ultimatum that our economy will fail completely. While imaginative, if that day would ever come, this discussion would be irrelevant because of greater dangers. In every instance of the modern era, the Government has been there to relieve the financial burden.

It is important to note some of the ways that a Government can intervene. One of the most common ways to affect economic change is by adjusting interest rates (Weil). What this does is either increase or decrease borrowing and investing. In difficult times, the interest rate is typically very low in order to encourage investment and increase in spending to stimulate the economy. If the money supply isn't changing enough by these tactics, then the Fed is allowed to buy or sell bonds in order to increase or decrease the money supply without simply just printing more money, which would lead to high rates of inflation (Weil). Our Government also has the ability to propose new regulations and policies that aid a struggling company or economy through federal loans or bailout as well as federally funded public works projects. Specific examples of these will be discussed later in the two economic cases.

While the Government has a large share of power in our country, there are certain limitations as to what they can't do. Examples of this include drastic measures such as implementing policies without a majority vote in both the house and senate. Without getting approval, the Federal Government isn't allowed to make any policy changes. If done, it undermines the integrity of a democracy. What this system does is allow each and every bill put forth to be highly debated and looked over in order to make sure it is truly beneficial for the country. While most of the time it is a long and ongoing process, it has stopped some not so beneficial bills being written into law.

The reason why the law making process is so lengthy is because of all steps that must be completed in order for a single bill to be passed into law. First, either House or Senate members, known as sponsors, must introduce the bill. After the bill has been recognized, it will then go to a committee or subcommittee and be decided if it is even worthy of being debated and voted on in the House and Senate. If the committee decides that the bill should be debated and voted on, then it will go to both the House and Senate, which have the options to pass, reject, or amend. If amended the other side must agree to the amendments and a majority vote from both the House and Senate must be present for the bill to move forward. From there, the bill is sent to the President who can sign the bill and it automatically becomes law or veto it and then it has to be sent back to Congress who can override the veto is a 2/3 thirds vote. As you can see, this process is long enough in itself, let alone the filibustering that happens in order to slow the process even more. It has been shown though that in times where time is of the essence, particularly in economic downfalls, policies and programs typically get approved faster in order to get the economy back to a stable performance. One of the best examples of this would be during the Great Depression in which the Emergency Banking Act was passed in a mere 5 days (History).

Introduction to the Cases

When deciding on what significant economic events I would analyze and compare, the first logical choice was the Great Depression. It is an event that we

have all learned about and is the most significant financial crisis in U.S. history. While the Great Depression was a significant event, the only information I knew about it was through reading. For this reason, I felt it to be necessary to have an event that I have witnessed. The Great Recession is arguably the next most significant economic crisis and I had the ability to see it unfold. Both of these cases provide excellent examples of key financial decisions and how those decisions have affected our country's economic future.

Case 1- Great Depression Background

Economic performance has always been a driver on determining the health of our country. In terms of non-adjusted GDP, the United States has had the largest economy in the world since roughly the 1890's (Cox). With this hold on the world's economy, it is significant to note the points in time where economic crisis occurred and how the United States handled it. In recent history, the most significant financial crisis occurred in October of 1929 and lasted until 1939. As we know, this time period became known as the Great Depression.

Causes

A day that has gone down in history as one of the worst financial days has been known by "Black Tuesday". Tuesday, October 29 is the day that the Great Depression began with the crash of the stock market (Kroszner). On this day and the months after, billions of dollars were completely gone and sent the financial well

being of the entire country in a downward spiral. Investors were left with nothing and the confidence of consumer spending dwindled. This however, was only the start to this long financial crisis. Following the stock market crash, the threat of losing money stored in financial institutions caused an alarm among the citizens. As a result, bank runs occurred. Bank runs are when large amounts of people go and withdraw their money from financial institutions (Diamond). These runs were detrimental to the viability of the banking industry. Banks didn't have the cash on hand to be able to distribute the large withdrawals. In this time during the 1930's, over 9,000 banks failed (Diamond). As a result of deposits not being insured, even more panic ensued for the American people.

Case 2- Auto Industry Background

The United States has been known for their quality American made vehicles since Henry Ford first started mass-producing the Model T. From that point, the automotive industry grew in the United States to become one of the leading industries and home to thousands of U.S. jobs. By having such a large influence on the economy and employment in the United States, any problem could prove to be a countrywide dilemma. As a result, the unexpected economic crisis put three large automakers, GM, Chrysler, and Ford, in a financial situation that deemed it imminent that they would fail if there was no intervention.

Causes

The automotive industry issues stemmed from a much larger catastrophe, the bursting of the housing bubble. The housing bubble consisted of thousands of poor mortgages that had been given to not qualified homeowners over the years to buy homes they truly couldn't afford (Bernanke). Bad loans along with false security in housing investments combined to create the largest economic crisis the United States had faced since the Great Depression (Bernanke). During this time stock prices plummeted, homes were being foreclosed everywhere and the financial security that Americans had been feeling for the past decades ceased to exist. So how did this affect the auto industry?

As with any economic downturn, the consumer confidence drops. People are less likely to go out and spend money when they aren't sure if there job will be there the next day. This presented the auto industry with a huge problem. Sales following the housing collapse dropped roughly 30% (Hill). A steep drop such as this one is hard to combat. All three of these major automotive companies experienced huge decreases in the shares of U.S. sales. The reason for this reaction was a result of what the other competitors at the time were focusing on, which was cheaper economy cars that provided great gas mileage that appealed to what people were willing to buy when the economy was hurting. Instead, these three automakers provided lackluster options in this category and were still focusing on expensive

SUVs and trucks. Most companies were able to hold on during this difficult time, but Ford, General Motors, and Chrysler were a different situation. The three companies had seen profits diminish and were reporting losses like they had not witnessed before. If nothing was done, it could have resulted in the end of all three of these automakers.

Federal Government's Perspective

The decision on whether or not the federal government should be involved is one that is constantly scrutinized. When industries such as banking and automotive are greatly affected by harsh economic times, the federal government must compare the costs and benefits of intervening. In most years, the automotive industry “historically has contributed 3 – 3.5 percent to the overall Gross Domestic Product” (CAR). For a specific industry, this is a large contribution that would equate to about \$500 billion dollars and that’s not even taking into consideration the benefit of jobs that are created here because of all the auto manufactures that reside in the United States. From this perspective, it is clear to see that any disruption in the either the banking or auto industry should be cleared up by the federal government for just the general knowledge of how important these industries are to the running of our country.

The situation above is ideal, but what we have to think about when the federal government intervenes and rescues these industries is the real benefit and if the benefit outweigh the cost. Whenever any economic reform or bailout occurs, it is

the taxpayer's dollars providing the ability for the government to even think about assisting these industries. While some citizens understand and accept this reality, the majority of Americans highly scrutinize the government's ability to do this. I conclude this has a lot to do with the fact that these industries are for profit businesses, yet they are willing to accept government aid to fix mistakes they made on their own. Either viewpoint that you decide to be on, there are positives and negatives that I will shed light on later. Until then, it is important to know the effects that both case studies had on their respective industries.

Case 1- Great Depression Effects

The Great Depression was an event that we hadn't experienced before of that kind of magnitude. Arguably the industry hit the hardest during this time was the banking industry. This was because after Black Tuesday, all financial confidence went to practically nothing. Stock prices continued to plummet and the wealthy, who were in control of roughly a third of the nation's wealth were losing money left and right because of the poor stock prices. This financial pandemonium trickled down the entire system as businesses weren't selling anything and millions were laid off. Americans had lost all trust in the financial institutions that had developed the country thus far. For this reason, a wave of bank runs began to ensue. A bank run is when large amounts of people look to withdraw their money from banks (Diamond). While it is their money, this creates solvency issues because a bank

doesn't actually hold that much money at a time. They are typically using individuals' money to provide loans and make interest off that money. As a result, the American people lost confidence in their security of banks and began withdrawing at the same time. As a result, between 9,000 and 11,000 banks dissolved during a three-year period (Diamond). Once a bank dissolved, there was no way of obtaining your funds and no insurance to cover your loss. With more banks dissolving, the little confidence that was still there for Americans began to dwindle more. The current president during the darkest days of the Great Depression was Herbert Hoover. His response to all of these events was, "a passing incident in our national lives" that it wasn't the federal government's job to try and resolve (History). A bold position by the president at that time considering that a quarter of the population was unemployed and the future of the United States was bleak. Luckily his term was coming to an end and the American people made it known that they were looking for a candidate that was going to act on the situation.

Solution

President Franklin D. Roosevelt, arguably one of the most famous Presidents because of his work during such a difficult time took office in 1933. Roosevelt came into office with a bold plan and acted on it swiftly, providing jobs and relief for those in need. "Over the next eight years, the government instituted a series of experimental projects and programs, known collectively as the New Deal, that

aimed to restore some measure of dignity and prosperity to many Americans. More than that, Roosevelt's New Deal permanently changed the federal government's relationship to the U.S. populace" (History). The New Deal consisted of a number of government-funded programs. For my purpose though, I want to focus on the Bank Act of 1933. The Bill was sponsored by Sen. Carter Glass (D-VA) and Rep. Henry Steagall (D-AL) and signed into law by Roosevelt in 1933. This policy change set up the banking industry for a successful recovery and a strong future. The Bank Act of 1933 contained many goals. One aspect that this act corrected was the interaction between commercial and investment banking. Before the act, there was no separation in funds and resulted in commercial funds being used in risky investment. After passing the act, the banks were no longer allowed to intertwine these businesses and allowed clients to feel safer. The Federal Deposit Insurance Corporation or FDIC, as many of us know it today was another beneficial part of the act. What the FDIC does is insure deposits up to a certain amount. This was great for the clients of the bank and brought back a sense of security among the American people. The original insurance deposit amount was up to \$2,500 (FDIC). Over the years, this number has been adjusted up to \$250,000 which is still where it stands today. A unique aspect of the FDIC is the way that it is funded, which is through bank premiums that are invested in U.S. treasury securities. (FDIC)

While the Bank Act of 1933 was successful in its main goal to bring the banking industry back to a financial institution that people could trust and count on,

it is important to note how many banks had dissolved before stability could come about. Without the new law, I find it very difficult to imagine the banking industry to bounce back. In the end, we can now see the importance and impact that lawmakers and President Roosevelt had on the rebuilding of our country during the darkest days our country has been through.

Case 2- Great Recession Effects

The housing market in the United States had always been a great investment. For the average American, a house is probably the largest investment you will have in your lifetime. For this reason, people expect that when they get a 30-year mortgage, they will still be ahead after interest payments because the value of their house is always rising. These misconceptions, as well as providing loans to under qualified people, were two of the largest reasons that we had the worst housing bubble the U.S. had ever seen. People weren't able to pay the monthly payments on their homes and trickled down to the owner of the mortgage, typically a bank. When the banks went to foreclose on these homes, the market was not responding well and banks weren't able to sell the home close to what the original loan amount was for. In late 2007 the bubble had burst nationwide. Foreclosed homes could be seen everywhere and housing prices completely slumped. Just like in the Great Depression, this negatively affected stock prices and devalued investments. Wondering what future awaits was the Auto Industry. As with any difficult

economic time, people are more aware of their finances and are reluctant to go out and spend money. As with a lot of items in our life, the automobile is considered a luxury good. Most Americans have them, but they are definitely not a necessity for life. Because of this, the automotive industry was hit hard. As you can see in Figure 1 below from the Economic Policy Institute, GM, Chrysler, and Ford all lost market share during this time to foreign competitors.

Percent of total U.S. auto industry market share, by automaker, 1961–2014

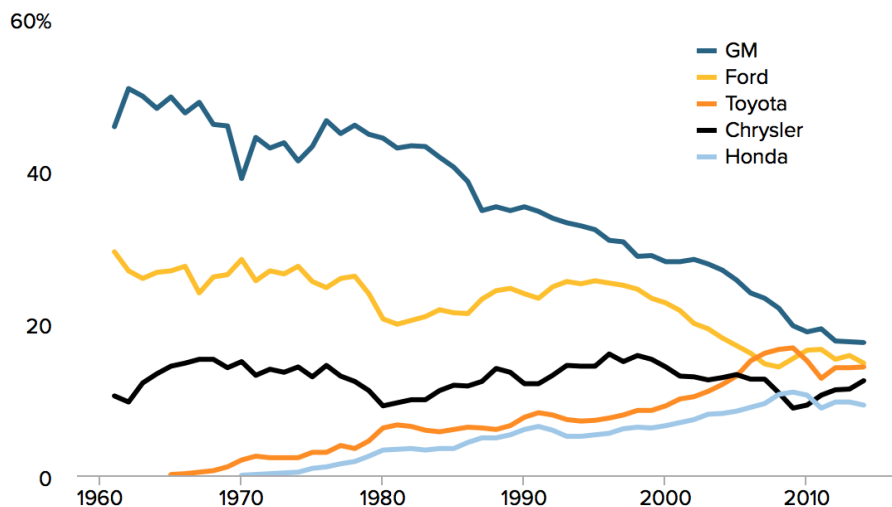


Figure 1 (EPI)

What are even more significant though are the financial struggles that these three faced because of the housing crisis. Roughly 50,000 former autoworkers in 2008

filed for unemployment due to strict budget cuts (Cutcher). Production and sales continued to decline however and it was deemed imminent if there were no intervention that these auto companies would fail completely.

The Government had a difficult task on their hand because of the repercussions that could result if the American auto industry failed. If they stood back and allowed nature to take its course, it is uncertain as to what could have happened. All that could be done was estimate the potential costs and benefits. However, even before the government had devised a plan for what would come for these companies, there was one company that had prepared for a situation such as this one and it was Ford Motor Company.

Solution

In 2006 Ford's then CEO, Alan Mulally made a bold move and was able to borrow \$23.6 billion with Ford's assets as collateral (Ingrassia). For most, this seemed like a shot of desperation and he was going to drive the company in the ground. What Mulally saw was the slow growth in the economy and realized that if Ford didn't secure these funds, it could prove to be a difficult future ahead of them. Well, it turns out his decision was exactly what Ford needed at the time because with this money he was able to revitalize Ford and, as he had predicted, use this money as a cushion in the event of a recession. This decision alone kept Ford from

receiving the eventual bailout that GM and Chrysler would have to receive in order to continue operations (Ingrassia).

As for GM and Chrysler, their lack of leadership left them in a position in which they were at the mercy of the government. If there wasn't government intervention, their future was looking unsightly. Thousands of jobs had already been cut and production was down in order to keep the companies running. It would turn out to be not enough and GM and Chrysler would have to plead their case to the government on why they deserved this bailout.

In November of 2008, the leaders of these companies had to travel to Washington and plead their case to the Senate on why they deserved public funding (Goolsbee). This event was highly controversial because every CEO flew in on private jets provided by the company. The irony of this was huge and made headlines everywhere. Because of their actions, the public perception worsened. Even with a negative public view, the federal government approved the bailout for these two companies. With this bailout, there were some mandatory changes that had to occur.

For General Motors, the structured plan was for them to file for bankruptcy reorganization. In this reorganization period, several brands such as Hummer were removed from production. As GM was provided billions in loans, the Government held roughly 61% of the company and ultimately pushed CEO, Rick Wagoner, out of his position (Stolberg). Over the next 4 years, GM was able to begin buying back

those shares in preferred and common stock (Stolberg). By doing so, General Motors would once again become a public company and have a fresh start.

Chrysler on the other hand had a bit of a different situation when it came to being bailed out. Chrysler was given an ultimatum of merging with Fiat or not receiving federal funding. President Obama had made it clear that in order for Chrysler to receive an additional \$6 billion that an agreement with Fiat would have to be made (Anginer). Not to anyone's surprise, Chrysler reached a deal and in 2014 the vehicle lineup would officially be name Fiat Chrysler Automobiles (Anginer). As a result of this merger, Chrysler was able to repay its debt to the United States and had successfully come through the bankruptcy reorganization.

The repayment of these debts from the automakers was a feat in itself. It has taken until the beginning of 2015 for the bailout to be paid back to the government. What signaled the end was the final sale of GM shares and Ally Financial, formally GM's financing center (Contorno). While the debt is considered paid back and the companies are once again performing well, there was a little over \$9 billion that was paid and is considered a loss to tax payers (Contorno). Overall, the Obama administration sees this as a major success because no company was lost during this time.

Analysis of cases

As you can tell from the two cases that I researched, the United States has gone through some difficult economic times. When trying to analyze and compare

these cases I found it important to not only look at the different approaches for each of the industries, but also the American outlook on these cases.

In the Great Depression, the federal government knew that an action had to take place in order to solve the failing bank crisis. This was why they implemented policy changes that would change the way the banking industry worked. What these policy changes did was bring back consumer confidence that a bank was an institution that you could feel safe putting your money into. This approach was different than the Great Recession because in the specific time it wasn't so much about changing the automotive industry, as it was being a financial backer to cushion them until the economy could bounce back and sales pick back up. Like I spoke earlier, it is important to note that some internal leadership was changed, but the overall approach was vastly different than what we had viewed in the handling of the Great Depression.

A similar aspect was the public perception about each of these situations. When it was announced that the banking industry was to have new changes, the American people saw it as an overall positive approach. This was because they were gaining confidence in the ability for the banks to responsibly handle their money and if anything were to happen again, it was guaranteed that their money was back by the government up to \$2,500. While the American people were happy with the announcement of those changes, it is apparent that in the Great Recession people had mixed feelings and most were against a bailout of General Motors and Chrysler.

The public perception was this way because many Americans felt that it was wrong for their tax dollars to be used to bail out two companies that had put themselves in such dire straits. What made it even worse was when the executives came to a hearing to plead their case for a bailout in their private jets. Whether harm was meant by it or not, the public perception dropped dramatically and no one is to blame but these companies.

Although both of these cases had different approaches and perceptions, it must be noted why both of these cases had to be dealt with by the federal government. In the Great Depression we were facing what could have been the destruction of the banking industry and possibly the whole economy. If nothing was done, banks could have continued to fail and jobs would have continued to be lost. In the Great Recession, GM and Chrysler could have likely gone under and millions would have been without a job.

Even more important is the issue of the phenomenon, too big to fail. This explains to us that if a company is large enough to cause enough damage to the American people in the event of failure, that the federal government will never allow it to fail. This thinking is absolutely correct because we have yet to see a company that has considerable economic status fail in difficult economic times even though the company itself is supposed to. To describe this in respects to the Great Recession a working research paper written by two well-known American economists, Austan Goolsbee and Alan Krueger, concluded that,

“We agreed with others in the administration that it was essential to rescue GM to prevent an uncontrolled bankruptcy and the failure of countless suppliers, with potentially systemic effects that could sink the entire auto industry. Our analysis suggested that a failure of the much smaller Chrysler, however, would not have systemic effects for the whole industry and that rescuing the company would make it more difficult and more costly for taxpayers to rescue GM, although we recognized that a failure of Chrysler would cause considerable hardship to its workers and their families and communities” (Goolsbee and Krueger).

This quote perfectly describes this dilemma that every analyst and economist in the U.S. was facing when deciding whether or not these companies should be bailed out. While we will never know what would have actually happened, the predictions of job loss and economic impact were astronomical. While the government is looking out for the American people and the condition of the economy, it has created a moral hazard for large corporations that are taking higher risks knowing that they will always be bailed out. It is a dilemma that has to be confronted, but is so difficult because of the repercussions it could have on millions of people.

Conclusion

Throughout modern history of the United States it is true that we have dealt with economic events that have changed the outlook and function on how our economy operates. With these events, it has shown that government intervention has proved to be relatively successful in the aspect that we still have banking institutions and automakers here in the United States. When looking at the big picture it is evident that the federal government has taken each economic event and devised unique plans for those situations. While we may never know what a modern world is like without government intervention, it can be concluded that the presence that they have had in their difficult economic times have shaped the way that future decisions will be made regarding the economy.

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