Would Banking Panics have been less Frequent in the US in 1863-1913 in the Presence of a Central Bank?

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Abstract
This paper explores the possibility that banking panic frequency could have been reduced through the installation of a central bank during the US national banking era. A historical comparison between the UK banking system and the US banking system illuminates the essential nature of an institution adhering to Bagehotian principles. The fact that no banking panics occurred after the creation of the Federal Reserve for a period of almost 20 years is perhaps the most convincing evidence supporting the view that the role of the lender-of-last-resort must be provided by a government authority.

1. Introduction
The National Banking Era spanned from the establishment of the National Banking Act in 1863 to the creation of the Federal Reserve in 1913. It followed the Free Banking Era of 1837-1862, when there were virtually no barriers to entry into banking and state banks were free to issue their own banknotes. The National Banking Act created a system of national banks, which were subjected to higher standards regarding reserve requirements and lending activities. This was accompanied by the creation of a uniform national currency in which all national banks had to accept each other's currencies at face value. Despite the introduction of stricter regulatory reforms, the era was plagued by three full-scale banking panics and convertibility suspensions in 1873, 1893, 1907, as well as embryonic crises in 1884 and 1890. The frequency of banking panics have led many to question the effectiveness of private
sector solutions and urge for the formation of a central bank to act as a lender of last resort during times of crisis.

This essay will present both sides of the debate on whether the presence of a central bank in the US would have reduced the number of banking panics. Advocates of free banking reject the need for any government body to lend extensively and believe private sector solutions, such as clearing houses which issued loan certificates that substituted for currency payments, would suffice.¹ According to this view, government authorities in fact intervened too much by setting up extensive banking restrictions,² or intervened in the wrong way by imposing uneven regulations among financial institutions.³ In direct opposition to the free banking view, scholarship under the auspices of Friedman and Schwartz have defended the classical lender-of-last-resort view by arguing for the necessity of a central bank.⁴ They have criticized the Federal Reserve for not acting fast enough or strong enough in lending extensively to US banks to provide liquidity and prevent bankruptcies to restore confidence among depositors during the Great Depression. A historical comparison between the UK banking system and the US banking system illuminates the essential role of a central bank adhering to Bagehotian principles in allaying banking panics.⁵ An examination of both the free banking view and the classical lender-of-last-resort view will be followed by the conclusion that banking panics would have been less frequent in the US in 1863-1913 in the presence of a central bank.

II. Private Sector Solutions to Banking Panics

Prior to the creation of the Federal Reserve, the US clearing house system served as the major institutional response to banking panics during the National Banking Era. During episodes of banking panics, clearing houses underwent a temporary transformation into a confederation of member banks, which acted

Would Banking Panics have been less Frequent?

collectively to publish aggregate balance sheets, suspend convertibility of deposits into currency and issue loan certificates to service depositors’ claims. The clearing house was willing to accept member banks’ illiquid assets as collateral for the loan certificates, which subsequently functioned as and substituted for paper currency. A risk-sharing arrangement featured in this process as the loan certificates were joint liabilities of the members. The clearing houses of the early 20th century were profoundly similar to central banks, as they provided liquidity to troubled banks and restored confidence amongst the public. Gorton went as far as to assert that the Federal Reserve was simply “the nationalization of the private clearing house system,” and the endogenous emergence of such an economic institution suggests private agents could devise effective solutions to banking panics without the help of any government authority.

In addition to clearing houses, powerful individuals in finance and industry also actively organized relief efforts during banking panics. For instance, in the Panic of 1907, J. P. Morgan took charge of nearly all the rescue operations, assembled prominent figures in the financial industry as well as the US Treasury and injected liquidity into sound institutions which were worthy of aid on October 23rd, most notably the Trust Company of America. John D. Rockefeller, the American business tycoon, injected a further $10 million in the National City Bank of New York the following day, leaving it with the deepest reserves in the city to cushion the bank runs. The determination of these key individuals to maintain credit provision, accompanied by press releases of the financial rescue package, restored much public confidence and brought back a sense of order in the US banking system despite the absence of a central bank.

III. The Free-Banking Argument

The ability of the private sector to tackle these crises on its own naturally leads us to postulate if the absence of the central bank was not the vital explanation for the high frequency of banking panics, what other causes could have contributed to this outcome. According to the free banking view, possible reasons may lie within the nature and extent of government regulation in US banking. Selgin, an advocate of this school of thought, contended that the legal restrictions which were peculiar to the United States, especially those prohibiting nationwide branch banking and free

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7 Ibid, 281.
8 Ibid, 277.
currency issue, were the main reasons for financial fragility and banking panics. Anti-branching laws have limited the geographical and portfolio diversification of banks, making them vulnerable to relative price shocks. The note-issuing monopoly held by national banks prevented other banks from freely issuing currency and independently accommodating depositors’ claims during bank runs. If these legal restrictions were lifted, there would be no artificial need for a lender of last resort. Furthermore, Grossman did not find evidence that central bank policy reduced banking instability during the Great Depression. In direct opposition to Friedman and Schwartz, his econometric results revealed that exchange rate policy and banking structure were more useful in explaining stability. Countries that departed from the gold standard earlier (and thus were able to devalue) and countries that possessed more extensive branch networks and greater concentration ratios in the banking sector exhibited exceptional banking stability.

Tallman and Moen employed the specific case of the 1907 Panic to illustrate the disastrous effects of uneven government regulations among financial institutions. Trusts were comparatively less regulated than the state or national banks in terms of reserve requirements and lending activities before 1906. Taking advantage of unorthodox investment opportunities paved the way for a concentration of riskier asset portfolios and reckless lending to less credible firms in this particular sector. Bank runs on trust companies spread to the state and national banks in New York. Arguably, if there were more uniform banking regulations, financial intermediaries would possess more diversified asset portfolios and the risk of banking panics would be substantially reduced. Hence, perhaps the frequency of banking panics was not determined by the presence of central banks, but by the degree of government regulation and the formulation of private sector solutions.

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10 Ibid, 433.
11 Ibid, 444.
14 Ibid.
15 Ibid.
Would Banking Panics have been less Frequent?

However, private sector solutions in the form of clearing house loan certificates and money funds created by benevolent individuals were not always effective in mitigating public fear and curtailing monetary contraction. According to Bordo, the interventions of the clearing houses were effective in only two out of the five banking panics but not in three others.\(^{16}\) During the panics of 1873, 1893 and 1907, private sector support was \textit{“too little and too late”}.\(^{17}\) The outsized role of powerful individuals such as J. P. Morgan and John D. Rockefeller also triggered a national debate on the creation of a public sector authority in the aftermath of the 1907 Panic. There was no guarantee that these tycoons and financiers would always lend a helping hand during times of crisis unless their own vested interests were severely affected. The presence of the Federal Reserve, therefore, was necessary because it served as a strong assurance to American financial institutions and investors that even if clearing houses and powerful individuals were no longer willing or able to intervene, the lender-of-last-resort function would always be provided by the central bank. Meanwhile, one should also be aware of the potential moral hazard that can arise. The implicit knowledge that a lender-of-last-resort would bail out troubled financial institutions in times of emergency may well encourage investment in riskier assets and more reckless lending to unreliable creditors.

\textbf{IV. In Support of the Classical Lender-of-Last-Resort}

The classical doctrine states that the fractional reserve banking system practised in the US carried an inherent risk of bank runs that could only be countered by the emergence of a central bank.\(^{18}\) In such a system, only a proportion of bank deposits are backed by cash reserves available for withdrawal whilst the remnants are invested elsewhere by the banks. The purpose of this is to free capital for extra lending and to expand the economy, but at the same time, it means the system is inherently crisis-prone and fragile. During a bank run, customers will attempt to withdraw deposits simultaneously and the bank will find it impossible to service all the requirements. Banking panics occur when such bank runs become contagious. Under these circumstances, central bank support for distressed banks are critical for survival. By publicly announcing the provision of high-powered money to satisfy market demand, the lender of last resort instils confidence and allay panics.\(^{19}\)


\(^{17}\) Ibid.

\(^{18}\) Ibid, 18.

\(^{19}\) Ibid.
Zhu

Drawing from empirical evidence, the fact that no banking panics occurred after the creation of the Federal Reserve for a period of almost 20 years until 1930 is perhaps the most convincing piece of evidence to support the view that such a role must be provided by a government authority.

A historical comparison between the UK and the US experience also illuminates the essential role of a central bank adhering to Bagehotian principles in allaying banking panics. In the early 19th century, the UK also experienced numerous banking panics which featured the scramble for high-powered money. After the Bank of England accepted its responsibility as the lender of last resort and followed the principle of lending extensively at a high interest rate and on the basis of good collateral, it managed to defuse incipient crises in 1878, 1890 and 1914 by organizing timely rescues and injecting considerable liquidity. For instance, during the Barings Crisis of 1890 the Bank of England organized a successful rescue by gathering the major London banks to create a money fund to guarantee Barings' Argentinian debts, thereby averting the possibility of a wider panic across the entire London banking system. Between 1870 and 1913, the US experienced four major panics whilst Britain faced none. The contrast between the frequency and severity of banking panics between the UK and the US within the same time period thus suggests the presence of a central bank could constitute the crucial missing piece of the puzzle.

Furthermore, Carlson et al. stressed the importance of central bank intervention in mitigating banking panics and reducing bank failures with the example of the crisis of 1929, which took place in the citrus-growing regions of Florida. The inability of the farmers to repay crop loans following a major crop failure in Florida fostered depositors’ concerns about the health of the banks’ balance sheets and resulted in widespread bank runs in the region. The public promise made by the district bank, the Federal Reserve Bank of Atlanta, to provide sufficient amounts of cash to cover depositors’ claims and its currency advancements to two major state banks effectively arrested the panic. Their calculations showed that

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20 Ibid, 23.
24 Ibid, 891.
25 Ibid.
Would Banking Panics have been less Frequent?

Bank failures would have doubled without central bank intervention. This plausibly points to the possibility of reducing banking failures and panics in earlier historical episodes if similar institutional establishments were already in place, accompanied by bold and prompt liquidity support.

V. Conclusion

In conclusion, despite the challenges posed by the free banking school of thought, the frequency of banking panics would have been considerably reduced in the National Banking Era of 1863-1913 if a central bank was present in the US. The inherent vulnerability of the fractional reserve banking system calls for a lender of last resort who could act decisively in the case of a panic. Whilst it is true that clearing houses and prominent individuals both played critical roles in credit provision and confidence restoration before the arrival of the Federal Reserve, they were by no means wholly effective or guaranteed. Central bank takeover of the lender-of-last-resort function resulted in much bolder, much more targeted and much more timely responses to banking panics, as the parallel developments in Britain have illustrated. Additionally, the virtual absence of major banking panics in the nearly twenty-year period following the creation of the Fed, along with the successful intervention of one of its district branches, the Federal Reserve Bank of Atlanta, in 1929 conceivably suggest that there would be a lower frequency of banking panics in earlier historical episodes if the central bank was already in place. The history of the US National Banking Era sheds much light for modern-day policymakers and government authorities, as they confront the ever-present possibility of banking panics and financial fragility.

Bibliography


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26 Ibid, 921.
Zhu


