Lecture 10: Gorton and Tallman, Ch. 1-4

ECON 43370: Financial Crises

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Antebellum Banking and Currency

The US had two quasi-central banks: the First (1791-1811) and Second (1816-1836) Banks of the United States

Along with private, state-chartered banks, issued bank notes

Andrew Jackson did not renew the charter of the Second Bank of the US

Led to the so-called "free banking" era. State-chartered banks issued banknotes

These promised specie on demand, but typically traded at a discount

The clearing process largely happened with "notebrokers" who would assume risk

Private Banknotes

Greenbacks and the National Banking Acts

Greenbacks were issued by the Union to finance the war; not backed by gold or silver

National Currency Act of 1863: Authorized federal charters for national banks and created the Office of the Comptroller of the Currency

National Bank Act of 1864: instituted capital and reserve requirements. Allowed national banks to issue national banknotes backed by US Treasury Bonds

These traded at par, whereas private banknotes from Antebellum era did not

1865 tax law effectively taxed state-bank notes out of existence

Greenbacks


No 66352
The United States
Promise to pay to the bearer
FIVE DOLLARS
On demand
Washington Aug. 10th 1861
Payable by the Assistant Treasurer of the United States
at New York
Act of July 17, 1861.
for the Register of the Treasury.
for the Treasurer of the United States
RECEIVABLE IN PAYMENT OF ALL PUBLIC DUES.
UNITED STATES OF AMERICA
FIVE
FIVE DOLLARS

National Banknotes

Federal Reserve

Federal Reserve was founded in 1913 and became operational in 1914

Begin issuing Federal Reserve Notes (which we now think of as the US paper currency)

These initially allowed for gold redemption

Until 1930s, national banknotes and Federal Reserve notes both circulated

With the Gold Reserve Act of 1934, ordinary Americans could no longer take paper dollars to the bank or the Treasury in exchange for gold

From 1930s until 1971, foreign monetary authorities could exchange dollar reserves for gold at $35 an ounce

This was ended by Nixon; we now have a fully fiat currency

Federal Reserve Notes

Gorton and Tallman

Study crises during the National Banking Era: 1873, 1884, 1890, 1893, and 1907

Was a uniform period without a central bank with an implicit promise to intervene

The New York Clearinghouse performed functions similar to a central bank

Main thesis: liquidity provision (clearinghouse loan certificates) and information suppression were the key to ending panics

Clearinghouses

Private association of banks, typically within a city or region

New York Clearinghouse was founded in 1853 and the most important

Basically, designed for check clearing

Grew to monitor member banks and serve as a private lender of last resort

Served as "correspondent" banks for interior banks, who could hold some reserves with them

Bagehot's Rule

Walter Bagehot wrote a famous book, *Lombard Street: A Description of the Money Market*, in 1873

The central rule or dictum: a foundational principle for central banks acting as a lender of last resort

- Lend early and freely to solvent firms against good collateral but at a high (penalty) rate

What is missing from the rule: secrecy

Managing the Information Environment

Gorton and Tallman emphasize managing the information environment as equally, if not more, important, than lending freely

In ordinary times, publish bank-specific information weekly

Suspend this during panics

Only provide information on the banking system as a whole

Want to protect weaker members to prevent situation from spiraling

In a sense, the collection of banks acted as a one super-bank during crises

Clearinghouse Loan Certificates

Clearinghouse Loan Certificates

These were issued as emergency liquidity during panics

Were collateralized with a large haircut and required paying interest

Were typically <u>not</u> used in circulation

Rather, were used as a cash substitute for wholesale settlement between banks

The goal: use these to conserve scarce cash reserves

Note: these were the liability of the clearinghouse as a whole, not of individual bank

Terms for discussion

- Too big to fail
- Moral hazard
- Currency premium
- Bank opacity
- Suspension of convertibility
- Correspondent banks
- *Livingston vs. the Bank of New York*
- Liabilities of failed business
- Seasonal currency demand
- Stigma