A bit of history

Two competing visions: Jefferson vs Hamilton

- We have been debating the relationship between government and society since the beginning of the republic. One side advocates States' rights, while the other wishes to see a strong central government.

Thomas Jefferson

- States' rights, weak federal government.
  Suspicious of power, especially banks.
  Believed decentralization would limit power, especially of banks.
  Wanted a rural, agrarian society like France, rather than an industrial society like England.

Alexander Hamilton

- Wanted a strong central government.
  Promoted development to compete with Britain, the industrial and manufacturing leader at the time.
  Business required credit. Borrow to invest.
  Argued a national bank was necessary to instill stability and to handle the finances of the US government.

- Hamilton initially won the economic argument.
- First Bank of the US was chartered.
- Jefferson worried that economic power would translate into political power of the bank.

The First Bank of the US 1791 - 1811

- Capitalized at $10m, $2m from Fed govt, $8m from private shareholders, located in Phil, had branches in other cities,
- Role:
- Collect tax revenues
- Make loans to the govt
- Pay govt bills
- Also accepted deposits, made private loans

1. Number of banks grew from 3 in 1789 to over 100 by 1810
2. Shareholders in banks had limited liability. They could only lose what they had put into the bank.
3. 1825 US pop = UK pop but US had 2.5 times the bank capital and the US economy was growing more rapidly.
4. Equity market was developing, 232 securities were listed on exchanges in the US by 1825

The first "Bank" War

- Jefferson and his allies, the Democratic – Republicans, successfully fought against renewing the bank's charter, 1811.
- Favored state banks and local regulations on banking. Fearful of the power of banks.
- War of 1812 - financial chaos ensued. Private efforts to finance the war were very uncoordinated.

Second US Bank chartered in 1816 for 20 years

- Role:
  regulate money supply,
  oversee the day to day cash flow of govt,
  issue bank notes,
  provide credit for member banks and private clients (including politicians).

By 1820, US had a well functioning modern (for the time) banking system, growth was strong. This was due to

A. First Bank of the US,

B. Hamilton's rules regarding cash flow in and out of the Treasury, while maintaining deposits at "approved banks."

C. Guaranteed debts incurred during the Revolutionary War. The US always pays its bills - origin of the current debt ceiling crisis!

D. Scientific Revolution was well under way ------> industrialization. Required financing. Businesses needed credit.

- Nicholas Biddle, president of the Second Bank - very important, with powerful friends in Congress.

- Banks were allowed to issue checking deposits to improve commerce.
- Very popular.
- New York Clearinghouse Association was established in 1853 to provide a way for the city's banks to exchange checks and settle accounts.

President Jackson

- Jackson opposed the Second Bank
  hated paper money,
  thought Biddle's power should be vested in the executive branch.
- Biddle and Senator Henry Clay want a renewal of the charter in 1832, Jackson opposed it and vetoed the bill. Transferred funds to Jackson's "pet banks."
- Biddle retaliated - called in loans to states causing a credit shortage and rates to rise from 6% to 12%. This caused a recession.

Result of not renewing the Second Bank's charter:

- Financial system stopped developing relative to Europe
- Economy suffered through a series of private bank panics and recessions

- Biddle's behavior confirmed Jefferson's suspicions all along.

Free Banking Era, 1837 - 1862

- Only state chartered banks existed.
- They could issue their own notes.
- States regulated interest rates, reserve requirements, and capital requirements, but only within the state.
- Wide variation in policy.

Problems:

- Average life span of a bank was about 5 years
- Half the banks failed
- Bank runs were quite common (no insurance!)
- Currency values could be manipulated by speculators (massive buying of one currency with another could alter the value of the two)

National Banking Act of 1863

- Ended financial problems by creating a system of national banks, stabilized currency.
  (federal charter subject to federal rules on rates, reserve requirements)
- One currency issued by the govt.
- Money was backed by Treasury bills.
- Result: created stability quickly.

- State banks remained quite popular due to the importance of checking accounts, primarily for business.

- By 1870 there were 1638 national banks and 325 state banks.
- Still no central bank.
- Individual banks were more stable. However, system was still subject to Panics.

Problems: 1870 - 1900

- Unstable period where bank panics occurred.

  (In a panic liquidity would dry up. Banks would go under, depositors would lose their money and this would cause a run on other banks leading to a decline in the money supply and a recession.)

- No lender of last resort to stabilize the system

- No insurance on deposits

1893 Bank Panic

- Panic precipitated worst depression to that date
- Unemployment rose from 3.7 to 8.1% in 1893 and 12.3% by 1894. It remained above 11% until 1898, fell slowly to 5% in 1900.
- Caused by railroad overbuilding, railroad bubble, which led to bank runs.
- US govt had to borrow $65m in gold from JP Morgan to maintain the gold standard.

Panic of 1907: watershed crisis

- Speculators tried to rig the share price of United Copper Co - triggered a bank run.
- Many banks are hit including the Knickerbocker Trust Co, one of the largest in NY at the time.
- JP Morgan stepped in and created a private bank consortium that put together a pool of funds to provide liquidity. Eased the crisis. Ruthless decisions were made by Morgan's men about which banks would be saved and which would be allowed to fail.
- Private sector could not completely solve the problem and the Treasury Dept had to step in with $25m deposited in the NY banks, a lot at the time.

Problems with “Private” solutions to a bank crisis:

- Ad hoc solution to "the" crisis at the moment not a general solution to "any" crisis.
- Such a private solution could allow big stronger banks to get bigger and take more control over banking.
- Concentration of power in one man, a private citizen.
- Concentration of power for solving the recession in one industry.
- No central bank who can act as a lender of last resort, Treasury Dept had to step in anyway.
- Banking was too lightly regulated, investors were not protected.
- Banks had to be bailed out only after the crisis ensued, no safeguards before to keep it from happening in the first place.

1913 Federal Reserve

- Reserve requirements
- Discount lending
- Open market operations

- Central banks are limited in their ability to undertake policy by the sophistication of the local financial system.
- 1923 Chairman Benjamin Strong used a large open market operation to increase liquidity in the system to combat the recession beginning in 1923. The swap of cash for govt bonds seemed to work as banks made loans and interest rates fell.

1920s

- Fed did little to rein in the big banks
- Regulation movement failed:
  investor protections were minimal,
  small investors were sold complex products they didn't understand,
  investors were given large loans to make the purchases
  ---> highly leveraged investments
- Fed kept rates low ----> fueled speculation in equities, created a bubble.
- Leverage was in widespread use in financing stock purchases for the first time.
- Margin requirement was only 10% and was waived in many cases.

Leveraging

- What is leverage?
- Consider: invest $10, make 10%, earn $1.
- Instead borrow $90, invest $100, make 10%, earn $10 on an investment of $10 (minus borrowing costs).
- Tax advantages to borrowing raise the return to leveraged investments even more.

Crash occurs, Oct 1929.

- Brokers demand repayment of loans -----> massive sell off of all assets
- Firesale!
- Massive deleveraging takes place, with many sellers, no buyers, so asset prices plummet, wiping many out completely.
- Unlimited liability on equities causes personal bankruptcies

1930 - 1932

- Many closed bank accounts to pay debts, bank runs were widespread.
- Three rounds of bank runs occur causing a massive contraction of the money supply.

FDR

- Bank holiday to calm fears
- SEC, FDIC created to regulate markets and oversee insurance of bank deposits
- Glass - Steagall Act separates commercial banks from investment banks reducing risk
- Regulation Q: Fed can control interest rates banks pay and charge,
- impose capital requirements and capital controls,
- impose limits on opening branches and crossing state lines to do business, which restricted competition.

Trade off:

- low interest rates and low profits versus lower risk.

Result:

- Safest period of banking in US history.
- Few banks fail in this era (1934 – 1980)
- Bank runs end.

General Themes

- Banking itself can be very unstable, based on trust.
- Lender of last resort to provide stability.
- Speculators can destabilize a market.
- “Animal Spirits” and investor psychology play a role.
- Need some entity that can provide liquidity in a crisis. Private or public?