Banking Panics of the Gilded Age

This is the first major study of post–Civil War banking panics in almost a century. The author has constructed for the first time estimates of bank closures and their incidence in each of the five separate banking disturbances. The book takes a novel approach by reconstructing the course of banking panics in the interior, where suspension of cash payment, not bank closures, was the primary effect of banking panics on the average person. The author also revaluates the role of the New York Clearing House in forestalling several panics and explains why it failed to do so in 1893 and 1907, concluding that structural defects of the National Banking Act were not the primary cause of the panics.

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To Roger and Vanessa

Beautiful Credit. The Foundation of modern Society. Who shall say that this is not the golden age of natural trust, of unlimited reliance upon human promises?

– Mark Twain and Charles Dudley Warner,
The Gilded Age, p. 243

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Preface

Mark Twain (1873) coined the phrase "The Gilded Age" to dramatize the foibles and excesses of the post–Civil War generation. His portrait of Colonel Sellers was an archetype for a generation of dreamers, panglossian optimists, and tireless promoters who pinned their hopes on gaining a speedy fortune by exploiting the opportunities of an ever expanding frontier.

Twain had in mind particularly the excesses of the Grant administration, and historians were slow to perceive a wider application. The Gilded Age is now one label for the era between the Civil War and the fin de siècle, though the terminal date has remained fuzzy. I have taken the liberty to extend it even further to include the 1907 panic because of the special role financiers, especially J. P. Morgan and his banking associates, played in its containment and the adamant refusal of the New York Clearing House bankers to subordinate their individual self-interest to the public good.

Frenzied railroad building ahead of demand represented speculative excess and was an important contributing cause of the panic of 1873. However, the 1893 panic cannot so easily be identified with speculation and speculative excesses on the part of individual bankers. Nevertheless, the banking panics of the post–Civil War era were not events separate and distinct from the forces shaping the behavior of society and the economy as a whole. And the Gilded Age captures perhaps as well as any other label what some of its characteristic features were.

Banking panics were a relatively infrequent feature of American banking experience during the Gilded Age. These episodes of banking instability were accompanied by money market stringency, a stock market collapse, loan and deposit contraction, runs on banks, bank failures, the issue of clearing house certificates, and in the case of the three major banking panics the partial suspension of cash payments. But the partial suspension of cash payment was not dictated by the depletion of

the reserves of the New York Clearing House (NYCH) banks, except perhaps in 1873. However, the identifying characteristic of all major banking panics was the general loss of depositor confidence manifest by a sudden and unanticipated switch from deposits to currency. The real effects, if any, as distinct from the purely financial effects, have been more difficult to quantify.

Banking panics belong to the class of financial disturbances which includes panics in the stock market, the foreign exchange market, and the acceleration of commercial bankruptcies. Banking panics are only one type of financial crisis and certainly not the most frequent. Kemmerer (U.S. National Monetary Commission, 1911, pp. 222–23) identified six major panics and fifteen minor panics between 1890 and 1908. Besides the three major panics recognized by Sprague (1873, 1893, 1907) he added three more (1899, 1901, 1903). There was neither a banking panic in any of the former three nor was there a banking panic in any of his fifteen minor panics. What Kemmerer called panics in these eighteen episodes was a period of money market stringency coupled with a sharp break in stock prices; there is no evidence of a general loss of depositor confidence leading to widespread bank runs and bank failures.

Calomiris and Gorton (1991, p. 132) labeled 1896 as a "quasi" panic and 1914 as a full-scale panic. But there was no banking panic in either year. Banking difficulties in 1896 were confined entirely to Chicago and Minneapolis–St. Paul with no further repercussions in the country as a whole. Nor was there a banking panic in 1914. Bank failures were forestalled by the issue of clearing house certificates and Aldrich-Vreeland notes. The first was a purely local banking panic, and the second a financial panic confined mainly to the stock market and to a disruption of the foreign exchanges. Their definition of a banking panic was purely empirical, that is, an event that coincided with collective action by the New York Clearing House without reference to any criterion about their costs or consequences.

What the national banking era experience tells us is that there were no more than three major banking panics between 1873 and 1907 and two incipient banking panics in 1884 and 1890. Twelve years elapsed between the panic of 1861 and the panic of 1873, twenty years between the panics of 1873 and 1893, and fourteen years between 1893 and 1907: three banking panics in almost half a century! And in only one of the three, 1893, did the number of bank suspensions match those of the Great Depression. The suspension of cash payment, not ubiquitous bank runs and bank failures, was how the average person experienced the banking panics of 1873 and 1907.

The banking panics of the national banking era were only one phase

of American banking panic experience and by no means the most serious. We can isolate three distinct phases characterized by the type of regulatory framework in place: pre–Civil War, the National Banking Era, and the Federal Reserve System era. In the pre–Civil War regime federal regulation was absent with panics in 1819, 1837, 1857, 1860, and 1861. In the second phase, the National Banking Era, banking disturbances occurred in 1873, 1884, 1890, 1893, and 1907. The third phase included the five banking panics of the Great Depression which I examined in a previous study (1996). We concentrate our attention on the second phase which encompasses the period between the passage of the National Banking Act in 1863 and the establishment of the Federal Reserve System. The chronological boundaries conveniently follow the tradition initiated by Sprague (1910).

The consensus among financial historians has been that certain structural weaknesses of the National Banking Act increased the vulnerability of the U.S. banking system to panics, three of which have received the most attention: (1) the inelasticity of the national bank note currency, (2) the pyramiding of reserves in New York, and (3) the fixed and invariant reserve requirements. The currency stock was composed of specie, a fixed quantity of greenbacks issued to finance the Civil War, national bank notes, and, before 1866 when they were taxed out of existence, state bank notes. The incentive to issue national bank notes depended on the price of government bonds used as collateral. And bond prices did not always behave in a manner conducive to new note issue. The structure of reserve requirements was conducive to the concentration of reserves among the NYCH banks. The weight of this consideration has been diminished substantially by Myers (1931), who showed that had the National Banking Act of 1864 been in effect in December 1860 the reserves of the New York banks would have closely approximated the actual bankers' balances held in that year. The inflexibility of reserve requirements immobilized a portion of the banking reserve, thereby constraining its use in emergencies.

It is not at all clear that the National Banking Act made the banking system more prone to panics. At a more fundamental level legislation prohibiting statewide branching laws was a necessary but not a sufficient condition for the existence of banking panics (Calomiris, 1993). We intend to show that the problem was not solely with the structure of the national banking system but institutional failure on the part of the NYCH; it had the power, instruments, and access to knowledge to have prevented banking panics. It could not agree after 1873 on an agenda that was incentive-compatible. Purely voluntary collective action apparently was not a viable option for banking reform.

Sprague's classic study – *A History of Crises Under the National Banking System* – appeared almost ninety years ago in response to an invitation of the National Monetary Commission. It has served its purpose so well as the principal source of our knowledge of what happened during this era that no work of comparable scale has replaced it. There are, however, ample reasons for undertaking a new study of the banking panics of the national banking era. There are the serious gaps in Sprague's earlier analysis that we can now attempt to remedy. Sprague, and everyone else for that matter, did not know the number or the incidence of bank suspensions in each of the five banking disturbances in either New York or the interior. He described carefully what happened in the New York money market, but he paid little or no attention to bank runs and bank failures outside New York, a task we are fully prepared to remedy. Furthermore, at the time Sprague wrote, documents and records illuminating more clearly what happened in 1907 were not available. He was certainly aware of the role J. P. Morgan played in the 1907 panic from newspaper accounts. We now have a better understanding of that role as revealed by Morgan's biographers and the biographies of his principal lieutenants, and the testimony given in the Stanley Hearings (U.S. House of Representatives, 1911) where we find eyewitness accounts of the Morgan initiatives to provide financial support to the troubled trust companies, the Stock Exchange, and the New York municipal authority. A reassessment of those initiatives faults Morgan for allowing the Knickerbocker Trust Company to succumb and for his reliance on the device of the "money pool" as a less efficient instrument than the prompt issue of clearing house certificates by the New York Clearing House. The NYCH was equally at fault for having relinquished leadership in the crisis to Morgan, whose efforts were successful though second-best. The role of the NYCH can better be discerned through its official records and documents not available to Sprague at the time.

Sprague was the first to have shown that the NYCH had access to the knowledge, instruments, and power to have prevented banking panics. It did so in 1860 and 1861. The power to equalize or pool the reserves of the NYCH banks effectively in his opinion turned the Clearing House into a central bank by mobilizing and reallocating the reserves of the central money market banks. The problem of the money center banks was not, except perhaps in 1873, an inadequate stock of total reserves; it was their distribution among the six or seven New York City banks holding the bulk of the bankers' balances.

Along the way we have also found some minor revisions were necessary in conventional interpretations of the banking panic experience. For example, banking unrest in 1884 and 1890 is perhaps better described as

incipient rather than full banking panics since there was no general loss of depositor confidence in either New York or the interior, and the NYCH acted with dispatch to forestall a banking panic. It is a success story that has gone largely unheralded. Sprague's doubts about how to classify the 1890 banking disturbance are revealed by his selection of a chapter heading: "Financial Stringency in 1890." Although he did label the 1884 disturbance a panic, it was unaccompanied by the adjective banking. He certainly underplayed its purely banking aspects.

My interest in the banking panics of the national banking era arose quite naturally from my previous study of the banking panics of the Great Depression. The question obviously posed itself: Was there a difference between banking panics in the two contiguous periods? But it immediately became apparent that our knowledge of what happened in the former period was much less than in the latter, especially with respect to the number and incidence of bank suspensions and the course of the banking panics in the interior, gaps that would require remedying if at all possible. Moreover, increasing scholarly attention was being paid to two questions: What role did the clearing house play, if any, in promoting banking stability? and Can we construct a theoretical model of banking panics to explain their existence? Seeking answers to these questions rekindled interest in the historical banking panic evidence.

There is a burgeoning literature on the role clearing houses might have played in preventing banking panics. Much of that literature, however, addresses the purely theoretical question: Can private market arrangements insure banking stability in the absence of a central bank? Timberlake (1993), for example, has asked why the clearing house system was rejected in favor of a government central bank (the Federal Reserve) when the clearing house system had proven so effective. Gorton and Mullineaux (1987) and Goodhart (1988) have given conflicting accounts of the efficacy of a purely voluntary association of banks as a safeguard against banking panics. According to the former the clearing house system would not work without regulations. But in the absence of government interference, a system of "endogenous" regulations would have to be put in place to insure bank cooperation, such as reserve requirements, bank surveillance, and penalties for noncompliance. Admittedly, these arrangements might not be completely successful, but they would mitigate the panic's worst effects.

Goodhart is not so sanguine. He does not believe that a really satisfactory solution could be found through purely voluntary action. Conflicting interests among competing banks would deter or postpone any effective response. Self-interest (profit) considerations could not always be reconciled with group interests as a whole. He concluded that a

nonprofit maximizing body was required in the form of a central bank. Timberlake, Gorton and Mullineaux, and Goodhart alike did not produce any detailed historical evidence about specific panics to support or reject their claims. Our evidence from the post–Civil War panics may throw some light on these issues.

Banking panics were regarded until quite recently as a manifestation of irrational or inscrutable behavior. The word "panic" itself means, according to the New Shorter Oxford English dictionary: "An excessive and increasing feeling of alarm or fear leading to extravagant or foolish behavior, such as that which may suddenly spread through crowds of people." Depositor runs on an individual bank spread to other banks by a process analogous to the spread of contagious diseases. And bank run contagion was considered for quite some time as the discriminating characteristic of historical banking panics. That view has now come to be questioned by Dowd (1996), who has claimed that bank run contagion has been vastly exaggerated, and that bank runs and bank failures were rare events not only in the United States but in many other countries as well. But the evidence upon which to base such judgment has been largely lacking. Only a detailed narrative of individual banking panics can contribute to resolving the problem.

In the contemporary finance literature banking panics have increasingly come to be treated as a rational response to asymmetric information, for example, Jacklin and Bhattacharya (1988) and Calomiris and Gorton (1991). Depositors do not have access to the same information as do the banks on the quality of the bank's loan portfolio. In response to news that a particular bank had suffered a severe loan loss or serious managerial malfeasance (asset shocks) depositors would withdraw their deposits from the offending bank and its close affiliates. With an asset shock that is more general, depositors may not be able to distinguish between sound and unsound banks and a contagious bank run ensues. The problem is to identify the asset shock or shocks and their effects, if any, on particular troubled banks.

There is an alternative approach attributable to Diamond and Dybvig (1983), who model banking panics as a response to liquidity shocks due to a maturity mismatch between bank assets and bank liabilities. These liquidity shocks depend solely on extraneous uncertainty (sunspots). The problem with the Diamond and Dybvig approach is to find an empirical counterpart to the alleged liquidity shock with which to distinguish it from an asset shock. Calomiris and Gorton (1991) attempt unsuccessfully to identify the liquidity shock with unexpectedly large demands for currency in the countryside due to seasonal demands during the crop moving season. But as we shall attempt to show, the most serious of the

post–Civil War panics (1893) did not occur during the crop moving season!

Almost all students of banking panics have noted the similarity in the timing of banking panics with seasonal crop movement considerations. There were two periods of seasonal demands for funds, in May at crop-planting time and September to November when the crops were harvested and shipped to the East Coast. The stronger of the two was autumnal movement of the crops which was frequently accompanied by money market stringency. The conditions for a banking panic were greatest when seasonal money market stringency was combined with a shock to the banking sector. Autumn banking disturbances occurred in September 1873, November 1890, and October 1907. Two were not in the autumn: 1884 (May) and 1893 (June–August). The most severe banking panic in terms of bank suspensions and geographical incidence was the 1893 panic when crop movement considerations were absent. Of the three major banking panics, two occurred in the fall (1873 and 1907) and one during the summer (1893). Of the two incipient panics one had its origin in May (1884) and the other in November (1890).

I am grateful to those who have read an individual chapter or chapters and made suggestions for improvements. These include Charles Calomiris, William Hutchinson, William Roberds, Hugh Rockoff, Anna Schwartz, and Ellis Tallman.

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The staff of the Interlibrary Loan Department of the Indiana University Libraries worked indefatigably to keep me supplied with microfilm copies of countless newspapers from all parts of the country over a four-year period.

Bloomington, Indiana E. W.
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