THE HISTORY OF FINANCIAL CRISES

Edited by
D'Maris Coffman and Larry Neal

CRITICAL CONCEPTS IN FINANCE

ROUTLEDGE

THE HISTORY OF FINANCIAL CRISES

Critical Concepts in Finance

Edited by D'Maris Coffman and Larry Neal

Volume III
The gold standard era

Routledge
Taylor & Francis Group
LONDON AND NEW YORK

First published 2015
by Routledge
2 Park Square, Milton Park, Abingdon, Oxon OX14 4RN

and by Routledge
711 Third Avenue, New York, NY 10017

Routledge is an imprint of the Taylor & Francis Group, an informa business

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

Library of Congress Cataloging in Publication Data
The history of financial crises : critical concepts in finance / edited by D'Maris Coffman, Larry Neal.
volumes ; cm
Includes bibliographical references and index.
ISBN 978-0-415-63506-6 (set : hardback) – ISBN 978-0-415-63507-3 (1) – ISBN 978-0-415-63508-0 (2) – ISBN 978-0-415-63509-7 (3) – ISBN 978-0-415-63510-3 (4) 1. Financial crises–History. 2. Banks and banking–History. 3. Corporations–Finance–History. I. Coffman, D'Maris, 1973– editor of compilation. II. Neal, Larry, 1941– editor of compilation.
HB3722.H57 2014
338.5'4209–dc23 2014019287

ISBN: 978-0-415-63506-6 (set)
ISBN: 978-0-415-63509-7 (Volume III)

Typeset in Times New Roman
by Wearset Ltd, Boldon, Tyne and Wear

Publisher's Note
References within each chapter are as they appear in the original complete work

MIX
Paper from responsible sources
FSC® C013056
FSC
www.fsc.org

Printed and bound in Great Britain by
TJ International Ltd, Padstow, Cornwall

THE HISTORY OF FINANCIAL CRISES

ACKNOWLEDGEMENTS

The publishers would like to thank the following for permission to reprint their material:

Sage Publications for permission to reprint Barry Eichengreen, 'The Baring Crisis in a Mexican Mirror', *International Political Science Review*, 20, 3, 1999, 249–270.

Cambridge University Press for permission to reprint Gail D. Triner and Kirsten Wandschneider, 'The Baring Crisis and the Brazilian Encilhamento, 1889–1891: An Early Example of Contagion Among Emerging Capital Markets', *Financial History Review*, 12, 2, 2005, 199–225.

Elsevier for permission to reprint Jan Körnert, 'The Barings Crises of 1890 and 1995: Causes, Courses, Consequences and the Danger of Domino Effects', *Journal of International Financial Markets, Institutions and Money*, 13, 3, 2003, 187–209.

The University of Chicago Press for permission to reprint Hugh Rockoff, 'The "Wizard of Oz" as a Monetary Allegory', *Journal of Political Economy*, 98, 4, 1990, 739–760.

Cambridge University Press for permission to reprint Charles R. Hickson and John D. Turner, 'Free Banking Gone Awry: The Australian Banking Crisis of 1893', *Financial History Review*, 9, 2, 2002, 147–167.

Elsevier for permission to reprint Mark Carlson, 'Causes of Bank Suspensions in the Panic of 1893', *Explorations in Economic History*, 42, 1, 2005, 56–80.

Elsevier for permission to reprint Carlos D. Ramírez, 'Bank Fragility, "Money under the Mattress", and Long-run Growth: US Evidence from the "Perfect" Panic of 1893', *Journal of Banking & Finance*, 33, 12, 2009, 2185–2198.

John Wiley & Sons for permission to reprint O. M. W. Sprague, 'The American Crisis of 1907', *The Economic Journal*, 18, 71, 1908, 353–372.

Cambridge University Press for permission to reprint Kerry A. Odell and Marc D. Weidenmier, 'Real Shock, Monetary Aftershock: The 1906 San Francisco Earthquake and the Panic of 1907', *Journal of Economic History*, 64, 4, 2004, 1002–1027.

Elsevier for permission to reprint Gary Gorton and Lixin Huang, 'Bank Panics and the Endogeneity of Central Banking', *Journal of Monetary Economics*, 53, 7, 2006, 1613–1629.

Cambridge University Press for permission to reprint Jon Moen and Ellis W. Tallman, 'The Bank Panic of 1907: The Role of the Trust Companies', *Journal of Economic History*, 52, 3, 1992, 611–630.

Elsevier for permission to reprint Ellis W. Tallman and Jon R. Moen, 'Liquidity Creation without a Central Bank: Clearing House Loan Certificates in the Banking Panic of 1907', *Journal of Financial Stability*, 8, 4, 2012, 277–291.

The American Economic Association for permission to reprint Michael D. Bordo and Hugh Rockoff, 'Not Just the Great Contraction: Friedman and Schwartz's *A Monetary History of the United States 1867 to 1960*', *American Economic Review*, 103, 3, 2013, 61–65.

The American Economic Association for permission to reprint Ben S. Bernanke, 'Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression', *American Economic Review*, 73, 1983, 257–276.

Ohio State University Press for permission to reprint Ben S. Bernanke, 'The Macroeconomics of the Great Depression: A Comparative Approach', *Journal of Money, Credit, and Banking*, 27, 1, 1995, 1–28.

The University of Chicago Press for permission to reprint Ben Bernanke and Harold James, 'The Gold Standard, Deflation, and Financial Crisis in the Great Depression: An International Comparison', in R. Glenn Hubbard (ed.), *Financial Markets and Financial Crises* (Chicago: University of Chicago Press, 1991), pp. 33–68.

The American Economic Association for permission to reprint Charles W. Calomiris, 'Financial Factors in the Great Depression', *Journal of Economic Perspectives*, 7, 1993, 61–85.

John Wiley & Sons for permission to reprint Ellen R. McGratten and Edward C. Prescott, 'The 1929 Stock Market: Irving Fisher was Right', *International Economic Review*, 45, 4, 2004, 991–1009.

Cambridge University Press for permission to reprint Peter Rappoport and Eugene N. White, 'Was there a Bubble in the 1929 Stock Market?', *Journal of Economic History*, 53, 3, 1993, 549–574.

Elsevier for permission to reprint Isabel Schnabel, 'The Role of Liquidity and Implicit Guarantees in the German Twin Crisis of 1931', *Journal of International Money and Finance*, 28, 1, 2009, 1–25.

The American Economic Association for permission to reprint Eugene N. White, 'The Stock Market Boom and Crash of 1929 Revisited', *Journal of Economic Perspectives*, 4, 1990, 67–83.

Elsevier for permission to reprint Joseph L. Lucia, 'The Failure of the Bank of United States: A Reappraisal', *Explorations in Economic History*, 22, 4, 1985, 402–416.

John Wiley & Sons for permission to reprint Yehning Chen and Iftekhar Hasan, 'Why Do Bank Runs Look Like Panic? A New Explanation', *Journal of Money, Credit and Banking*, 40, 2–3, 2008, 535–546.

M. E. Sharpe, Inc., for permission to reprint William H. Janeway, 'The 1931 Sterling Crisis and the Independence of the Bank of England', *Journal of Post Keynesian Economics*, 18, 2, 1995, 251–268.

Disclaimer

CONTENTS

VOLUME III THE GOLD STANDARD ERA

INTRODUCTION

Both those who criticise and those who lionise the 'gold standard' often do so in comparative ignorance of the bimetallic standard it replaced. As Eichengreen (2008) has argued, network externalities ensured the transformation happened swiftly and comprehensively, but widespread demonetisation of silver was by no means uniformly stabilising for the international monetary order. In fact, as Rockoff (1990) argues in his unpacking of the *Wizard of Oz* as a monetary allegory, the 'free silver' movement rested on strong theoretical and empirical grounds. This volume opens with two episodes, the British Barings Crisis of 1890 and the American Panic of 1893, which together reflect both step-changes in institutional development and the degree of fragility inherent in the classical gold standard.

The Baring Crisis of 1890 was arguably the most famous sovereign bond crisis of the nineteenth century. Whether or not it was worse than the 1825 Crisis is hard to assess, but where the Bank of England had been reluctant to act in 1825, this time was different, in that they did act as a lender of last resort, going as far as cajoling the Rothschilds into sourcing loans from the Bank of France and doing so themselves from the Russians (Eichengreen 1999). How far the blame can be put at the feet of loose Argentine fiscal and monetary policy and how much should lie with the British appetite for outsized returns on sovereign debt remains difficult to assess, but here too Akerlof's 'lemons problem' caused mispricing of risk. Although the contagion spread from Argentina to Brazil with ripple effects as far away as North America and even Australia, the crisis derives its name from the near-collapse of the Barings Brothers banking house, which had been the main underwriter of Argentine bonds. Triner and Wandschneider (2005) offer a nuanced and balanced account of transmission dynamics by documenting the extent to which Argentinean financial failure served as an exogenous shock to the Brazilian economy. Brazil might have run into trouble on its own terms, but the domino effect was pronounced. As Eichengreen (1999) observed, Barings was spared, but the Argentine economy suffered for years to come. It is, not surprisingly, easier to bail out banks than it is to rescue entire countries! Both Eichengreen (1999) and Körnert (2003) comment on modern parallels with the Mexican Crisis of 1994–1995 and the Barings Crisis of 1995, which led to the bank's acquisition by ING.

The Panic of 1893 in the United States had a rather different character, though some still regard it a belated sequel to the Argentine Crisis. More immediately, it was triggered by the bankruptcy of the Philadelphia and Reading Railroad, culminating in a series of bank runs. The effect on the real economy was severe, driving unemployment rates from 3 per cent in 1892 to 11.7 per cent in 1893 and as high as 18.4 per cent in 1894 (Rockoff 1990), and led to the repeal of the Sherman Silver Purchase Act. Carlson (2005) resolves competing explanations of the impetus for these bank runs (economic shocks, information asymmetries, insolvency fears) in favour of economic shocks in a general sense and liquidity (more than solvency) concerns at the local level. Whereas in the Panic of 1857 Calomiris and Schweikart found networks of corresponding banks to be protective against transmission, Carlson (2005) finds the opposite to be true in 1893. Ramírez (2009) assesses the spatial dimensions of the crisis (why bank failures were more common in some states than others) and suggests the long-term economic effects of the crisis could be felt for two or three decades and were ultimately only remedied with the introduction of deposit insurance. The Australian Crisis of 1893 offers an important basis for comparison, as it represented one of the largest 'free banking experiments' of the classical gold standard era. Hickson and Turner (2002) offer the most comprehensive deconstruction of this episode, and find, as one might expect, a 'concentrated and cartelized banking system' which 'arose out of the ashes of 1893' and which 'operated "in the government's shadow"' (Hickson and Turner 2002, p. 167). More recent waves of deregulation have had similar consequences.

The Panic of 1907, which led to the establishment of the Federal Reserve System in the United States, was a watershed moment in American financial history. The best place to begin is the account offered by O.M.W. Sprague (1908), who also authored the still seminal *History of Crises under the National Banking Act* (1910), an official publication of the National Monetary Commission. Although the Panic itself is conventionally dated from the collapse of Otto Heinze's attempted corner on the United Copper Company in October 1907, recent work argues that the San Francisco earthquake of 1906 was more a readily identifiable and credible exogenous shock (Odell and Weidenmier 2004). Whatever the cause, most readers, however, will be more interested in a discussion of the role of the trust companies (Moen and Tallman 1992) or the timely intervention of J.P. Morgan who organised a consortium that effectively acted as a lender of last resort through the facility offered by the issuances of clearing-house loan certificates (Tallman and Moen 2012). Although Sprague himself only reluctantly supported the creation of a Federal Reserve Bank, his deep knowledge of the institutional mechanics should be helpful to both general and specialist readers (Rockoff 2013). Gorton and Huang (2006) discuss the respective merits of private bank coalitions acting as lenders of last resort versus central banks performing that role. Not surprisingly, central banking makes sense because the state can wield more political power and mobilise more economic resources than private agents, and because the wider public is more concerned about externalities than private agents tend to be

(Gorton and Huang 2006, pp. 1627–8). For a modern economy to function properly, bank liabilities must remain a credible medium of exchange.

Almost half the space in this volume is devoted to the vast literature of the Great Depression. We begin with Bordo and Rockoff's appreciation (2013) of Friedman and Schwartz's *A Monetary History of the United States 1867 to 1960*, which they place within its broader research programme. They are no doubt correct that its influence remains exceptional, not only among academic economists but among policymakers coping with the events after 1960, which Bordo and Rockoff split into three regimes distinguished by successive changes in the Federal Reserve Bank's control over the US money supply. They are (1) the Great Inflation (1965–1982), (2) the Great Moderation (1982–2008) and (3) the Great Recession (2008–2012), which are the focus of articles included in Volume IV. The monetarist argument that Friedman and Schwartz used to frame their narrative account of US financial history is that most financial crises begin with a 'scramble for liquidity' and only become panics with serious effects on the real economy if the supply of money is not expanded in response, however that may be achieved, whether by private or public interventions. Chen and Hasan (2008) are offered as an alternative approach to the relationship between bank runs and panics.

Friedman and Schwartz pilloried the Federal Reserve Bank of New York (FRBNY) particularly for its failure to bail out the Bank of United States when it failed in 1931. Despite its name, the Bank of United States was a private bank that catered mainly to garment district workers in New York, and had engaged in mortgage loans during the housing bubble of the late 1920s. Failure to rescue the bank or at least preserve the accounts of the small depositors was a fatal mistake by the FRBNY, according to Friedman and Schwartz, a mistake they attributed to weak leadership after the death of Benjamin Strong and to pervasive anti-Semitism among the banking elite of New York with regard to the Jewish owners and managers of the Bank of United States. Lucia's (1985) examination of the accounts of the Bank of United States and the efforts of the New York Fed officials to find a buyer for it largely exonerated the Fed, but elicited a vigorous response by Friedman and Schwartz.

While Ben Bernanke, Chairperson of the Federal Reserve System from 2006 to 2014, famously told Friedman at his 90th birthday party, 'Regarding the Great Depression. You're right. We did it. We're very sorry. But thanks to you, we won't do it again', his previous essays on the Great Depression laid out substantial extensions of the basic monetarist argument and its emphasis on the role of the domestic money supply in propagating financial crises. Bernanke (1983) lays out the basic 'debt deflation' argument to explain why a failure to cope with an initial scramble for liquidity can lead to an extended contraction in the real economy as both firms and households try to de-leverage their balance sheets in the face of persistent price deflation, while their debts remain fixed in nominal terms at the higher prices ruling before the crisis. Rather than account for the spread of the Great Depression through a withdrawal of funds from the United

States, Bernanke (1995) compared how other countries in the industrial world had responded to the price deflation that followed in 1930. Bernanke and James (1991) actually lay the groundwork for laying the blame for the Great Depression on the French insistence on building up their gold reserves right up to 1936, an argument that has been hotly contested by gold standard enthusiasts but is laid out in compelling fashion in Johnson (1997).

Calomiris expands the debt deflation argument of Bernanke, by distinguishing the various sources of finance for investment projects by businesses, large and small, during the 1930s. Provocatively, McGrattan and Prescott (2004) put forth a real business cycle model of the Great Depression, putting aside both monetary and financial factors as epiphenomena to surge in technological advances. Arguably, their argument could have support from White (1990), which downplays the role of the stock market crash in 1929 in general while Rappoport and White (1993) demonstrate that, consistent with earlier stock market bubbles covered in previous volumes, exuberance of buyers was focused on new technologies or trades, whether one thinks they were rational or irrational. Eichengreen (2008) further highlights the importance of the adherence to the gold standard internationally well past its 'sell by' date, which both Schnabel (2009) and Janeway (1995) take as 1931, Schnabel for Germany and Janeway for the UK.

Additional reading

Akerlof, George A. (1970) 'The market for "lemons": quality uncertainty and the market mechanism', *The Quarterly Journal of Economics*, 84, 3, 388–500.

Eichengreen, B.J. (2008) *Globalizing Capital: A History of the International Monetary System*. Princeton, NJ: Princeton University Press.

Johnson, H. Clark. (1997) *Gold, France, and the Great Depression, 1919–1932*. New Haven, CT: Yale University Press.

Rockoff, Hugh. (2013) 'O.M.W. Sprague (the man who "wrote the book" on financial crises) and the founding of the federal reserve', NBER Working Paper No.19758, December.

Sprague, O.M.W. (1910) *History of Crises under the National Banking System*. U.S. 61st cong., 2d sess. senate. doc. 538. Washington, DC: Govt. Print Off.

35

THE BARING CRISIS IN A MEXICAN MIRROR

Barry Eichengreen

Source: *International Political Science Review* 20:3 (1999): 249–270.

Abstract

In the now conventional wisdom, the Mexican crisis of 1994–95 was the first financial crisis of the twenty-first century. In this article I argue that it may be better understood as the last financial crisis of the nineteenth. The Mexican crisis exhibits striking similarities to the Baring Crisis of 1890. Parallels include the enthusiastic reaction of foreign investors to the combination of low interest rates in the financial centers and economic reform elsewhere in the world. They extend to the role of state banks in accentuating the impact of foreign capital on the domestic economy and of political weakness in hamstringing the government's management efforts. The comparison underscores just how difficult it has become to arrange financial rescues of countries and financial institutions in distress.

Conventional wisdom has it that the Mexican crisis of 1994–95 was "the first financial crisis of the 21st century." In this article I argue that it may be better understood as the last financial crisis of the nineteenth. The crisis in Mexico exhibits striking similarities to the Baring Crisis of 1890, an event that did much to shape modern opinion about the causes and consequences of financial crises and the role of official management.

Parallels between the two episodes are extensive. Just as Mexico was the benchmark for investors in emerging markets in the 1990s (it was the single largest borrower, and the spreads it commanded set the floor for other borrowers), Argentina, the country whose financial difficulties ignited the Baring Crisis, was commended to investors as "The United States of South America." It was the single most important destination for British capital outside the United States and the British Empire. While lending in both periods was encouraged by policy reform and economic development in recipient countries, the wheels of international finance were greased by declining interest rates worldwide, associated with Goschen's debt conversion in the 1880s and recession-induced cuts in interest rates by the Federal Reserve in the 1990s. In both cases, investors who had been slow to join the bandwagon climbed on board in the final stages of the boom.

While foreign borrowing was portrayed as financing investment in productive capacity, in both cases capital inflows fueled rising levels of consumption. Foreign capital flowed through the banking system, and bank lending financed purchases of luxury imports as well as capital goods. Governments failed to boost their savings to offset dissaving by the private sector. In both cases powerful opposition existed to the government in power, leaving officials reluctant to tighten monetary and fiscal policy for fear of alienating their core constituencies. Hence, they did little to damp down the impact on the economy of international capital flows.

But increased demand did not automatically elicit increased supply. Investment in capacity took time to translate into improved export performance. In both cases questions arose about the capacity of the economy to sustain mounting levels of debt. Political shocks (strikes and an incipient coup in Buenos Aires in 1889–90; the Chiapas revolt and Colosio assassination in 1994) then raised doubts about the ability of the government to carry out adjustment. Better-informed investors grew wary significantly in advance of the crisis.

The crisis itself drove the Argentine government, like the Mexican government after it, to the brink of default. The fallout destabilized the banking system. It provoked a major recession; and it spilled over to other countries. In 1995 the Tequila Effect was felt in Argentina, Brazil, Thailand, and Hong Kong. In the wake of the Baring Crisis, interest rates rose in Brazil, Uruguay, Venezuela, and Turkey. Countries as far afield as Australia and New Zealand found it difficult to access external finance. Thus, the Baring Crisis provides an even more extreme example of the destabilizing dynamics that infected emerging markets little more than a century later.

At the same time there are important differences between the two episodes. Monetary and fiscal excesses were more clearly evident in Argentina in the 1880s than in Mexico in the 1990s. In Argentina in the 1880s, monetary and fiscal excesses were a principal element in the crisis; the Mexican government may not be free of blame, but it took significant steps in the direction of monetary and fiscal reform. In 1995 the Clinton administration and the IMF saw the need to help Mexico avert a suspension of debt-service payments. Default on government bonds, they feared, would prompt equity investors to flee, force Mexico to impose comprehensive exchange and capital controls, spread contagiously to other emerging markets, and set back economic reform and liberalization worldwide. But in 1994 there was no single financial institution as exposed as Baring Brothers. In 1890 the fear was for the stability of financial markets in the First World, not the Third. Where the US government's first reaction in 1994 was to assemble financial aid for Mexico, in 1890 the Bank of England and the British government arranged a rescue fund for Baring Brothers, not for Argentina. The assistance offered Argentina was hardly generous, and it was provided by markets, not governments.

Where the Bank of England could make arrangements with other financial institutions before news of Baring's difficulties became public, the 1995 crisis was a very public affair. Unable to induce commercial banks to contribute to the Mexican rescue, the Clinton administration relied on a larger ratio of public to private funds than had the Bank of England a century before. The capital market being less cohesive and concentrated than in 1890, it found it more difficult to reach an agreement with other governments than had the Bank of England and the British government.

In a sense, then, the Mexican crisis is both the last financial crisis of the nineteenth century and the first financial crisis of the twenty-first. Its implications resemble those of the Baring Crisis insofar as it marks a return to an international market increasingly dominated by bonded debt. But today's international financial market being even more nimble and decentralized than that of the 1880s, it anticipates the kind of crises that will become increasingly prevalent in the twenty-first century.

In elaborating these points, I focus on the period leading up to the 1890 crisis. Information on the recent Mexican episode is abundant, and interpretations abound. Hence, I assume that the reader is familiar with the outlines of the Mexican crisis. I concentrate mainly on Argentina in the 1880s, providing just as much information on the Mexican crisis as is needed to place the comparison in relief.

Context for capital flows

Structural changes significantly improving the prospects for economic growth and development served as the backdrop for the surge in foreign investment in both periods. An important precondition for Mexico's return to the international capital market was put in place by its negotiation of a Brady deal, which reduced its debt and exchanged its floating-rate bank debt for bonds. Economic reform then provided the impetus for lending. Policy initiatives included liberalizing international trade, privatizing public enterprises, reducing the size of the government, reforming the tax system, and deregulating and liberalizing domestic markets. The country's application to the GATT and its negotiation of the North American Free Trade Agreement (NAFTA) effectively locked in the new regime. The time-profile of the capital inflow that ensued is shown in Figure 1.

Late nineteenth-century Argentina returned to the international market more gradually. None other than Baring Brothers had floated Buenos Aires' first public loans in 1824–25, but these soon lapsed into default and remained there until 1857, when a settlement was reached. Although Barings offered another Argentine loan in 1866, the country's commercial prospects were hardly glowing. Until the 1880s it remained a minor player in the European capital market.