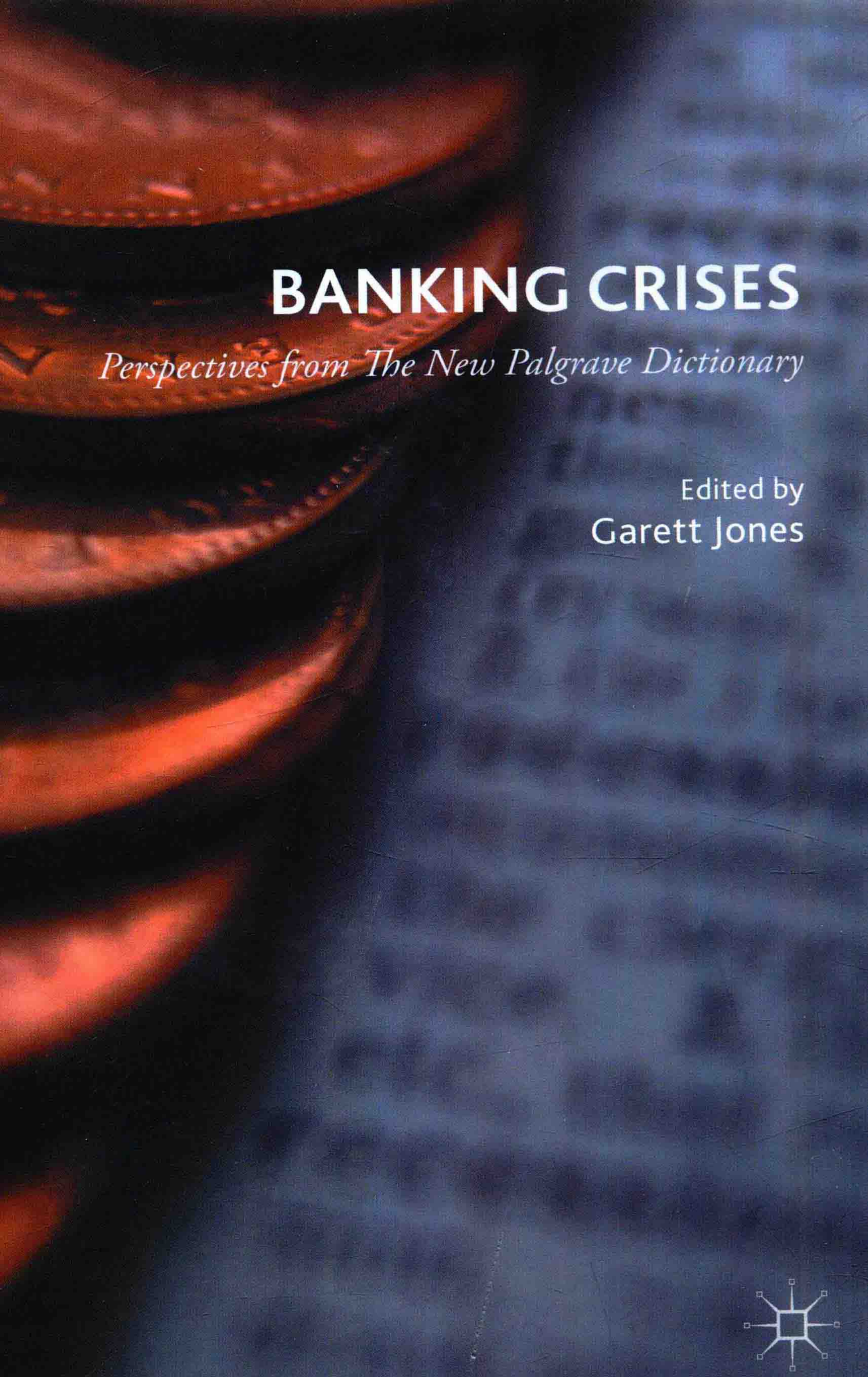

BANKING CRISES

Perspectives from The New Palgrave Dictionary

Edited by
Garett Jones

Banking Crises

Perspectives from *The New Palgrave Dictionary*

Edited by
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List of Figures

List of Tables

Preface

Banking panics are nothing new: in rich and poor countries, the banking sector has long had a troubling tendency to collapse. In the aftermath workers lose jobs, investment collapses and the banking system tries to piece itself back together. Banking crises are a puzzle, and economists love nothing more than a hard puzzle.

This volume collects some remarkable articles from *The New Palgrave Dictionary of Economics* on banking crises, their historical background, the theories and laboratory experiments that have investigated their causes, and some policy recommendations that might make them less likely—or at least less destructive—in the future. About one third of the articles were written after 2008, and so aren't included in the print version of the most recent *New Palgrave*, although I should note that all are available through an online subscription to the Dictionary. Together with Palgrave editor Alison Howson, I commissioned many of these more recent articles in the wake of the global financial crisis. And through the efforts of Palgrave editor Rachel Sangster the present volume brings together many of those new articles plus more from the 2008 edition.

Allow me to point out three exceptional articles, all quite readable, that give a sense of the volume's scope:

1. A brief biography of Walter Bagehot, the Victorian-era editor of *The Economist* and author of one of the best and most enjoyable essays on banking crises and their cure, *Lombard Street*. The biography, written by the influential British historian and life peer Asa Briggs, along the way describes the early banking panics that have shaped how economists approach the topic.
2. Foote and Willen's article entitled "subprime mortgage crisis" is provocative and fact-driven. They argue the evidence doesn't easily fit the popular story of a financial crisis caused by Wall Street insiders. In that story, financial insiders lent money for mortgages that were "doomed to failure," and then sold off the resulting low-quality mortgage-backed securities to ignorant investors. Foote and Willen are both Federal Reserve economists; their article summarizes and synthesizes their own influential work on the topic, work that has substantially (though not entirely) shifted the narrative regarding the root causes of the crisis.
3. A thorough overview of Greece's recent economic crises by Nicos Christodoulakis, an economist and former Greek finance minister. This is just one sign of the volume's international scope, as well as a reminder that banking crises and debt crises are all too often simultaneous events.

We can break the articles into four categories: historical crises, the global financial crisis and aftermath, key economic institutions, and more theoretical, analytical pieces.

Historical Financial Crises
Bagehot, Walter
bubbles in history
gold standard
Great Depression
Great Depression, monetary and financial forces in
Kindleberger, Charles P.
Law, John
New Deal
South Sea bubble
tulipmania

The Global Financial Crisis and Its Aftermath
Credit Crunch Chronology
credit rating agencies
euro zone crisis 2010
Greek crisis in perspective
Lehman Brothers bankruptcy
quantitative easing by the major western central banks during the global financial crisis
Run on Northern Rock, the
shadow banking: a review of the literature
subprime mortgage crisis, the

Key Financial Institutions
Bank of England
banking industry
Federal Reserve System
International Monetary Fund
international monetary institutions

Explanations and Solutions
banking crises
bubbles
capital controls
currency crises
currency crises models
laboratory financial markets
liquidity trap
Minsky crisis
speculative bubbles

You'll note that the word "bubble" appears in the titles of four articles, and the concept is central to even more, including the article "laboratory financial markets," which summarizes the work of Nobel laureate Vernon Smith. Understanding financial market bubbles is central to understanding banking crises, and this volume offers a quite thorough and diverse survey of the topic.

Overall, the articles are intellectually serious without being heavily mathematical; in fact most contain no equations at all. While I am certainly not an unbiased observer, I believe it's a great volume for browsing, a good source of ideas and insights both to the undergraduate writing a term paper and the faculty member looking for inspiration. Banking crises are unlikely to vanish any time soon, so, alas, it's safe to forecast that this volume will be useful and relevant for decades to come.

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Contents

Bagehot, Walter (1826–1877)

Editor and literary critic as well as banker and economist, Bagehot was described in retrospect by Lord Bryce as 'the most original mind of his generation' (Buchan, 1959, p. 260). It is a difficult claim to sustain, certainly as far as his scattered economic writings are concerned. There was no doubt, however, about his intellectual versatility: there was an immediacy, a clarity and an irony – what he said of his friend Arthur Hugh Clough's poems, 'a sort of truthful scepticism' – about Bagehot's essays in different fields which make them still pre-eminently readable. Bagehot saw connections, too, between economics, politics, psychology, anthropology and the natural sciences – 'mind and character' – refusing to draw rigid boundaries between most of these subjects and 'literary studies', while recognizing in his later years that the frontiers of political economy needed to be more carefully marked. 'Most original' or not, he was, as the historian G.M. Young (1948) has observed, *Victoranum maxime*, if not *Victoranum maximus*: 'he was in and of his age, and could have been of no other.' He pre-dated academic specialization and professionalization, and he was never didactic in his approach.

His first writing on economics, a revealing if not a searching review of John Stuart Mill's *Principles of Political Economy*, appeared in 1848 before the sense of a Victorian age had taken shape. His last and most voluminous writing on the subject appeared posthumously in a volume of essays, the first on 'the postulates of English political economy', which his editor-friend Richard Holt Hutton entitled *Economic Studies* (1879). By then the economic confidence of the mid-Victorian years was over, and there were many signs both of economic and social strain, some of which Bagehot had predicted. It was in 1859, the *annus mirabilis* of mid-Victorian England, however, the year of Darwin's *Origin of Species*, Mill's *On Liberty* and Smile's *Self Help*, that Bagehot became editor of *The Economist*, a periodical founded by his father-in-law James Wilson, and it was through his lively editorship, which continued until his death, that he was in regular touch with an interesting and influential, if limited, section of his contemporaries. 'The politics of the paper', he wrote simply, 'must be viewed mainly with reference to the tastes of men of business.'

The mid-Victorian years constituted, in his own phrase, 'a period singularly remarkable for its material progress, and almost marvellous in its banking development'. It was the latter aspect of the period which provided him with the theme of his best-known and brilliantly written book *Lombard Street*, which was begun in 1870 and appeared in 1873. It dealt, however, as it was bound to do, not only with the 'marvellous development', but with the 'panics' of 1857 and 1866 to which the Bank of England, the central institution in the system, had to respond. Indeed, the germ of *Lombard Street* was an article written in *The Economist* in 1857, 13 years after Peel's Bank Charter Act, and it was in 1866 that he took up the theme again.

Bagehot's conviction that the Bank of England neither fully understood nor fully lived up to its responsibilities was the product of years of experience which went back to his own early life between 1852 and 1859 as a country banker with Stuckey's at Langport, his birthplace, in the West of England, where his father also was a banker. The chapter on deposit banking reflects this. So, too, does his complaint that the directors of the Bank of England were 'amateurs', and his insistence that the 'trained banking element' needed to be augmented.

Lombard Street is a book with a distinctive purpose rather than an essay in applied economics; and, as Schumpeter has observed, 'it does not contain anything that should have been new to any student of economics'. The main stress in it is on confidence as a necessary foundation of London's banking system. 'Credit – the disposition of one man to trust another – is singularly varying. In England after a great calamity, everybody is suspicious of everybody; as soon as that calamity is forgotten everybody again confides in everybody.' Bagehot underestimated the extent to which through joint stock banks' cheques trade was expanding without increases in note issue and the extent to which the Bank of England itself was beginning to develop techniques of influencing interest rates. He also overestimated the extent to which in 'rapidly growing districts' of the country 'almost any amount of money can be well employed'. In the last resort, too, his policy recommendations were deliberately restricted. He was disposed in principle to a 'natural system' in which each bank kept its own reserves of gold and legal tender, but in English circumstances he saw no more future in seeking to change the system fundamentally than in changing the political system. 'I propose to retain this system because I am quite sure that it is of no manner of use proposing to alter it.' With a characteristic glance across the Channel to France for a necessary comparison – things were done very differently there – he noted how the English system had 'slowly grown up' because it had 'suited itself to the course of business' and 'forced itself on the habits of men'. It would not be altered, therefore, 'because theorists disapprove of it, or because books are written against it'.

Bagehot had little use for 'theorists' and disdained the French for what he called their 'morbid appetite for exhaustive and original theories'. He described political economy 'as we have it in England' as 'the science of business' and did not object to the fact that it was 'insular'. Yet he talked of the 'laws of wealth' and believed that they had been arrived at in the same way as the 'laws of motion'. Free trade was such a law. It was impossible, he argued, to write the history of 'similar phenomena like those of Lombard Street' without 'a considerable accumulation of applicable doctrine': to do so would be like 'trying to explain the bursting of a boiler without knowing the theory of steam', a not very helpful analogy since the invention of the steam engine preceded the discovery of the laws of thermodynamics. Bagehot relied considerably on analogies. 'Panics', for example, were 'a species of neuralgia'. The 'unconscious "organization of capital"' in the City of London, described by Bagehot as a 'continental phrase', depended on the entry into City business of a 'dirty crowd of little men'; and this 'rough and vulgar structure of English commerce' was 'the secret of its life' because it contained 'the propensity to variation' which was 'the principle of progress' in the 'social as in the animal kingdom'.

Such an approach to political economy was radically different from that of W.S. Jevons who, like Bagehot, had been educated at University College, London, or 'M. Walras, of Lausanne' who, according to Bagehot himself, had worked out 'a mathematical theory' of political economy 'without communication and almost simultaneously'. There were however three defects, Bagehot maintained, in the British tradition of political economy, which started with Adam Smith but was sharpened and 'mapped' by David Ricardo. First, it was too culture-bound; for example, it took for granted the free circulation of labour, unknown in India. Second, its expositors did not always make it clear that they were dealing not with real men but with 'imaginary' ones. Abstract political economy did not focus on 'the entire man as we know him in fact, but . . . a man answering to pure definition from which all impairing and conflicting elements have been fined away'. It was not concerned with 'middle principles'. Third, considered as a body of knowledge, English political economy was 'not a questionable thing of unlimited extent but a most certain and useful thing of limited extent'. It was certainly not 'the highest study of the mind'. There were others 'which are much higher'.

Bagehot did not push such criticism far. He had much to say about primitive and pre-commercial economies, but he put forward no theory of economic development. Nor, despite an interest in methodology, did he draw out the full implications of his own behaviourist (and in places institutionalist) approach to economics. Finally, he offered no agenda for political economists in the future. He noted, as others noted, that during the 1870s political economy lay 'rather dead in the public mind. Not only does it not excite the same interest as it did formerly, but there is not exactly the same confidence in it.' His own precoccupations in that decade were more practical than theoretical despite the writing of such essays as 'The Postulates of English Political Economy', which first appeared in article form in the *Fortnightly* in 1876. He never completed a new essay on Mill, and an essay on Malthus, whom he took along with Smith, Ricardo and Mill to be the founders of British political economy, revealed more interest in the man than in his thought. In the year when the 'Postulates' appeared, he successfully suggested to the Chancellor of the Exchequer the value to the Treasury of short-term securities resembling as much as possible commercial bills of exchange. The result was the Treasury Bill. The fact that the Chancellor was then a Conservative mattered little to the liberal-conservative Bagehot, who was described by his Liberal admirer W.E. Gladstone as a 'sort of supplementary Chancellor of the Exchequer'.

Bagehot was as out of sympathy with the liberal radicals of the 1870s as he was with the bimetallists, and he had never shown any sympathy for socialist political economy. He saw the capitalist as 'the motive power in modern production' in the 'great commerce', the man who settled 'what goods shall be made, and what not'. Nonetheless, he stated explicitly in several places that he had 'no objection whatever to the aspiration of the workmen for more wages', and he came to appreciate more willingly than Jevons the role of trade unions and collective bargaining. In his first review of Mill in 1848 he had stated that 'the great problem for European and especially for English statesmen in the nineteenth century is how shall the [wage] rate be raised and how shall the lower orders be improved'. Some of the views he expressed on this subject – and on expectations – were not dissimilar to those of the neoclassical Alfred Marshall. He did not use the term 'classical' himself in charting the evolution of British political economy.

Bagehot left no school of disciples. He was content to persuade his contemporaries. His sinuous prose style was supremely persuasive. So, too, was his skill in sifting and