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## 11 Real and Pseudo-Financial Crises

A widely held belief in the United States and the world financial community is that the default of major debtors—whether companies or municipalities or sovereign countries—could lead to bank failures that would precipitate a financial crisis. The remedy proposed by those propagating this view is that major debtors therefore must be rescued from the threat of bankruptcy to avert the projected dire consequences for banks and for the stability of the financial system. I shall argue that (a) a debtor whose affairs have been mismanaged should be liquidated or reorganized under new management; (b) default by major debtors need not result in bank failures; (c) if defaults do result in bank failures, so long as the security of the private sector's deposits is assured, no financial crisis will ensue. The bugaboo of financial crisis has been created to divert attention from the true remedies that the present financial situation demands.

A financial crisis is fuelled by fears that means of payment will be unobtainable at any price and, in a fractional-reserve banking system, leads to a scramble for high-powered money. It is precipitated by actions of the public that suddenly squeeze the reserves of the banking system. In a futile attempt to restore reserves, the banks may call loans, refuse to roll over existing loans, or resort to selling assets. Such a sequence of events is to be distinguished from what happens during a disinflation or a deflation. A deflation or a disinflation is a consequence of restricted growth of bank reserves but it is not precipitated by the public's behavior. The essence of a financial crisis is that it is shortlived, ending with a slackening of the public's demand for additional currency. A disinflation or a deflation may be long drawn out. Nominal wealth may decline, real debts may rise, but these are not financial crises.<sup>1</sup>

No financial crisis has occurred in the United States since 1933, and none has occurred in the United Kingdom since 1866. All the phenom-

ena of recent years that have been characterised as financial crisis—a decline in asset prices of equity stocks, real estate, commodities; depreciation of the exchange value of a national currency; financial distress of a large non-financial firm, a large municipality, a financial industry, or sovereign debtors—are pseudo-financial crises.<sup>2</sup>

A real financial crisis occurs only when institutions do not exist, when authorities are unschooled in the practices that preclude such a development, and when the private sector has reason to doubt the dependability of preventive arrangements. Institutional changes introduced since 1933 in the United States and since 1866 in the United Kingdom and the private sector's familiarity with and confidence in the responses of institutions and authorities assure that concern with financial crises is misplaced. What should be the object of concern with respect to the proposals to deal with pseudo-financial crises is the perpetuation of policies that promote inflation and waste of economic resources.

Section 11.1 reviews the last real financial crisis in England and notes developments at later dates when a financial crisis did not occur in England but did in the United States. Section 11.2 tries to account for the record in the two countries. Section 11.3 examines the link that Kindleberger (1978) attempts to establish between manias and financial crises from 1720 to 1975. Finally, section 11.4 questions the emphasis currently given to financial distress as the trigger for financial crises and shows that it is based on a misinterpretation of the development of past real financial crises. It is not financial distress that triggers a crisis. The failure of authorities or institutions to respond in a predictable way to ward off a crisis and the private sector's uncertainty about the response are the triggers of a real financial crisis.

### **11.1 England's Last Real Financial Crisis in 1866 and Later Dates When None Occurred There But Did Occur in the United States**

I begin by reviewing the circumstances that led to a financial crisis in England in 1866 and then turn to developments in 1873, 1890, 1907, 1914, and 1931—dates when real financial crises might have but did not occur in England. I also refer to the experience of the United States at these dates leaving for the next section reference to its experience in 1884, when a financial crisis was averted and in 1893, when it was not. In that section, I try to show why the record changed after 1866 in England, and why it was variable in the United States.

#### **11.1.1 1866**

The onset of the financial crisis in 1866 may be traced to the collapse in January of a firm of contractors, Watson, Overend & Company, and

two other companies, the Contract Corporation and the Joint Stock Discount Company, with which the first had ties. These three drew on paper issued to one another and discounted with Overend, Gurney & Company, among others. Overend, Gurney in earlier years had been a solid conservative partnership, one of the pillars of the City. About 1860, a younger generation then in charge of the business became less circumspect in its lending operations, accepting equity interests for unrepayable loans extended to ironworks and shipping companies. Losses led to a decision to incorporate with the possibility of turning over a new leaf. The new company was launched in 1865 just after the conclusion of the US Civil War, when there was every reason to anticipate a strong revival of demand for British exports, but the new company did not live long enough to benefit from it. The failures noted above in January 1866 were followed by additional ones in March and April, but again those were firms of marginal significance. However, when on 10 May Overend, Gurney shut down, the market was shaken. The next day panic broke loose.

#### 11.1.2 1873

Twice during the year financial crises were said to have occurred but only the second time was the characterization accurate. The first occasion, centred on the Continent, began on 9 May with a sharp decline in prices on the Vienna Stock Exchange. The price decline spread to Germany, Switzerland, and Italy, affecting assets like real estate, building, railways, and iron and steel ventures that had been in great favour. Contraction and liquidation followed but no disruption of payments. In England, the only reflection of events abroad was a series of increases in the Bank rate over a four-week period, followed by stepwise reductions over the succeeding ten weeks.

The real financial crisis, centred on the United States, had its beginnings on 8 September when the New York Warehouse & Security Company, organized to lend on grain and produce but involved in railway loans, failed. Five days later, Kenyon, Cox & Company, a stock brokerage firm that had endorsed the paper of another railroad, also failed. A depressed railroad bond market had led these railroads to obtain temporary financing; with the loans about to fall due, neither the lenders nor borrowers were prepared to pay up. The failures were marginal firms, but on 18 and 19 September two leading firms were suspended, Jay Cooke & Company (failure followed the suspension) and Fisk & Hatch (resumed but failed in 1884). At the same time runs began on two small banks, and on 20 September, on a larger New York bank. Panic selling on the New York Stock Exchange led to the closing of the market for ten days. Currency went to a premium as the New York and interior banks restricted payment in greenbacks. By 22 October, the currency was obtainable virtually at par.

Gold was exported to the United States on 25 September by the Bank of England, exports from other central banks as well continuing until the end of October. Bank rate rose. Since investors in England and Germany were holders of American securities, the stock market crash in New York had reverberations. A sharp sell-off on the London Stock Exchange on 6 November led to a rise in Bank rate to 9 per cent the next day, but the payment system was not impaired.

#### 11.1.3 1890

Two monetary disturbances occurred, one in New York, the other in London. Prices on the New York Stock Exchange in November had been falling, partly due to selling by English investors, in order "to carry the load of investments of a less desirable description" (Sprague 1910, p. 132) in South America. On 11 November, the failure of Decker, Howell & Company was announced, involving the Bank of North America. The next day a stock brokerage firm failed and another bank closed. On 15 November, the failure of Baring Brothers in London was cabled to New York and stock prices fell. The following week several firms failed but panic did not develop.

In England, the imminence of failure by Baring Brothers, owing to imprudent investments in the Argentine, became known to the Bank of England on 8 November. In addition to underwriting South American securities, Barings had a large short-term banking business and considerable liabilities on deposit account. The actions undertaken by the Bank of England and a syndicate of bankers, to be discussed in the following section, prevented a crisis.

#### 11.1.4 1907

London was exposed to a series of disturbances from abroad in October, beginning with a stock market decline in New York. The London and Amsterdam stock markets registered sympathetic declines in the prices of American railway securities, but the main disturbance began during the week of 14 October when five banks that were members of the New York Clearing House and three outside banks required assistance from a group of Clearing House banks. These eight banks were controlled through stock ownership on margin by a few men of no great financial standing, who used the banks to further speculation in the stocks of copper-mining companies. A decline in the price of those stocks alarmed depositors who started runs. Order seemed to have been restored by Monday 21 October, when the Knickerbocker Trust Company, the third largest trust company in New York, began to experience unfavourable clearing balances because the president had connections with one of the men in control of the banks that were in difficulty. The former's resignation did not allay distrust. On 22 October

a run on Knickerbocker forced it to suspend business. The next day, a run began on the second largest trust company, and the day following on still another trust company. Assistance was given to these two companies, but by that time alarm had spread to the rest of the country. Restriction of payments by the banks followed and currency went to a premium over deposits.

Despite the repercussions from abroad, no financial crisis developed in London. Three increases in Bank rate from 31 October to 7 November sufficed to replenish gold exported to New York during the crisis there. No bank failures occurred, although voluntary company liquidations were abnormally high in 1908, presumably because of the level interest rates reached in 1908 (Clapham 1945, II, p. 393).

#### 11.1.5 1914

The problems that arose with heightened war fears in Europe were not dissimilar to those that characterised earlier peacetime episodes of threats to the dependability of the credit and payments system. What was different was the range of financial markets—long-term capital, short-term credit, foreign exchange, and gold markets—affected in both England and the United States.

In the summer of 1914, New York, as usual, was in debt to London on short-term account, dependent for its supply of sterling exchange on the proceeds of commercial bills accepted in London and bought on a daily basis by the London discount market. The disruption of remittances from European clients of English accepting houses to cover maturing bills led, on 27 July, to a cessation in London of discounting of foreign bills. At the same time, heavy liquidation of foreign-held securities was in process on the London and New York stock markets, the proceeds of sales in New York, on London's instructions, to be remitted abroad. New York banks without sterling exchange could remit only in gold, draining reserves. Moreover, the New York banks could not count on the proceeds of the sales to provide bank accommodation for domestic purchasers of the securities. For the London clearing banks, their main liquid assets—bills, loans to the bill market, and loans to the Stock Exchange—ceased to be liquid. Both London and New York closed the stock markets on 31 July. A countrywide panic both in England and the United States threatened.<sup>3</sup>

#### 11.1.6 1931

Britain's abandonment of the gold standard on 20 September has been described as a crisis, as have all the subsequent devaluations of the pound and more recently of the dollar. The overvaluation of sterling reflected in weakness in the current account in fact was corrected by the decision to stop selling gold at a fixed price. As Moggridge has

noted (1982, pp. 181–2), the many repercussions of Britain's suspension of convertibility included the decision of others to follow in her wake; elsewhere the imposition of exchange controls, tariffs, and trade controls; a traditional tightening of monetary policy in the United States in response to an external drain of gold followed by a massive wave of bank failures; and further deflation not only in the United States but in all countries that remained on gold. The so-called crisis does not refer to the situation in other countries. Indeed, there was no crisis internally, except for Bank of England, Treasury, and other officials involved in negotiating credits for the Bank before the event and scheduling meetings on what to do next as reserves dwindled. As the text of the press notice announcing the decision stated, "There will be no interruption of ordinary banking business. The banks will be open as usual for the convenience of their customers; and there is no reason why sterling transactions should be affected in any way" (Sayers 1976, 264). Schumpeter commented, "[I]n England there was neither panic nor—precisely owing to the way in which the thing had been done or, if the reader prefer, had come about—loss of 'confidence,' but rather a sigh of relief" (Schumpeter 1939, 956).

### **11.2 When Did a Real Financial Crisis Occur?**

I begin the answer to the question by citing Bagehot's analysis with respect to 1866, the last real financial crisis in England (Bagehot 1873, repr. 1902, pp. 64–5):

And though the Bank of England certainly do make great advances in time of panic, yet as they do not do so on any distinct principle, they naturally do it hesitatingly, reluctantly, and with misgiving. In 1847, even in 1866—the latest panic, and the one in which on the whole the Bank acted the best—there was nevertheless an instant when it was believed the Bank would not advance on Consols, or at least hesitated to advance on them. The moment this was reported in the City and telegraphed to the country, it made the panic indefinitely worse. In fact, to make large advances in this faltering way is to incur the evil of making them without obtaining the advantage. What is wanted and what is necessary to stop a panic is to diffuse the impression, that though money may be dear, still money is to be had. If people could be really convinced that they could have money if they wait a day or two, and that utter ruin is not coming, most likely they would cease to run in such a mad way for money. Either shut the Bank at once, and say it will not lend more than it commonly lends, or lend freely, boldly, and so that the public may feel you mean to go on lending. To lend a great deal, and yet not give the public confidence that you will lend sufficiently and effectually, is the worst of all policies; but it is the policy now pursued.

Bagehot thus stressed the importance of predictable action by the monetary authority to prevent a panic; failing that, a bank holiday was the course to follow. In 1866, the Bank's actions were hesitant so the public was not convinced that there was no reason to panic. H. H. Gibbs, Governor of the Bank, 1875–7, referred to the 1866 crisis as "its only real blunder in his experience," because, instead of lending freely at an appropriately high rate, as Bagehot advised, "it erred in lending at too low a rate before the crisis turned into panic" (Presnell 1968, p. 188). Although in 1873, when Bagehot wrote he still regarded the Bank's behavior in 1866 as undependable, Gibbs did not blame the then Governor since "the matter was not as well understood as it is now," noting that the Bank had done the right thing in 1873, when the underlying situation was just as troublesome as in 1866.<sup>4</sup>

The United States, by contrast, experienced a real financial crisis in 1873 because no institutional framework was immediately available to deal with the surge of demand for high-powered money by the public and banks. Belatedly, the crisis was alleviated by the issue against collateral of clearing-house loan certificates for use in the settlement of clearing balances and by US Treasury redemption with greenbacks of outstanding government debt.<sup>5</sup>

During the next two decades both England and the United States were spared the experience of financial crisis in circumstances that might have been breeding grounds for it. The impact of the failure of the City of Glasgow Bank in 1878 was sufficiently great to suggest to some observers that suspension of the Act of 1844 was required (Presnell, 1968, p. 189), but it was not.<sup>6</sup>

In May 1884, the failure of a Wall Street brokerage firm involving a bank whose president was a partner in the brokerage firm was followed by the suspension of several other banks. However, a phenomenal rise in money market rates brought in an inflow of foreign capital and the supply of funds was further expanded by prompt issue of clearing-house loan certificates. The suspended banks were thereby enabled to resume. Sprague commented (1910, pp. 113–15):

It will be seen that the steps taken to allay alarm were immediate and effective. . . . The success which crowned the efforts of the banks in dealing with the crisis affords convincing evidence that if clearing-house loan certificates are to be issued at all, they should be issued at the beginning of a disturbance. Local runs on the banks did not become severe, because announcement was made that assistance would be granted at the moment when the disasters which might have weakened general confidence became known to the public.<sup>7</sup>

The final episode of the two decades under consideration, when financial crisis did not occur either in England or the United States,



was occasioned by the troubles of Baring Brothers in 1890. In the United States, Sprague noted (1910, p. 142) that it was "the prompt action taken by the clearing-house authorities," by issuing loan certificates to meet the needs of particular banks experiencing runs, that prevented "the spread of panic." Sprague summarised (p. 144) "one of two specifics for the proper treatment of a panic—the continuance of loans to solvent borrowers. A second equally important specific is the prompt payment by the banks of every demand by depositors for cash." In England, the principal device the Bank of England adopted to prevent a crisis—it also borrowed gold from France and bought it from Russia—was to advance sums to meet Barings' immediate maturing liabilities, with the guarantee of a syndicate of bankers to make good any loss sustained by the Bank in liquidating Barings over a period of years.<sup>8</sup> No loss was sustained by the Bank and no call on the guarantors was needed. Presnell concludes: "The news of the guarantee allowed knowledge of Barings' troubles to spread beyond the inner circles without causing panic; indeed, anxiety lifted" (1968, p. 207).<sup>9</sup>

For two decades after 1873 clearing houses and the US Treasury took actions that neutralized monetary disturbances so that crisis conditions did not develop. Why did similar actions in 1893 and 1907 not have comparable effects? No simple explanation is at hand to account for the occurrence of financial crisis in the United States in 1893. It is easier to account for the crisis in 1907.

Two features of the situation in 1893 that differed from earlier experience may be noted: fears that silver advocates would succeed in forcing the country off gold first had to be put to rest, and only subsequently did the condition of the banks as a result of mercantile failures excite independent concern. At that point the clearing houses issued loan certificates. Sprague reports (1910, p. 173), "Serious strain had been met boldly and successfully," but that was not to be the end of the episode. A second wave of distrust of banks spread over the west and south with consequent withdrawals of cash reserves from New York banks. Thereupon the Erie Railroad went into receivership and the stock market suffered the worst decline of the year. Bank suspensions followed in the east as well as in the south and west. Starting with banks in New York, banks throughout the country partly restricted cash payments, sending currency to a premium. The restriction, which lasted from 3 August to 2 September, came six weeks after the issue of clearing-house loan certificates and when gold was arriving from Europe.

Why did the issue of loan certificates not cut short the episode? One suggestion is that some banks did not avail themselves of the opportunity to obtain the certificates and therefore were unable to offset the

shrinkage of their reserves (Noyes 1894, p. 22). In addition, individual banks with the bulk of bankers' deposits had reserve deficiencies even though aggregate reserves of the banks were adequate. The suggestion that best conforms to the view I am presenting is that as early as July (Noyes 1894, p. 25) rumors of refusal of banks to convert deposits into cash incited the financial crisis. A misinformed public can nullify the beneficial effects of actions designed to avert panic.

In 1907, the explanation for the occurrence of crisis appears straightforward. Assistance to troubled trust companies was granted slowly and without dramatic effect. The runs on the trust companies depleted the currency holdings of the New York Clearing House banks which were also shipping currency to interior banks and paying it out over their counters to their own frightened depositors. Although the Treasury helped by depositing currency with these banks, New York was threatened with panic, loans were obtainable only with great difficulty, and stock market prices collapsed. Sprague argued that at this point the clearing-house banks should have issued loan certificates to enable banks to extend loans more freely to borrowers and also to prevent the weakening of particular banks with unfavourable clearing-house balances. In his view, the banks did not do so due to their mistaken belief that an issue of clearing-house loan certificates would cause restriction (Sprague, pp. 257–8, 272–3). While local runs in New York subsided, alarm spread throughout the country. Loss of confidence was displayed less by the public than by country banks. They demanded currency for the funds on deposit or on call in New York. Belatedly, the New York Clearing House issued loan certificates and immediately restricted the convertibility of deposits into currency. Countrywide restriction followed. In 1907, the right actions were taken too late to be effective.<sup>10</sup>

The wartime features of the 1914 episode make it not wholly comparable to earlier cases of threatened crises that were averted. Yet to cope with the problems that rose in the summer of 1914, some of the methods relied on in peacetime episodes were applied. Foremost was the provision of emergency currency issues, in the United States, both clearing-house loan certificates and Aldrich-Vreeland currency (issued by groups of banks under the Act of 1908 establishing the National Monetary Commission), and in England, Treasury Currency Notes, which soon displaced gold coin. Initially, in the United States, concern was directed to limiting shipments of gold, but that became otiose: with the reopening of the sterling acceptance market in London, the belligerents' growing demand for exports, and the balance of trade turning strongly in favor of the United States. In England, initially Bank rate was lifted to 10 percent, the level at which it had stood on the suspension of the Act of 1844 on three previous dates. This time no sus-

pension was needed, and Bank rate was lowered to 5 percent within the week to remain unchanged for the duration.

The additional measures taken to restore the channels of international and domestic financial activity were basically government subsidies (to the export trade in the United States in the form of war risk insurance) or government guarantees against loss (to the banking system in England). The guarantees in England led to the termination of an extended August Bank Holiday and of moratoria on the payment of bills making possible the renewal of availability of acceptance credits in London. A protracted closing of the stock markets in both New York and London was ultimately ended.

Britain's decision to suspend convertibility into gold in September 1931, as I noted earlier, does not qualify as a financial crisis. Real financial crises *par excellence* were experienced by the United States from 1930 to 1933. The lender-of-last-resort was responsible for a series of crises that intensified over time because it did not recognize the need to provide liquidity to the fractional reserve banking system that was confronted with surges of repeated runs. A multiple contraction of deposits was enforced by the inability of the banks to acquire adequate amounts of high-powered money. By March 1933 the entire financial system was prostrate.

The reasons may now be summarized, accounting for financial crises that did or did not occur in the past. In both cases the setting is one in which the financial distress of certain firms became known to market participants, raising alarm as creditors became concerned about the value of their claims not only on those firms but also firms previously in sound condition. Banks that were creditors of the firms in distress became targets of suspicion by their depositors. When monetary authorities failed to demonstrate readiness at the beginning of such a disturbance to meet all demands of sound debtors for loans and of depositors for cash, a financial crisis occurred. A financial crisis *per contra* could be averted by timely predictable signals to market participants of institutional readiness to make available an augmented supply of funds. The sources of the funds supplied might have been inflows from abroad—attracted by higher domestic than foreign interest rates—or emergency issues of domestic currency. The readiness was all. Knowledge of the availability of the supply was sufficient to allay alarm, so that the funds were never drawn on. In a few instances, orderly liquidation of the firms in distress, with a guarantee against loss by the liquidator, isolated the problem so that it did not spread to other firms and averted a financial crisis in this way.

A breakdown of the payments system has not occurred in the last century and more in England—ignoring the 1914 episode—and in the last half-century in the United States. The lesson has been learned that

the financial distress of the few must not be permitted to become a financial crisis for all. Individual debtors fail but their difficulties do not become widespread and undermine creditors in general. Bad banks fail, or more likely are reorganized under new management or merged with a good bank, but if a run on a bank occurs—it is said to have occurred on the Banco Ambrosiano in the recent scandal in Italy—it is not permitted to cumulate into a banking panic. In the United States, federal deposit insurance attempts to remove the problem of a loss of confidence in the ability of banks to convert deposits into currency and thus to eliminate the reason for bank runs, but, as the experience of other countries proves, such insurance is not essential. Not only are authorities better educated. So also is the public. As its experience has grown with the institutional arrangements that prevent disruption of the payments system, its behavior contributes to the dependability of the system.

### 11.3 Manias, Panics, Crashes

The preceding sections have focused on the relation between financial distress of firms with perceived significant market presence and the historical incidence of financial crises. In this section the focus shifts to the validity of the identification of manias with financial crises (Kindleberger 1978).

For Kindleberger, manias, panics, and crashes are three phases of the same process. During manias, investors shift from money to real or financial assets. During panics, they try to shift from real or financial assets to money. Crashes are the denouement of the process, with the collapse of prices of whatever was eagerly acquired during the mania—“commodities, houses, buildings, land, stocks, bonds” (1978, p. 5). He takes for granted that manias occur during cyclical expansions and the panic phases at peaks, while disclaiming that every business expansion leads “inevitably to mania and panic. But the pattern occurs sufficiently frequently and with sufficient uniformity” (p. 5). Finally, he regards the manias, panics, and crashes that he discusses as financial crises *per se*.

In current economic analysis, the word “bubble” has supplanted the pejorative “mania.” In the definition proposed by Flood and Garber (1982, p. 275), “The possibility of . . . a price bubble exists when the expected rate of market price change is an important factor determining current market price.” No reference is made to cyclical conditions in the definition. In my view, bubbles may arise independently of the economy’s cyclical stage, although business expansion may foster them. No one has systematically examined all the cases, so the ones associated with particular cycle movements have had the lion’s share of

attention. Kindleberger's assertion that, according to a monetarist view, "mania and panic would both be avoided if only the supply of money were stabilized at some fixed quantity, or at a regular growing level" (pp. 5–6) does not accord with my monetarist view. Bubbles, like bankruptcies, would occur even if the money stock were free of destabilising cyclical swings. The Florida land boom of 1925–6 and the gold price bubble of 1979–80 were created by opportunities those markets appeared to offer rather than the pattern of monetary growth.

A basic fact concerning bubbles is that they leave eager investors in sure-fire, get-rich schemes at the take-off considerably poorer at the landing. The loss of wealth attendant on misguided, unprofitable, voluntary investment decisions is, of course, not confined to bubbles. Bankruptcy proceedings are a daily occurrence in economic life. Willingness to spend may be reduced and previously glowing expectations may be replaced by uncertainty. But loss of wealth is not synonymous with a financial crisis.

At the stock market peak in 1929, the total value of all shares listed on the New York Stock Exchange was about \$200 billion. The decline in October is estimated at nearly \$15½ billion, so many investors undoubtedly were poorer. Yet no financial crisis occurred following the great crash. The reason is that prompt and effective action by the New York Federal Reserve Bank provided additional reserves to the New York banks through open market purchases. Kindleberger acknowledges that the crash did not "lead to a money market panic . . . or to runs on banks, probably because of the effective action of the New York Federal Reserve in pumping funds into the market" (p. 113), but still classifies the crash as a financial crisis apparently because it "spread liquidation to other asset markets, such as commodities, and seized up credit to strike a hard blow at output" (p. 113). Any deflation would thus qualify as a financial crisis.

In a perceptive comment on bubbles, Wood (1983) has noted that they concern markets "where quantities traded have varied little, while there have been enormous variations in price. They are interesting, but the fate of nations seldom depends on them."

Kindleberger provides a tabulation in an appendix to his book that lists some three dozen financial crisis during two and a half centuries, characterizing each one by the subject of the mania, how it was financed, dates of the peak and crash, and a final entry identifying the lender-of-last-resort. It is the final entry that motivates Kindleberger's study. He argues the importance of a lender-of-last-resort "who comes to the rescue and provides the public good of stability that the private market is unable to produce for itself" (p. 4).<sup>11</sup> Yet he does not discriminate between episodes in which successful action was taken to prevent the development of a crisis and episodes in which no action was taken or the action was unsuccessful.<sup>12</sup>

Despite his designation of all episodes as financial crises without differentiation of those where the “rescue” provided stability, even Kindleberger notes that there has been a dwindling of the number and a lessening of the severity of domestic financial crises since 1866 in Britain and since 1929 in the United States and on the Continent. He considers three possible explanations: (i) the decline of usury laws, making it possible for interest rates to be raised sufficiently to limit manias; (ii) the shunning of manias by markets that had learned from experience; (iii) the calming of anxieties owing to the known existence of a lender-of-last-resort. He dismisses the first two out of hand, but his position on the third is ambiguous. Nor is it clear why at this point he cites Minsky’s reference (1977) to “near panics” in 1966, 1969–70, and 1974–5, and “incipient crises” in 1974 (p. 218).

The record on domestic financial crises may thus be reassuring to Kindleberger, but his current concern is the greater frequency now than in the nineteenth century of foreign exchange crises. The solution he suggests is an international lender-of-last resort.<sup>13</sup> The recent analytical literature on bubbles also encompasses runs on a currency that is fixed in price in terms of at least one other currency and runs under flexible exchange rates (Flood and Garber 1982). The underlying assumption that a run on a currency is a crisis seems to me untenable. The market will sell off an overvalued currency under fixed or floating exchange rates and will shift to an undervalued currency. If authorities resist the market’s evaluation, it may be costly for them, but the problem facing the currency is more fundamental: the economic policies that are responsible for the currency’s plight are the heart of the matter. If there is a crisis, it resides in the failure to adjust those policies.

I conclude that manias, panics, and crashes reduce wealth. They are not *per se* financial crises unless the shift from tangible or financial assets to money leads to a run on banks. A lender-of-last-resort can forestall such a development, so I agree with Kindleberger that there is an important role for such an entity, although I do not subscribe to the notion that only a public authority has in the past filled or can at present fill that role.

#### 11.4 Financial Distress versus Financial Crises

In my lexicon, the events since the mid-1960s that have been termed “financial crises” or “threats of a financial crisis” have been pseudo-financial crises. Essentially the response to each of these events (to be noted in what follows) has been a form of bail-out, for which the justification was that the action averted crisis. Since no financial crisis would in fact have been experienced had a bail-out not been undertaken, the events were pseudo-financial crises. Moreover, the policies adopted were economically inefficient or inflationary in effect.

The first event to be considered here was the failure of the Penn Central Railroad in June 1970. The Federal Reserve was concerned lest the company's default on its \$200 million commercial paper borrowings would jeopardize that market. The Fed assumed that lenders would not discriminate between a troubled issuer and other perfectly sound issuers. The scenario envisaged by the Fed was that the latter would need to pay off their commercial paper because of generalized distrust of the instrument. Accordingly, the banks were informed that the discount window was "wide open" (Maisel 1973, p. 9) if they needed funds to make loans to customers unable to roll over commercial paper. In addition, to enable banks to bid freely for funds in the open market, the Fed suspended interest rate ceilings on 30 to 89-day large denomination certificates of deposit—an action that was desirable in its own right. Maisel concludes that the Fed's actions averted a panic (p. 4). However, if there were commercial paper issuers that faced difficulties, as Carron notes (1982, p. 398), it was not owing to the condition of the market as such but to "conditions peculiar to those firms" (Chrysler Financial and Commercial Credit among others). The verdict of the 1971 *Economic Report of the President* (p. 69) was that no "genuine liquidity crisis existed in mid-1970."

Events in 1973–4 centred on bank failures in the United Kingdom, West Germany, the United States, and Switzerland that were thought to threaten the international financial order. Hirsch (1977, p. 248), who believes that cooperation to achieve "collective intermediate goods" of bank stability is technically easier to organize in a small group of like minded individuals and institutions than in an open group" (p. 249)—a view reminiscent of de Cecco's—describes what happened in Britain when "fringe banks," bank new-comers, experienced difficulties in December 1973. A deterioration of the market value of real estate investments of these banks led to deposit withdrawals and the switching of new deposits to established banks. To save depositors of the fringe banks from losses, the four-member oligopoly of deposit banks had to commit resources to that end. Hirsch interprets the action taken by the established banks as in their self-interest by removing a source of competition. Whatever the motivation of the established banks, their collective action bespeaks an understanding that the failure of individual banks must not be allowed to contract the aggregate money stock.

Two views have been presented with respect to the actions taken by the Federal Reserve when Franklin National Bank announced, in May 1974, that it had lost heavily in forward transactions in the foreign exchange market. The Federal Reserve initially announced that it would advance whatever funds Franklin needed, so long as it remained solvent, the loans ultimately reaching a maximum of \$1.75 billion in early

October. At that point the bank was merged with another institution and the FDIC assumed the Federal Reserve's loan.

One view (Carron 1982, p. 400) is that the preconditions of a genuine financial crisis existed, as evidenced by the fact that corporations paid premiums on their borrowings that reflected risks perceived in the banking system rather than in their own positions. The preconditions were, however, mitigated both because markets remained orderly with no lack of confidence on the part of investors and the central bank intervened effectively. An opposite view is that the immediate impact of Franklin's failure was erased by a Federal Reserve bail-out that led market participants to believe that no bank failures would be tolerated and that encouraged 'banks to become more reckless than ever' (Wojniower 1980, pp. 298–9). It was not only the losses in the foreign exchange market that the Franklin case revealed. The aftermath of its failure also disclosed the near-bankruptcy of real estate affiliates many banks owned. The affiliates had financed construction with short-term funds and invested in real estate and mortgages whose value declined when interest rates rose. Selling off real estate at distress prices further compromised the position of the affiliates, so that they experienced problems in selling their paper.

The perception of increased risk in lending to banks raised the cost of funds for them. Does this justify a bail-out or concern that a financial crisis was imminent?

Banking difficulties in Europe in 1974 that arose because of losses sustained in the foreign exchange market were apparently met without bail-outs. The Bundesbank announced the liquidation of Bankhaus I.D. Herstatt. Neither Westdeutsche Landesbank Girozentral of West Germany nor Union Bank of Switzerland was mortally wounded by its losses.

It was not banking difficulties but financial distress of two large real sector firms—Lockheed Corporation (1971) and Chrysler Corporation (1979)—and a municipality—New York City (1975)—that also provided occasions for a prognosis of a threat of financial crisis. In each case federal government legislation was enacted to guarantee private loans to these entities. The object was to avoid bankruptcy. Though Penn Central Railroad had filed for bankruptcy and subsequently restructured its operations to become an efficient firm, the view that has since come to prevail is that bankruptcy proceedings by themselves will create a financial crisis. The loan guarantees thus serve to mask the inefficient use of resources that had produced financial distress. It is true that some restructuring of claims on and operations of the entities was required as a condition of the guarantees, but it is not clear why reorganisation under bankruptcy proceedings would have precipitated a financial crisis. Again, the underlying assumptions seems to be that



markets cannot discriminate between a firm or municipality in financial distress and others in sound condition. The inefficient are sustained in their misuse of resources because of the imagined hardship that would be imposed on the efficient.

Another class of events that is said to raise the prospect of domestic financial crisis is still impending—the impairment of the ability of many sovereign countries to make scheduled payments on their outstanding bank loans. Short-term loans extended to governments and to private borrowers abroad in some cases appear to be beyond their prospective capacity to repay. Acknowledgement of default on outstanding loans would require write-downs that would reduce capital of the banks involved and that would undoubtedly raise the cost to them of funds obtained in the open market. This course has been rejected on the ground that confidence in the stability of the banking system would be shaken. The alternative chosen has been the subterfuge that all the loans will be repaid, with the banks exhorted to provide an increase in lending sufficient to enable delinquent borrowers to maintain interest payments and to reschedule principal. In addition, the goal of stable non-inflationary monetary growth has been sacrificed as part of the effort to resolve the international debt problem. It is taken for granted that, if the policy of papering over the true economic prospects of the borrowing countries ultimately fails, standing in the wings will be the authorities ready to bail out the lenders. The costs of renewed inflation will then be dismissed as an unfortunate side effect.

Real financial crises need not occur because there is a well-understood solution to the problem: assure that deposits can be converted at will into currency whatever the difficulties banks encounter. The solution does not preclude failure of mismanaged banks. Recent discussion of moral hazard in relation to real financial crises would be more apt in relation to pseudo-financial crises. They provide the rationale for bail-outs and shoring up inefficiency. Pseudo-financial crises in recent years have generated expectations “that no monetary authority will allow any key financial actor to fail” (Wojnilower 1980, p. 299). Political authority seems well embarked in the direction of not allowing any key non-financial actor to fail, and of encouraging inflationary actions by domestic monetary authorities and international agencies in the cause of pseudo-financial crises.

## Notes

1. The example of the deflation in 1920–1 in the United States may be cited. Bank reserves declined from \$2.8 billion in April 1920 to \$2.4 billion in August 1921. Wholesale prices (on the base 1926) fell from a peak of 167 in May 1920

to a trough of 91 January 1922. An index of liabilities of business failures rose from a trough of 6.0 in January 1920 to a peak of 71.2 in February 1922. Although 506 banks suspended business in 1921, there was no financial crisis. The deposit-currency and the deposit-reserve ratios in August 1921 were higher than in April 1920.

2. Financial distress defines the condition of an individual, a non-financial firm or an individual bank, or an industry that has assets with realisable value in money that is less than the amount of its indebtedness.

3. De Cecco (1975) argues that no problem would have arisen, had not the joint stock banks arbitrarily begun a credit squeeze in the middle of July, recalling loans they had made to bill brokers, and refusing to finance foreign clients of the accepting houses who usually borrowed in London to meet their maturing bills that the London houses had accepted. Stock Exchange dealers who worked on loans from foreign banks dumped their stocks to be able to return borrowed money, compelling the joint stock banks to call for extra margin from customers with Lombard loans, since the value of the collateral had declined. De Cecco says that the banks assumed a crisis of confidence on the part of the public would occur but in fact it did not happen. Therefore the banks engineered a crisis of confidence by refusing to pay out gold to the public and themselves drawing on the Bank's gold. The motive for the banks' behaviour, according to de Cecco, was to "substitute themselves in lucrative international business" and "exclude traditional intermediaries from their functions," though they wanted only "to threaten them with the possibility of . . . death, in order to have them rescued *in extremis* and to paralyze their future action" (p. 149).

According to Sayers (I, p. 70), it was sales of internationally traded securities on European stock exchanges that initiated the credit squeeze in London. He also notes that the joint stock banks' refusal to pay out gold before the August Bank Holiday may be interpreted in a more favorable light than de Cecco presents (I, p. 72).

4. De Cecco (1975, pp. 80–2) dismisses Bagehot's analysis. According to de Cecco, the Bank deliberately sought the fall of Overend, Gurney because "they were encroaching upon the very branch of business on which the Bank thrived: the discounting of bills from all over the country. . . . So conflict between the two giants seemed inevitable, particularly as their business had become very similar in nature" (p. 80). "The Bank watched its rival fall without making any attempt to come to its rescue; on the contrary, it implemented a six-month 'dear money' policy specifically to make Gurney's fall inevitable. Only after its rival had gone under did the Bank go to the market's rescue by extending unlimited assistance to anybody needing it, to allay the panic induced by Gurney's failure" (p. 82).

If de Cecco is right, the Bank was culpable because it deliberately ignored "what was well understood." But the evidence does not support de Cecco's opinion that by 1866 the Bank understood what needed to be done in a timely way to prevent a crisis.

5. In Austria, in 1873, the main response to the stock market decline which was followed by a large number of insolvencies and bankruptcies was the suspension of the Banking Act of 1862 to "assist the mobilization of central bank funds in case a liquidity shortage should make itself felt" (März 1982, p. 188). No shortage occurred. Six months later, a consortium of banking houses and the central bank rescued from collapse the Bodencredit-Anstalt, an issuer of mortgage bonds with credit standing abroad equal to that of Austrian treasury certificates. The firm had been involved in "risky stock-exchange operations" (p. 189).

6. *The Economist* 5 October 1878 (Gregory 1929, II, pp. 289–90), commented on the bank's failure: "There was no run, or any semblance of run; there was no local discredit. . . . The fact that the other Scottish banks are willing to take up the notes of the City of Glasgow Banks appears to support the belief that all the liabilities of the bank will be met in full. The danger of discrediting the circulation may, however, have had some influence on the other banks in determining their action in this matter."

7. Presnell (1982, p. 152) reports the actions taken in Ceylon, when the Oriental Banking Corporation, a major international bank with many branches in Southeast Asia and in Australia, collapsed in May 1884. The colony's governor guaranteed the bank's substantial note issues and the other banks imported silver rupees from India. A financial crisis was averted.

8. A similar device had apparently been used by the Bank of France in 1889. Presnell (1968, p. 205) cites a French historian as crediting France with helping England in "two ways in 1890: with gold and by her example." The example refers to the use of a collective guarantee by French banks in support of the Bank of France. A certain Comptoir d'Escompte, in 1889, experienced a run as the result of unwise loans it had made to a company that speculated in copper. The Bank provided the Comptoir with funds to reimburse its depositors and creditors and then liquidated it.

9. According to de Cecco (1975, p. 92), because of the Bank of England's rivalry with the joint stock banks, only merchant bankers were first asked to underwrite the guarantee, and the joint stock banks only later. He concludes that the Baring crisis "proved to be the swan song of the power of the Bank of England and of the merchant banks. Barings were prevented from going down and taking other houses with them; but this was made possible only by a series of expedients—all traditional instruments of policy had been abandoned" (p. 95).

Presnell deplores the device of the guarantee as "not central banking," as well as loss of the opportunity the Barings' situation created to advance reform of the Act of 1844, and more particularly the need for larger banking and larger gold reserves.

10. Bonelli's article (1982, pp. 51–65) on "The 1907 Financial Crisis in Italy" should be retitled "The 1907 Financial Crisis That Did Not Occur in Italy." He defines the crisis as a prolonged decline in prices of shares that brought one of the largest mixed banks close to suspension. It did not happen because the Banca d'Italia, the largest of the three issuing banks, initiated and coordinated "anticrisis measures" (p. 51). "It began to provide liquidity in all directions by means of discounts and advances . . . it also announced that its reserves were increasing, that it could issue money without any difficulty, and that it could even count on the government's readiness to take any extraordinary measures that might become necessary (to wit, removal of the ceiling established by law as regards the volume of circulation not enjoying full metallic coverage)" (p. 58).

11. Kindleberger cites no evidence in support of the proposition that the private market is unable to serve as the lender-of-the-last-resort. The clearing houses at times undertook that function under the National Banking System in the United States.

12. An oddity is that the tabulation includes an entry for 1819 in England. The listing for that episode is "none" under "crisis," and "none needed" under "lender-of-last-resort."

13. I share the view expressed by Griffiths (1983) that the proposal should be rejected. The grounds for rejection that he cites relate to the role of banks and international debt. They also apply to foreign exchange markets.