Journal of Financial Stability 17 (2015) 22–34

Contents lists available at ScienceDirect

Journal of Financial Stability

journal homepage: www.elsevier.com/locate/jfstabil

Liquidity provision during the crisis of 1914: Private and public sources

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ARTICLE INFO

Article history:
Received 27 January 2014
Received in revised form 10 June 2014
Accepted 29 July 2014
Available online 7 August 2014

JEL classification:
E42
E59
E65
N22

Keywords:
Liquidity provision
Lender of last resort
Closure of stock exchange
Financial crisis
Clearing houses
Aldrich-Vreeland emergency currency

ABSTRACT

Caught between the end of the National Banking Era and the beginning of the Federal Reserve System, the crisis of 1914 provides an example of a banking panic avoided. We investigate how this outcome was achieved by examining data on the issues of Aldrich-Vreeland emergency currency and clearing house loan certificates to New York City institutions that identify the borrower and the quantity requested for each type of temporary liquidity measure. The extensive provision of temporary credit to a wide array of financial intermediaries was, in our opinion, essential to the successful alleviation of financial distress in 1914. Empirical results indicate an important role for clearing house loan certificates that is distinct from the influence of Aldrich-Vreeland emergency currency issues.

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1. Introduction

This paper examines how the United States avoided a banking panic in 1914 despite threatening circumstances following the initial stages of World War I. During the summer of 1914, the U.S. suffered gold outflows, Europe was at war, blockades threatened world trade, and cash was soon to become scarce. Following the actions of stock exchanges worldwide, the New York Stock Exchange was closed on July 31, 1914, isolating New York City banks from their main market for financial liquidity. The stock exchange closure likely forestalled an impending financial crisis by preventing large-scale sales of foreign-owned bond and stock securities and the related (and feared) outflow of gold overseas. The shutdown of the exchange also exposed the financial system to the risk of a liquidity shortage. In New York City, two liquidity provision mechanisms, Aldrich-Vreeland emergency currency and clearing house loan certificates, became crucial stop gap measures to prevent vulnerable financial markets from spiraling into a full-scale panic.

We investigate the 1914 episode because crisis prevention mechanisms were able to support deposit levels and thus promote the growth of the aggregate money supply, an outcome consistent with standard policy prescriptions for combating financial distress. Powerful market participants and policymakers engaged in a successful intervention before the Federal Reserve System was operational and remarkably prevented the occurrence of a far more damaging financial event (see Silber, 2007a). Existing literature lauds the successful outcome in 1914 as the result of the issuance of Aldrich-Vreeland emergency currency, which made its simultaneous debut and exit in 1914. In New York City in particular, clearing house loan certificates may still have been an important liquidity resource, even though they were unable to prevent

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http://dx.doi.org/10.1016/j.jfs.2014.07.004
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full-scale banking panics and financial crises in 1907, 1893, and 1873.

We show that the financial intermediaries in New York City that requested temporary liquidity loans through these two mechanisms were able to maintain (or increase) their level of deposits and hence stave off a contraction in the money supply.[2] We examine data on the issues of Aldrich-Vreeland emergency currency and clearing house loan certificates in New York City institutions that identify the borrower and quantity requested for each type of temporary liquidity measure. We combine these data with high-frequency (weekly) balance sheet data to verify how temporary liquidity borrowing affected changes in deposits.

Banks that borrowed temporary liquidity instruments maintain interbank payments despite initial cash drains to the interior and large gold outflows arising from asset liquidations by foreign investors. By comparing the characteristics of the financial distress in 1914 with previous National Bank Era (1863–1913) panics, specifically those in 1907, 1893, 1890, 1884, and 1873, we infer that the outcome of 1914 is benignly different. In the earlier instances of financial distress, bankers employed only clearing house loan certificates as a temporary liquidity mechanism because emergency currency did not exist as an alternative. Several features of 1914 play out differently and more favorably compared to these prior crises, suggesting that the addition of emergency currency was crucial in alleviating the financial distress.

We argue that clearing house loan certificates in 1914 play a secondary, but still consequential, role in forestalling financial panic. Our data and statistical examinations reveal that financial intermediaries borrowing solely Aldrich-Vreeland emergency currency and, separately, those borrowing only clearing house loan certificates are associated with an increase in net deposits that is larger than the increase in net deposits among those intermediaries that did not borrow either form of temporary liquidity. Clearing house loan certificates as a liquidity provision were particularly important for state banks and trust companies that did not have access to emergency currency. Intermediaries that borrowed both emergency currency and clearing house loan certificates – a subset of national banks – experienced a decline in net deposits. We suspect that the decline in net deposits arises from the fact that national banks borrowing large proportions of clearing house loan certificates required additional liquidity most intensively.

The extensive provision of temporary liquidity to a wide array of financial intermediaries was, in our opinion, essential to the successful alleviation of financial distress in 1914. Although emergency currency was crucial in preventing a panic in 1914, it was mainly available to national banks – a subset of financial institutions. Clearing house loan certificates, however, were available to trust companies and state banks that were members of the New York Clearing House. The access of these institutions to borrowing a form of temporary liquidity provision prevented the isolation of important, non-national banks in New York City. The borrowing of clearing house loan certificates in addition to emergency currency by a subset of national banks further suggests a non-trivial role for this form of temporary liquidity provision.[3] As a result, the private (and perceived as inferior) form of temporary liquidity in the form of clearing house loan certificates may have a secondary yet still palliative role that may have been previously overlooked.[4]

The analysis in this paper highlights liquidity provision features that have been underemphasized in research that examines previous crises. Multiple liquidity mechanisms appear to work better than only one. To reach the intermediary types most in need of liquidity, multiple forms of liquidity provision were necessary to overcome the institutional structure of the national banking system. Features of liquidity provision in 1914 display notable similarity to some of the liquidity provision mechanisms implemented by the Federal Reserve System in 2007–2008 to combat the financial distress of the large, complex financial institutions.

2. Background

The motivation for our historical comparison arises from the existing literature examining the 1914 crisis, the aggregate effects of the liquidity provision mechanisms in New York City, and the challenging circumstances facing the financial system in 1914. The existing literature studies the successful alleviation of the financial distress and emphasizes the provision of emergency currency in 1914 as the key liquidity mechanism that prevented anything like the Panics of 1907, 1893, or 1873 from arising.[5] Friedman and Schwartz (1963: 196) highlight how emergency currency enabled the US financial market to stabilize after the declarations of war in Europe. Silber (2007a: 82) suggests that emergency currency produced an outcome – the increase in the monetary base by seven percent – that clearing house loan certificates were unable to generate on their own. The decline in the money supply observed in previous National Banking Era panics indicates that the issuance of clearing house loan certificates failed to reverse the forces of contraction endemic to financial panic.

Clearing house loan certificates were loans issued by the New York Clearing House to member bank borrowers upon approval by the Clearing House Loan Committee. The Committee's decision to lend (or not) hinged on their assessment of the value of posted collateral. The certificates traded at par at the New York Clearing House, paid 6 percent interest to the holder, and were effectively guaranteed by the entire membership of the clearing house. Clearing house loan certificates substituted for specie and legal tender claims that were exchanged at the New York Clearing House to settle transaction balances between clearing house members. Members of the clearing house were obliged to accept them, and non-acceptance was grounds for expulsion from the clearing house association. Functionally, clearing house loan certificates freed up cash and other forms of lawful money to be paid out to depositors and corresponding banks without forcing the liquidation of bank assets or collapsing the size of balance sheets. One can think of them as allowing a mutually enforced forbearance on final payments at the New York Clearing House.

While the private clearing house system was largely the inspiration for Aldrich-Vreeland emergency currency, the crisis of 1914 presented a challenge for the untested public liquidity provision. At the beginning of World War I, United States Treasury Secretary William McAdoo, in concert with the leaders of the New York

[2] Our empiric analysis focuses on the role of Aldrich-Vreeland emergency currency and clearing house loan certificates in New York City because New York City represented nearly half of the banking assets in the United States in 1914. New York City institutions were also most acutely affected by the closure of the stock exchange.

[3] Further work will investigate institutional characteristics associated with this distinctive fact. The role of clearing house loan certificates in national bank borrowing is complicated by the presence of emergency currency, an alternative liquidity mechanism thought of as superior.

[4] The Panic of 1907, in particular, demonstrated the importance of access to temporary liquidity when the isolation of trust companies from liquidity sources heightened the severity of trust depositor withdrawals (see Tallman and Moen (1990), and Moen and Tallman (2000)). Hoag (2011) and Hoag (2012) offer a contrasting view.

[5] Wicker (2005: 47) suggests that if a crisis issue of emergency currency occurred prior to the adoption of the Federal Reserve System, the question of panic prevention would have been addressed and perhaps a central bank would not have been established in the United States.

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