

Crises and Capitalism: Does History Suggest Where We Are Heading?

Remarks prepared for the Council on Foreign Relations Roundtable
January 12, 2009

U.S. Capitalism has been faced with many financial crises in the past 220 years . The first financial crisis was in 1792. A similar story can be told for virtually every advanced country with an even more turbulent history for the emerging countries.

Financial crises are nasty events involving significant wealth losses, failures of banks and non bank financial institutions and often declines in real output . In U. S. history recessions associated with financial crises are almost always more severe.

Despite their negative effects financial crises can also have a good side to them. They can be learning experiences for important institutional changes . This occurred on several occasions in U.S. history as well in other countries..

In U.S. history we can identify several financial crises which led to significant institutional learning. The first that I will discuss is the crisis in the Free Banking era after Andrew Jackson vetoed the renewal of the charter of Second Bank of the United States in 1836. The Second Bank ,1816-1836,like its predecessor the First Bank performed many of the functions of a modern central bank including providing a relatively stable money supply and serving as a lender of last resort to the commercial banks.

After the demise of the Second Bank, the states regulated commercial banking under a regime referred to as Free banking. Under Free Banking barriers to entry were low (minimum capital requirements and gold convertibility) and free bank notes were issued competitively. The Free Banking era 1837-1863 was characterized by several endemic problems: frequent bank failures and bank notes circulating at discounts. It also suffered two severe financial crises 1837 and 1857 and two minor crises 1839 and 1847.

In reaction to the financial instability, Congress passed the National Banking Act in 1863 which created the National Banking system made up of federally chartered banks issuing U.S. government bond backed notes convertible into gold. The institutional reform of the National Banking system which lasted from 1863 -1914 eliminated the problem of the proliferation of state bank notes at varying discount rates by creating a uniform safe national currency. However the National Banking system did not eliminate the problem referred to by Milton Friedman and Anna Schwartz(1963) as the inelasticity of high powered money, the attempt by the public to convert their deposits en masse into currency and precipitating a banking panic. This required the institution of a lender of last resort which with (the notable exceptions of occasional private clearing house loan certificates and US Treasury actions) was absent. The National Banking era was characterized by 3 large banking panics , 1873, 1893 and 1907. The last was the straw that broke the camel's back. It was resolved in part by the intervention of JP Morgan but in reaction to the public outcry that the rescue had been arranged by a powerful private

individual, the Congress created a major institutional reform by passing the Aldrich Vreeland Act in 1908. The AV act created National Reserve Associations which issued emergency currency (it was only used once in 1914 at the outbreak of World War I) and also instituted the National Monetary Commission which in its report in 1912 recommended the establishment of a U.S. central bank, the Federal Reserve system.

The Fed was established to provide a stable currency and also to act as a lender of last resort, a role that had been well preceded by the Bank of England and other European central banks.

The Fed maintained stability for 15 years and then failed miserably in its task by failing to stem four successive banking panics between 1930 and 1933 which converted a serious recession into the Great Contraction characterized by a 33% decline in the money stock and comparable declines in real output and prices. The Fed's failure it has been argued was caused by flaws in its basic structure(a stalemate between the Board of Governors in Washington and the Reserve Banks) and in its following of a flawed monetary theory(the real bills doctrine).

The crisis of the Great Contraction which was the worst financial crisis of all time led to major institutional innovation. The slump was blamed by FDR on the bankers (central and commercial). Reforms included : the establishment of federal deposit insurance (FDIC) in 1934 which finally eliminated the problem of banking panics by removing the incentive by depositors to stage speculative attacks on their banks; the revision of the Federal Reserve System in 1935 to centralize power in the Board of Governors in Washington DC; the subservience of the Federal Reserve to the Treasury (which lasted until 1951);the Glass Steagall act of 1933 which separated investment from commercial banking; and numerous regulations such as the prohibition of interest on demand deposits and a ceiling on interest on time deposits which was extended to savings and loan institutions. These reforms created a stable monetary and financial system which lasted for close to 40 years.

However the financial reforms which came out of the 1930s crisis went too far and stifled financial innovation in the postwar period. Think of the story of the banker who started work at 10 AM, made a few safe loans, took a 2 martini lunch and then left the bank for the golf links by 3 PM.. The financial controls and regulations from the New Deal era lasted as long as the Fed provided price stability. With the advent of the Great Inflation the financial controls led to distortions and were increasingly evaded and by the 1970s and the 1980s, following the S and L crisis, the financial system was deregulated to create the system we know today.

Today's crisis has been attributed to major changes in regulation, lax regulatory oversight, a relaxation of normal standards of prudent lending and a period of abnormally low interest rates. When the crisis ends there will likely be major reforms in the U.S. financial regulatory framework. Whether they will be as extensive as in the 1930s will soon be revealed.

The lesson that comes from this process of institutional learning triggered by financial crisis is that we often go two steps forward but then one step backward. The risk facing the U.S. today is that of government overkill. The Fed and Treasury have created a host of new facilities to stem the credit crunch. The Fed is engaged in extensive quantitative easing which will ultimately pose a risk of inflation. The incoming administration promises a massive fiscal stimulus. These policies undoubtedly will complement normal market forces to produce recovery from the recession. But they will also increase the size and scope of government. This may, as in the postwar era stifle innovation. Also the government overreach may be difficult to roll back as a constituency develops which benefits from government protection. The experience of Western Europe in the postwar of extensive nationalization of key industries and much tighter regulation of the financial system than experienced in the U.S. is a cautionary tale. It took until the 1990s to unravel the controls and when that was accomplished many countries experienced more serious banking crises than we have just witnessed.

Supportive empirical evidence for my hypothesis that crises can lead to institutional learning comes from a recent excellent study by Alberto and Eduardo Cavallo which shows for a large panel of countries over the past 30 years that countries with sound democratic institutions institute growth enhancing institutional reforms following financial crises.

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