Blameless Banking
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Imagine: For 140 years, financial institutions in the U.S. were highly competitive, loosely regulated and exceedingly innovative. Institutions were free to appear, fail or succeed, change and even trench on each other's business. And, mirabile dictu, it all worked very well. The country prospered as the financial system developed and refined itself to accommodate growth and the deepening of the economy.

The Depression, however, marked the end of such goings-on. A legislative hazing transformed many financial institutions into noncompetitive or highly constrained fraternities, with commercial banks bearing the heaviest regulatory punishment. Why the banks? Had they been especially naughty? Were they to blame for the Depression? Herewith an expurgated history of banking.

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Panics and failures punctuated the first 140 years of unfettered banking. Doesn't sound innocent, does it? But wait. The banks didn't cause these panics and failures, exactly. They were caused by an economy which had to absorb shocks without a shock absorber like, say, a central bank. Before the Civil War, the U.S. was prey to shocks from the British economy and international trade flows. After the Civil War, the U.S. economy was tugged around by business and agriculture cycles. Consider, for example, a typical 19th Century crisis generated by the agriculture sector.

Most small banks kept their reserves at big banks, generally in New York City. Big banks, in turn, lent these funds on the call market. In spring, of course, small banks had to accommodate increased money demand from farmers; so they would recall their reserves from the big banks who then called in their loans. But the system wasn't perfectly liquid or perfectly perfect. Some banks might come up short, meaning that either the big bank was out of specie—gold or silver — and/or the little banks couldn't get back all their reserves.

A "bank failure" happened when one of those banks, big or small, had to suspend convertibility—that is, stop redeeming notes or currency in specie. Often depositors at other banks would then panic and cause a run on otherwise sound banks. As banks scrambled for specie, their drive to get liquid would further contract credit. These bank failures usually meant a few days of suspended convertibility. (Of course banks did really fail — go bankrupt — regularly because of normal cycles or normal greed.)

Between 1873 and 1907 there were five serious panics. Indeed, the panic of 1907 was so serious that, in some cities, specie redemption was impossible for as much as two months. This seemed a bit much, so Congress brought forth the Federal Reserve Bank in 1913. Since the Fed was to provide the liquidity necessary to combat cyclical crunches, banks were enjoined from suspending specie redemption.

It sounded good, all right; unfortunately, the Fed didn't help much in the Depression. There were three distinct banking panics during the Depression. The first, in 1930, was a tough, garden-variety crisis which started in the Midwest after big crop failures in the Corn Belt. The second, tougher crisis hit in 1931 after the Fed pushed up interest rates to stop a gold exodus. The final crisis, which began in 1932 and rolled along to 1933, was devastating. The banks—along with everything else—were clobbered by the Depression.

There was also the stock market crash. At the time, the Fed among others blamed the banks for fueling "excessive speculation" in the market through irresponsible lending. "Excessive" however is a call made after the fact. Throughout the Twenties speculation in stocks made sense—prices went ever up and returns were competitive. The market fell because profits and expectations of profits fell. The market crashed because margin buying made the financial system less liquid and more vulnerable. The market debacle itself was just a dramatic preface to a long and sickening economic decline for which the banks bore no responsibility.

But the banks were blamed anyway—especially after Roosevelt declared a Bank Holiday making them visible and convenient targets. The remedy, similar to other New Deal solutions, was to cartelize the banking industry. After all, given the country's recent experience, competition and free markets seemed full of downside risk. Thus, as New York University professor William Silber has observed: What was done was the safe solution, not the optimal one.

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