The Great Depression and Other ‘Contagious’ Events

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Introduction

Concerns about the susceptibility of banks to unwarranted withdrawals of deposits during panics, the possibility of bank failures, and contractions of bank credit resulting from unwarranted withdrawals of deposits (which is sometimes described as the result of ‘contagious’ weakness among banks) and the attendant adverse macroeconomic consequences of bank disappearance or bank balance sheet contraction have motivated much of the public policies toward banks. The global financial crisis of 2007–9 was the most recent illustration of this phenomenon (Calomiris, 2008; Litan, 2012). In reaction to initial bank losses (e.g., on subprime mortgage-related exposures), a scramble for liquidity ensued in which banks reduced their lending and scrambled to shore up their liquidity and reduce their leverage. Interest rate spreads on risky assets skyrocketed, and money market instruments (commercial paper, interbank deposits, and repurchase agreements) contracted sharply, adding to the ‘liquidity crunch’.

Several policies have come into existence to deal with such shocks, including assistance mechanisms intended to protect banks from unwarranted withdrawals of deposits (central bank lending during crises, deposit insurance, and government-sponsored bank bailouts), and a host of prudential regulatory policies (intended to promote banking system stability, and especially to prevent banks from taking advantage of government protection by increasing their riskiness—the so-called ‘moral-hazard’ problem of protection). This chapter reviews the theory and historical evidence related to the prevalence of banking contagion and the effects of the policies designed to mitigate it.

‘Contagion’ vs. fundamentals as causes of bank failures

Theoretical models have been devised in which banking crises result from systemic ‘contagion’, when banks that are intrinsically solvent are subjected to large unwarranted withdrawals, and may fail as a consequence of this withdrawal pressure. Advocates of the view that banking systems are inherently vulnerable to such contagion often emphasize that the structure of banks—the financing of illiquid assets with demandable debts, and the ‘sequential service constraint’ (which mandates that depositors who are first in line receive all of their deposits)—tends to aggravate the tendency for unwarranted withdrawals (see Diamond and Dybvig 1983; Allen and Gale, 2000; and Diamond and Rajan, 2002).

Unwarranted withdrawals (that is, those unrelated to the solvency of the bank) can occur, in theory, for a number of reasons. Diamond and Dybvig (1983) develop a banking model with multiple equilibria, where one of the equilibria is a systemic bank run, which occurs simply because depositors believe that others will run. More generally, observers of historical panics sometimes document depositors imitating each other's withdrawal behavior; depositors may line up to withdraw their funds simply because others are doing so, particularly in light of the incentives implied by the sequential service constraint. It is important to recognize, however, that evidence about mimetic withdrawals does not generally confirm the all-or-nothing runs by all depositors imagined by some theoretical models; rather, mimesis may be partial and gradual (see O’Grada and White, 2003; and Bruner and Carr, 2007).

A second possibility, which is particularly relevant for understanding pre-World War I banking panics in the US (e.g., the nationwide US Panics of 1857, 1873, 1884, 1890, 1893, 1907, and some events during the Great Depression, including the Chicago banking panic of June 1932) is that a signal is received by depositors, which contains noisy information about the health of the various banks. Depositors have reason to believe that a loss has occurred that
might cause a bank to suffer a significant loss or even become insolvent, but they cannot observe which bank has suffered the loss. In that circumstance, depositors may withdraw large amounts of funds from all banks, including those that are (unobservably) financially strong, simply because they would rather not risk leaving their money in a bank that turns out to be weak or insolvent.

For fundamental shocks to precipitate withdrawals they need not lead depositors or other holders of similar short-term “money market” debts (such as commercial paper or repurchase agreements) to believe that insolvency risk has risen substantially. Indeed, one of the key insights of recent models of banking is that depositors may have reason to be risk-intolerant, not just risk-averse – meaning that even a small increase in the risk of default may lead to significant withdrawals (for recent evidence, see Calomiris, Himmelberg and Wachtel, 1995; Gorton and Metrick, 2011). In theory, this can be a consequence either of concerns about changes in behavior by weakened banks (Calomiris and Kahn, 1991; Calomiris, Heider and Hoerova, 2013), or the reduced liquidity of bank deposits when they become risky (Gorton and Pennacchi, 1990; Dang, Gorton and Holmstrom, 2012).

Third, exogenous shocks to depositors' liquidity preferences, or to the supply of reserves in the banking system, unrelated to banks' asset condition, may cause an excess demand for cash on the part of depositors relative to existing reserves, which can lead banks to a scramble for reserves, which can produce systemic runs (a banking version of the game ‘musical chairs’). Liquidity demand and supply shocks may be related to government policies affecting the reserve market, or to foreign exchange risks that lead depositors to want to convert to cash. This mechanism may have had a role in some banking system crises (notably, the nationwide US Panics of 1837 and 1933).

Withdrawal pressures can be associated with warranted concerns traceable to fundamentals or unwarranted withdrawals that result from ‘panic.’ Withdrawal pressures can accumulate over time or can take the extreme form of a sudden ‘bank run’ (when depositors decide en masse to remove deposits). During the Great Depression, deposit withdrawals, bank closures, and even the threat of withdrawal, induced substantial contraction of bank credit as banks disappeared or sought to shore up their liquidity and reduce their fundamental risk to increase their chances of surviving. Such contractions in credit supply can have important macroeconomic consequences, which can amplify business cycle downturns and spread financial distress from banks to the whole economy (Bernanke, 1983; Calomiris and Mason, 2003b; Calomiris and Wilson, 2004; Carlson and Rose, 2011). Part of the reason that bank distress during the Depression caused such a significant decline in bank credit was that many banks were forced to exit the market, not only because their losses were large, but because few banks were healthy enough to acquire those that were failing (Carlson, 2010; Carlson and Rose, 2011). Other episodes of banking panics outside the Great Depression have also been identified as times of severe withdrawal pressure on banks, especially in the US during the nineteenth and early twentieth centuries, although the adverse consequences for bank credit seem to have been less severe.

Differences in opinion about the sources of shocks that cause bank failures can have important implications for policy. While it is true that both concerns about panic and concerns about fundamental loss can motivate public policies to prevent runs, bank closures and credit crunches, the emphasis on panics provides special motives for public policies to protect banks from withdrawal risk. The fundamentalist view, in contrast, sees banks as generally inherently stable—that is, neither victims of unwarranted withdrawals, nor a major source of macroeconomic shocks. According to the fundamentalist view, market discipline of banks is not random, and indeed, helps preserve efficiency in the banking system. It may be desirable to limit or even avoid government protection of banks to preserve market discipline in banking (making banks more vulnerable to the risk of depositor withdrawal). Preserving
market discipline encourages good risk management by banks (Calomiris, Heider and Hoerova, 2013), even though bank deposit and credit contractions attendant to adverse economic shocks to bank borrowers may aggravate business cycles. Indeed, some empirical studies have argued that policies that insulate banks from market discipline tend to produce worse magnifications of downturns, due to excessive bank risk taking in response to protection (e.g., Barth, Caprio, and Levine, 2006).

These two views of the sources of bank distress (the panic view that banks are fragile and highly subject to panic, or, alternatively, the fundamentalist view that banks are stable and generally not subject to unwarranted large-scale withdrawals) do not define the universe of possibilities. One or the other extreme view may do a better job explaining different historical crises, and both fundamentals and unwarranted withdrawals may play a role during some banking crises. The recent empirical literature on banking crises has tried to come to grips with the causes and effects of systemic bank failures in different places and times, to ascertain the dominant causal connections relating banking distress and macroeconomic decline, and to try to draw inferences about the appropriate public policy posture toward banks. The remainder of this chapter selectively reviews the empirical literature on the causes of bank failures during systemic banking crises. This review begins with a lengthy discussion of the Great Depression in the US, which is followed by a discussion of US bank distress prior to the Depression, historical bank distress outside the US, and contemporary banking system distress (which is discussed more fully in Chapter 26 of this volume, by Caprio and Honohan).

**US bank distress during the Great Depression**

The list of fundamental shocks that may have weakened banks during the Great Depression is a long and varied one. It includes declines in the value of bank loan portfolios produced by waves of rising default risk in the wake of regional, sectoral, or national macroeconomic shocks to bank borrowers, as well as monetary-policy-induced declines in the prices of the bonds held by banks. There is no doubt that adverse fundamental shocks relevant to bank solvency were contributors to bank distress; the controversy is over the size of these fundamental shocks—that is, whether banks experiencing distress were truly insolvent or simply illiquid.

Friedman and Schwartz (1963) are the most prominent advocates of the view that many bank failures resulted from unwarranted ‘panic’ and that failing banks were in large measure illiquid rather than insolvent. Friedman and Schwartz's emphasis on contagion imagined that bank failures mainly reflected a problem of illiquidity rather than insolvency. Illiquid but solvent financial institutions, in their view, failed purely as the result of withdrawal demands by depositors, particularly during sudden moments of panic. In contrast, an insolvent institution fails to repay depositors as the result of fundamental losses in asset value, rather than the suddenness of depositor withdrawals.

Friedman and Schwartz attach great importance to the banking crisis of late 1930, which they attribute to a ‘contagion of fear’ that resulted from the failure of a large New York bank, the Bank of US, which they regard as itself a victim of panic. They also identify two other banking crises in 1931—from March to August 1931, and from Britain's departure from the gold standard (21 September 1931) to the end of the year. The fourth and final banking crisis they identify occurred at the end of 1932 and the beginning of 1933, culminating in the nationwide suspension of banks in March 1933. The 1933 crisis and suspension was the beginning of the end of the Depression, but the 1930 and 1931 crises (because they did not result in suspension) were, in Friedman and Schwartz's judgment, important sources of shock to the real economy that turned a recession in 1929 into the Great Depression of 1929–33.
The Friedman and Schwartz argument is based upon the suddenness of banking distress during the panics that they identify, and the absence of collapses in relevant macroeconomic time series prior to those banking crises (see charts 27–30 in Friedman and Schwartz, 1963: 309). But there are reasons to question Friedman and Schwartz's view of the exogenous origins of the banking crises of the Depression. As Temin (1976) and many others have noted, the bank failures during the Depression marked a continuation of the severe banking sector distress that had gripped agricultural regions throughout the 1920s. Of the nearly 15,000 bank disappearances that occurred between 1920 and 1933, roughly half pre-date 1930. And massive numbers of bank failures occurred during the Depression era outside the crisis windows identified by Friedman and Schwartz (notably, in 1932). Wicker (1996:1) estimates that ‘[b]etween 1930 and 1932 of the more than 5,000 banks that closed only 38 percent suspended during the first three banking crisis episodes’. Recent studies of the condition of the Bank of US indicate that it too may have been insolvent, not just illiquid, in December 1930 (Joseph Lucia, 1985; and Wicker, 1996). So there is some prima facie evidence that the banking distress of the Depression era was more than a problem of panic-inspired depositor flight.

How can one attribute bank failures during the Depression mainly to fundamentals when Friedman and Schwartz's time series evidence indicates no prior changes in macroeconomic fundamentals? Friedman and Schwartz omitted important aggregate measures of the state of the economy relevant for bank solvency—for example, measures of commercial distress and construction activity may be useful indicators of fundamental shocks. Second, aggregation of fundamentals masks important sectoral, local, and regional shocks that buffeted banks with particular credit or market risks. The empirical relevance of these factors has been demonstrated in the work of Wicker (1980; 1996) and Calomiris and Mason (1997; 2003a).

Using a narrative approach similar to that of Friedman and Schwartz, but relying on data disaggregated to the level of the Federal Reserve districts and on local newspaper accounts of banking distress, Wicker argues that it is incorrect to identify the banking crisis of 1930 and the first banking crisis of 1931 as national panics comparable to those of the pre-Fed era. According to Wicker, the proper way to understand the process of banking failure during the Depression is to disaggregate, both by region and by bank, because heterogeneity was very important in determining the incidence of bank failures.

Once one disaggregates, Wicker argues, it becomes apparent that at least the first two of the three banking crises of 1930–1 identified by Friedman and Schwartz were largely regional affairs. Wicker (1980; 1996) argues that the failures of November 1930 reflected regional shocks and the specific risk exposures of a small subset of banks, linked to Nashville-based Caldwell and Co., the largest investment bank in the South at the time of its failure. Temin (1989: 50) reaches a similar conclusion. He argues that the ‘panic’ of 1930 was not really a panic, and that the failure of Caldwell and Co. and the Bank of US reflected fundamental weakness in those institutions.

Wicker's analysis of the third banking crisis (beginning in September 1931) also shows that bank suspensions were concentrated in a very few locales, although he regards the nationwide increase in the tendency to convert deposits into cash as evidence of a possible nationwide banking crisis in September and October 1931. Wicker agrees with Friedman and Schwartz that the final banking crisis (of 1933), which resulted in universal suspension of bank operations, was nationwide in scope. The banking crisis that culminated in the bank holidays of February-March 1933 resulted in the suspension of at least some bank operations (bank ‘holidays’) for nearly all banks in the country by 6 March.

From the regionally disaggregated perspective of Wicker's findings, the inability to explain the timing of bank failures using aggregate time series data (which underlay the Friedman-Schwartz view that banking failures were an unwarranted and autonomous source
of shock) would not be surprising even if bank failures were entirely due to fundamental insolvency. Failures of banks were local phenomena in 1930 and 1931, and so may have had little to do with national shocks to income, the price level, interest rates, and asset prices.

The unique industrial organization of the American banking industry historically plays a central role in both the Wicker view of the process of bank failure during the Depression, and in the ability to detect that process empirically. Banks in the US (unlike banks in other countries) did not operate throughout the country. They were smaller, regionally isolated institutions. In the US, therefore, large region-specific shocks might produce a sudden wave of bank failures in specific regions even though no evidence of a shock was visible in aggregate macroeconomic time series (see the cross-country evidence in Bernanke and James, 1991; and Grossman, 1994). The regional isolation of banks in the US, due to prohibitions on nationwide branching or even statewide branching in most states, also makes it possible to identify regional shocks empirically through their observed effects on banks located exclusively in particular regions.

Microeconomic studies of banking distress have provided some useful evidence on the reactions of individual banks to economic distress. White (1984) shows that the failures of banks in 1930 are best explained as a continuation of the agricultural distress of the 1920s, and are traceable to fundamental disturbances in agricultural markets.

Calomiris and Mason (1997) study the Chicago banking panic of June 1932 (a locally isolated phenomenon). They find that the panic resulted in a temporary contraction of deposits that affected both solvent and insolvent banks, and, in that sense, unwarranted deposit contraction did occur. Fundamentals, however, determined which banks survived. Apparently, no solvent banks failed during that panic. Banks that failed during the panic were observably weaker \textit{ex ante}, judging from their balance sheet and income statements, and from the default risk premiums they paid on their debts. Furthermore, the rate of deposit contraction was not identical across banks; deposits declined more in failing weak banks than in surviving banks.

Calomiris and Wilson (2004) study the behavior of New York City banks during the interwar period, and, in particular, analyze the contraction of their lending during the 1930s. They find that banking distress was an informed market response to observable weaknesses in particular banks, traceable to \textit{ex ante} bank characteristics. It resulted in bank balance sheet contraction, but this varied greatly across banks; banks with higher default risk were disciplined more by the market (that is, experienced greater deposit withdrawals), which encouraged them to target a low-risk of default.

Calomiris and Mason (2003a) construct a survival duration model of Fed member banks throughout the country from 1929 to 1933. This model combines aggregate data at the national, state, and county level with bank-specific data on balance sheets and income statements to identify the key contributors to bank failure risk and to gauge the relative importance of fundamentals and panics as explanations of bank failure. Calomiris and Mason find that a fundamentals-based model can explain most of the failure experience of banks in the US prior to 1933. They identify a significant, but small, national panic effect around September of 1931, and some isolated regional effects that may have been panics, but, prior to 1933, banking panics were not very important contributors to bank failures compared to fundamentals.

The fact that a consistent model based on fundamentals can explain the vast majority of US bank failures prior to 1933 has interesting implications. First, it indicates that the influence of banking panics as an independent source of shock to the economy was not important early in the Depression. Only in 1933, at the trough of the Depression, did failure risk become importantly delinked from local, regional, and national economic conditions and from fundamentals relating to individual bank structure and performance. Second, the timing
of this observed rise in risk unrelated to indicators of credit risk is itself interesting. In late 1932 and early 1933, currency risk became increasingly important; depositors had reason to fear that President Roosevelt would leave the gold standard, which gave them a special reason to want to convert their deposits into (high-valued) dollars before devaluation of the dollar (Wigmore, 1987). Currency risk, of course, is also a fundamental.

It is also interesting to connect this account of bank distress during the Depression—which emphasizes fundamental shocks, rather than simply illiquidity, as the source of bank distress—with the history of lender of last resort (LOLR) assistance to banks during the Depression. Many commentators have faulted the Federal Reserve for failing to prevent bank failures with more aggressive discount window lending. While it is certainly true that expansionary monetary policy, particularly in 1929–31, could have made an enormous difference in preventing bank distress (through its effects on macroeconomic fundamentals), that is not the same as saying that more generous terms at the discount window (holding constant the overall monetary policy stance) would have made much of a difference. Discount window lending only helps preserve banks that are suffering from illiquidity, which was not the problem for most banks in the 1930s that were experiencing large depositor withdrawals.

At the same time, recent work on the Depression has shown that under some circumstances, timely liquidity assistance can be useful in preventing crises from becoming more severe. For example, Carlson, Mitchener and Richardson (2011) show that aggressive action by the Federal Reserve Bank of Atlanta to provide liquidity to banks in Florida in 1929 arrested a panic and prevented many banks from failing. Similarly, Richardson and Troost (2009) show that the Atlanta Fed’s relatively aggressive approach to liquidity assistance reduced bank failure rates in the early 1930s.

Nevertheless, the impact of liquidity assistance was limited. In 1932, President Hoover created the Reconstruction Finance Corporation (RFC), to enlarge the potential availability of liquidity, but this additional source of liquidity assistance seems to have made no difference in helping borrowing banks avoid failure (Mason, 2001; Calomiris, Mason, Weidenmier and Bobroff, 2013). Commentators at the time noted that, because the collateralized RFC and Fed loans were senior to deposits, and because depositor withdrawals from weak banks reflected real concerns about bank insolvency, loans from the Fed and the RFC to banks experiencing withdrawals did nothing to help, and actually often did harm to banks, since those senior loans from the Fed and the RFC reduced the amount of high quality assets available to back deposits, which actually increased the riskiness of deposits and created new incentives for deposit withdrawals.

In 1933, however, once the RFC was permitted to purchase preferred stock of financial institutions (which was junior to depositors), RFC assistance to troubled banks was effective in reducing the risk of failure and increasing the supply of lending (Mason, 2001; Calomiris, Mason, Weidenmier and Bobroff, 2013). Finland enjoyed similar success with its use of preferred stock in the early 1990s. Preferred stock injections were not so successful in resolving Japanese bank distress in 1999 and 2000, which reflected the magnitude of the Japanese banks’ problems, problems in the implementation of the program, and the limitations of preferred stock injections for helping resolve problems of deep bank insolvency (Calomiris and Mason, 2004; Calomiris, 2009). Preferred stock injections had limited beneficial effects on large global banks during the 2007–9 crisis, perhaps for similar reasons.

**Microeconomic studies of local contagion**

As part of their bank-level analysis of survival duration during the Depression, Calomiris and Mason (2003a) also consider whether, outside the windows of ‘panics’ identified by Friedman and Schwartz, the occurrence of bank failures in close proximity to a bank affects
the probability of survival of the bank, after taking into account the various fundamental determinants of failure. This measure of ‘contagious failure’ is an upper bound, since in part it measures unobserved cross-sectional heterogeneity common to banks located in the same area, in addition to true contagion. Calomiris and Mason (2003a) find small, but statistically significant, effects associated with this measure. The omission of this variable from the analysis raises forecasted survival duration by an average of 0.2 percent. They also consider other regional dummy variables associated with Wicker's (1996) instances of identified regional panics, and again find effects on bank failure risk that are small in national importance.

O’Grada and White (2003) provide a detailed account of depositor behavior based on individual account data during the 1850s for a single bank, the Emigrant Savings Bank of New York, which offers a unique perspective on depositor contagion during banking panics. In 1854, Emigrant experienced an unwarranted run that can be traced to mimetic behavior among inexperienced, uninformed depositors. This run, however, was easily handled by the bank, which was able to pay off depositors and restore confidence. In contrast, the run in 1857 was an imitative response to the behavior of informed, sophisticated depositors who were running for a reason, and that run resulted in suspension of convertibility. Furthermore, in both of these episodes, mimesis was not sudden: ‘In neither 1854 nor 1857 did depositors respond to a single signal that led them to crowd into banks all at once. Instead, panics lasted a few weeks, building and sometimes ebbing in intensity, and only a fraction of all accounts were closed’ (O’Grada and White, 2003: 215). O’Grada and White show that contagion can be a real contributor to bank distress, but they also show that runs based on random beliefs tend to dissipate with little effect, while runs based on legitimate signals tend to grow in importance over time. The fact that runs are not sudden, and that many depositors do not participate in them at all, is important, since it implies the ability of events to unfold over time; that is, for a form of collective learning among depositors to take place during panics.

A similar account of mimetic withdrawals based on a random rumor can be found in an article by Nicholas in Moody’s Magazine in 1907. A bank in Tarpen Springs, Florida experienced an unwarranted outflow of deposits based on a false rumor that was spread through the local Greek-American community, which included many of the bank's depositors. The bank quickly wired to have cash sent from its correspondent bank, which arrived in time to prevent any suspension of convertibility, and brought the run to an end. Nicholas noted that, if the bank had really been in trouble, not only would the correspondent not have provided the funds, but it and other banks would have probably withdrawn any funds it had on deposit at the bank long before the public was aware of the problem (a so-called ‘silent run’; see the related discussions in Halac and Schmukler, 2004; and Stern and Feldman, 2003).

**US bank distress in the pre-Depression era**

As many scholars have recognized for many years, for structural reasons, US banks were unusually vulnerable to systemic banking crises that saw large numbers of bank failures before the Depression, compared to banks in other countries (for reviews, see Bordo, 1985; Calomiris, 2000; Calomiris and Haber, 2014). Calomiris and Gorton (1991) identify six episodes of particularly severe banking panics in the US between the Civil War and World War I, and prior to the Civil War, there were other nationwide banking crises in 1819, 1837, and 1857. In the 1920s, the US experienced waves of bank failures in agricultural states, which have always been identified with fundamental shocks to banks, rather than national or regional panics. Other countries, including the US’s northern neighbor, Canada, however, did not suffer banking crises during these episodes of systemic US banking system distress. The key difference between the US and other countries historically was the structure of the US
banking system. The US system was mainly based on unit banking—geographically isolated single-office banks; no other country in the world imitated that approach to banking, and no other country experienced the US pattern of periodic banking panics prior to World War I, or the waves of agricultural bank failures that gripped the US in the 1920s.

Canada’s early decision to permit branch banking throughout the country ensured that banks were geographically diversified and thus resilient to large sectoral shocks (like those to agriculture in the 1920s and 1930s), able to compete through the establishment of branches in rural areas (because of low overhead costs of establishing additional branches), and able to coordinate the banking system’s response in moments of confusion to avoid depositor runs (the number of banks was small, and assets were highly concentrated in several nationwide institutions). Coordination among banks facilitated systemic stability by allowing banks to manage incipient panic episodes to prevent widespread bank runs. In Canada, the Bank of Montreal occasionally would coordinate actions by the large Canadian banks to stop crises before the public was even aware of a possible threat.

The US was unable to mimic this behavior on a national or regional scale (Calomiris, 2000; Calomiris and Schweikart, 1991; Calomiris and Haber, 2014). US law prohibited nationwide branching, and most states prohibited or limited within-state branching. US banks, in contrast to banks elsewhere, were numerous (e.g., numbering more than 29,000 in 1920), undiversified, insulated from competition, and geographically isolated from one another, thus were unable to diversify adequately or to coordinate their response to panics (US banks did establish clearing houses in cities, which facilitated local responses to panics beginning in the 1850s, as emphasized by Gorton, 1985).

The structure of US banking explains why the US uniquely suffered banking panics despite the fact that the vast majority of banks were healthy, and were able to avoid ultimate failure. Empirical studies show that the major US banking panics of 1857, 1873, 1884, 1890, 1893, 1896, and 1907 were moments of heightened asymmetric information about bank risk. Banking necessarily entails the delegation of decision-making to bankers, who specialize in screening and monitoring borrowers and making non-transparent investments. Bankers consequently have private information about the attendant risks. During normal times, the risk premium banks pay in capital markets and money markets contains a small ‘opacity’ premium—part of the risk depositors and bank stockholders face and charge for comes from not being able to observe the value of bank assets moment to moment—that is, not being able to mark bank portfolios to market. During the US panics, the normally small opacity premium became very large, as people became aware that risks had increased and as they also were aware of what they didn’t know—namely, the incidence among banks of the probable losses that accompanied the observable increased risk.

Calomiris and Gorton (1991) show that banking panics were uniquely predictable events that happened at business cycle peaks. In the pre-World War I period (1875–1913), every quarter in which the liabilities of failed businesses rose by more than 50 percent (seasonally adjusted) and the stock market fell by more than 8 percent, a panic happened in the following quarter. This happened five times, and the Panic of 1907 was the last of those times. Significant national panics (i.e., events that gave rise to a collective response by the New York Clearing House) never happened otherwise during this period.

Bank failure rates, even during these panic episodes, were small, and the losses to depositors associated with them were also small. In 1893, the panic with the highest failure rate and highest depositor loss rate, depositor losses were less than 0.1 percent of GDP. Expected depositor losses during the panics also appear to have been small. Oliver Sprague (1910: 57–8, 423–4) reports that the discount applied to bankers' cashier checks of New York City banks at the height of the Panic of 1873 did not exceed 3.5 percent and, with the exception of an initial ten-day period, remained below 1 percent, and a similar pattern was
visible in the Panic of 1893. A 1 percent premium would be consistent with depositors in a New York City bank estimating a 10 percent chance of a bank's failing with a 10 percent depositor loss if it failed. Clearly, banking panics during this era were traceable to real shocks, but those shocks had small consequences for bank failures in the aggregate and even at the height of the crisis those consequences were expected to be small. Historical US panics teach us that even a small expected loss can lead depositors to demand their funds, so that they can sit on the sidelines until the incidence of loss within the banking system has been revealed (usually a process that took a matter of weeks).

Bank failure rates in the 1830s and the 1920s were much higher than those of the other pre-Depression systemic US banking crisis episodes. The 1830s saw a major macroeconomic contraction that caused many banks to fail, which historians trace to large fundamental problems that had their sources in government-induced shocks to the money supply (Rousseau, 2002), unprofitable bank-financed infrastructure investments that went sour (Schweikart, 1988), and international balance of payments shocks (Temin, 1969). The 1920s agricultural bank failures were also closely linked to fundamental problems—in this case, the collapses of agricultural prices at the end of World War I, which were manifested in local bank failures in the absence of regional or national bank portfolio diversification (Calomiris, 1992; and Alston, Grove, and Wheelock, 1994).

Other historical experiences with bank failures

Although the US was unique in its propensity for panics, it was not the only economy to experience occasional waves of bank failures historically. Losses (i.e., the negative net worth of failed banks), however, were generally modest and bank failure rates were much lower outside the US. The most severe cases of banking distress during this era, Argentina in 1890 and Australia in 1893, were the exceptional cases; they suffered banking system losses of roughly 10 percent of GDP in the wake of real estate market collapses in those countries. Only three other countries experienced severe insolvency crises during the pre-World War I period: Brazil in 1892, Italy in 1893, and Norway in 1900.

Loss rates tended to be low because banks structured themselves to limit their risk of loss by maintaining adequate equity-to-assets ratios, sufficiently low asset risk, and adequate liquidity. Market discipline (the potential for depositors fearful of bank default to withdraw their funds) provided incentives for banks to behave prudently (Calomiris and Kahn, 1991; Calomiris, Heider and Hoerova, 2013). The picture of small depositors lining up around the block to withdraw funds has received much attention by journalists and banking theorists, but perhaps the more important source of market discipline was the threat of an informed ('silent') run by large depositors (often other banks). Banks maintained relationships with each other through interbank deposits and the clearing of deposits, notes, and bankers' bills. Banks often belonged to clearing houses that set regulations and monitored members' behavior. A bank that lost the trust of its fellow bankers could not long survive.

Bank failures in the late twentieth century

Recent research on systemic bank failures has emphasized the destabilizing effects of bank safety nets. This has been informed by the experience of the US Savings and Loan industry debacle of the 1980s, the banking collapses in Japan and Scandinavia during the 1990s, and similar banking system debacles occurring in 140 developing countries in the last two decades of the twentieth century, all of which experienced banking system losses in excess of 1 percent of GDP, and more than twenty of which experienced losses in excess of 10 percent of GDP (data are from Caprio and Klingebiel, 1996, updated by Laeven and Valencia, 2012).
Empirical studies of these unprecedented losses concluded that deposit insurance and other policies that protect banks from market discipline, intended as a cure for instability, have instead become the single greatest source of banking instability. The theory behind the problem of destabilizing protection has been well known for over a century, and was the basis for Franklin Roosevelt's opposition to deposit insurance in 1933 (an opposition shared by many). Ironically, federal deposit insurance is one of the major legacies of the Roosevelt presidency, despite the fact that President Roosevelt, the Federal Reserve, the Treasury, and Senator Carter Glass—the primary authorities on banking policy of the time—all were opposed to it on principle. Deposit insurance was seen by them and others as undesirable special-interest legislation designed to benefit small banks. They acquiesced in its passage for practical reasons—to get other legislation passed—not because they wanted deposit insurance to pass per se. Numerous attempts, dating from the 1880s, to introduce federal deposit insurance legislation failed to attract support in the Congress (Calomiris and White, 1994). Opponents understood the theoretical arguments against deposit insurance espoused today—that deposit insurance removes depositors' incentives to monitor and discipline banks, and frees bankers to take imprudent risks (especially when they have little or no remaining equity at stake, and see an advantage in 'resurrection risk taking'); and that the absence of discipline also promotes banker incompetence, which leads to unwitting risk taking.

Research on the banking collapses of the last two decades of the twentieth century have produced new empirical findings indicating that the greater the protection offered by a country's bank safety net, the greater the risk of a banking collapse (see, e.g., Caprio and Klingebiel, 1996; Demirgüç-Kunt and Detragiache, 2002; Barth, Caprio, and Levine, 2006; Demirgüç-Kunt, Kane and Laeven, 2008). Empirical research on prudential bank regulation similarly emphasizes the importance of subjecting some bank liabilities to the risk of loss to promote discipline and limit risk taking (Shadow Financial Regulatory Committee 2000; Mishkin, 2001; Barth, Caprio and Levine, 2006).

Studies of historical deposit insurance reinforce these conclusions (Calomiris, 1990). Opposition to deposit insurance in the 1930s reflected the disastrous experience with insurance in several US states in the early twentieth century, which resulted in banking collapses in all the states that adopted insurance. Government protection of banks played a similarly destabilizing role in Argentina in the 1880s (leading to the 1890 collapse) and in Italy (leading to its 1893 crisis). In retrospect, the successful period of US deposit insurance, from 1933 through the 1960s, was an aberration, reflecting limited insurance during those years (insurance limits were subsequently increased), and the unusual macroeconomic stability of the era.

Conclusion

Banking failures, in theory, can be a consequence either of fundamental, exogenous shocks to banks, or, alternatively, unwarranted withdrawals by depositors associated with contagions of fear, or panics. Interestingly, although many economists associate contagions of fear with the banking distress of the Great Depression, empirical research indicates that panics played a small role in Depression-era distress, which was mainly confined to regional episodes (e.g., June 1932 in Chicago) or to the banking collapse of 1933.

More importantly, empirical research on banking distress clearly shows that panics are neither random events nor inherent to the function of banks or the structure of bank balance sheets. Panics in the US were generally not associated with massive bank failures, but rather were times of temporary confusion about the incidence of shocks within the banking system. This asymmetric-information problem was particularly severe in the US. For the late nineteenth and early twentieth centuries, system-wide banking panics like those that the US experienced in that period did not occur elsewhere. The uniquely panic-ridden experience of the US, particularly during the pre-World War I era, reflected the unit banking structure of
the US system. Panics were generally avoided by other countries in the pre-World War I era because their banking systems were composed of a much smaller number of banks operated on a national basis, who consequently enjoyed greater portfolio diversification \textit{ex ante}, and a greater ability to coordinate their actions to stem panics \textit{ex post}. The US also experienced waves of bank failures unrelated to panics (most notably in the 1920s), which reflected the vulnerability to sector-specific-shocks (e.g., agricultural price declines) in an undiversified banking system.

More recent banking system experience worldwide indicates unprecedented costs of banking system distress—an unprecedented high frequency of banking crises, many bank failures, and large losses by failing banks, sometimes with disastrous costs to taxpayers who end up footing the bill of bank loss. This new phenomenon has been traced empirically to the expanded role of the government safety net. Government protection removes the effect of market discipline. It thereby encourages excessive risk taking by banks, and also creates greater tolerance for incompetent risk management (as distinct from purposeful increases in risk). Ironically, the government safety net, which was designed to forestall the (overestimated) risks of contagion, seems to have become the primary source of systemic instability in banking.

\textbf{References}


