The Transmission of the Financial Crisis in 1907: An Empirical Investigation

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Comment by Mary O'Sullivan

What the paper does

- Draws a comparison between the Panic of 1907 and the contemporary financial crisis
- Investigates how the Panic of 1907 was transmitted from a local shock (run on Knickerbocker Trust) throughout the US (and international) financial system to become a "systemic event"
- Uses new evidence -- daily observations of clearing house loan certificate issues – as well as other complementary data (e.g. daily call loan interest rates) to understand transmission of crisis

What the paper claims

- Confirms the conventional view that the Panic of 1907 was sparked by the suspension of KT
- Transmission of crisis to rest of financial system in New York, then to rest of country, exacerbated by the decision of the New York Clearing House to impose a suspension of convertibility of deposits into currency (October 26)

Why the paper is interesting

- Inspired by contemporary analyses of transmission of sub-prime crisis (Gorton and Metrick, 2009)
- To understand a crisis we still do not properly understand (Panic of 1907)
- From scholars who know more than they can tell

How the paper might be better

- The comparison between the Panic of 1907 and the financial crisis of 2008
- The analysis of mechanisms for the transmission of the Panic of 1907
- The historical context of the Panic of 1907

Comparison between Past & Present

- Their basic observation that trusts then were like investment banks now, in terms of their relationship to "lenders of last resort", seemed interesting
- But the analogies they draw between specific events did not seem intuitive
  - Action of Fed – JPMorganChase - Bear Stearns analogous to Action of New York Clearing House (NYCH) & Mercantile Bank
  - Inaction of Fed re Lehman Bros like Inaction of NYCH re Knickerbocker Trust
- A better comparison might be
  - Action of Fed re Bear Stearns v. Inaction of NYCH/ J.P. Morgan, etc re Knickerbocker Trust
  - Inaction re Lehman Bros v. Action of Morgan, etc re Trust Co of America
- That would suggest that the response to the Panic of 1907 was exactly the opposite of today (hesitation, then action, versus action, then hesitation)

Comparison between Past & Present

- But the appropriate comparison should only be drawn based on a more comprehensive account of what happened in the Panic of 1907
- And there are some important holes in the authors' account right now
  - Too much focus on the New York Clearing House
  - To the exclusion of
    - Knickerbocker Trust and Morgan et al.
    - Trust Company of America & Morgan et al.'s salvage plan
    - Cortelyou and money injection into banks
    - etc
- As well as a lack of clarity as to what we learn (or might hope to) from comparison between past and present

Transmission of the Panic of 1907

- Authors consider the transmission by analysing how different segments of the financial system were linked together through functional relationships (lending and borrowing)

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- How about the alternative hypothesis?

Sheer, bloody panic!

"Six banks and trust companies in Brooklyn, including the oldest financial institution in the borough... suspended all payments on October 25. Three banks in Harlem closed their doors as well. All were declared solvent by the state superintendent of banks but closed because they did not have sufficient cash to meet depositor demands (Silber, 2007, p. 49)".

Sheer, bloody panic!

"The architecture of the Knickerbocker's new building on Fifth Avenue, completed in 1906, justly reflected its prominence. The company also maintained a large office downtown near Wall Street and two remote branches in the Bronx and Harlem – at this time branches were an innovation among the trust companies" (Bruner & Carr, 2007, p. 68)

Sheer, bloody panic!

"The unsettled condition of public feeling is illustrated by the fact that at the Dollar Savings Bank at the Bronx a crowd of Italian depositors arrived to withdraw their deposits, alarmed by yesterday's run on the adjoining branch of the Knickerbocker Trust Company, with which the Dollar Savings Bank had no connexion. So threatening did the demeanour of the excited Italians become that the police had to be called in to prevent the doors of the bank being stormed"

The Times (of London), October 24, 1907

Stages of the Panic of 1907

1. Why was there a run on the Knickerbocker Trust?
2. Why did it lead to runs on other trusts in New York?
3. How was the run on trusts transmitted to the call loan market (and the securities market)?
4. How did the panic spread to the New York banks?
5. And beyond New York, especially to the interior banks in the United States
6. And, ultimately, to the international financial system?

Stages of the Panic of 1907

1. Why was there a run on the Knickerbocker Trust?
   – Still considerable uncertainty about this question
   – Authors review the evidence that exists
   – Connection between Heinze/Morse and KT by way of Charles Barney well known but authors highlight fact that evidence of any substantive relationship remains elusive
   – However, this is least important part of the puzzle

Stages of the Panic of 1907

2. Why did it lead to runs on other trusts in New York?
   - Authors seem to indicate that transmission stemmed from decision of New York Clearing House not to cover KT (via National Bank of Commerce)
   - But was this really news? High-profile disagreement between NYCH and trusts as recently as 1903 & 1904 – wasn't it widely known that trusts did not have direct access to clearing house privileges and why that was so
   - Authors say little about the fact that Morgan et al also decided not to support KT
   - The newspapers on Oct 22 announced something different, the lack of banker support for KT became clear as day unfolded

Stages of the Panic of 1907

2. Why did it lead to runs on other trusts in New York?
   - What did Morgan's decision reveal about KT?
   - Why did the run begin Trust Company of America?
   - Why did Morgan et al decide to back the Trust Company of America?
   - And why did the public not believe that even when the announcement was made?

Morgan & Knickerbocker

- Morgan "was a stockholder in the Knickerbocker himself, some of his own firm's money was on deposit in it, and he had a sentimental attachment for it because it had been founded by an old school friend of his (Allen, 1948, p. 246)"
- Other connections to Knickerbocker via Barney as well as National Bank of Commerce and ...(Strouse, 2000, p. 575) – good reasons for people to think Morgan might back Knickerbocker
- But on October 21 Morgan "doubted that it could be saved. And anyhow he had too little precise information about its condition to offer help (Allen, 1948, p. 246, Strouse, 2000, p. 577)."
- On Oct 22 "Benjamin Strong, one of Morgan's team of examiners, had been making a quick examination of the Knickerbocker's condition, and his report, while incomplete was unfavourable. There was nothing to be done (Allen, 1948, p. 246; Strouse, 2000, p. 577)"

Frederick Lewis Allen, The Great Pierpont Morgan, 1948, p. 246

Stages of the Panic of 1907

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Stages of the Panic of 1907

3. How was the run on trusts transmitted to the call loan market?
   - Authors emphasise rapidity and extent of effects on call loan interest rates
   - Suggest transmission mechanisms
     - Trusts as lenders in the call loan market?
     - Trusts as depositors in the NY banks who lent on the call loan market?
   - But speculative right now with little direct evidence (although...)

Stages of the Panic of 1907

4. How did the panic spread to the New York banks?
   - Could be more explicit discussion of extent of problem (Chart 1, 4)
   - And, especially, timing of withdrawals (only weekly data right now in Chart 4)
   - Authors' speculate that trusts contributed to NY banks' problems by withdrawing their deposits ($30m?) – more evidence and Cortelyou's deposits as counter-balance?
   - And where's the evidence for the authors' BIG claim – NYCH's suspension of convertibility turned a local panic into a national panic
     - Consistent outflow of deposits from NY banks after decision on Oct 26 (Oct 25-Nov 1)? Yes, but lots of other possible causes (note that depositors kept withdrawing money from Trust Co of America until November 7)
     - And what do the new data buy us in terms of new insights? Negative correlation between clearing house certs and reserve deficit (isn't this almost mechanical?)

Stages of the Panic of 1907

5. How did the panic spread beyond New York, especially to the interior banks in the United States?
   - As authors recognise, "the demands of interior banks (or country) banks for cash from New York City banks were largely responsible for the depletion of cash balances among New York Clearing House banks in 1907 (p. 12)"
   - They provide some discussion of why interior banks might be concerned about getting their money out of NY banks (in light of previous panics)
   - But they never address the question of why interior banks became so concerned so early about the implications for them of the suspension of Knickerbocker Trust
   - This is a crucial part of the puzzle since as authors note, interior banks were not depositors in trust companies

Stages of the Panic of 1907

6. And, ultimately, to the international financial system?
   - Authors' emphasis not just on currency premium as incentive for gold inflows but clearing house certificates as means to finance them
   - The link between gold inflows and foreigners' demand for American securities is a promising one that I'd like to see them develop
   - Especially since doing that might also lead them back before October 1907 to look at gold outflows from May to September

How the paper might be better

- The comparison between the Panic of 1907 and the financial crisis of 2008
- The analysis of different stages of the Panic of 1907
- The historical context of the Panic of 1907
  - "The initial decline of about 2½ percent [in the money stock] from May to September 1907 reflected in part a decline in high powered money by about 1 percent, largely the result of the gold exports" (Friedman & Schwartz, 1963, p. 158)... exacerbating the panic when it happened