



Central Banking *and the Incidence of* Financial Crises

By Richard Sylla

THE CENTENNIAL ANNIVERSARY in 2013–2014 of the founding of the Federal Reserve System, America’s central bank, is a fitting occasion to consider the question: Why do we have a central bank? To many people, the answer is far from obvious. Here I want to discuss in particular one good reason why we have a central bank, namely that our history as a nation shows that central banks reduce the incidence of financial crises.

The Fed and Its Critics in the Recent Crisis

During the financial crisis of 2007–2008, the Fed acted dramatically to prevent a financial meltdown. It made currency swaps with other countries’ central banks to alleviate dollar shortages overseas. It made loans, often termed “bailouts,” to US and foreign financial institutions to prevent them in one way or another from failing. It more than doubled the size of its balance sheet in 2008–2009 by purchasing government and mortgage-backed securities with the intent of providing ample liquidity and keeping interest rates low to promote recovery from the economic recession triggered by the financial crisis.

In the aftermath of the crisis, the Fed again has nearly doubled the size of its balance sheet through further securities purchases, termed “quantitative easing.” Despite these actions, the recovery from the crisis has been protracted and rather anemic. So the Fed announced in September, to Wall Street’s and others’ surprise, that it intended to keep on pursuing its low interest policies as long as unemployment remained too high and inflation showed no signs of rearing its ugly head.

The Fed’s unprecedented actions have produced a backlash. Its critics charge the central bank with creating the financial crisis by keeping interest rates too low from 2001 to 2006, thereby underwriting the housing bubble that collapsed in 2007 and 2008. In recent years, possibly

with some inconsistency, the critics have claimed that the central bank has too much power and that its quantitative easing policies have proven ineffective. Congress responded to the first charge by reining in some of the Fed’s powers in the Dodd-Frank Act of 2010. But that did not go far enough to please a vociferous critic of the Fed such as former congressman Ron Paul, who in 2009 published a book entitled *End the Fed*, a not-so-thinly-veiled policy recommendation.

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If the Fed’s actions during the recent crisis were unprecedented, Ron Paul’s recommendation to get rid of it was not. Early in US history, Americans got rid of not one, but two central banks. So our country has some experience in ending central banks. It also has even more experience in creating new central banks. We have created three, and ended only two.

Congress chartered our first central bank, the Bank of the United States, in 1791 on the recommendation of the first Secretary of the Treasury, Alexander Hamilton. A decade earlier, while he was serving as an officer in the Continental Army, Hamilton had already (at age 24) made himself an expert on modern finance in a new nation whose financial arrangements were decidedly pre-modern. In 1781, during what turned out to be the late stages of the War of Independence, Hamilton wrote a long letter to Robert Morris. Morris had just been appointed by Congress to clean up the financial mess created by over-issuing paper Continental currency to the point that it became worthless. That problem had virtually destroyed the credit of the United States with foreign supporters of the American cause and with its own citizens.

Hamilton’s solution, based on European precedents, was to create a national or central bank—one he already had termed the “Bank of the United States”—that would create a sound currency, attract foreign loans, lend money to Congress to finance the war effort and stimulate the growth of the American economy. He told Morris:

The tendency of a national bank is to increase public and private credit. The former gives power to the state

for the protection of its rights and interests, and the latter facilitates and extends the operations of commerce among individuals. Industry is increased, commodities are multiplied, agriculture and manufactures flourish, and herein consist the true wealth and prosperity of a state. Most commercial nations have found it necessary to institute banks, and they have proved to be the happiest engines ever invented for advancing trade. Venice, Genoa, Hamburg, Holland and England are examples of their utility.

Remarkably, Hamilton had not been to Europe (and never would), and when he wrote Morris neither the colonies nor the new nation had ever had a modern bank of any kind. Shortly after Hamilton’s letter, Morris would recommend that Congress create the country’s first modern bank, the Bank of North America. It opened at the beginning of 1782.

Ten years later, Hamilton persuaded Congress to charter, and President Washington to approve, his far larger Bank of the United States (BUS). The BUS, along with a restructured national debt and the specie-based dollar, became a component of the new nation’s financial architecture. Owned 20% by the United States, the BUS lent to the government and to the private economy, established a branch network throughout the nation giving the country nationwide banking facilities and acted to regulate the expansion of credit by state-chartered banks. Economically, by all accounts, the BUS was a great success.

Politically, it was a different matter. Those who opposed its creation in 1791 continued to regard it as unconstitutional. Two decades later, when the BUS’s 20-year charter came up for renewal, they were joined in the opposition by state legislative and banking interests. If these interests could get rid of the central bank, they would get rid of a competitor and a regulator, and they would likely get the US government’s banking business. It was a win, win, win proposition. Despite the support of President Madison, who had opposed the BUS as a congressman in 1791, and also that of Treasury Secretary Gallatin, the BUS lost its bid for re-chartering by one vote in the Senate.

Illustration titled “Run on the Union Trust Company,” from the October 11, 1837 issue of *Harper’s Weekly*.

That was in 1811. A year later came the War of 1812 with Great Britain, and without a central bank the Treasury encountered a host of problems in financing the war. Chastened, when the war was over Congress chartered a second Bank of the United States in 1816, an enlarged version of the first BUS. Like its predecessor, the second BUS was an effective central bank for most of the period of its 20-year charter. It stabilized domestic and foreign exchange rates, managed a rapid downsizing of the US national debt, established an even larger nationwide branch network than that of the first BUS, and presided over a happy period of marked, non-inflationary economic growth.

But such achievements were not sufficient to placate the second BUS's political foes, who resurrected the very same coalition of principle (a strict construction of constitutionality) and interest (state banks had much to gain from ridding themselves of a competitor and regulator) that had been raised in 1811 debates on re-chartering the first BUS. The political opposition to the second BUS had a powerful champion in the popular President, Democrat Andrew Jackson, who said he had long-standing suspicions about banks and banking in general since he had read about the 1720 South Sea Bubble crisis in England.

Jackson's Whig Party opposition attempted to embarrass him before he came up for re-election in 1832 by pushing through Congress a bill to give the BUS an early renewal of its federal charter, which would not expire until 1836. The bill passed both the House and the Senate with comfortable majorities, but the strategy backfired when Jackson vetoed it in the summer of 1832. His veto failed to be over-ridden by the supermajorities required, and when Jackson won re-election that fall he felt he had a mandate to begin scuttling the second BUS well before its charter expired in 1836. Thus came to an end America's second central bank.

Enter the Fed

From 1836, when the second BUS charter expired, to 1914 when the third BUS, the



The three central banks in the nation's history (top to bottom): The Bank of the US, the Second Bank of the US and the Federal Reserve.

Fed, opened for business, the United States was without a central bank. Attempts early in this eight-decade period to charter a new one failed. Congress, in 1846, enacted a so-called "Independent Treasury System" in which the government would keep its funds apart from the country's banking system. But over time the Treasury adopted the practice of moving its funds into banks during financial stringencies, so the Independent Treasury became something of a substitute for a central bank. Bank clearinghouses were another such partial substitute; by issuing clearinghouse loan certificates to their members during stringencies, bank reserves could be extended to meet the public's demands for cash. Finally, after Congress created the National Banking System during the Civil War, its pyramided reserve system concentrated reserves in

New York City national banks, which in that sense served as the central reserves of the expanding US banking system.

The financial panic of 1907, a major embarrassment because the United States by then had become the world's leading and most dynamic economy, revealed that none of the substitutes for a central bank, or even all of them together, could prevent or do much to alleviate such panics. In the panic's wake, Congress studied the world's financial systems and determined to create a new central bank, the Federal Reserve. President Woodrow Wilson signed the bill late in 1913, and the Reserve Banks and System came on stream a year later.

Are Central Banks a Bad Idea?

Economists, like other social scientists, find it difficult, if not impossible, to replicate the controlled laboratory experiments that foster so much progress in the natural sciences. But history can help, for it demonstrates a variety of experiences. In the case at hand, we have a country, the United States, which had three periods of central banking in its history, and a couple of periods without a central bank.

One of the main arguments given by proponents of central banking is that a central bank can prevent financial crises from occurring, as well as alleviate the negative economic effects of such crises if they do occur. To test that hypothesis as a natural scientist might do in a laboratory experiment, the main requisite would be evidence on the incidence of financial crises from the laboratory of history.

The accompanying table of US financial crises from 1792 to 2007-08 provides such evidence. It lists 15 financial crises over the course of US history taken from the accounts of several reputable historical sources. A good scientist tries to be careful to include evidence that works against the hypothesis he suspects has validity. Since I suspect that central banks do indeed prevent or alleviate the incidence of financial crises, I chose the sources for the table in part because they identify crises in the central-banking periods of US history that are not widely considered to be

US Financial Crises, 1789–2013

Year(s)	Related to:
1792	Speculation in new US debt
1814	British invasion and bank suspensions
1819	Postwar economic adjustments
1837–39	Speculation in public lands, problems with state debts
1857	Public lands, railroads
1873	Railroads
1884*	Brokerage house failures
1890*	Fallout from Baring crisis in Britain
1893	Run on Treasury gold reserves
1907	Trust company failures
1929–33	Stock crash and bank failures
1973–75	OPEC and currency crises
1979–82	Double-digit inflation, LDC debts, OPEC, real estate and farmland
1982–87	Real estate, stock crash, S&L problems
2007–08	Subprime real estate loans and securitization

Source: Charles P. Kindleberger and Robert Z. Aliber, *Manias, Panics, and Crashes* (6th ed., 2011), Appendix A, with additional US crises not noted by Kindleberger, but noted by O.M.W. Sprague, *History of Crises under the National Banking System* (1910) and Elmus Wicker, *Banking Panics of the Gilded Age* (2000) designated by *.

major crises. Thus, during the Fed era the table lists crises as occurring in 1973–75, 1979–82 and 1982–87, even though those years are not usually regarded as periods when bank failures and/or stock market crashes did substantial damage to the US economy. In fact, during and after the recent 2007–08 crisis, it was sometimes remarked that the crisis was shocking in part because the United States had not experienced a comparable financial crisis since the Great Depression of the 1930s. Such views would exclude the three crises I have included.

How should we analyze and interpret the evidence from history? A simple first pass at this is revealing. From the first financial crisis in 1792 to the present is a period of 222 years. For 140 of those years, the country had a central bank: the first BUS in the 20 years from 1792 to 1811; the second BUS in the 20 years from 1817 to 1836; and the Fed for the most recent 100 years, 1914–2013. During the 140 years of central banking there were seven crises, or one in every 20 years on average.

The periods of US history without a central bank were 1812–16 (five years) and 1837–1913 (77 years), for a total of 82 years. During those 82 years there were eight financial crises, or one crisis every 10.25 years on average.

Thus a lesson of US history is that financial crises were roughly twice as frequent when the country did not have a central bank as they were when it did. If we were to exclude the three crises of the 1970s and 1980s that are not widely regarded as particularly damaging—perhaps because there was a central bank to counteract them—then the results would be even more lopsided. The central banking eras would then have had five crises in 140 years, or one every 28 years on average, instead of one every 10-plus years without a central bank.

Is the US experience exceptional? For the United Kingdom, the Kindleberger-Aliber source cited in the table identifies 16 financial crises from 1793 to 2008, rather similar to the US experience. A potential complication is that the UK's central bank, the Bank of England, was present for that

entire period, so it would seem one is not able to compare periods with and without a central bank, as we can for the United States. But Forrest Capie, the official historian of the Bank of England, and other British financial historians argue that the Bank of England did not assume central banking responsibilities until the 1860s, just before a major crisis in 1866.

Accepting that argument, the UK experienced nine crises in the 73 years from 1793 to 1865, or one every eight years. From 1866 to 2013, the UK had seven crises in 148 years, or a crisis on average once every 21 years. Thus the UK's overall

experience was similar, with differences in timing, to that of the United States. Financial crises were more frequent without than with a central bank.

As we observe the centenary of the Federal Reserve System, we would do well to remember that one of the main theoretical arguments for a central bank has always been that by acting as a lender of last resort to other banks and financial institutions, such a bank can both prevent crises and alleviate their economic damage if they do occur. More than two centuries of experience with and without central bank on both sides of the Atlantic provides substantial empirical support for that argument. **\$**

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