Financial Crises

Understanding the Postwar U.S. Experience

Second Edition

M.H. Wolfson

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Martin H. Wolfson

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To my parents
Eli and Emma Wolfson

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Preface to the Second Edition

The period since 1986, when the first edition of this book was published, has been a turbulent time for the financial system. Stock markets crashed around the world; the junk-bond and commercial real estate markets collapsed; large commercial banks failed in record numbers; savings and loan associations were rescued in a massive government bailout; foreign-exchange speculation severely disrupted plans for a single European currency. So with this revised edition, I welcome the opportunity to bring the story of financial crises in the United States up to date.

A new chapter (chapter 10) has been written that recounts in detail the recent crises. The figures and tables from the first edition have been completely revised and updated through the third quarter of 1993, and more than a dozen new ones have been added to this new edition. The chapter on evaluating the business-cycle model (chapter 12) has been thoroughly revised to take account of the new data.

However, it is not sufficient to simply recount the events since 1986. The objective of the book always has been to put economic events into a framework of understanding, to provide a theoretical overview for seemingly disparate phenomena. The framework for the first edition was the business cycle: the theory attempted to demonstrate why developments over the course of the business-cycle expansion made financial crises likely at the cycle's peak. This framework, I would contend, is still useful and important; but the events since 1986 have clearly pointed to the need for an explanation for financial crises that do not occur at the business-cycle peak. Accordingly, two new chapters (chapters 13 and 14) explore noncyclical theories of financial crises and develop significantly the analysis of institutional change only hinted at in the first edition.

The first edition closed with the suggestion that perhaps 1982 was a transition point between two different financial structures. The current edition attempts to give some substance to that suggestion by tracing the changes in the financial structure since the 1930s, in particular those affecting commercial banks and thrift institutions. Hopefully the result is greater clarity on why the financial landscape since 1986 has been so especially turbulent.

In preparing the revised edition I have had the help of a number of people. For help in the formulation of my ideas, I would like to thank Ray Boddy, Jim Campen, John Caskey, Jim Crotty, Jane D'Arista, Gary Dymski, Steve Fazzari, Don Goldstein, Teresa Ghilarducci, David Gordon, Dorene Isenberg, Marc Jarsulic, David Kotz, Arthur MacEwan, Michele Naples, Bob Pollin, Tom Schlesinger, Howard Sherman, Tom Weisskopf, and Chuck Wilber. (Of course, none of these people are responsible for any errors.) A special word of thanks goes to Doug Carpenter for his help in updating the data. The excellent research assistance of Bill Barnes, Jose Cordero, Heather Grob, Jeff Henke, Muhammad Iqbal, Reynold Nesiba, Shankar Raman, and Brad Smith is much appreciated.

I would also like to thank my colleagues at the Federal Reserve Board and the University of Notre Dame (both faculty and students), from whom I have learned much about the financial system and about economics. My editor at M.E. Sharpe, Dick Bartel, first proposed the idea of a second edition, and has consistently supported my efforts. Finally, I would like to thank my wife, Linda, whose shared commitment to a better world has continually encouraged and informed my efforts to understand (so as to change for the better) the financial system; and my children, Sara and David. It is they, and the children of their generation, who hopefully will inherit that better world.

FINANCIAL CRISES

1

Introduction

In the nineteenth and early twentieth centuries, financial crises occurred regularly in the United States, with particularly severe episodes in 1873 and 1893. Closer to the present time were the Panic of 1907 and the banking crises that took place during the Great Depression of the 1930s. In that latter case, faith in the banking system had fallen to such a low level that a national Banking Holiday that closed all banks was declared on March 6, 1933.

The severe financial and economic trauma of the Great Depression led to major reforms in the structure of the economy, including important institutional changes in banking and finance. The hope at the time was that these reforms would put an end to the dislocations resulting from financial crises.

For a while after the Great Depression and the Second World War, it appeared that these hopes might be realized. For twenty years after the end of World War II, although certain sectors of the economy suffered financial strains from time to time, events in the financial markets did not resemble those that took place during the financial crises of an earlier era.

During the period immediately following World War II, when financial crises seemed to have disappeared forever from the economic scene, mention of them also disappeared from the economics literature. Nearly an entire generation of economists was trained without ever studying the origins and causes of financial crises. If the prevailing wisdom were true, though, such neglect made sense: why study a phenomenon that no longer existed?

Thus the "credit crunch" of 1966 came as quite a shock. For a period of time during the summer of 1966, the market for municipal securities was "disorganized" by the liquidation of bonds from commercial bank portfolios, and thrift institutions came under strong financial pressure. Events seemed to be developing in the same way as they had during past financial crises.

As it turned out, the crisis was resolved before it caused significant damage to the economy. Though the 1966 crisis was much less intense than the Panic of 1907 or other similar crises, it was nonetheless a shock to observers who had thought financial crises were a thing of the past.

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The credit crunch of 1966 was followed by another crisis in 1970. Then the surprise bankruptcy of the Penn Central company threatened the commercial paper market and led to a "flight to quality" (i.e., a preference for safe investments). Corporations that had relied upon commercial paper borrowing scrambled desperately for alternative sources of funds. As in 1966, prompt action by the Federal Reserve Board in its capacity as lender of last resort, and appropriate monetary and fiscal policies, prevented the crisis from developing into a full-scale panic. The downturn in economic activity was relatively mild, but of greater intensity than the growth recession of 1966.

In 1974 an even more serious financial crisis took place when the troubles of the Franklin National Bank, the twentieth-largest bank in the United States, were announced in May. This time the crisis had international implications. Franklin had borrowed heavily in the Eurodollar interbank market and had engaged in substantial foreign-exchange speculation. Both of these markets were threatened by Franklin's difficulties. In addition, the market for bank certificates of deposit in the United States came under increased pressure.

Again, government action prevented the situation from escalating rapidly. At the time, however, it became quite clear that the economy of the United States was susceptible to financial crises.

Silver speculation by the billionaire Hunt brothers again threatened to set off a serious financial crisis in 1980. When the price of silver began to fall in January 1980, the Hunts borrowed on a massive scale—an incredible total of nearly $1 billion—from commercial banks in order to cover their losses. Potential default on this mountain of debt put the banking system under considerable pressure.

A financial crisis occurred again in 1982. Because of the degree of interconnection among the nation's banks, the failure of two relatively small financial institutions—Drysdale Government Securities, Incorporated, and Penn Square National Bank—affected other, bigger institutions and created a crisis of confidence in the banking system as a whole.

In addition, conditions in 1982 pushed two other problems towards crisis proportions: the financial troubles of savings and loan associations and the debt burden of less-developed countries. In September 1982, fear of Mexico's default on its obligations to commercial banks aggravated the banks' problems, set off a capital flight, and required lender-of-last-resort operations on an international scale to manage the crisis.

The problems of financial intermediaries continued past 1982. Weakened significantly by the legacy of bad loans they had purchased from Penn Square, both Continental Illinois and Seattle First National Banks were hit by a run on deposits by large investors. Only an unprecedented government bailout in the summer of 1984 prevented the difficulties at Continental from spreading throughout the banking and financial systems.

The thrift industry also continued to be under financial pressure. During the summer of 1984, a run developed on the deposits of the American Savings and

Loan Association, at the time the largest thrift in the United States. In March 1985, the failure of ESM Government Securities, Inc., a small securities dealer in Florida, resulted in the closing of Home State Bank in Ohio. Home State's deposits were insured by a state-backed fund, rather than the federal government. The demise of Home State threatened the solvency of the fund, led to a run on the deposits of all seventy-one state-insured thrifts in Ohio, and eventually led to their closing by the governor of Ohio. A similar crisis developed among state-insured thrifts in Maryland. The image of depositors waiting in long lines to withdraw their money was one that had not been seen in the United States since the Depression.

Since 1985, financial crises and disturbances to the financial system have continued apace. Problems in the commercial banking sector continued. Banks in Texas succumbed to a deterioration in the quality of energy and real estate loans, and several major bailouts were undertaken. By the end of the 1980s, none of the large Texas banks that existed in 1986 had survived as an independent entity. Commercial bank profitability declined sharply in 1987 after major multinational banks, for the first time, set aside provisions for losses on loans to less-developed countries. Citicorp initiated the process with a $3 billion charge to earnings.

The stock market crashed on October 19, 1987; the Dow-Jones Industrial Average lost 508 points. In a demonstration of the increasing interconnection among the world's financial markets, the crash spread worldwide. The market for high-yield securities, or "junk bonds," did not crash quite so dramatically, but had suffered a significant collapse by the end of the decade. Some firms that had issued junk bonds to finance corporate takeovers, such as the Campeau Corporation, filed for bankruptcy; financial institutions that had overwhelmed their portfolios with junk bonds, such as Columbia Savings and Loan and First Executive Insurance, failed. Michael Milken, the man who almost single-handedly created and developed the market, was indicted for securities law violations—his firm, Drexel Burnham Lambert, failed in February 1990.

The mounting problems in the thrift industry were finally acknowledged in 1989. Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), which provided for an industry-wide bailout of insolvent thrifts. In January 1991 the Bank of New England, overcome by mounting real estate loan losses, was rescued by the Federal Deposit Insurance Corporation. And most recently, in yet another episode of speculation, the stability of the European Monetary System was threatened by insistent attacks on its weaker currencies by foreign-exchange speculators in September 1992.

This book attempts to understand these developments by several lines of investigation. First, in chapter 2, there is a survey of theories of financial crises that are situated within the context of the business cycle. This survey includes writers in the modern era, such as Hyman P. Minsky, Allen Sinai, and Albert M. Wojnilower. It also includes theorists from an earlier time, when financial crises were more common and more disruptive to the stability of the economy; these include Thorstein Veblen, Wesley Clair Mitchell, and Karl Marx. In chapter 3, these theories are compared and contrasted.

Chapters 4 through 10 examine the history of financial crises in the postwar U.S. economy. The method of examination employed, dictated by the nature of the subject matter to be investigated, is institutional, dynamic, and historical. It is institutional because the particular institutions of the postwar economy—particularly institutional constraints on bank lending—have played an important role in affecting how financial crises have unfolded and developed. It is dynamic because the events of financial crises, involving uncertainty, psychological reactions, and disruptions to financial markets, cannot be understood in a static framework. Finally, it is historical because financial crises are due to an evolution of events constantly unfolding in historical time, in a process of endogenous change and perpetual disequilibrium. In the words of Joan Robinson:

> Once we admit that an economy exists in time, that history goes one way, from the irrevocable past into the unknown future, the concept of equilibrium based on the mechanical analogy of a pendulum swinging to and fro in space becomes untenable. The whole of traditional economics needs to be thought out afresh.[1]

Chapter 11 begins the process of generalizing and interpreting that experience by formulating a business-cycle model of financial crises. The emphasis is on understanding those developments during the business-cycle expansion that make financial crises likely at the peak. Chapter 12 evaluates the business-cycle model by systematically comparing it to the history of financial crises and to time-series data since 1961.

Despite the importance of cyclical forces in the generation of financial crises, it is necessary to take into account two different time periods in the postwar U.S. economy. The first is the period from World War II until 1966, in which financial crises (but not business cycles) were absent. The second is the period since 1982, in which financial crises became increasingly frequent and severe, and often appeared before the peak of the business-cycle expansion.

The last two chapters attempt to understand the reasons for these anomalies. Chapter 13 considers several noncyclical theories of financial crises. Their content ranges from monetarism to asymmetric information to speculation. Finally, chapter 14 analyzes the changing financial system. The analysis is significantly expanded and developed compared to the tentative ideas advanced in the first edition of this book. Specifically, it tries to understand the changing nature of financial crises in the United States by putting them into the context of the establishment and subsequent erosion of a "system of financial regulation." Such a system brought stability after the banking crises of the 1930s, but its increasing incompatibility with the changing economic and financial conditions of the 1970s and 1980s led to increasing financial crises in the present period.

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