The History of Financial Crises

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The Global Crisis 1857

A Year to Forget
The First Factor: Globalization

- “Globalization”: trade between Britain and the United States of America was flourishing
- America was running a $25 m of trade deficit with its majors trading partners: Americans bought more than what they sold
- By the mid 1850s Britain held $80m in American stocks and bonds
Railway Expansion in America

- Railway in America was expanding
- Railway investment became so popular among British investors
- Many British investors sat on the board of these American companies
- The earning of these companies didn’t justify their valuations. But their popularity increased and their stock prices as well
Situation in Britain

♦ Britain was doing better after 1825 crisis

♦ British exports went booming to the rest of the world

♦ Gold discoveries were made in Australia
Financial Innovation

- Bank deposits grew by 400% between 1847 and 1857 after the birth of big banks in Britain.
- Discount houses made their entrance in London as *lending institutions*. They match investors with firms that needed cash: they became unofficial banks without the strict regulations of banks!
The Discount Houses

- Because of competition in interest rates offered by other banks, the discount houses couldn’t compete with the bigger institutions, they couldn’t offer higher rates to their investors.

- Feeling the squeeze, the new discount houses reduced their capital reserves.
Edward Ludlow, is the manager of **Ohio Life**: an insurance company.

New railroad lines were being built to link eastern cities with new western towns.

Ludlow took a huge bet: he invested $3m in the railway companies.

One investment alone in the Cleveland and Pittsburgh line, accounted for a quarter of the Ohio Life capital.
The Panic

* In 1857, the railroad stocks began to drop
* Ohio Life became highly indebted and overexposed
* Stock prices continued to fall
* On October 13th, depositors rushed to Wall Street demanding their money
* The banks refused to convert deposits into currency
* The American financial system failed!
Bank run 1857
Causes of the Panic in the US

- More and more people moved West. The government was encouraging this migration.
- In mid-year 1857, lots (pieces of land) in Western cities could pass through the hands of as many as 12 people in 60 days.
- Omaha property selling for $500 in spring 1856 went for $5,000 in spring 1857.
- Wisconsin farmers bought up railroad securities using personal notes backed by mortgages on their holdings.
- The case of Dred Scott v. Sanford: thinking that the West will be an opportunity for newly freed slaves but this came to a halt with the outcome of the case.
More Causes

♦ Some British investors started to remove funds from U.S. banks, which raised questions about overall U.S. economic soundness

♦ The fall of grain prices, which spread economic misery into rural areas, because of the end of the Crimean War and Russian re-entry into global markets

♦ The collapse of land speculation programs that depended on new rail routes, ruining thousands of investors
The Panic in the US
Domino Effect

- The first British cities to suffer were: Glasgow and Liverpool
- Dennistoun, Cross and Co. an American bank that had branches in Liverpool, Glasgow, New York and New Orleans collapsed on November 7th. The Western Bank of Scotland quickly followed
- The discount houses magnified the problem
- They became a crucial source of credit to firms. But, They were extremely risky: investors were so nervous
The British Bankruptcy

- Over a capital of £10,000, some had a risky loans of £900,000. Huge leverage ratio by all standard

- Gradually, the discount houses crumbled and were followed by the ordinary firms

- In the last three-month period of 1857, 135 bankruptcies were registered. £42m of capital were wiped out
What Went wrong

- The discount houses acted in risky manner.
- They kept few liquidity and small capital reserves because they knew they can always borrow more from the Bank of England.
The European Contagion
The Consequences in Britain

- In 1858, the Bank of England changed the rules: Discount houses can no longer easily borrow
- Discount houses have to self-insure, need to hold cash reserves
- In 1866, Overend and Gurney, a huge lender, needed emergency cash
- The Bank of England refused to rescue it. The lender failed
- The prudence of banking sector became the norm
The Consequences in the US

♦ A year after the Panic, the economy improved

♦ The US President asked state banks to keep one dollar in specie for every three issued as paper, and discouraged the use of federal or state bonds as security on bank notes to avoid future inflation

♦ Moreover he encouraged the Congress to pass a law to provide immediate penalty of a bank's charter in the event that the bank suspended specie payments
“The other day... valued at a dollar and now I ain’t worth a cent!”

ANOTHER TERRIBLE FAILURE.
First Small Boy.—“Just to think—only the other day I had property in peanuts and lozenges valued at a’host a dollar, and now I ain’t worth a cent.”
Second Small Boy.—“Oh, t-h-u-n-d-e-r !!!”
The Crisis of 1907
The Financial System up to 1907 in America

- By 1907, America had 22,000 banks: one for every 4000 people
- In every town, there was a choice of local banks or state-owned lenders
- Trust companies emerged in America. They appeared in 1890 to act as “Trustees”: hold customers bonds and shares
- Trust companies undertook riskier business: underwrite and distribute shares, owning property and railways. They became banks without the liabilities they entailed
The Historical Context in America

- Between 1896 and 1906, the average annual growth of America was 5%, despite the Baltimore fire of 1904, the San Francisco earthquake of 1906

- However, in 1907, the economy started to slow

- Raw materials and metals prices fell down
The Knickerbocker Crisis

- America and England had very different approaches in banking.
- The Bank of England was very powerful. It oversees all the banking system in Britain.
- America developed a decentralized system.
- American thought that banks can look after themselves.
The Risky Business

- Trust companies were little regulated
- They invested in risky businesses
- Banks had to hold 25% of their assets as cash, the trusts had only 5% as a minimum
- With less regulation, they were able to pay higher interest rates to their customers. They became very popular
- By 1907, trust companies were as big as national banks. They grew by nearly 250% in ten years
The Creeping Greed

- Augustus Heinze and Charles Morse two speculators and scammers borrowed huge sums in an attempt to make vast profits on the share of United Copper.

- When the price of raw materials and metals fell down, United Copper’s shares fell.

- Heinze and Morse faced huge losses magnified by their large debts.

- United Cooper share never recovered.

- It sparked a chain of losses that reached the Knickerbocker Trust.
Short Sell

- You believe that Stock A, which is trading at $100 per share, will decline.
- So you borrow 100 shares from a broker.
- Then you sell them (promise to sell).
- A week later, Stock A’s price falls to $90 per share. You decide to close the short position, so you buy 100 shares of Stock A from the market at a price of $90 per share and return those shares to the broker.
- Your profit is $10 per share.
Corner the Market?

- Heinze knew that there were speculators short selling United Copper’s stocks
- He purchased many stocks and drove the prices high
- Then, with prices high, and Heinze controlling most of the stock, he would force the short-sellers to repay the borrowed stock, a move called a "short squeeze" (make them loose)
- The short-sellers would have no option but to settle with Heinze for high prices
- But Otto Heinze overestimated how much of the company the family controlled
- When he forced the borrowers to buy back stock they were able to get it from other sources (cheaper) and Heinze lost badly!
The Knickerbocker Trust
The Knickerbocker Trust

- It is a trust in Manhattan located on the corner of 34th Street and 5th Avenue
- Its deposits soared from $10 m to over $60m in 1907, the third largest trust in America
- But on October 22 1907, the Knickerbocker was caught up in the Heinze-Morse financial scheme
- Depositors panicked. They started to line up in front of the Knickerbocker Trust to demand their cash
- In less than a day, $8 m were withdrawn in cash!
The Missing Cash

♦ New Yorkers moved cash from one trust to another as the trust started toppling

♦ When everything collapsed, Americans asked for more cash...

♦ The Panic continued to spread. The interest rates spiked to 125%

♦ John Pierpont Morgan stepped in, organized pools cash to ease the crisis

♦ He helped organize a $25m bail-out fund
“Untermyer: Is not commercial credit based primarily upon money or property?

Morgan: No, sir. The first thing is character.

Untermyer: Before money or property?

Morgan: Before money or anything else. Money cannot buy it ... a man I do not trust could not get money from me on all the bonds in Christendom”
Alternatives to Cash

- A nationwide shortage of cash crippled America
- Between 1907 and 1908, the national output fell to 11%
- Cash substitutes started to circulate
- Cheques and IOUs written by banks
- The total value of this emergency cash was around $500 m far bigger than Morgan bail-out
- In 1909, the American economy was back on track
The Consequences

- A plan of $500 m of official emergency money was put together.

- New currency laws included the creation of the National Monetary Commission to study how money worked and to study other models.

- In 1913, the Federal Reserve Act came out.
Criticism
Too Big to Fail...
J.P Morgan

♦ "I Like a Little Competition"—J. P. Morgan by Art Young. Cartoon relating to the answer Morgan gave when asked whether he disliked competition at the Pujo Committee
Your thoughts...