Local banking panics of the 1920s: Identification and determinants

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Abstract
Using a newly discovered dataset of U.S. bank suspensions from 1921 to 1929, we discovered that banking panics were more common in the 1920s than had been believed. Besides identifying panics, we investigate their determinants, finding that local banking panics were more likely when fundamental economic conditions were generally weak and more likely in "overbanked" states; they were less likely in states with deposit insurance or states where a relatively large share of banks belonged to chain banking organizations. © 2014 Elsevier B.V. All rights reserved.

1. Introduction
It is well known that during the 1920s the incidence of bank suspensions in the United States was very high. On average, from 1921 through 1929, there were 635 bank suspensions per year, then-unprecedented levels that have been surpassed only by the extremely high rate of bank suspensions during the Great Depression years from 1930 to 1933. The wave of suspensions that engulfed the banking system during the 1920s affected mostly small banks. Previous research has highlighted several causes for these suspensions: agricultural shocks (Alston et al., 1994), overbanking (O'Hara, 1983), government policy (Calomiris, 1992, 1993a, 1993b; Mitchener, 2005; Wheelock, 1992, 1993; Wheelock and Wilson, 1994), lax supervision by state banking authorities (Gambis, 1977; White, 1983), and even the growing use of the automobile, which permitted bank customers to bank farther from home (Alston et al., 1994). All of these factors can be considered fundamental reasons for bank suspensions.

The very high incidence of bank suspensions, however, leaves open the possibility that, concurrent with failures driven by fundamentals, some proportion of the suspensions of the 1920s may have resulted from local banking panics.
The voluminous literature on banking panics points out that no major banking panics took place during the 1920s, and (perhaps as a result) the role of panics during that decade has received limited attention. Only a few papers make reference to the occurrence of either panics or bank runs during the 1920s. In a passing footnote, Schwartz (1987) cites several reports from the Comptroller of the Currency claiming that only a handful of the national bank suspensions of the early 1920s could be attributed to panics; moreover, Schwartz also notes that no runs on national banks were reported after 1925. Vickers (1994) examines a panic in Florida and Georgia in 1926. More recently, Jalil (2013) indicates that five minor panics took place in the 1920s, and one of these—the Florida panic of 1929—is analyzed in Carlson et al. (2011).

But although no national or even major banking panic took place during the 1920s, there are good reasons for suspecting that localized panics took place more frequently than the literature suggests. First, it is well known that before the establishment of national deposit insurance in 1933, banking panics were recurrent phenomena in the United States, and it has been shown that they tended to have long-lasting adverse consequences for depositor confidence (Ramirez, 2009). Inasmuch as the last major panic before the 1920s had occurred quite recently, in 1907–1908, a certain amount of depositor distrust or apprehension about the banking system ought to have been still present during the 1920s. Second, shortly after that earlier panic, several states began to experiment with their own deposit insurance schemes in an effort to restore confidence and forestall bank runs; the very creation of these schemes attests to many state authorities’ continuing concerns about the fragility and vulnerability of their banking systems. Third, even if a deterioration of fundamentals can explain a large portion of the bank suspensions of the 1920s, it is still possible that, in the absence of perfect information, a bank suspension caused by fundamentals may have had spillover or contagion effects on neighboring banks—for if depositors observe a signal indicating that the health of the banking sector within a geographical area has been compromised, their lack of perfect information about the asset quality of the area’s banks leaves them uncertain which bank is most vulnerable to the shock, and they may run on all banks in the exposed area (Calomiris and Gorton, 1991).

The use of a unique and previously unused dataset held by the FDIC allowed us to identify 35 clusters of suspended banks (182 suspended banks in all) between 1921 and 1929 and then to identify 14 of these clusters as local banking panics. Identification of local panics was followed by an investigation of the extent to which the incidence of these panics was influenced by a range of factors.

The dataset identifies all bank suspensions that took place between 1921 and 1933 and provides relevant information about each suspension. To identify clusters of bank suspensions—defining cluster as a group of at least three suspensions during a specified period of time and within a specified geographical area—we complemented the information in this dataset with geographical coordinates of each financial institution’s locality as well as with other financial data.

Although our method generates a variety of clusters with different numbers of suspensions and radii, the focus of our analysis is the clusters that have a minimum of four suspensions, with the specified period of time being 30 days and the specified geographical area being 10 miles. In other words, by definition each of the four or more suspensions in each cluster took place no more than 30 days after the preceding suspension in the cluster and within a 10-mile radius of the location of the previous one. Application of these criteria resulted in the identification of 182 bank suspensions occurring in 35 clusters between 1921 and 1929. After the clusters are identified, it is then possible—using reopening dates and contemporary newspaper reports of runs—to ascertain which of the clusters resulted from local banking panics. Of the 35 clusters, 14 fall into that category.

Identification was followed by an investigation of the extent to which differences in various state characteristics (such as banking structure or banking regulation) influenced the incidence of these 14 local panics. Our findings are that the likelihood of panic increases with bank density and with a deterioration of economic fundamentals, and decreases with average bank size, with deposit insurance, and with an increase in the fraction of banks operating in chains. Branching regulation appears not to have any measurable effect on the incidence of panics.

Our paper contributes to the banking literature in at least two ways. First, this analysis demonstrates that during the 1920s local banking panics were more common than has been believed. Despite the measures taken by regulatory authorities after the Panic of 1907 (measures such as the adoption of deposit insurance in eight states), panics remained part of U.S. banking experience during the 1920s.

Second, investigating the determinants of these panics sheds light on the mechanism by which bank contagion takes place. For example, some theoretical papers on this topic (e.g., Allen and Gale, 2000; Dasgupta, 2004) highlight the possibility that contagion may arise through network effects or interbank linkages, but our finding that the incidence of panics decreases with an increase in the fraction of banks operating in chains (an observable characteristic that entails interconnection) suggests that network effects may be less important than the literature implies. Instead, our results seem more consistent with asymmetric-information theories of bank contagion (Calomiris and Gorton, 1991; Gorton, 1985; Chen, 1999). A weakening of underlying fundamentals (for example, a rise in commercial failures), in combination with
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