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Haelim Park Anderson , John C. Bluedorn

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Stopping contagion with bailouts: Micro-evidence from Pennsylvania bank networks during the panic of 1884☆

Haelim Park Anderson[a], John C. Bluedorn[b,*]

[a] Office of Financial Research, U.S. Treasury, 717 14th St NW, Washington, D.C., 20220, United States
[b] International Monetary Fund, 700 19th St NW, Washington, D.C., 20431, United States

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ABSTRACT

Using a newly constructed historical dataset on the Pennsylvania state banking system, detailing the amounts of "due-froms" on a debtor bank-by-debtor bank basis, we investigate the effects of the Panic of 1884 and subsequent private sector-orchestrated bailout of systemically important banks (SIBs) on the broader banking sector. We find evidence that Pennsylvania banks with larger direct interbank exposures to New York City changed the composition of their asset holdings, shifting from loans to more liquid assets and reducing their New York City correspondent deposits in the near-term. Over the long-term though, only the lower correspondent deposits effect persisted. Our findings show that the banking turmoil in New York City impacted more exposed interior banks, but that bailouts of SIBs by the New York Clearing House likely short-circuited a full-scale banking panic.

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1. Introduction

The global financial crisis highlighted the issues of regulatory forbearance and the public bailout of systemically important banks (SIBs). Public interventions around the world were based on the notion that the failure of SIBs, like Citigroup in the U.S. and the Royal Bank of Scotland in the U.K., would precipitate runs and failures elsewhere in the financial sector, freeze the flow of credit and payments to the real economy, and lead to a depression (Laeven et al., 2014). In the wake of the crisis, many of these SIBs have actually grown larger, due to consolidation within the industry, potentially increasing the need for collective support for these institutions in times of stress (Lambert et al., 2014).[1] Yet, despite the expectation of interventions in future crises, there has been little empirical study on how the public bailout of SIBs affects the rest of the financial sector.

An empirical study of the effects of bailouts of SIBs on other banks confronts a number of practical difficulties. First, it is often hard to identify *ex ante* which banks are systemically important. For example, the Financial Stability Board, which monitors global financial stability and proposes international standards, only began constructing lists of global systemically important banks (G-SIBs) in 2011 (FSB, 2011 and 2014). When the U.S. government decided to provide asset guarantees and additional capital to Citigroup in November 2008, its decision was based "as much on gut instinct and fear of the unknown as on objective criteria," accord-

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* Corresponding author.
E-mail addresses: Haelim.Anderson@ofr.treasury.gov (H.P. Anderson), jbluedorn@imf.org (J.C. Bluedorn).

[1] At the same time, there have been a number of legal and regulatory changes passed around the world to limit the contingent taxpayer liability for such bailouts. For example, the European Union now requires "bail-in" of a minimum of 8% of other liabilities (that is, conversion of debt or debt-like instruments to equity) before a public bailout of a bank may be undertaken (see the Bank Recovery and Resolution Directive, adopted April 2014).

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