Chapter 3

The Panic of 1907 and the Savings and Loan Crisis

I. Introduction

Banking crises go back hundreds of years to the origin of fractional reserve banking. In such a system, banks and other depository institutions maintain only a small fraction of their deposit liabilities in the form of reserves, defined loosely as cash on hand and deposits in other banks. As the story is told in textbooks, fractional reserve banking began with English goldsmiths. Turning the clock back nearly 400 years, the East India Company and other recently chartered British organizations involved in long-distance trade began amassing large amounts of gold around 1650 AD. These companies, along with merchants and other wealthy individuals in seventeenth-century London, needed a place to store their precious metals—mostly gold and silver coins. Goldsmiths were private firms that originated as jewelers. Because they owned impregnable safes in which to store their jewelry, goldsmiths provided the logical place in which to store the increasing stocks of gold and silver.

Goldsmiths built prosperous businesses warehousing the precious metals. They held the gold and silver until requested by the owner, and issued paper notes to depositors. These notes were receipts acknowledging rights to a specific amount of gold or silver coins, payable by the goldsmith on demand to the bearer of the notes. Because these notes were fully redeemable, they quickly became as acceptable a medium of exchange for the purchase of goods and services as the gold and silver coins that backed the paper notes.

The goldsmiths soon discovered that only a very small portion of the gold or silver would typically be withdrawn in any given week or month. It became clear that it was unnecessary for the paper notes to be backed
100 percent by gold and silver. Goldsmiths became bankers as they began to grant loans by issuing paper notes in amounts greater than the amount of gold and silver held in safekeeping. They began to loan these notes to businesses and other worthy borrowers, earning a handsome income in the form of interest payments in the process. Moreover, some of the benefits of this new practice could be returned to the owners of the precious metals in the form of reduced service charges for safekeeping the metals. Everyone came out ahead—depositors, borrowers, and goldsmiths.

In view of the fact that failure to honor note holders’ requests to exchange notes for gold would cause the business to fail, how much should a prudent goldsmith loan out in the form of newly issued notes? Twenty percent of the value of gold in storage? Five hundred percent? The former figure seems quite conservative inasmuch as the goldsmith would be easily able to honor all requests as long as an overwhelming majority of note holders did not ask to redeem the notes in gold and silver. A more aggressive goldsmith, tempted by the prospect of earning robust profits during heady economic times and periods of high interest rates, might grant loans amounting to several times its holdings of the metals. This consideration illustrates the tension between bankers’ conflicting goals of scrupulously maintaining safety on the one hand and achieving greater profitability on the other. This tension has challenged bankers throughout the course of history.

Extrapolating Minsky’s theory of the credit cycle backward to the seventeenth century, a long period of good times would inevitably lead goldsmiths to revise downward their perception of risk and therefore to leverage themselves more highly by increasing the volume of notes issued relative to gold held in their safes. This periodic easing of credit contributed to the formation of costly bubbles in financial and real asset prices.

This chapter analyzes the nature of fractional reserve banking and discusses the nineteenth-century U.S. banking crises that culminated in the Panic of 1907. The latter episode led directly to the creation of the Federal Reserve System. In addition, the chapter analyzes the U.S. savings and loan crisis of the 1980s. Later chapters examine the Great Depression and the recent Great Crisis in detail.

II. Fractional Reserve Banking and Recurring Panics in U.S. History

These English goldsmiths were forerunners of modern fractional reserve banking systems that exist in all developed nations today. In such systems, reserves of each bank constitute only a small fraction of the bank’s