Motivations for policymaker interventions during banking stress episodes in the 1920s

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Abstract

Around 1920, an agricultural and commodity boom in the United States fueled by World War I swept up farmers, miners, and others with promises of prosperity but left them struggling when the boom turned to bust not long after the war ended. Banks experienced stress as they dealt with customers who were long delayed in repaying loans, if repayment was to come at all, and as depositors withdrew funds suddenly and at scale as they become concerned about the viability of the banks. An unprecedented number of banks ended up closing their doors.

Officials at the newly established Federal Reserve had to decide whether particular stresses constituted crises that warranted interventions and, if so, how to respond. This study uses contemporary letters, examination reports, and internal memos regarding several case studies to understand the characteristics that led policymakers to deem the episode sufficiently severe that a response was warranted. Several characteristics stands out. One was the potential for problems at one bank to spread to others due to direct exposures through interbank linkages and or indirect exposures through effects on confidence regarding the general solvency of banks in the area. Another characteristic was the potential for negative consequences for the local community. The form of the response—whether the intervention was to support the institution experiencing stress or to other institutions to contain the fallout—appears to have depended on officials' perceptions of the quality of the bank at the center of the episode.

In some situations, the Federal Reserve intervention stabilized the situation and enabled the bank to recover and return to health. In other episodes, the crisis was arrested, but the central bank ended up having to absorb losses of a failing institution. This study also discusses aspects of the interventions that concerned policymakers and that led them to adjust policies. Subsequent curtailing of emergency responses may have resulted in the Federal Reserve being less aggressive in responding to the banking stresses of the Great Depression than it otherwise might have been.