Collecting to the Core -- Financial Crises

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The “Collecting to the Core” column highlights monographic resources for college libraries.

**Other Big Questions**

Another facet of Curating the Collective Collection will be thoughtful essays wrestling in a public forum with some of the larger questions attendant to this remarkable conceptual and operational shift from managing individual institutional collections to reliance on a cooperatively curated, shared national collection. Some of obvious questions include:

- What is the political economy of a national shared collection? Who will own and have access to materials? What are the long range cost and power implications of the structures we establish for sharing? Who might be left out? Will shared print archiving ameliorate or exacerbate inequitable access to scholarly materials?
- How can we build sustainable trust networks that will endure for generations?
- How do we coordinate shared print archiving nationally and internationally?
- What existing models outside librarianship and higher education might inform the development of the social and technical infrastructure?
- What voices outside librarianship need to be heard and what ideas and concerns need to be grappled with as we systematically and strategically (or not) “drawdown” “redundant” library holdings?

**Invitation to Participate**

While those already active in shared print archiving will read and contribute to this column, a primary purpose is to engage a broader spectrum of librarians in thinking about and discussing these issues. You are invited to help shape this column by:

- Offering opinions, ask questions and suggest topics for articles. Remember, please send me a note now suggesting three topics you’d like to see covered in the year ahead.
- Proposing to write or co-author articles on relevant issues about which you are passionate and knowledgeable.
- Commenting on and contributing to a possible Curating the Collective Collection blog.

Stay tuned and be in touch! 🍀

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**Collecting to the Core — Financial Crises**

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**Column Editor’s Note:** The “Collecting to the Core” column highlights monographic works that are essential to the academic library within a particular discipline, inspired by the Resources for College Libraries bibliography (online at http://www.rclew.net). In each essay, subject specialists introduce and explain the classic titles and topics that continue to remain relevant to the undergraduate curriculum and library collection. Disciplinary trends may shift, but some classics never go out of style. — AD

“Money will not manage itself, and Lombard Street has a great deal of money to manage.” — Walter Bagehot, Lombard Street

In 1873 the British journalist, political commentator, and economist Walter Bagehot, the long-time editor of The Economist, published Lombard Street: A Description of the Money Market. At the time, London was the financial capital of the world and Lombard Street — home to the Bank of England, private banking houses, joint stock banks, and bill brokers — was the epicenter of finance, much like today’s Wall Street. Bagehot’s book was based on a series of essays published in The Economist beginning in the 1850s. In addition to a lively portrait of the contemporary money market and leading personalities in mid-nineteenth century London, the book forcefully argued that the Bank of England must play the key role of lender of last resort in stemming a banking panic. Today, Lombard Street is widely regarded as the original crisis management manual for central banks. This essay discusses some of the fundamental works covering modern financial crises, from nineteenth-century Lombard Street to twenty-first century Wall Street.

Founded in 1694 to finance the War of the League of Augsburg against France, the Bank of England grew to become the de facto issuer of British currency and the country’s central bank. In addition to its role as the government’s bank, it became the bankers’ bank and the keeper of Great Britain’s currency and reserves, colloquially coined “The Old Lady of Threadneedle Street.” When the British Parliament officially established the gold standard in 1821, the Bank of England was required to redeem all of its notes in gold on demand. In contrast to today’s “ fiat money” system whereby money has value based on government decree and is intrinsically useless, the Bank of England’s ability to create money was restricted since new note issues had to be backed by gold. For a comprehensive history of gold and its role as both an economic unit and a mythologized object of human desire, see financial historian Peter Bernstein’s The Power of Gold: A History of an Obsession. While the Bank of England performed many public functions, such as establishing the gold-backed legal tender and purchasing government bonds, it remained privately owned. There was an inherent conflict between its role as a private institution whose primary constituency was its shareholders and its public role to promote financial stability. In a crisis, the key question was whether the Bank of England would preserve the wealth of its private shareholders or help rival banks in order to preserve the public financial system. The nineteenth century saw frequent, frightening financial crises that intensfied this tension. As Carmen Reinhart and Kenneth Rogoff chronicle in This Time Is Different: Eight Centuries of Financial Folly, the United Kingdom alone experienced banking crises in 1810, 1815, 1825, 1837, 1847, 1857, and 1866.

These frequent financial crises highlight how the banking system functions as a continuing process of...
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confidence game, not in the traditional sense of a swindling operation, but in the sense that any bank's deposits are on the belief that a bank's depositors and creditors can get their money at a moment's notice. Banks borrow for short periods and lend for long periods, profiting from the difference in the rate they pay to depositors and the rate they charge borrowers. Because of this, a modern bank will typically maintain only about ten percent of its assets in liquid securities such as United States Treasuries. For every one dollar in reserves, a bank has nine dollars on loans to businesses and individuals. Modern fractional reserve banking relies on public confidence that a depositor can obtain funds on a moment's notice. During a banking crisis, credit contracts and players seek safety in cash or its nearest substitute. Historically, this has led to bank runs — a rush to withdraw cash that depletes banks' cash reserves, causing banks to fail and credit markets to freeze. Individuals and institutions acting rationally in their self-interest can cause the entire financial system to collapse, and the crisis becomes catastrophic.

Given the historical frequency of financial crises, there is much practical, as well as theoretical, evidence to draw from. In Lombard Street, Bagehot argued that in a financial crisis the Bank of England must "... lend freely, boldly, and so that the public may feel you mean to go on lending," even though "...the first instinct of everyone is to the contrary." His dictum flies in the face of the most basic economic survival instinct: preserve capital. The wisdom of Bagehot's primary principle has been repeatedly proven in financial crises ever since. In the classic work Manias, Panics and Crashes, first published in 1978 and now in its sixth edition, economic historian Charles P. Kindleberger reviews the anatomy of financial crises and thoroughly explores the concept of the lender of last resort, determining that "practice preceded theory." The necessity for a lender of last resort in a crisis was born from repeated crises in the nineteenth century: "The lender of last resort stands ready to halt a run out of the depositors and the rate they charge borrowers. Because of this, a modern bank will typically maintain only about ten percent of its assets in liquid securities such as United States Treasuries. For every one dollar in reserves, a bank has nine dollars on loans to businesses and individuals. Modern fractional reserve banking relies on public confidence that a depositor can obtain funds on a moment's notice. During a banking crisis, credit contracts and players seek safety in cash or its nearest substitute. Historically, this has led to bank runs — a rush to withdraw cash that depletes banks' cash reserves, causing banks to fail and credit markets to freeze. Individuals and institutions acting rationally in their self-interest can cause the entire financial system to collapse, and the crisis becomes catastrophic.

The Panic of 1907: Lessons Learned from the Market's Perfect Storm further illustrates the necessity of a lender of last resort. Authors Brunner and Carr trace the origin of the 1907 crisis to the San Francisco earthquake of April 18, 1906. The earthquake damage and subsequent fires created a monumental rebuilding effort that drew gold from the world's financial centers and created a liquidity crisis. The authors argue that this shortage of cash for transactions and business loans caused a recession that started in June 1907. At the time, the United States, like other major countries, was on the gold standard, which limited money creation. This was further eroded by Wall Street speculation and fraud. The immediate trigger for the crisis was the failure of the Knickerbocker Trust Company, one of the largest banks in the United States. Its president, Charles T. Barney, had been using bank funds in an attempt to corner the market in copper. When the scheme failed, the bank suffered large losses that caused a bank run and forced it into bankruptcy. Doubts about the soundness of other banks and trusts resulted in anxious depositors lining up to withdraw funds, causing more failures. The money market froze, the stock market fell sharply, and the City of New York almost went bankrupt. This panic occurred in the National Banking Era, when the United States did not have a central bank that could lend freely and halt the panic. The legendary John Pierpont Morgan organized a group of leading private bankers and financiers to put up enough money to stop the panic, effectively serving as the lender of last resort. Perhaps ironically, the financial system in 1907 was saved by an ad hoc group of wealthy businessmen, and the crisis led to the establishment of a modern U.S. central bank in 1913 — the Federal Reserve System.

The Great Depression shows what can happen when the lender of last resort fails to act forcefully enough. Liaquat Ahamed's Lords of Finance: The Bankers Who Broke the World won the Financial Times "Best Business Book of the Year" award in 2009. Ahamed recounts how mistakes made by the world's leading central bankers — Montagu Norman of the Bank of England, Émile Moreau of the Banque de France, Hjalmar Schacht of the Reichsbank, and Benjamin Strong of the Federal Reserve Bank of New York — led the world's central banks to inadequately respond to the Great Depression. Belief in and adherence to the gold standard effectively handcuffed the central banks. Ahamed notes: "They failed to fulfill even the most basic central banker's responsibility: to act as lender of last resort and support the banking system at a time of panic." In their economic history of the Depression, The Great Contraction 1929-1933, Nobel Laureate Milton Friedman and Anna Schwartz wrote that Bagehot's Lombard Street was "the locus classicus of central bank policy." They conclude that the Federal Reserve could have greatly lessened the severity of the crisis had it fully embraced Bagehot's principle.

However, the lender of last resort doctrine presents a paradox: if market participants are confident that the central bank will always introduce funds into the market during an economic crisis, then they are more likely to take on greater risks to generate higher returns, simultaneously producing the next financial crisis. Economists call this condition, clearly illustrated during the recent financial crisis, "moral hazard." The Financial Crisis Inquiry Report explains how the large commercial and investment banks — Goldman Sachs, JP Morgan, Merrill Lynch, Bear Stearns, Lehman Brothers, Citi, et al. — engineered the highly profitable mortgage-backed securities and their derivatives that fueled the housing boom, only to become toxic and poison the international financial system when the housing market collapsed in 2007 and many of the securities became worthless. Yet today, banks "too big to fail" are even bigger and the top executives are earning record bonuses while the global economy continues struggling to emerge from the worst recession since the Great Depression.

Bagehot's principle that the central bank must lend freely in a financial crisis is the key to understanding how the Federal Reserve responded to the current economic conditions. As Federal Reserve Chairman Ben Bernanke noted in a 2008 speech given at the height of the crisis, "Walter Bagehot's Lombard..." continued on page 80
Street, published in 1873, remains one of the classic treatments of the role of the central bank in the management of financial crises.13 As a scholar of the Great Depression, Bernanke was determined to maintain the flow of credit in the United States and also internationally. Perry Mehrling points out in The New Lombard Street just how far the Fed has pushed the lender of last resort principle to save the international financial system by extending credit to money market funds, the commercial paper market, asset-backed securities, and even by purchasing mortgage-backed securities to prevent a total collapse of the housing market.14 The crisis has forced the Fed to become a market maker or, as Mehrling argues, “The Dealer of Last Resort.” The lasting influence of Bagehot’s Lombard Street is clear. It continues to inform economic policy and theory and is a classic, yet ever-current work for a library collection covering economics. This and the other works discussed here offer finance and business students important scholarly perspectives on past, present, and the almost-certain future financial crises.

Endnotes
2. Ibid.
5. Ibid. I, p. 65.
7. Ibid., p. 146.
10. Ibid., p. 503.
*Editor’s note: An asterisk (*) denotes a title selected for Resources for College Libraries.