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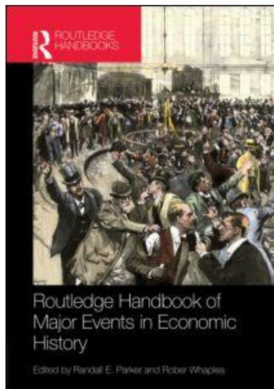

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THE BANKING PANIC OF 1873

Elmus Wicker

The 1873 panic was a watershed in U.S. financial history whose historical significance resided in the prompt response of the New York Clearing House (NYCH)[1]. The NYCH had a coherent strategy for responding to the banking panics of 1860 and 1873. The strategy called for the issue of clearing house certificates to meet local reserve drains, and the pooling or equalization of reserves to meet the external drains to the interior parts of the country. To conserve the supply of legal tender reserves among the member banks, the NYCH was authorized to issue clearing house certificates during emergencies to petitioning banks who submitted the requisite collateral for the purpose of meeting their deficits at the clearing house. To meet cash withdrawals for out-of-town banks it also had the power to pool or equalize the reserves of the associated banks; that is, the reserves of the stronger banks could be put at the disposal of the weaker. By treating the reserves of the NYCH as a common pool, the NYCH was effectively converted temporarily into a central bank, like the Bank of England, with reserve power greater than that of any European central bank. It was successful in forestalling the suspension of cash payments in 1860, and as it shall be argued, suspension in 1873 was unnecessary. Just at the point that success was imminent there was a failure of will. Reserves at the Clearing House had fallen to a low that undermined the courage of officials, and cash payment was suspended. Nevertheless, the NYCH continued to pay out cash to the interior thereby moderating the anticipated effects of the panic on the interior.

Shortly after the panic had ended, the NYCH issued a report—the Coe Report (New York Clearing House 1873)—that clearly recognized the responsibility of the NYCH in the absence of a central bank for achieving banking stability. The report made a persuasive case that the NYCH had the knowledge, the power, and the instruments to prevent banking panics. Sprague (1910) called the report the most important financial document in U.S. financial history. Sprague's mentor Charles Francis Dunbar, professor at Harvard from 1871 to 1900, had described the use of reserve pooling by the NYCH in response to a panic that occurred in 1860 (Dunbar 1904). In the succeeding panics of 1893 and 1907, however, the fifty or so banks in the Clearing House could not reach agreement to equalize reserves and the bold experiment initiated in 1860 was abandoned.

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Panic vocabulary

Although the term panic had been used for all major banking crises of the nineteenth century, the meaning remains ambiguous. As used originally, it referred specifically to an identifiable kind of emotional behavior, i.e. the behavior of depositors engaged in a run on the banks, behavior dominated by fear and anxiety in contrast to behavior guided by reason. Webster captured its ordinary meaning:

> as widespread fear of the collapse of the financial system, resulting in unreasoned attempts to turn property into cash, withdrawing money et cet.

The keyword is unreasoned. The evidence for such behavior of depositors seeking to withdraw cash—a bank run—is contained in the accounts of journalists in local newspapers and national financial journals. There are vivid and detailed descriptions of depositor behavior, sometimes resulting in disorder requiring police intervention.

Revisionists, for example Kaufman (2003) and Gorton (2010), have been at work in the past decade redefining what happened during a banking panic. They reject the traditional view that bank panics were an irrational depositor response, that is, that depositor behavior was dictated by extreme fear and anxiety. They argue, to the contrary, that bank runs were a rational response of depositors and were information based. Rational economic agents are presumably maximizers and pursue behaviors that are best for them. Depositors engaged in runs on banks were simply attempting to retrieve their deposits for cash to avoid the threat of loss in the event of bank suspensions in accord with the principle of maximizing their own self interest. Gorton (2010: 31) redefined a banking panic as a situation where the banking system is insolvent, unable to convert deposits into cash. Depositors run on banks "en masse." Fear and anxiety play only a minor role. There were no banking panics in the original sense. The only evidence Gorton advances, however, is the allegation that small denominational clearing house certificates traded initially at a discount from which he inferred that the clearing house was insolvent (unable to convert deposits into cash). That was not the case in 1873.

Number of bank suspensions

There are no official estimates of total bank suspension during the month of September 1873. My estimates have been constructed from two principal sources: contemporary newspaper accounts and financial journals including *Bradstreet's* and the *Commercial and Financial Chronicle*. I make no claim that my estimates account for all failures during the panic month of September. Every effort was made however to check and crosscheck claims that specific banks had shut down, if only temporarily.

Table 2.1 shows the number of suspensions in New York and the interior for September 1873 classified by type of bank organization. Private banks include brokerage houses as well. Two things stand out prominently: the small number of closures (excluding brokerage houses) in New York City—one national bank and two trust companies—and the high percentage of brokerage houses (60 percent). For the interior the percentage is much smaller, of which one half were in Philadelphia. Bank suspensions other than brokerage houses could easily be exaggerated in September 1873. Just as 1907 was described as a trust company panic, 1873 could equally well be labeled a brokerage house panic.

The geographical incidence of bank failures is revealed in Table 2.2. The highest concentration was in three states: New York, Pennsylvania and Virginia had over 70 percent of all bank suspensions. The middle Atlantic region accounted for 60 percent, due almost

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Table 2.1 Bank suspensions in New York and interior by type of bank organization, September 1873

	National	*State*	*Savings*	*Private*	*Trust*	*Unclassified*	*Total*
New York	1			34	2		37
Interior	15	11	7	25	2	4	64
Total	16	11	7	59	4	4	101

Source: Author's estimates

Table 2.2 Bank suspensions by state and grouped by region, September 1873

Middle Atlantic	
New York	37
Pennsylvania	22
Southern	
Virginia	10
Washington, D.C.	2
Georgia, Alabama, Tennessee	7
Midwest	
Illinois	8
Ohio	4
Wisconsin, Iowa, Michigan	7
Other regions	4
Total	101

Source: Author's estimates

entirely to the collapse of 45 brokerage houses in New York and Philadelphia. The Southern and Midwestern regions each accounted for 20 percent. City-wide bank runs were serious in Augusta and Savannah, Georgia; Louisville, Kentucky; Charleston, South Carolina; Memphis, Nashville and Knoxville, Tennessee; and Petersburg and Richmond, Virginia.

Origins

The panic had its origins in the failure of Jay Cooke and Company on September 18, 1873. The Philadelphia branch had made a $15 million advance to the Northern Pacific railroad for construction credit. First National Bank in Philadelphia, wholly owned by Cooke, suspended; and the First National Bank of Washington, D.C., also a Cooke company, did likewise. Jay Cooke and Company was one of the most prestigious banking houses in the U.S. Its closing was a surprise and changed the character of the 1873 crisis. Although it

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was not the first of the private banks in New York to fail, it generated the most attention. These failures brought pandemonium to Wall Street and stock prices tumbled followed by a veritable wave of insolvencies including more than thirty brokerage houses.

According to Henrietta Larson (1968: 410), Cooke's biographer, the firm was overloaded with investments and advances made to specific railroads including the Northern Pacific. Credit stringency made it impossible to obtain funds to tide it over. She maintained that the failure of Jay Cooke marked the close of an important phase of American business, that is, the speculative promotion of railroads beyond a reasonable expectation of satisfactory returns under post-Civil War conditions. Frenzied railroad building ahead of demand encouraged speculative excess and was an important contributor to the 1873 panic.

Following Cooke's failure runs began on several New York City banks. On September 20 the Stock Market closed for ten days for the first time in the city's history. The same day the NYCH authorized the issue of clearing house certificates. The Clearing House had also voted to equalize the reserves of the member banks; it gave the NYCH the authority to redistribute currency reserves of the individual banks, a measure that could have avoided the suspension of cash payment.

From September 18 to September 25, banking unrest spread down the eastern seaboard from New York, Philadelphia and Washington, D.C. to Petersburg and Richmond, Virginia, and then on to Augusta and Savannah, Georgia and Charleston, South Carolina. Simultaneously, banking disturbances erupted in the middle of the country: Chicago, Memphis, Indianapolis and Louisville. The residue of so much banking turmoil was bank runs and bank closings. On September 24, the NYCH suspended cash payment.

I conclude (Wicker 2000) that suspension of cash payment was unnecessary. The behavior of legal tender reserves of NYCH banks from September 20 to October 24 is shown in Table 2.3. Since specie did not circulate, the relevant component of total reserves was legal tender. Between September 20, the date of the issue of clearing house certificates, and September 24, when cash payment was suspended, the NYCH banks lost $18 million in reserves. The clearing house continued to pay out cash to the out-of-town banks even after suspension. Legal tender fell from $15.8 million on September 24 to $5.8 million on October 15. Considering that the NYCH was prepared to continue to pay out cash after suspension, we can well wonder why cash payment was suspended. It was the pooling of reserves that made possible the ultra-liberal policy that made the continuation of payment of cash to the interior. Since the suspension of cash payment was always accompanied by the hoarding of cash, the actual level of legal tender understates what reserves would have been in its absence. There was really no need for suspension. Had payment not been suspended legal tender reserves would not have fallen so precipitously and there would have been less reason for interior banks to have withdrawn their New York balances.

Sprague (1910: 54) concluded, however, that "the bankers were clearly at the end of their reserves, and the step taken on September 24 seems amply justified." Bagehot (1887: 199) would have counseled otherwise: "The only safe plan for the Bank of England is the brave plan, to lend in a panic on every kind of security, or on every sort on which money ordinarily and usually lent. Their policy may not save the Bank; but if it does not, nothing will save it." According to Bagehot no constraint whatsoever should be placed on the paying out freely of the reserve.

Causation

The consensus among financial historians is that at the deepest level certain structural weaknesses of the National Banking Act increased the vulnerability of the U.S. banking

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Table 2.3 Legal tender reserves of New York Clearing House banks, September 20 to October 24, 1873 (in millions of dollars)

September	20	33.8	October	10	6.6
	24	15.8		11	6.5
	25	14.9		13	6.0
	26	14.1		14	5.8
	27	12.3		15	6.2
	29	10.1		16	6.1
	30	9.3		17	6.6
October	1	8.3		18	7.0
	2	7.7		20	6.8
	3	7.2		21	7.7
	4	6.9		22	8.4
	7	5.9		23	9.4
	8	6.5		54	9.9
	9	6.8			

Source: New York Clearing House Loan Committee, Minutes, December 2, 1861 to January 8, 1874, p. 24

system to panics. There are three weaknesses that have received the most attention: (1) the inelasticity of the national bank note currency, (2) the pyramiding of reserves in New York, and (3) the fixed and invariant reserve requirements. The currency stock was composed of specie, a fixed quantity of greenbacks issued to finance the Civil War, national bank notes, and, before 1866 when they were taxed out of existence, state bank notes. There was no incentive to expand the money stock seasonally nor during emergencies. National bank notes could only be expanded with the purchase by the national banks of government securities, the amount being limited to 90 percent of the par or market value, whichever was lower. Therefore the supply of national bank notes depended on the bond market. When government bonds could be purchased at below par it was profitable to issue notes. As the market value rose relative to their par value the incentive disappeared. There was no assurance that the note issue would expand during a financial crisis. Reserves were pyramided in New York and were largely fictitious. There were three separate reserve classifications with reserve requirements: for country banks 15 percent, reserve city banks and central reserve city 25 percent, some of which could be held as cash in vault, and the rest in the next highest reserve classification as deposits, a large part of which was not available in emergencies.

It is not at all clear that the National Banking Act made the banking system more prone to panics. At a more fundamental level legislation prohibiting statewide branch banking may also have been important.

At another level was the extraordinary expansion of railroad mileage in the immediate post-Civil War decade. A veritable transportation revolution was underway and one of its objectives was to link the developed East with the undeveloped West. Railroad mileage doubled between 1865 and 1873, the focal point being the completion of the first transcontinental route to Ogden, Utah, in 1869.

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The expansion of railroad mileage encouraged speculation by creating expectations of generous future returns. Mileage was expanded beyond the capacity to generate supporting revenue. Some banks and brokerage houses overextended themselves to accommodate the long line of eager borrowers. The whole process was accelerated by grants of free land to the railroads and outright dollar grants of government assistance. As noted above, more than 60 percent of bank closures were brokerage houses in the two cities of New York and Philadelphia. Brokerage houses succumbed not because of banks runs but because of insolvency.

Financial effects

The financial effects of the panic are fairly easy to identify. Sprague enumerated at least three: (1) disruption of the domestic exchanges, (2) delays in the transshipment of commodities to the East, and (3) payroll difficulties. But he provided no estimate or quantitative measure by which to judge their significance. Transaction costs simply increased.

Friedman and Schwartz's (1963) annual estimates (February 1873 to February 1874) of M1 (currency and demand deposits) and M2 (currency, demand deposits and time deposits) reveal a 1.8 percent decline in M1 and an increase of 1.3 percent in M2. It seems to be quite clear that bank failures in 1873 did not cause a serious contraction of the money stock because of the fewness in number. Nor do we have any direct estimates of the amount of hoarding, a predominant characteristic of the Great Depression. We might have expected an increase in hoarding with the restriction of cash payment. The currency premium, however, reflected a scramble for currency. Between September 12 and October 13, legal tender notes held by national banks declined by more than 25 percent. By November one-half of that loss had been recovered. Sprague (1910: 70) conjectured that no considerable amount of money lost by the banks was being hoarded by depositors because of the normal seasonal increase due to the crop-moving season.

The extent of money market stringency is apparent in Table 2.4 which shows monthly commercial paper rates in New York. Rates soared in August and October by over 10 percent. Call money rates suffered even wilder gyrations.

Table 2.4 Prime commercial paper rates in New York, 1873

January	9.40
February	9.15
March	10.10
April	10.75
May	8.20
June	6.80
July	6.50
August	7.20
September	12.50
October	17.00
November	13.85
December	10.15

Source: Crum (1923)

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Another indicator of the financial panic is revealed in the change in loans and discounts, total deposits and legal tender currency between 1871 and 1873. Both loan and deposit contraction was substantial in 1873 relative to comparable call dates in the two prior years. Country and reserve city banks responded to the panic by drawing down reserves by $242 million. There was a substantial flow of funds from New York banks to the interior (outside New York). The New York banks shipped $14.5 million of legal tender currency notes. Interior banks reduced their deposits in New York by $134 million. Although the number of suspensions in the interior was not large and was region-specific, there still was substantial flow from New York to the interior measured solely by national bank balance sheets. After October currency, began to flow back to New York. Flows of currency were short-lived.

Real effects

An information deficit complicates any serious attempt to measure the real effects on output and employment, We have two separate annual estimates of real GNP, one by Romer (1989) and the other by Balke and Gordon (1989), but no annual estimate for unemployment. Lebergott's estimates for unemployment begin in 1890, as do Romer's.

According to business cycle annals a serious cyclical contraction followed the panic in September 1873. The National Bureau of Economic Research identified a cyclical peak in October 1873. Fels (1959: 98) opted for September but he did not rule out the possibility that the expansion may have leveled off before the panic. Without reliable estimates of unemployment there is no way to assess the basis for the alleged perception of unrelieved gloom or any comparison with the depression of the 1890s and the 1930s. Annual estimates for real GNP do not support a claim of a serious depression. There is no decline in Romer's estimate (see Table 2.5) in the post-panic year 1874 when real GNP increased by 1.4 percent and a less than one percent decline in the Balke–Gordon estimate. There is, however, a basis for gloom in the agricultural sector where persistently falling commodity prices increased

Table 2.5 Romer and Balke–Gordon real GNP and price deflator estimates, 1869–1879

	Real GNP (1982 = 100)		*Price deflator (1982 = 100)*	
	Romer	*Balke–Gordon*	*Romer*	*Balke–Gordon*
1869	75.609	78.2	10.244	10.49
1870	76.464	84.2	9.661	9.98
1871	76.952	88.1	9.769	9.86
1872	89.605	91.7	9.423	9.60
1873	94.863	96.3	9.329	9.51
1874	96.205	95.7	9.169	9.25
1875	97.684	100.7	8.945	8.85
1876	104.628	101.9	8.539	8.51
1877	110.797	105.2	8.207	8.38
1878	118.906	109.6	7.627	7.87
1879	127.675	123.1	7.378	7.64

Sources: Romer (1989: 22) and Balke and Gordon (1989: 84), Real GNP in billions

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the burden of mortgage indebtedness and freight rates did not fall as rapidly as the price of the major crops, thereby creating a cost-price squeeze. Farmer unrest is attested by the growth of pressure groups such as the Grange. Increased political activity was evidenced by the formation of the Greenback Party in 1875 whose main objective was currency expansion.

The Coe Report

In November 1873, shortly after the end of the panic, the NYCH issued a report (New York Clearing House 1873) that was acclaimed by Sprague (1910: 90) as "the ablest document which has ever appeared in the course of our banking history." The Chairman of the Committee was George C. Coe, president of the American Exchange Bank, who was one the ablest bankers in the U.S. at the time, if not the ablest. Redlich (1968: 424–38), in his brief biographical sketch, attributed to Coe the origin of the clearing house loan certificate. He may very well have been responsible for reserve equalization. Coe fervently believed that the NYCH banks possessed the knowledge, the power and the instruments to prevent banking panics in the U.S. A purely voluntary association of New York banks working through the NYCH and who recognized their responsibility for the maintenance of banking stability was a feasible solution to the banking panic problem. The Coe Report made the case that banking panics could be averted if the NYCH exercised bold leadership by exercising its power and instruments to achieve that objective.

The Report clearly stated that in the absence of a central bank, such as existed in other countries, the NYCH banks were the last resort in time of emergency. In a speech delivered to the Clearing House in June 1884, he made the point explicit that the New York banks, like the Bank of England, were holders of the country's banking reserve. The report denied the right of any bank to conduct its affairs in defiance of the best interest of all the clearing house banks. There could be no stronger statement of the collective responsibility of all the banks.

The main problem during panics was not the insufficiency of reserves but their unequal distribution. The report stated: "An expedient was found by which the stronger banks placed themselves under an unequal burden and equalized the pressure of gathering in their reserves and placing them at the disposal of the weaker who were thus furnished with the means to meet the demands of their depositors to save themselves … from ruin."

Moreover, the NYCH requested the authority from Congress to relax the reserve requirements and the cessation of interest payments on interbank balances. Not only was the nation's banking reserve concentrated in New York, but it was concentrated among a few banks. Of the approximately 60 members of the Clearing House at least 15 held almost all of the bankers' balances of the New York banks. According to Sprague (1910: 233) seven of these banks controlled 30 percent of total reserves, one-third of the loans, and two-fifths of the cash reserve. The size of these reserves was greater than that held by any one of Europe's central banks.

In subsequent years, opposition within the Clearing House to reserve equalization was so strong that it was abandoned in future panics.

Conclusions

The restriction of cash payment by the NYCH was not inevitable. The Clearing House continued to pay out currency to the interior thereby moderating the effects of the panic. What made that possible was the Clearing House policy of equalizing the reserves of the member banks by an assessment levied on the strong banks who supplied reserves to the

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weaker banks. The continued pay out of currency to the interior would have dispelled any doubts of interior banks about the ability of the NYCH banks to remain liquid and solvent thereby reducing the demands of interior banks for cash. The 1873 experience with pooling reserves was not repeated in 1893 and 1907. The opposition was too strong. A majority probably favored the policy. A few banks, however, were simply opposed to sharing their reserves in times of emergency, contrary to the decisions of the NYCH in 1860 and 1873.

The number of bank suspensions (101) was relatively small in contrast to the over 500 suspensions in 1893. Brokerage houses (private banks) made up a large percentage of the total. Insolvency, not banks runs, accounts for the closure of so many brokerage houses. Bank runs were confined to the eastern seaboard and the Midwest.

The extraordinary expansion of railway mileage contributed to heightened expectations of generous future returns. Mileage was simply expanded beyond the capacity to generate the necessary revenue.

The lesson we should have learned from the 1873 panic is that the continued payout of reserves through a policy of reserve equalization was a solution to the bank panic problem within the context of voluntary association of banks organized as the NYCH. A European central bank was an option, not a necessity. In the debate on banking reform prior to the establishment of the Federal Reserve no thought whatsoever was given to the reserve pooling arrangement (Wicker 2005).

Note

1 I have drawn heavily from my book: *Banking Panics of the Gilded Age* (2000).

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