
Bank Runs in History

Homework - The Banking System

DIRECTIONS

Over the past several hundred years, numerous bank runs and financial panics have occurred in the United States and elsewhere around the world. Summaries of two banking crises are provided below. Read the summary of each and answer the questions that follow.

BANKING CRISIS #1

The Argentine Economic Crisis, 1998 - 2002

Military dictatorships, hyperinflation, and depression characterized Argentina for the decades leading up to the 1990s. After a brief cycle of economic growth, several factors caused the country to fall back into depression. In the late 1990s, other Latin American countries fell into recession, government spending remained high, many political leaders were corrupt, and the government was in debt. One of the measures taken to combat the hyperinflation of the past was still in effect: conversions from pesos to U.S. dollars was set at 1:1. This kept the value of the peso artificially high, which caused the country to suffer a major trade deficit (more imports than exports). The International Monetary Fund (IMF) had loaned money to Argentina. When Argentina needed more money in the late 1990s, the IMF advised the government that the country had not taken enough measures to ensure the confidence of investors. As a result, the government cut spending and reduced the wages it paid its workers. This weakened the economy further. In 2001, an IMF loan was finally denied to the government, causing the financial system to panic. Businesses and people realized the peso was worth much less than the government-mandated conversion ratio. They withdrew funds from Argentinian banks, turning their pesos into dollars, and then deposited their money in foreign banks. In response, the government declared a "corralito" on all bank accounts. No person could withdraw more than 250 pesos per week, and no money could be withdrawn from an account denominated in U.S. dollars. Not only did this restriction make it difficult for the economy to recover, it also quickly angered the populace, causing mass demonstrations and riots. Some members of the government resigned, but the corralito was still in effect. It took a year for the government to erase this restriction, and they also did away with the mandated 1:1 ratio. Analysts feared a return of the hyperinflation of the 1980s, but only moderate inflation took place.

EXTENDED RESPONSE

Evaluate the performance of the Argentinian government before and during this economic crisis. What would you have done differently? Write your answer in paragraph form.

BANKING CRISIS #2

The Panic of 1893

The economic crisis of the early 1890s in the United States had many deeply rooted causes. One of the many precursors was the depression in Europe that began in 1889. This caused demand for American goods to fall, while simultaneously forcing Europeans to cash in their investments in America. Railroads in the United States, which had been a main force for economic expansion over the last several decades, began to falter. Early in 1893, the Philadelphia and Reading Railroad declared bankruptcy, soon followed by many more railroad companies. Because a great deal of money had been invested in railroads, individual investors lost their money when a railroad went bankrupt, and other investors began to realize railroads were no longer a safe investment. As a result, investors began taking money away from the railroad sector of the economy. Banks, which had financed many of these railroads, lost money, and depositors began to worry about whether or not their bank still had enough liquid assets to satisfy their deposits. At the same time, the agricultural sector of the economy was also finding itself in a credit crunch. The wheat and corn farmers of the Midwest, along with the cotton farmers in the South, had experienced declining prices for several years. This not only meant they had less money to purchase new goods and services from other sectors of the economy, but they were also unable to pay their mortgages. Needing the liquidity from mortgage payments from farmers to compensate for the railroad catastrophe, banks found it difficult to stay solvent (stay in business). During the 1890s farmers banded together to advocate for favorable legislation in order to soften their financial burden. The details, motives and consequences, are complex, but farmers tended to favor the Free Silver movement. As a result, silver flooded the market, depressing its value. The United States economy still functioned on a representative money system. This meant paper money was redeemable in silver or gold. With the onset of the economic crisis and with silver's value consistently falling, people began redeeming money for gold. When the United States' gold reserve fell below \$100 million--a psychological minimum threshold--the financial system panicked further.

Due to these many factors, depositors, especially other banks, began to realize their money might not be safe in a bank. Bank runs began occurring in June and the system began to recover by July. Unfortunately, several banks suspended cash payments and refused to process large withdrawals. This made depositors very uncomfortable, causing bank runs to continue through September. The parts of the country hardest hit were not in the traditional financial center of New York City, though it did experience its share of bank runs. Most bank failures and economic hardships were experienced in the Mountain West where the silver mines were located, and also in the Midwest and Southern states where the main agricultural heart of the economy existed.

EXTENDED RESPONSE

The Federal Reserve was not created until 1913, which means there was very little bank regulation in 1893. Of the four major regulations currently imposed by the Federal Reserve, banks in 1893 only had to obey a reserve requirement. (The other regulations are deposit insurance, capital requirements, and the discount window.) Using the Panic of 1893 as an example, explain why a combination of all four bank regulations are needed to prevent similar banking crises from happening. Write your answer in paragraph form.