

ECONOMICS U\$A
21ST Century Edition

PROGRAM # 20

THE BANKING SYSTEM:
WHY MUST IT BE PROTECTED?

AIRSCRIPT

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Final Transcript

Annenberg Learner (Logo and Music)

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DAVID SCHOUMACHER: New York, 1907. One of the city's major banks, the Knickerbocker Trust, closes...one man commits suicide...the banking system nearly collapses. What is it about the nature of banking that could lead to such a calamity? In the 1920s the banking system helped spread prosperity. By the 1930s it dragged the nation down. How could a holiday put an end to the deepening crisis? Despite stringent banking laws and more than seventy years of financial and regulatory experience why did the banking system nearly collapse?

Our nation has a long history of trying to protect the business of banking. But we've never eliminated all the risks. The Banking System...Why must it be protected? That's the question economic analysts Richard Gill, Nariman Behraves and I will investigate on this 21st Century Edition of Economics USA...I'm David Schoumacher...

(MUSIC PLAYS --OPENING TITLES)

(THE BANKING SYSTEM: Why Must It Be Protected? Appears on screen)

PART I

DAVID SCHOUMACHER: America's businessmen and women know how dependent they are on a friendly bank for their success of their companies and the growth of their communities, and this country's banking system has provided that success and that growth for more than a century. Although most banks are healthy and long-lived, historically we have had to face the tragedy of bank failures. While we can accept the failures of other businesses with a shrug, the closing of a bank is another matter...as we learn in our story of a bank that is no longer with us. New York at the turn of the century. Financial capital of America. It was money that kept New York moving and growing...money that built its elevated trains and skyscrapers...and most of the money that built New York came from the banks, of which New York boasted hundreds. From the powerful national firms on Wall Street to the more modest banks like the Knickerbocker Trust, which served the city's neighborhoods and its people...and as banks had done for centuries, the Knickerbocker held only a fraction of its depositors' money in reserve and loaned out the rest. Wall Street analyst Henry Kaufman explains how a bank earns money...

HENRY KAUFMAN: "Banks tended to earn money the same way as they do today in a general way...by making loans and by making investments. There was perhaps in those days, in hindsight, a somewhat greater risk taking than has tended to occur within the last forty years or so in the United States or in banking in modern times. It was and had a stronger entrepreneurial drive in those days and at the same time there was inadequate governmental supervision."

DAVID SCHOUMACHER: Charles Barney, the Knickerbocker's president, was one of those entrepreneurs, ambitious for his bank's success. Apparently, for Charles Barney, the chance came along to make a lot of money...this is if he was willing to take some major risks with the bank's money. Barney had connections with a speculator named Charles Morse. Morse and a partner, Frederick Hines, headed a scheme to manipulate the price of copper on Wall Street. Historian Robert Sobel explains...

ROBERT SOBEL: “Hines came to New York where he met Morse, who was a small-time speculator who was behind American Ice Company and a few other companies like that, and their plan was to get four or five banks behind them...and, once they had the banks’ assets, to use it to create a new copper company...United Copper...push the stock up, squeeze the shorts....that is to say, squeeze those people who sold the stock thinking it would go down, and make themselves a bundle. Perfectly legal for that period...”

DAVID SCHOUMACHER: What happened?

ROBERT SOBEL: “The stock market at that time was heading downward because of this “money crunch” I mentioned just briefly before...that is to say, the economy was overheating, many people were frightened that perhaps there would be a crash. They were taking their gold out of the banks. Most people knew that Knickerbocker was part of this group...and when United Copper started to collapse they put two and two together. Depositors started to appear at the Knickerbocker with those pieces of paper...as I said before, gold certificates written by the Knickerbocker...and said, ‘Give us our gold...’ and the money starts flowing out of the Knickerbocker. Now under normal circumstances...had the Knickerbocker been just a major bank...they would have gone to Morgan or someone else and said, ‘help us out of this. Otherwise there’s going to be a panic.’ ”

DAVID SCHOUMACHER: On Sunday, October 20, Charles Barney left his home here on Park Avenue to try to borrow the cash he needed. He went to appeal to the only source that he knew could save him...J.P. Morgan. Morgan had helped banks in trouble before...he was one of the few men with the resources and reputation to do it. But when Barney got to Morgan’s headquarters here at his library, Morgan wouldn’t even see him. For Barney disaster was now inescapable. The rumors took on a life of their own. Monday...the runs on the Knickerbocker began. Depositors panicked and tried to withdraw their savings. Tuesday, at noon, the Knickerbocker’s cash was gone and the panic spread to other banks until 246 banks across the country closed...their customers out of luck. J.P. Morgan, realizing the entire system was threatened, not to mention his

holdings, finally stepped in to end the panic of 1907. Under his leadership, a large reserve fund was put together. Then, facing appeals from banks and trust companies and brokerage firms, Morgan met with a group of New York City bankers in his library. Together they often worked through the night. In fact, it's said that at one point Morgan locked them in while they argued over which firms to save and which to let die. Morgan played solitaire at his desk...until they made their decision. Morgan had saved the day...as a grateful nation acknowledged...but the costs of the 1907 panic were high, as it affected banks and businesses and personal lives...including that of disgraced, distraught, Charles Barney...who killed himself. Ironically, the Knickerbocker Trust was not a bad bank. It was to re-open five months later, and the people who frantically lined up along here got most of their money back. As for the nation's bankers, they had to face two important realities. Could they allow the power to save the banking system to remain in the hands of a J.P. Morgan? What would they do if a J.P. Morgan wasn't there? The bankers turned to the federal government for help. They accepted the need for a central bank. The other important reality was that, despite all its inherent instability, neither the bankers nor businessmen wanted to give up fractional-reserve banking. Economic analyst Richard Gill explains why...

(MUSIC PLAYS - COMMENT & ANALYSIS I)
(ECONOMICS USA LOGO appears on screen)

RICHARD GILL: The reason why bankers wouldn't want to give up a fractional reserve system is pretty obvious. It's because they make money by lending out their depositors' money. Is this somehow sinful? Hardly. Banks are commercial enterprises. If they didn't make money on their loans, they'd have to charge us hefty fees to hold our deposits for us. Most of us, I suspect, would regard this as even more sinful. The Knickerbocker case, naturally, was a bit alarming but the fact is that, most of the time, fractional reserve banking works well. In its simplest form, a commercial bank's balance sheet might look like this. We have two columns here: assets and liabilities. Roughly speaking, "assets" are what the bank owns and "liabilities" are what the bank owes. In this stripped down case, the bank's assets consist of cash--money we have deposited in

the bank...and its loans to businesses. This bank owns a claim of \$80 million against the industrial firms, who have borrowed money from the bank and will pay interest back to the bank. Against these assets, we have what the bank owes to its depositors -- what we call demand deposits since they are, in principle, payable whenever we write a check on them...that is to say, "on demand." And what "fractional reserve banking" means is not that our assets exceed our liabilities...as you see, they balance here at \$100 million...but that the bank's demand deposit liabilities exceed the bank's cash reserves. The "fraction" here is one-fifth. Now what the Knickerbocker case shows is that there is an inherent vulnerability in this kind of banking. If this bank's \$80,000,000 in loans turns out to be bad loans, it can get into serious financial trouble. Even if the loans are O.K., the bank can get into bad trouble if people believe it is in trouble. If everybody wants their cash "on demand," obviously our bank is not going to be able to satisfy them. "Believing makes it so!" But this same principle also explains why the system usually works just fine. By believing our money is safe in the bank, it becomes so. Most of us never even think to ask our banks to show us their balance sheets. Not knowing, we have no need to know. Most of the time.

PART II

DAVID SCHOUMACHER: The Federal Reserve, Washington D.C...The central bank in a sense was a kind of institutionalized J.P. Morgan. It was intended as a "lender of last resort"...loaning money to banks such as the Knickerbocker Trust which were basically sound but temporarily in need of "shoring up." All of the nationally chartered banks were automatically members of the Federal Reserve System and many of the state banks joined as well. Did the Federal Reserve work? Well, through the 1920s, there were few complaints. In fact, the presence of the Federal Reserve in part reflected and in part reinforced the optimistic view of the times. The banking system supported the boom of the '20s. In fact, it increased the amount of money in circulation during those years. How did the banking system create money? Well, by making loans. As a loan was granted, credit was created and more money flowed through the banks. It had a multiplying effect. Workers earned their wages and the wages went into a bank, where it

could be loaned out to other people to buy cars...and more money flowed through the banks. Auto company profits could then be invested in steel mills, and so it would go... more and more money flowing through the banks. Would we grow forever? Henry Kaufman explains why most Americans in the '20s acted as if we would.

HENRY KAUFMAN: "When you get into an economic expansion, the commercial banking system or a financial institutional structure can aggravate problems by becoming too liberal in its loans...allowing a liberalization in credit standards. Now that immediately drives the economy very sharply, but within time adds to problems."

DAVID SCHOUMACHER: Banks gave liberal loans to investors. Investors in turn speculated widely on the stock market. Wall Street boomed...until "Black Thursday." October 24, 1929, the inevitable happened. The market fell! The "crash" pushed the country into the "Great Depression." Americans felt the pain of an economy grinding down...the money in circulation virtually drying up. Workers lost their jobs and took their savings out of the banks. Loans weren't made to industry...they were called in. Many losses couldn't be recovered. People weren't looking to buy new homes or cars or furniture. They were lucky to hold on to what they had. The economy hurt the banks...the banks hurt the economy. Historian Eugene White explains...

EUGENE WHITE: "The problems with the banks began to feed the fires of the Depression and it worked through a multiple credit contraction...that is that once a bank began to cease to make a lot of loans...when it began to increase its reserves...not make new loans to new customers...an increasing number of businesses began to fail, and other businesses couldn't pay back their loans. That meant that many banks found that their loans were weaker and they contracted even further...so it was a real slow unwinding of the system of financial intermediation."

DAVID SCHOUMACHER: What was the Federal Reserve doing at this time?

EUGENE WHITE: "What the Fed was supposed to do was to engage in a countercyclical policy to counteract the trends in the economy, but instead, it at the beginning...began to play a very neutral role. It just let the banking system slide

very slowly into chaos.”

DAVID SCHOUMACHER: Once again panic took hold. In 1930, a thousand banks failed. In 1931, more than two thousand. In 1932, the American people looked to new leadership to lift the country out of its economic crisis.

FRANKLIN ROOSEVELT: “Let me assert my firm belief that the only thing we have to fear is fear itself.”

DAVID SCHOUMACHER: In his inaugural address, Roosevelt pledged to establish strong banking safeguards.

FRANKLIN ROOSEVELT: “There must be a strict supervision of all banking and credit and investments.”

DAVID SCHOUMACHER: Responding to the urgent need, one of Roosevelt’s first presidential acts was to declare a national bank holiday. Merritt Sherman, who was with the Federal Reserve at the time, tells us why Roosevelt took this course of action...

MERRITT SHERMAN: “What Roosevelt was trying to do was to create a period in which the whole banking system...individual banks...could be reviewed by bank examiners...by experts who had a great deal of information about banks...and enable them, through the procedure of licensing banks, to re-open to carry out the promise made by the President, that any bank that was re-opened would be able to stay open.”

DAVID SCHOUMACHER: In his fireside chat, FDR announced to the people that the re-opened banks were safe.

FRANKLIN ROOSEVELT: “Let me make it clear that the banks will take care of all needs, and it is my belief that hoarding, during the past week, has become an exceedingly unfashionable pastime.”

DAVID SCHOUMACHER: And Roosevelt did more. Legislation following the bank holiday extended the powers of the Federal Reserve...forced banks to meet

tougher regulatory standards...and created the Federal Deposit Insurance Corporation to guarantee each customer's account up to \$10,000.

LITTLE BOY: "Give me my sixty cents."

CASHIER: "How do I know you got sixty cents?"

LITTLE BOY: "Here's my bank book..."

DAVID SCHOUMACHER: Americans showed their faith in the re-opened banks and the crisis passed. The "bank holiday" was a watershed in the Depression and is remembered as one of the most popular political moves by any President. The action was unprecedented, but, Richard Gill... Was a "bank holiday" really necessary? What had happened to the money supply?

(MUSIC PLAYS - COMMENT & ANALYSIS II)
(ECONOMICS U\$A LOGO appears on screen)

RICHARD GILL: Well, the money supply shrank drastically between 1929 and 1933, but you have to understand that by "money supply" we mean not just coins and currency, but also our checking accounts in the banks. In fact, since we make most of our major purchases by checks rather than cash, these banks deposits are by far the most important part of our money supply. And a point not all of us may be aware of is that commercial banks can actually "create" these deposits--actually create "money!" This really does seem a bit much, but in fact, it's a simple consequence of our old friend, fractional reserve banking. Let's follow through a million dollar new deposit of cash in the banking system. Let's suppose there is a rich widow who, frightened by the panic of 1907, has been keeping her \$1 million in cash under her mattress...hopefully not in one dollar bills -- and now, in the "Roaring '20s," she deposits this million in the bank. The bank has \$1 million more in cash and she has a \$1 million demand deposit in her name. Now we get to the fractional part of it. The bank lends out, say, \$800,000 of this to businessmen, and now the businessmen withdraw this money so that our bank now looks like this. But

what do the businessmen do with this money? They pay it out to workers, landowners, and so on, who deposit it in their bank. So now we have a second bank that has a new cash deposit. Its balance sheet looks like this. But now the second bank...on the familiar fractional reserve principle...lends out most of its new cash...say, \$640,000. Its balance sheet now looks like this. But hold on a second. Look what's happened. There are now \$800,000 more demand deposits in the economy...\$800,000 more money in the economy. We have the original \$1 million in the first bank plus \$800,000 in the second bank. And you ain't seen nothin' yet. Because this \$640,000 that the second bank lends out now becomes a cash deposit in a third bank, and so on and so on. We have had, by the time we are finished, a multiple expansion of money throughout the economy. Or a multiple contraction of money, because this same process can also work in reverse. Not only can, but did during the Great Depression. No wonder Roosevelt called for a bank holiday! No wonder our money supply collapsed so completely!

PART III

DAVID SCHOUMACHER: For almost fifty years after the Great Depression, the banking system worked--and worked well. Federal laws guaranteed deposits and watchful regulators kept banks out of high-risk ventures. Tens of thousands of Americans prospered and invested in homes, thanks to low interest mortgages from highly profitable banks. All considered it a solid investment.

DAVID SCHOUMACHER: President George Bush thought banks ought to be able to expand -- across state lines, or into the securities or insurance businesses -- so that they could earn even higher profits.

DAVID SCHOUMACHER: Some, like Congressman John Dingell Jr., Chairman of the powerful House Energy and Commerce Committee, thought giving banks more freedom was asking for economic trouble.

Then in 1999, pressured by powerful financial lobbies, Congress partially repealed the Glass-Steagall Act, the legislation that severely limited commercial and investment banking and opened the doors to risky ventures.

By 2008 the Great Recession with its double digit unemployment struck the nation with a vengeance. Thousands of Americans could no longer afford their mortgages. Foreclosures mounted. The housing bubble burst. Once again the banking system was in crisis. What had Congress wrought? By 2008 investment banks, like Washington Mutual, got into trouble.

PETER WALLISON: “The banks got into trouble for doing what banks always did. They made bad loans. In this case they bought and held a lot of mortgages. Bank regulation actually encourages people to believe that banks will not fail, and as a result they are much more likely to put their funds in a bank and not pay any attention to whether that bank is taking any kinds of risks. That’s called moral hazard.”

DAVID SCHOUMACHER: Were Fannie Mae and Freddie Mac, two mortgage companies the government helped create, also to blame for the banking crisis?

PETER WALLISON: “I think it actually came from government housing policy that created or assisted in the creation of 27 million sub prime and otherwise risky mortgages.”

DAVID SCHOUMACHER: But why didn’t the regulators- the Fed, the SEC- why didn’t they see the danger?

KAREN PETROU: "Regulators in the run-up to the crisis failed to understand the complexity of the market. The growth of what’s been called the shadow banking system outside regulated institutions.... They’ll buy a lot of banking assets through securitization markets. They’ll make lots of things that look like loans, and they’ll place lots of bets in the capital markets without being regulated.”

STEVEN PEARLSTEIN: “Furthermore, because the shadow banking system was so profitable for the Wall Street investment houses and the big banks, it kept wanting more

and more stuff, loans, to be packaged and sold, because they were making a fortune on the trading and the making of these things. So they kept asking for more and more...so then they had to make less good loans, and then less good, and less good, until well we know what happened. They made some really lousy loans.”

DAVID SCHOUMACHER: In his column for the Post, Pearlstein was astonished by what some of the regulators revealed.

STEVEN PEARLSTEIN: “I was particularly struck by how they admitted that they didn’t know fully what was going on. That is a pretty damning admission...and to the degree that they did know what was going on in the shadow banking system, not letting the rest of us know that it was going to be a problem. That was their duty, and they shirked that duty because they did not want to offend the banking industry.”

KAREN PETROU: “I think the fundamental thing that went wrong was overconfidence in the market’s ability to discipline itself.”

DAVID SCHOUMACHER: In a rare moment, Fed Chairman Alan Greenspan, an opponent of regulation, testified about why he had erred.

ALAN GREENSPAN: “I made a mistake in presuming that the self interest of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in their firms.”

DAVID SCHOUMACHER: So why did the Federal Government have to step in with a massive bailout? What did they mean by ‘too big to fail’?

PETER WALLISON: “Too big to fail is the idea that a certain institution, if it were allowed to fail, would cause damage to the economy.”

DAVID SCHOUMACHER: In 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act.

BARACK OBAMA: “All told, these reforms represent the strongest consumer financial protections in history. The American people will never again be asked to foot the bill for Wall Street’s mistakes.”

DAVID SCHOUMACHER: Will the new legislation truly work, and end the worry of “too big to fail?”

STEVEN PEARLSTEIN: “It is a fantasy to think that the solution here is to break the system up into a lot of little banks run by Jimmy Stuart. That is going back a hundred years. It is not going to go that way. Do we have to live with this problem and manage this problem? Yes.”

STEVEN PEARLSTEIN: “And they have got tools now that allow them to better manage the system, but ...human beings being what they are, there will be times when they don’t prevent a big bank from getting into trouble, and in which they might have to do things that prevent it from failing.”

DAVID SCHOUMACHER: During the go go years of Wall Street, low interest mortgages and deregulation, banks and investors made millions and consumers were protected from the loss of savings by the FDIC. Some were outraged by the rescue of banks deemed “too big to fail.” But, the American Banking System as a whole emerged safe and sound. Was it all worthwhile? We asked that question of Economic Analyst Nariman Behraves.

(MUSIC PLAYS - COMMENT & ANALYSIS II)

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NARIMAN BEHRAVESH: At the risk of oversimplification, the root cause of financial crises is the tendency of banks and other financial institutions to make lots of bad loans. When economic times are good, a portfolio of bad loans is not a big problem. However, the moment growth falters banks are left holding the bag.

The major point of financial regulation has been to save bankers from themselves! Well-designed financial regulation should be simple and easy to enforce with the goals of reducing the risks of future crises without curtailing the ability of financial markets to provide greater access to credit for everyone.

The issue during the 2007 – 2008 sub prime crisis was not so much the lack of regulation as the lack of enforcement. Unfortunately, there is no guarantee that new financial regulation will be enforced any more effectively than past regulation.

DAVID SCHOUMACHER: Everybody agrees that a sound economy requires a safe and reliable banking system. That's why the government has paid hundreds of billions of dollars to stand behind its guarantee to protect the deposits of millions of American Citizens. It's also why, although they disagree on political philosophy, the policy makers in the White House and Congress, and at the regulatory agencies, don't really argue whether to protect the system, but how. For this 21st Century edition of Economics USA, I'm David Schoumacher.

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