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6 Money versus Credit Rationing

Evidence for the National Banking Era, 1880–1914

Michael D. Bordo, Peter Rappoport, and
Anna J. Schwartz

6.1 Introduction

The provisions of the Acts of 1863 and 1865 that established the national banking system were designed to remedy two perceived defects of the antebellum state banking systems. One was the circulation of a wide variety of state bank notes, often at a discount, which made for an inefficient payments system. The second defect was instability of the note issue, marked by over-issue, bank runs and failures, and periodic suspensions of convertibility into specie. To remedy the first defect, state bank notes were replaced by national bank issues of U.S. bond-secured currency. To remedy the second defect, stringent reserve and capital requirements, oversight, and regulation by the Comptroller of the Currency were conditions for national bank charters. Unfortunately, the remedies did not work as intended by the architects of the national banking system. Instead, the system was characterized by monetary and cyclical instability, four banking panics, frequent stock market crashes, and other financial disturbances.

In this paper we examine the evidence for two competing views—monetarist and credit-rationing—on how monetary and financial disturbances influenced the real economy during the national banking era. These views stress either the asset or the liability side of the banking system's balance sheet as the way in which monetary shocks are transmitted.

According to the monetarist view, the way in which monetary disturbances—such as gold flows and banking panics in the national banking era—affected the real economy was through changes on the liability side of the banking system's balance sheet.¹ Changes in bank deposits impinge directly

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1. Milton Friedman and Anna J. Schwartz, *A Monetary History of the United States, 1867 to 1960* (Princeton, 1963).

and indirectly (through changing interest rates) on spending, while the composition of bank portfolios (reflected on the asset side of the balance sheet) is not important in explaining transmission.

According to the alternative, credit-rationing view, the composition of the asset side is important: changes in bank loans and other credit variables, independent of changes in the quantity of money, are the determinants of real fluctuations in the national banking period.² Banks engage in credit rationing rather than raise interest rates because in a world of asymmetric information, a rise in interest rates may encourage adverse selection, that is, borrowing by individuals and firms more likely to default. This approach follows an older tradition stressing the asset side of the balance sheet.³

Theoretically, credit rationing has been cast as an equilibrium concept. Several authors have suggested that changes in the equilibrium quantity of credit rationing can explain short-run fluctuations in real output.⁴ The idea is that changes in the "level of uncertainty" in the economy induce changes in the equilibrium quantity of loans, and thereby affect real activity.

Recently Charles Calomiris and Glenn Hubbard provided support for the credit-rationing view for the national banking period.⁵ We have followed their approach but expand their simultaneous equations model by considering additional factors that could explain the link they find between credit and the real economy. Our evidence suggests that it is difficult to distinguish between the two views. When monetary variables are introduced into the credit model, money is significant and credit declines in importance though its contribution is not eliminated. When credit variables are introduced into the monetarist model, money is robust but credit effects are also significant.

The inconclusive simultaneous equations results have led us to examine institutional data for the national banking period for evidence that helps distinguish between the two views. The key feature is the intimate connection between the stock market and the national banking system. A substantial fraction of the reserves of all national banks ended up being invested in the New York City call loan market. We show that loans secured by stock in New York City were volatile, but other loans were not. A similar but more muted pattern is found for the United States as a whole. Yet other loans comprise direct loans

2. Charles W. Calomiris and R. Glenn Hubbard, "Price Flexibility, Credit Availability, and Economic Fluctuations: Evidence from the United States, 1894–1909," *Quarterly Journal of Economics* 104 (Aug. 1989), pp. 429–52.

3. Joseph Stiglitz and Andrew Weiss, "Credit Rationing in Markets with Imperfect Information," *American Economic Review* 71 (June 1981), pp. 393–410; "Credit Rationing with Many Borrowers," *American Economic Review* 77 (Mar. 1987), pp. 228–31; Mark Gertler and R. Glenn Hubbard, "Financial Factors in Business Fluctuations," in *Financial Market Volatility* (Federal Reserve Bank of Kansas City, 1988), pp. 33–71.

4. Ben Bernanke, "Alternative Explanations of the Money-Income Correlation," *Carnegie-Rochester Conference Series on Public Policy* 25 (Autumn 1986), pp. 49–99; Calomiris and Hubbard, "Price Flexibility," pp. 429–52.

5. Calomiris and Hubbard, "Price Flexibility," pp. 429–52.

to businesses and so are the principal candidates for credit effects, if such effects were present.

This pattern suggests that disturbances in the stock market were mirrored in the call loan market, which in turn dominated total New York City bank loans and, to a lesser extent, total U.S. loans. Thus the significant influence of bank loans found in credit models may simply be reflecting volatility in the stock market. To test this possibility, we introduce a stock price index and the call loan rate into a simultaneous equations model incorporating both loans and money. The effect is to reduce greatly the influence of bank loans on real activity. The influence of money, however, remains robust.

The rest of the paper is organized as follows. Section 6.2 explains the money and credit-rationing views. We first set out the credit-rationing story and contrast it with the money story. We then trace the effects to be expected from various shocks according to the two views, beginning with the more familiar modern setting in which a central bank engages in open market sales that reduce bank reserves and money supply, with contractionary effects on national income. Then we turn to a gold standard setting, subject to gold outflows, in which banking panics occur. Section 6.3 reviews past attempts to assess the roles of money and credit in the transmission mechanism, and then turns to the empirical results of four simultaneous equations models of quarterly data that we present to test the two views.

In section 6.4 we examine the role of the stock and call loan markets. We describe the relation between the inverted pyramid of credit and the call loan market. Data from the Comptroller of the Currency's annual reports reveal the diverse pattern of loans secured by stock and of other bank loans. We present a simultaneous equations model incorporating stock market variables, money, and U.S. loans. Section 6.5 summarizes the paper, drawing lessons for research strategy.

6.2 Money versus Credit-Rationing: Theory

A considerable theoretical and empirical literature exists on whether the monetary system affects the real economy through the liability or the asset side of the banking system.⁶

Emphasis on bank credit as an alternative or additional channel to money goes back to Adam Smith and the classical economists. The real bills doctrine that dominated both nineteenth and early twentieth century thinking stressed that bank lending based strictly on self-liquidating commercial bills would always be sufficient to finance economic activity. John Maynard Keynes in *The General Theory* suggested the possibility of credit rationing. That sugges-

6. For a useful survey, see Mark Gertler, "Financial Structure and Aggregate Economic Activity: An Overview," *Journal of Money, Credit and Banking* 20 (Aug. 1988, pt. 2), pp. 559-88.

tion led to the availability doctrine, whereby the Federal Reserve would influence the availability of bank loans through its open market operations.⁷ It was assumed that changes in bank deposits would be offset by substitution into nonmonetary assets. Hence the only way the monetary authorities could affect spending was by influencing total credit.⁸ A modern proponent of these views bases them on extensive empirical evidence showing a close connection between various credit aggregates and economic activity.⁹

In the past decade, various authors have given a new impetus to the credit approach. Based on the theory of incomplete information and the seminal "lemons" article, they have argued for a theory of "equilibrium credit rationing."¹⁰ In their view, the market for loans is a customer market where factors other than price are important, unlike the auction markets which characterize many other commodities. Specifically, because of asymmetric information available to lenders and borrowers, a rise in the loan rate, by encouraging adverse selection (a predominance of loan applicants with risky projects) and moral hazard (engaging in risky behavior after receiving a loan) on the part of borrowers, can increase the incidence of defaults and reduce the real return earned by the lenders. Under these circumstances, banks will charge a "lemons premium" to highly qualified borrowers, causing them to reduce their borrowing, and will restrict loans to marginal borrowers. With equilibrium credit rationing, loan rates will not rise to clear the loan market. The supply curve is backward bending. In a macro setting, this theory predicts that restrictive monetary policy will lead to a reduction in bank lending with little influence on interest rates. Extensions of this approach view commercial banks as important because they use their expertise to screen borrowers, and hence reduce the information asymmetry. One device used is the posting of collateral. In this context, restrictive monetary policy, if it produces bankruptcy and declines in net worth because of debt deflation, will disrupt the valuable credit-intermediation network created by the banking system, further reducing bank lending and economic activity.¹¹

With these views in mind, we trace the transmission of both monetary and

7. Robert Roosa, "Interest Rates and the Central Bank," in *Money, Trade and Economic Growth: Essays in Honor of John H. Williams* (New York, 1951), pp. 270–95.

8. Committee on the Working of the Monetary System (Radcliffe), *Report*, Cmnd. 827 (H.M.S.O., 1959); Commission on Money and Credit, *Money and Credit: Their Influence on Jobs, Prices, and Growth* (New York, 1961); John Gurley and Edward Shaw, *Money in a Theory of Finance* (Washington, D.C., 1960).

9. Benjamin Friedman, "Debt and Economic Activity in the United States," in B. Friedman, ed., *The Changing Role of Debt and Equity in Financing U.S. Capital Formation* (Chicago, 1982).

10. Stiglitz and Weiss, "Credit Rationing in Markets with Imperfect Information," pp. 393–410; "Credit Rationing with Many Borrowers," pp. 228–31; Joseph Stiglitz, "Money, Credit and Business Fluctuations," *The Economic Record* 64 (Dec. 1988), pp. 307–22; George Akerlof, "The Market for Lemons: Qualitative Uncertainty and the Market Mechanism," *Quarterly Journal of Economics* 84 (Aug. 1970), pp. 488–500.

11. Ben Bernanke, "Nonmonetary Effects of the Financial Collapse in the Propagation of the Great Depression," *American Economic Review* 73 (June 1983), pp. 257–76.

real shocks according to the money and credit-rationing views. We initially focus on a modern setting, and then on the pre-Federal Reserve System and the classical gold standard.

6.2.1 The Modern Setting

We compare the two views of transmission, first, following an open market sale of government securities and second, following an unexpected decline in exports.

An Open Market Sale of Government Securities

In the simplest version of the money view, an open market sale reduces the reserves of the commercial banks (we neglect the distinction between borrowed and nonborrowed reserves). In the face of declining reserves (assuming no excess reserves), the banks sell investments and call in (do not renew) their loans. As a result deposits decline. The decline in deposits leads to a fall in expenditures, which in turn reduces output and the price level. Rising market interest rates as well as implicit rates connecting assets to service flows will be a key conduit connecting money supply to spending. This approach assumes that deposits and other financial assets are not close substitutes, whereas loans and other earning assets are.¹²

In the credit view, the open market sale reduces reserves and leads to a decline in bank loans (presumably, because loans and investments are not close substitutes, the former decline more). As in the money view, deposits are reduced, but because of a high degree of substitution between transaction balances and near-monies, there is little effect from this source on spending. In the approach put forward by Joseph Stiglitz and Andrew Weiss, as the decline in lending threatens to raise interest rates, the danger of adverse selection and moral hazard increases for lenders, so banks reduce their lending further (they engage in credit rationing). If the contractionary policy leads to bankruptcies, a stock market crash, or deflation, then the decline in the net worth of firms subjects lenders to greater moral hazard and increases adverse selection. The reduction in the value of collateral can lead to further declines in bank loans.

12. The story can be complicated by distinguishing between certificates of deposit and other deposits, with the former being close substitutes for marketable securities. In this case, as Eugene F. Fama, "What's Different About Banks?" *Journal of Monetary Economics* 15 (Jan. 1985), pp. 24–39, and Christina Romer and David Romer, "New Evidence on the Monetary Transmission Mechanism," *Brookings Papers on Economic Activity* 1 (1990), pp. 149–213, have demonstrated, if the reserve requirements on certificates of deposit were the same as on demand deposits, the reduction in bank liabilities would have no effect on interest rates and bank loans would dominate in the transmission mechanism. Since reserve requirements on certificates of deposit are considerably lower than on demand deposits, this is unlikely.

According to Karl Brunner and Allan H. Meltzer, loans and other assets (bonds) are not perfect substitutes (see Brunner and Meltzer, "Friedman's Monetary Theory," in Robert J. Gordon, ed., *Milton Friedman's Monetary Framework: A Debate with His Critics* (Chicago, 1976), pp. 63–76. They construct a monetarist model including a credit market, in which the effects of money dominate those of credit.

Both views assume that the central bank will act as a lender of last resort to prevent the onset of a banking panic. The two views differ, however, with respect to the empirical behavior of interest rates and loan aggregates at the business cycle peak. According to the money view, money growth decelerates during mid-expansion and is accompanied by a rise in interest rates that persists beyond the business cycle peak and well into the recession phase. According to the credit-rationing view, interest rates do not exhibit this pattern because of the adverse selection problems banks are assumed to confront should interest rates rise. According to the money view, the allocation of credit between loans and investments in bank portfolios has no effect on the aggregate of deposits. Banks expand their portfolios and deposits with the availability of reserves. According to the credit-rationing view, banks withdraw from loan expansion when their attitude toward loan applicants hardens. It is precisely that behavior which proponents of this theory claim causes a contraction of the economy.

A Decline in Exports

The outcome of a transitory real shock, such as a decline in exports, according to the money view, depends on the actions of the central bank. In the absence of a shock to bank reserves, banks will hold excess reserves and will lower interest rates. If demand for loans does not increase in response to the interest rate decline, banks will expand their portfolio of investments. A stable money supply and lower interest rates will eventually provide a stimulus to the economy.

In the credit view, a transitory real shock that lowers the demand for loans may be exacerbated if the degree of uncertainty is affected.¹³ If uncertainty is increased, this will cause banks to reduce their lending further, because of the adverse selection and moral hazard problems mentioned above. Unlike the money view, the credit-rationing view, as represented by Stiglitz, provides no role for accommodating monetary policy to mitigate the effects of a real shock.¹⁴

6.2.2 The National Banking Era

In the pre-Federal Reserve setting, two key institutional differences affected the transmission mechanism: the absence of a central bank and the classical gold standard. The first factor was important because an effective lender of last resort did not exist.¹⁵ The importance of the second factor was that a

13. William W. Lang and Leonard I. Nakamura, "The Dynamics of Credit Markets in a Model with Learning," *Journal of Monetary Economics* 26 (Jan. 1990), pp. 305-18; and Stiglitz, "Money, Credit and Business Fluctuations."

14. Stiglitz, "Money, Credit and Business Fluctuations."

15. On a number of occasions, the clearing houses, a consortium of large New York City commercial banks, and the U.S. Treasury performed this role.

gold outflow, induced typically either by a rise in Bank Rate by the Bank of England or by a severe harvest failure—a real shock that led to a deficit in the current account—reduced monetary gold reserves.

A Gold Outflow

If the Bank of England raised its discount rate, a short-term capital outflow from the United States ensued, as did a gold outflow that reduced the reserves of the commercial banks.¹⁶ According to the money view, both loans and investments declined, *pari passu* with deposits, interest rates rose, and spending declined along with output and prices. A key difference from the modern setting could, however, arise. There was no ready source of high-powered money to replace the loss of monetary reserves. In addition, if the external drain was also accompanied by an internal drain, such as a seasonally induced demand for reserves by country national banks, the possibility arose of a banking panic generated by a decline in the public's deposit-currency ratio as well as the banking system's deposit-reserve ratio.¹⁷ This could produce a further decline in the money supply. Resultant bank failures could lead to bankruptcies, reductions in firms' net worth, and further bank failures, as the value of bank assets declined. This process could continue unless some authority intervened as a lender of last resort or the convertibility of deposits into currency was suspended.

In the credit view, the decline in bank reserves reduced loans (more than investments and more than deposits), as it would today, but the incipient rise in interest rates could lead to credit rationing because of adverse selection and moral hazard. The fall in activity and the price level would reduce the value of bank collateral, causing a further reduction in bank loans. If a banking panic ensued, this exacerbated the process, leading to a rise in the cost of intermediation. A stock market crash also would reduce the net worth and collateral of firms, in turn reducing bank lending.

A Harvest Failure

In the money view, a transitory real shock such as a harvest failure reduced output. If country banks withdrew reserve balances from their city correspondents and reduced loans and deposits, the national banking system contracted. A fortuitous short-term capital inflow from abroad could, however, cut short this process of decline. If the inflow did not occur, interest rates fell, leading

16. Friedman and Schwartz, *A Monetary History*, chap. 3. See section 6.4 below for an elaboration of the institutional framework of the U.S. banking system in this period.

17. For alternative explanations of banking panics in this period, see Michael D. Bordo, "The Contribution of *A Monetary History of the United States, 1867–1960* to Monetary History," in Michael D. Bordo, ed., *Money, History, and International Finance: Essays in Honor of Anna J. Schwartz* (Chicago, 1989), pp. 15–70; and Charles W. Calomiris and Gary Gorton, "The Origins of Banking Panics: Models, Facts, and Bank Regulation," in R. Glenn Hubbard, ed., *Financial Crises and Financial Markets* (Chicago, 1991).

to a gold outflow. The gold outflow reduced the money supply, output, and the price level until equilibrium was restored. If a banking panic ensued, further declines in the money supply occurred.

In the credit-rationing view, the story is the same for the modern period and the national banking era. The real shock reduced the demand for loans and the level of interest rates. If uncertainty increased, bank lending would be reduced, reflecting adverse selection and moral hazard. If bankruptcies, declines in net worth, and debt deflation ensued, then further declines in bank lending occurred. Finally, if the real shock caused a stock market crash, then equity rationing might follow, as declines in the net worths of firms made it harder for them to obtain external finance.¹⁸

6.3 Money versus Credit: Some Empirical Results

An early approach to these issues compared correlations between bank loans (and other credit aggregates) and economic activity, and those between various monetary aggregates and activity in the post–World War II United States, with the result that credit usually dominated.¹⁹ Two later studies based on Granger-causality tests and standard vector autoregressions (VARs) led to the conclusion that both money and credit together explain variations in real output.²⁰

The Granger-causality tests examine the reduced-form predictive power of money and credit variables, which is not necessarily the same as their causal role. In particular, it is necessary to abstract from contemporaneous effects of output on financial variables. One approach was to run a race between money and credit by identifying episodes in the post–World War II period when a contractionary monetary policy was adopted independent of the state of the real economy.²¹ In this approach, univariate forecasting regressions lead to the conclusion that money is an active force in transmission, with bank lending a reflecting force.

Another approach, using structural VARs, makes explicit allowance for contemporaneous interactions between output and credit and money, and finds that bank loans account for at least as much of the variance of output as

18. Dwight Jaffee and Joseph Stiglitz, "Credit Rationing," in Benjamin M. Friedman and Frank H. Hahn, eds., *Handbook of Monetary Economics*, vol. 2 (Amsterdam, 1990), chap. 16, pp. 838–98.

19. Friedman, "Debt and Economic Activity."

20. Benjamin Friedman, "Monetary Policy with a Credit Aggregate Target," *Carnegie Rochester Conference Series on Public Policy* 18 (1983), pp. 117–18, and "The Roles of Money and Credit in Macroeconomic Analysis," in *Macroeconomics, Prices and Quantities*, James Tobin, ed. (Washington, D.C.: Brookings Institution), pp. 161–99. Stephen King, "Monetary Transmission: Through Bank Loans or Bank Liabilities?" *Journal of Money, Credit and Banking* 18 (Aug. 1986), pp. 290–303, in his VAR found that money dominated credit. The relationship of VARs to other methods of estimating simultaneous equations systems is discussed below.

21. Romer and Romer, "Monetary Transmission Mechanism," pp. 149–213.

money. Subsequently the approach was applied to the pre-1914 national banking era.²²

Assessing the relative merits of the money and credit-rationing explanations requires that one disentangle a complex set of interactions among economic variables. This task is complicated by different views about the structure of these interactions held by the two schools of thought. In this section of the paper, we use a structural VAR approach to analyze a number of different models of the relationships among the variables of central concern to the money and credit views.

Structural VARs involve a strategy for identifying parameters in a simultaneous equations model that preserves some of the intent of the original Cowles Commission approach, while remaining sensitive to Christopher Sims's criticism of the "incredible" identification assumptions it necessitated.²³ The cost of this compromise is that the structural VAR approach requires the investigator to have great faith in the validity of all aspects of the model.

The structural and reduced forms of a linear simultaneous system can be expressed as

$$(1) \quad Y_t \Gamma + X_t B = V_t, \quad E(V_t' V_t) = \Sigma$$

$$(2) \quad Y_t = X_t \Pi + U_t,$$

$$(3) \quad \Pi = -B \Gamma^{-1}$$

$$(4) \quad U_t \Gamma = V_t,$$

$$(5) \quad E(U_t' U_t) = \Gamma^{-1'} \Sigma \Gamma^{-1} = \Omega$$

Here, Y_t and X_t are row vectors, respectively, of observations on the K endogenous and M exogenous or predetermined variables. U_t and V_t are K -element row vectors of reduced form and structural errors, respectively. The structural parameters are contained in the matrices Γ , B , and Σ , whose respective dimensions are $K \times K$, $M \times K$, and $K \times K$, while Π and Ω are $M \times K$ and $K \times K$ matrices of reduced-form coefficients that can be estimated consistently from ordinary least squares regression of Y on X .

Identification is accomplished by placing sufficient restrictions on the structural coefficient matrices—that a unique solution for Γ , B , and Σ is possible

22. This approach was first applied in this context by Bernanke, "Money-Income Correlation," pp. 49–99. The Bernanke method was applied to the pre-national banking era by Calomiris and Hubbard, "Price Flexibility," pp. 429–52.

23. Structural VARs were conceived by Bernanke, "Money-Income Correlation," and Christopher Sims, "Are Forecasting Models Usable for Policy Analysis?" *Federal Reserve Bank of Minneapolis Quarterly Review* (Winter 1986), pp. 2–16. For a discussion of the Cowles Commission approach, see Thomas Cooley and Stephen LeRoy, "Atheoretical Macroeconomics: A Critique," *Journal of Monetary Economics* 16 (Nov. 1985), pp. 283–308. For his criticism, see Christopher Sims, "Macroeconomics and Reality," *Econometrica* 48 (Jan. 1980), pp. 1–48.

from equations (3) and (5), given Π and Ω .²⁴ The three prominent approaches to identification can be summarized as:

- (a) Restrict Γ and B, and leave Σ unrestricted (Cowles).
- (b) After ordering the endogenous variables in a suitable manner, make Γ triangular, Σ diagonal, and leave B unrestricted (standard VAR).
- (c) Impose $K(K - 1)$ restrictions on Γ and Σ , and leave B unrestricted (structural VAR).

The rationale for the Cowles approach was that the structural errors contained the effects of variables not captured by the model, and since there could be no presumption that the same variables had not been omitted from more than one equation, one would expect the elements of V_t to be correlated contemporaneously. This implied that a total of $K(K - 1)$ zero restrictions needed to be placed on the Γ and B matrices.

Sims criticized this approach, arguing that it was difficult to believe the exclusion restrictions typically used, especially in the light of rational expectations models that conditioned people's behavior, and therefore observable variables, on all available past data.²⁵ He advanced the standard VAR approach, without claiming it represented structural relationships. However, several authors argued that little meaningful could be said unless a structural interpretation were placed on the triangular form of Γ used in Sims's approach, which, in turn, did not seem plausible.²⁶

The structural VAR approach adopts Sims's skepticism concerning restrictions on B, but sides with the Cowles approach in maintaining that restrictions on Γ are sensible. There are $K(K - 1)$ free elements in Γ , which is the number of restrictions required for identification. The fewer restrictions placed on Γ , the more must be imposed on Σ . Typically, the maximum of $K(K - 1)/2$ restrictions are placed on Σ , making it diagonal.²⁷ This strains credibility from the Cowles viewpoint, since it does not allow for correlation among variables omitted from equations: it is tantamount to an extreme expression of faith in the specification of the model.

In identifying the models that follow, we use the diagonal- Σ structural VAR strategy. This, in turn, necessitates that $K(K - 1)/2$ of the elements of Γ be zero. Since we are very far from believing any of these models to be the last word, we shall attempt to trace patterns that are consistent with the results of all the models.

24. Aside from K restrictions on Γ that normalize to unity the coefficient of one endogenous variable per equation.

25. Sims, "Macroeconomics and Reality," pp. 1-48.

26. The authors include Cooley and Leroy, "Atheoretical Macroeconomics," pp. 283-308; Rodney L. Jacobs, Edward Leamer, and Michael P. Ward, "Difficulties with Testing for Causation," *Economic Inquiry* 17 (July 1979), pp. 401-13; and Bernanke, "Money-Income Correlation," pp. 49-99.

27. An exception is Bernanke, "Money-Income Correlation," who, in a six-variable system, permits one off-diagonal element of Σ to be non-zero.

In all, we present four models in this section. The first two specifications we estimate include only the variables considered relevant to the determination of real output by proponents of the money and credit views, respectively. The drawback with these models is that neither allows for the effects of variables considered important by the other story: neither is sufficiently rich to distinguish the roles of the asset and liability sides of the banks' balance sheets. In order to compare the merits of the two stories, we need to nest the two models in a larger model. Unfortunately, such a system would be computationally intractable, and so we present a separate generalization for each model.

All models are estimated using quarterly data spanning the period 1880.I to 1914.IV. All variables except those involving interest rates enter the estimated models as quarterly rates of change, but, for the sake of brevity, we refer to these changes as M2, real GNP, etc. The sources of the data series used are described in the Appendix. The same estimation procedure is used for all the structural VAR specifications that we examine, and it will prove useful to describe it in detail in the context of the first model we discuss.

6.3.1 Monetarist Model

Our basic monetarist model involves five variables, the monetary base, M2, real GNP, the commercial paper rate, and the GNP deflator. Thus the vector Y_t in equation (1) is a row vector with five elements, the observations at time t on these five variables. The first step in implementing the structural VAR approach is to run a vector autoregression of the system, which is equivalent to estimating the reduced-form (2). The variables in X_t are four lagged values of each of the five variables, a constant term, time trend, and three seasonal dummies. These reduced-form regressions produce estimates of the reduced form errors, U_t , which are related to the structural errors, V_t , by the linear transformation Γ , as shown in equation (4). The object of the second stage of the estimation procedure is to extract estimates of Γ and Σ from the estimated reduced-form errors, essentially by using equation (5), which shows how the covariance matrix of U_t is related to these two parameter matrices.²⁸ Equation (5) contains $[K + K(K - 1)/2]$ (that is, 15) distinct relationships. Before the imposition of identification restrictions, Σ has $[K + K(K - 1)/2]$ (15) distinct parameters, and Γ has K^2 (25). For a unique solution to equation (5), K^2 (25) restrictions on the parameters are required (to produce as many equations as

28. The actual estimation procedure used is full information maximum likelihood (FIML) which converges in probability to the same values as the "method of moments" solution of equation (5) mentioned in the text. FIML minimizes the concentrated likelihood function:

$$-2\ln|\Gamma| + \sum_{i=1}^K \ln(\Gamma' \Omega \Gamma)_{ii}$$

over the unrestricted elements in Γ . The sample covariance matrix of U_t , Ω , is used in place of Ω , for which it is a consistent estimator. The covariance matrix of the structural errors, Σ , is then estimated as $\Gamma' \Omega \Gamma$.

unknowns). As discussed above, $K(5)$ of these come from normalizing diagonal elements of Γ to unity, $[K(K-1)/2](10)$ come from restricting Σ to be diagonal, and the remaining $[K(K-1)/2](10)$ come from setting elements of Γ to zero. The last type of restriction is a limitation on the contemporaneous interactions among variables.²⁹ Equivalently, in view of equation (4), it involves restrictions on the way the observable reduced-form errors, U_p , are composed of the unobserved structural errors, V_r .

Using the letters b , m , y , i , and p to refer to the base, M2, real GNP, commercial paper rate, and GNP deflator, respectively, and $g_{ij} = -\Gamma_{ij}$, the contemporaneous interactions we identify in the monetarist model are³⁰

$$\begin{aligned} u_b &= g_{41}^{(+)}u_i + g_{31}^{(-)}u_p + v_b \\ u_m &= g_{12}^{(+)}u_b + g_{42}^{(-)}u_i + v_m \\ u_y &= g_{23}^{(+)}u_m + g_{43}^{(-)}u_i + g_{53}^{(+)}u_p + v_y \\ u_i &= g_{24}^{(+)}u_m + g_{34}^{(-)}u_y + v_i \\ u_p &= g_{25}^{(+)}u_m + v_p \end{aligned}$$

The monetarist model allows the base to be affected contemporaneously only by interest rate and price shocks, reflecting the operation of the gold standard.³¹ Increases in the interest rate and decreases in the inflation rate are postulated to increase the base, via capital inflows. Some authors have argued that, during this period, interest rate and price shocks from abroad were reflected fully and quickly in domestic interest rate and price movements.³² These effects are allowed for by the interest rate and price channels included in the base equation. This explains why it is unnecessary to include explicit open economy variables. The money multiplier drives the dependence of the money supply on the base, while liquidity preference accounts for the presence of the interest rate. The presence of M2 in the output equation reflects demand shocks, and the interest rate and inflation rate are inserted to allow for the possibility of supply side, or real interest rate shocks. The interest rate is influenced by M2 and real output as a result of the demand for money. Finally, inflation is driven by shocks to the quantity of money. Notice that, since Σ is assumed to be diagonal, the shocks to each variable (v_b , v_m , etc.) are assumed independent of each other.

The estimates of the contemporaneous interactions are shown in the top

29. The i th column of Γ contains the contemporaneous coefficients in the structural equation for the i th variable. Thus, in the monetarist model for example, one would impose the restriction that M2 does not contemporaneously affect the base by restricting Γ_{21} to be zero.

30. The signs are those of the g_{ij} terms. Since K equals 5 in the monetarist model, ten of the off-diagonal elements of Γ are restricted to be zero.

31. We also ran the model with gold flows in place of the monetary base. The results are similar to those with the base, though less pronounced.

32. See Donald N. McCloskey and J. Richard Zecher, "How the Gold Standard Worked," in Jacob A. Frenkel and Harry G. Johnson, eds., *The Monetary Approach to the Balance of Payments* (Toronto, 1976), pp. 357-85.

panel of Table 6.1. As the table shows, three of the ten coefficients do not have the anticipated signs. Several factors may be involved here, besides the obvious possibility that the model is misspecified. First, the theory we are using to predict the signs of these interactions is comparative static in nature and does not necessarily require that the predicted effects be contemporaneous. Second, even if the theory were to apply to contemporaneous relationships, the synchronization of the available data leaves much to be desired.³³ For both of these reasons, we believe it to be more appropriate to examine jointly the contemporaneous and lagged influence of one variable on another, by using impulse response functions and decompositions of the variance of forecast errors.

Figure 6.1 shows the response of real output to innovations in the base, M2, and the interest rate. Shocks to the *levels* of M2 and the base have positive but permanent effects on output. Innovations in the interest rate have approximately a zero output effect on net, although the response is initially positive for four quarters.

The relative importance of shocks assigned to each variable can be assessed from the decomposition of the variance of the forecast errors, which is shown in the lower panel of Table 6.1. Here the columns correspond to the sources of the shocks (i.e., which element of V is responsible), and the row names are those of the variable being predicted. The horizon of the forecasts is twelve quarters in all cases. The salient feature of these results is that 26.8 percent of the variance of output forecast errors is assigned to base and M2 innovations. It is also worth noting that two-thirds of the variability of the interest rate comes from the innovations to the base and the money supply, while innovations to the interest rate have a considerably smaller effect.

In summary, there is little in these results that would lead a monetarist to revise his or her views on the nature of the transmission mechanism.

6.3.2 Credit Model

Table 6.2 describes the results of estimating a model designed to capture the effects of variables important to the credit view. This model was developed by Calomiris and Hubbard and is described in detail in their paper.³⁴ In their structural VAR, in addition to prices, output, and interest rates, they introduce three variables to capture the role of credit: real bank loans, a spread between risky and riskless assets of similar maturity, and the liabilities of business failures. These variables capture both traditional credit interpretations and the determinants of equilibrium credit rationing. The spread and business failures variables are intended to capture the increased “agency costs” faced by lower

33. For example, output and prices are quarterly averages, while the financial variables are measured at the end of each quarter.

34. Calomiris and Hubbard, “Price Flexibility,” pp. 429–52.

Table 6.1 Monetarist Model

Interactions Among Contemporaneous Variables					
Equation	Base	M2	Real GNP	Commercial Paper	Deflator
Base				1.077 ⁺ (0.498)	0.118 ⁻ (0.021)
M2	0.43 ⁺ (0.264)			0.886 ⁻ (0.469)	
Real GNP		0.876 ⁺ (2.51)		0.531 ⁻ (3.49)	0.017 ⁺ (0.02)
Commercial paper		-0.818 ⁻ (0.633)	-0.192 ⁻ (0.833)		
GNP deflator		0.246 ⁺ (0.038)			
Variance Decomposition (percent)					
Equation	Source of Innovation				
	Base	M2	Real GNP	Commercial Paper	Inflation
Base	64.5	12.1	2.9	16.5	3.9
M2	30.1	30.7	6.9	24.5	7.8
Real GNP	8.5	18.3	52.2	12.1	8.9
Commercial paper	35.8	32.0	4.8	18.8	8.8
Inflation	11.0	2.9	2.2	4.0	80.0

Notes: The entries in the table are the negative of the respective elements of the transpose of Γ . For example, the entry 0.43 means that the coefficient of the contemporaneous effect of Base growth on M2 growth is 0.43. The plus sign to the right of a coefficient signifies that its expected sign is positive; the minus sign, negative. All variables except those involving interest rates are percentage rates of change. Standard errors are in parentheses.

quality firms in their efforts to raise funds in a downturn.³⁵ They do not include money in their model on the assumption that the money supply was endogenous under the classical gold standard.³⁶

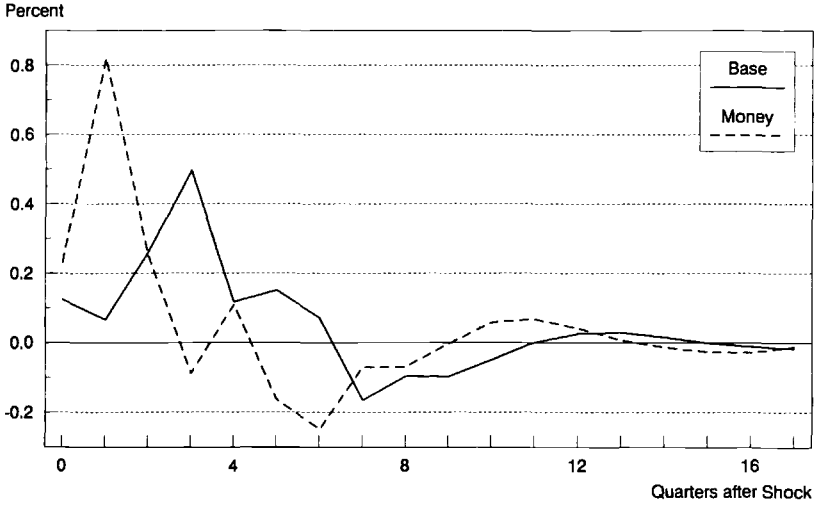
The model focuses on the effects of the loan market on economic activity, and so relates the *real* volume of loans to the spread between interest rates on low- and high-grade loans, and the rate of business failures.³⁷ Calomiris and Hubbard used a monthly series on loans extended at national banks in New York, Boston, and Philadelphia, while we use total national bank loans for the

35. See Frederic S. Mishkin, "Asymmetric Information and Financial Crises: A Historical Perspective," in R. Glenn Hubbard, ed., *Financial Crises and Financial Markets* (Chicago, 1991).

36. As evidence for this position, they cite studies showing interest rate and price arbitrage between the United States and Britain, and unpublished evidence that gold shocks reversed themselves within a short period of time.

37. The spread variable was constructed from rates on different grades of commercial paper, which are only available for Calomiris and Hubbard's 1894 to 1909 sample period. We used the spread between rates on low- and high-grade railroad bonds, constructed by Mishkin (see Appendix).

a) Response of real GNP to a one-standard-deviation shock in base and money



b) Response of real GNP to a one-standard-deviation shock in the commercial paper rate

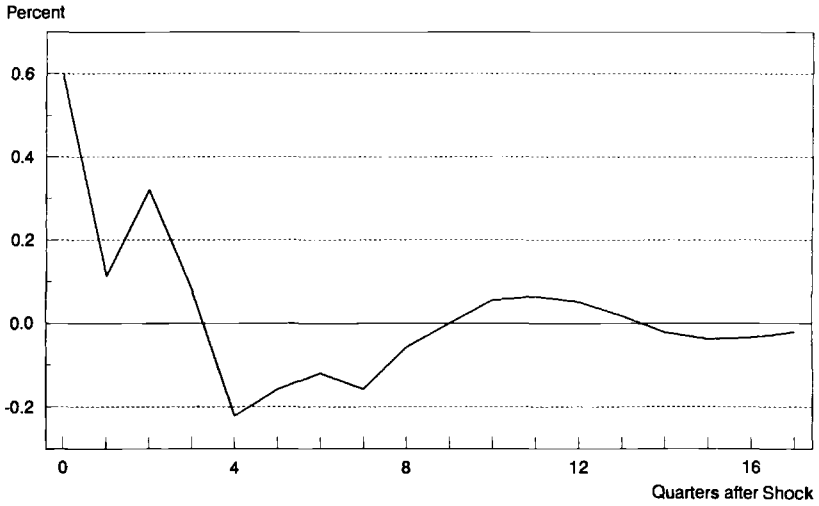


Fig. 6.1 Impulse Response Functions: Monetarist Model

Source: See text.

Table 6.2 Credit Model

Interactions among Contemporaneous Variables						
Equation	Real Loans	Commercial Paper	Spread	Deflator	Real GNP	Business Failures
Real loans			1.55 ⁻ (4.64)			0.364 ⁻ (0.90)
Commercial paper	-0.187 ⁻ (0.037)					
Spread		0.031 ⁺ (0.006)		-0.001 ⁻ (0.003)		0.032 ⁺ (0.016)
GNP deflator		-0.071 ⁺ (0.19)				0.871 ⁻ (0.544)
Real GNP	0.453 ⁺ (0.083)	0.37 ⁻ (0.23)	-2.13 ⁻ (2.76)	0.38 ⁺ (0.100)		-0.246 ⁻ (0.541)
Business failures		0.165 ⁺ (0.031)				
Variance Decomposition (percent)						
Source of Innovation						
Equation	Real Loans	Commercial Paper	Spread	Deflator	Real GNP	Business Failures
Real loans	82.2	7.9	5.8	2.1	0.7	1.2
Commercial paper	35.8	35.5	5.5	18.0	1.7	3.6
Spread	12.2	13.0	69.1	2.2	1.4	2.2
GNP deflator	10.7	4.5	1.9	76.2	2.7	3.9
Real GNP	35.9	3.4	3.3	16.8	37.2	3.2
Business failures	8.5	12.3	0.7	6.1	0.4	71.9

Notes: See Table 6.1.

entire United States. Similarly, our output variable is real GNP, while their's is the monthly pig-iron series. In spite of these differences, in addition to the fact that their sample spanned the 1894 to 1909 period, the results from the two versions of the model are quite similar.³⁸

As with the basic monetarist model, not all structural coefficients are of the anticipated signs, the most notable being the positive impact of the interest rate on output. The impulse response functions show a healthy impact of loan innovations on output, and also exhibit the initial positive response to interest rate shocks found in the monetarist model (Fig. 6.2). The most striking feature of the results is the 35.9 percent of output forecast-error variance explained by loan innovations. Calomiris and Hubbard found that only 10.6

38. A minor difference between the two specifications is that we do not include the spread variable in the inflation equation, which aids the convergence of our estimation procedure. This interaction was not statistically significant in Calomiris and Hubbard's work.

Response of real GNP to a one-standard-deviation shock in real loans and the commercial paper rate

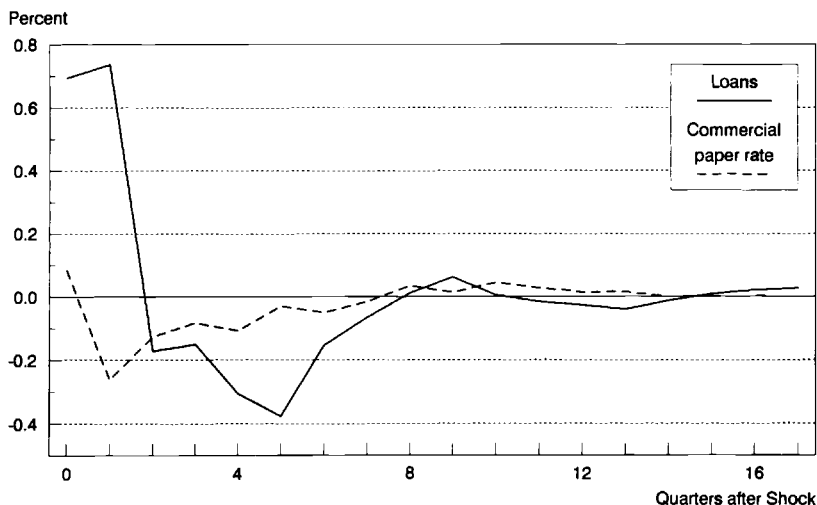


Fig. 6.2 Impulse Response Functions: Credit Model

Source: See text.

percent of this variance could be explained by real loan shocks in their monthly data. We will have occasion to return to this difference in section 6.4 below. In summary, the basic credit model, applied to the national banking era, does not turn up any evidence that would lead one to doubt it.

6.3.3 Hybrid Monetarist Model

Table 6.3 describes the results of estimating a hybrid monetarist model, expanded by adding credit variables. Thus, we add business failures and the spread variable to the five variables of the basic monetarist specification. In addition, we use the *real* money supply and base, since, from the credit viewpoint, it is real balance sheet variables that are important. Unfortunately, we are not able to add the loans variable to the basic monetarist model, because of the close relationship between movements in the quantity of loans on the one hand, and the base and money supply on the other. Of course, this difficulty dogs all tests of the relative merits of the two views.³⁹ This omission is remedied in the fourth model, discussed below.

The identification restrictions in the top part of Table 6.3 are driven by those in the two basic models. Thus, increases in business failures and the spread are anticipated by the credit view to have a depressing effect on M2, real GNP,

39. See Alan Blinder and Joseph Stiglitz, "Money, Credit Constraints, and Economic Activity," *American Economic Review* 73 (May 1983), pp. 297-302; and Karl Brunner and Allan H. Meltzer, "Money and Credit in the Monetary Transmission Process," *American Economic Review* 78 (June 1988), pp. 446-51.

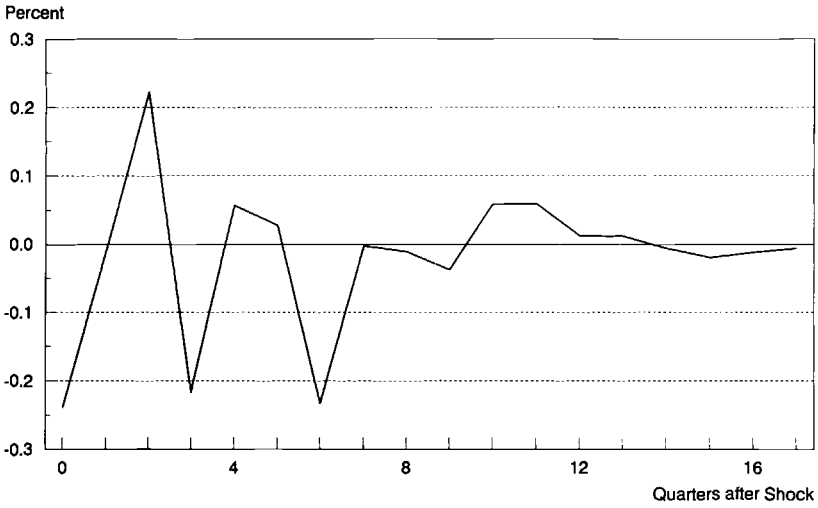
Table 6.3 Hybrid Monetarist Model

Interactions among Contemporaneous Variables							
Equation	Real Base	Real M2	Real GNP	Commercial Paper	Deflator	Business Failures	Spread
Real base				-3.24 (2.81)	-1.25 ⁻ (1.03)		
Real M2	-2.66 ⁺ (6.88)			2.33 ⁻ (8.0)		0.271 ⁻ (0.7)	0.100 ⁻ (0.27)
Real GNP		-0.012 ⁻ (0.24)		-0.358 ⁻ (0.28)	-0.150 ⁺ (0.18)	-0.071 ⁻ (0.06)	-0.01 ⁻ (0.03)
Commercial paper	0.514 ⁻ (0.13)	-0.827 ⁻ (0.29)	0.149 ⁻ (0.11)				
GNP deflator		-0.848 ⁻ (0.08)				-0.054 ⁻ (0.03)	-0.023 ⁻ (0.02)
Business failures				1.29 ⁺ (0.34)			
Spread				2.733 ⁺ (0.67)	-0.017 ⁻ (0.54)	-0.429 ⁺ (0.17)	
Variance Decomposition (percent)							
Equation	Source of Innovation						
	Real Base	Real M2	Real GNP	Commercial Paper	Deflator	Business Failures	Spread
Real base	13.6	73.1	1.5	2.3	4.3	3.2	1.9
Real M2	4.4	48.2	5.8	17.9	10.4	1.9	11.3
Real GNP	12.3	12.7	52.2	4.2	8.9	4.1	5.5
Commercial paper	32.4	24.6	5.4	8.7	10.9	5.4	12.5
GNP deflator	2.3	48.7	3.0	21.0	18.2	3.3	3.5
Business failures	8.9	12.6	0.8	5.3	4.4	66.8	1.1
Spread	10.4	4.2	0.5	3.0	4.8	3.4	73.7

Notes: See Table 6.1.

and the deflator, after the monetarist effects of the first model have been accounted for, while an increase in business failures is expected to increase the spread between rates on low- and high-quality bonds. The dependence of business failure and spread innovations on interest rate and price innovations is as specified in the basic credit model. A substantially higher proportion of the contemporaneous interactions have the wrong sign than in the basic monetarist model, the most egregious being the response of M2 to the base, and of real output to money. However, there is a strong positive response of output to M2 innovations after two quarters have elapsed (Fig. 6.3). Money innova-

a) Response of real GNP to a one-standard-deviation shock in the commercial paper rate



b) Response of real GNP to a one-standard-deviation shock in real base and real money

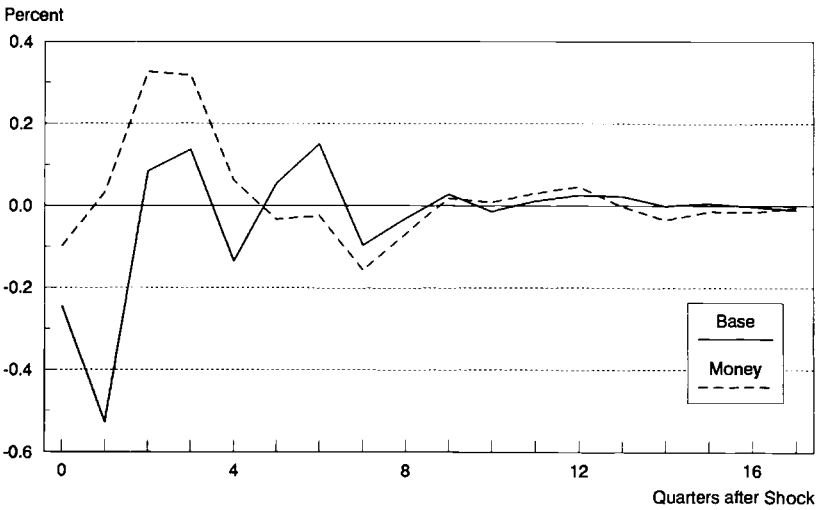


Fig. 6.3 Impulse Response Functions: Hybrid Monetarist Model

Source: See text.

tions appear to have a smaller permanent effect on the level of output, and the permanent effect of base innovations has disappeared.⁴⁰ Similarly, the proportion of the output forecast-error variance explained by money and base innovations is 25 percent, little changed from the 26.8 percent found in the basic monetarist model. We also note that the variables added to represent the credit story—the interest rate spread and the rate of business failures—together explain only 9.6 percent of the variability of real GNP, which approximately matches their performance in the basic credit model.

6.3.4 Hybrid Credit Model

Table 6.4 describes the results of expanding the basic credit model to include the effects of changes in the quantity of money. The delicate issue here is whether loans and money should be expressed in real or nominal terms. The credit view holds that it is the real quantity of loans that is important for real output, while the monetarist view focuses on the short-run output effects of changes in the nominal quantity of money. The specification of Table 6.4 casts both variables in nominal terms, but allows for real effects to be consistently estimated by including the inflation rate in the output and loans equations.⁴¹

The responses of real GNP to nominal loans and money both die out after about three years, as Figure 6.4 shows. Loans exhibit a substantial permanent change in response to a money shock, but there is not a marked response of money to a loan shock. Similarly, the variance decompositions in the lower panel of Table 6.4 show that 14.4 percent of loan variability is accounted for by money shocks, while only 5.9 percent of money variability comes from loan shocks. This may, however, be a consequence of including money in the loan equation while excluding a contemporaneous effect of loans on the supply of money. For this reason, the model is to be understood as a monetarist generalization of the credit model.

The variance decomposition also shows that the fraction of the forecast-error variance of real output attributable to loan shocks declines dramatically, from 35.9 percent in the basic credit model to 16 percent when money is included. The contribution of money shocks to the forecast-error variance of real output is 14.3 percent. These figures do not provide an exact comparison with the basic credit model, however, since in that model loans enter in real terms. To provide such a comparison, we recalculated the variance decomposition to assess the effect of real loan shocks on real output, leaving money in nominal terms. The results, which are shown in the addendum to Table 6.4, are little changed, although the influence of money shocks declines slightly

40. The permanent or long-run effect on the *level* of real GNP is the sum of the impulse responses over the time horizon.

41. We also ran the model using real loans, nominal money, and the deflator, and found that the deflator coefficient in the real loans equation was -0.94 . This suggests that deflation of the loans series was inappropriate in this model.

Table 6.4 Hybrid Credit Model

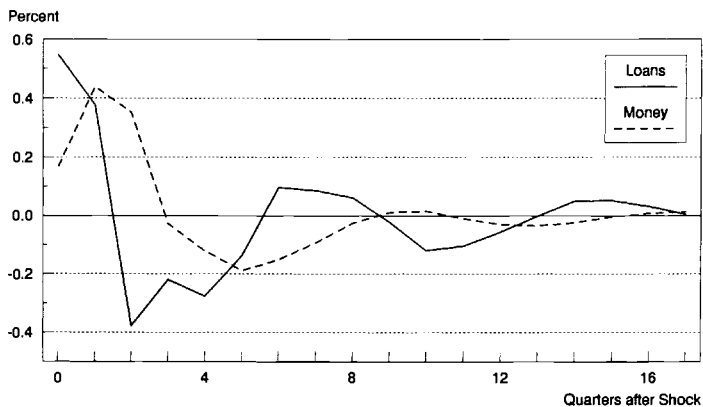
Interactions among Contemporaneous Variables							
Equation	Loans	Commercial Paper	Spread	Deflator	Real GNP	Business Failures	M2
Loans			-1.35 ⁻ (2.95)	0.302 ⁺ (0.09)		0.053 ⁻ (0.06)	0.58 ⁺ (0.16)
Commercial paper	-0.184 ⁻ (0.04)						
Spread		0.0328 ⁺ (0.01)		-0.0124 ⁻ (0.01)		0.0024 ⁺ (0.002)	
GNP deflator		0.0169 ⁺ (0.54)	11.11 ⁺ (16.6)			-0.089 ⁻ (0.07)	0.433 ⁺ (0.18)
Real GNP	0.437 (0.09)	0.402 ⁻ (0.22)	-3.04 ⁻ (2.72)	-0.0717 ⁺ (0.08)		-0.0209 ⁻ (0.05)	-0.038 ⁺ (0.16)
Business failures		0.136 ⁺ (0.03)					
M2		-0.236 ⁻ (0.11)				-0.0749 ⁺ (0.03)	
Variance Decomposition (percent)							
Equation	Loans	Commercial Paper	Spread	Deflator	Real GNP	Business Failures	M2
Loans	49.6	5.4	6.4	10.3	1.5	0.5	14.4
Commercial paper	16.2	41.7	9.3	7.7	2.9	3.0	19.1
Spread	9.6	9.9	57.1	10.8	1.2	2.9	8.5
Inflation	0.9	4.1	9.5	70.4	2.7	3.8	8.6
Real GNP	16.0	5.2	7.0	7.5	47.1	2.8	14.3
Business failures	3.6	8.2	0.8	5.0	0.5	76.0	5.8
M2	5.9	6.9	18.3	6.5	2.1	3.2	57.3
<i>Addendum: Model Using Real Loans</i>							
Real output	18.5	3.1	9.4	6.0	47.1	2.9	13.0

Notes: See Table 6.1.

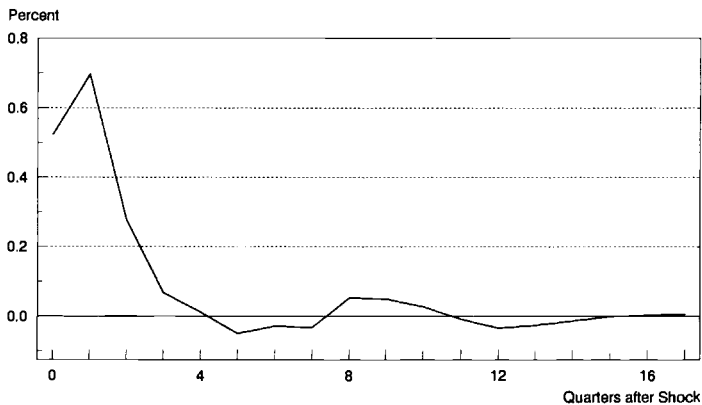
while that of real loan shocks is 2.5 percentage points larger than that of nominal loan shocks.

The central message of this "hybrid credit model" is that the channel of influence on output that operates through the money supply cannot be ignored. Of course, loan shocks still account for a respectable fraction of the variance of output forecast errors, even after money shocks have been allowed for, and this is perhaps a greater surprise to the monetarist camp than to those

a) Response of real GNP to a one-standard-deviation shock in nominal loans and money



b) Response of loans to a one-standard-deviation shock in money



c) Response of money to a one-standard-deviation shock in loans

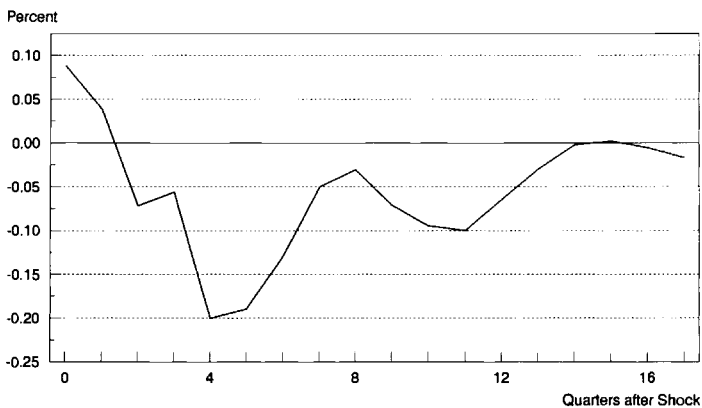


Fig. 6.4 Impulse Response Functions: Hybrid Credit Model
 Source: See text.

holding the credit view. However, it is always possible that the loan variable is picking up shocks to the base, which is not included in this model.

The message of this section thus turns out to be generally negative as to the possibility of a clear choice between the two schools of thought, using such aggregate data. The basic models both appear reasonably soothing to members of the associated school. The hybrid monetarist model leaves the money story intact when the interest rate spread and business failures are added, but credit proponents could argue that the base variable is accounting for the effects of loans. The hybrid credit model suggests that money effects are important in addition to those said to operate through the asset side of the banks' balance sheets, but it is not a plank of the credit platform to say that money does not matter at all. The close comovement between loans, money, and the base also clouds the interpretation here: monetarists could argue that the incremental explanatory power of the loans variable arises because its inclusion helps to separate base shocks from money demand shocks.

It therefore appears that other data must be consulted, if we are ultimately to be able to assess the relative merits of the two views. We offer a first step in this direction in the next section, by examining the composition of loans.

6.4 The Role of the Stock Market and Call Loan Market in the Institutional Framework, 1880 to 1914

The results of the VARs in the preceding section, if taken at face value, suggest that both bank loans and money are important in the transmission mechanism. However, the institutional structure of the national banking era directs attention to the fundamental reason for the importance of bank loans in this period—the intimate connection between the stock market and the national banking system established by the inverted pyramid of credit and the New York City call loan market. Disturbances to the stock market were transmitted to the call loan market, which in turn had a dramatic impact on total bank loans in New York City and in the rest of the country.

A key feature of the regulations that defined the national banking system was the imposition of different reserve requirements on three separate classes of national banks. Specifically, the Act of 1874 required country banks to hold 15 percent against their deposits, three-fifths of which, or 9 percent, could be held as bankers' balances with correspondent national banks in reserve cities (with populations greater than 50,000) or in central-reserve cities (New York City and, after 1887, also Chicago and St. Louis). These balances earned interest up to 2 percent. The remaining two-fifths of required reserves were to be held in lawful money (U.S. notes, specie, gold, and clearing-house certificates). Reserve-city national banks were required to hold 25 percent of their deposits in reserves, half of which had to be held in lawful money, the other half available to be held as bankers' balances in central-reserve-city national

banks. Central-reserve-city national banks were required to hold 25 percent of their deposits in lawful money.⁴² Country and reserve-city banks kept excess reserves far above the required levels in the form of bankers' balances in central-reserve cities. These funds were a form of secondary reserves. The reserve structure of the national banking system has been described as an inverted pyramid, whereby most of the nation's reserves ended up as bankers' balances in the central-reserve cities, but especially in New York City.⁴³

Most of the reserves held as bankers' balances in New York City national banks were invested in the call loan market. Call loans were demand loans secured by stock traded on the New York Stock Exchange and also by U.S. and other bonds. Most of the loans were made to brokers who would then consign the stock serving as collateral to the banks. The commercial banks considered call loans the most liquid form of investment, since they could be called at any time. The New York national banks dominated the call loan market, with between a third and a half of their loan portfolios in call loans during the period we cover.⁴⁴ Close to 75 percent of bankers' balances in New York were held in call loans between 1880 and 1904, the amount to be expected if the New York banks held the required 25 percent reserve requirement against those balances. In addition, country and reserve-city national banks and state commercial, savings, and trust companies invested directly in the call loan market (using their central-reserve-city correspondents as intermediaries) whenever the call loan rate rose significantly above the 2 percent earned on bankers' balances. Thus an inverse relationship existed between the call loan rate and bankers' balances in New York City, and a direct one between the call loan rate and country bank excess reserves invested directly in the call loan market.⁴⁵

The inverted pyramid as well as the correspondent balance arrangement and its intimate connection to the call loan market are widely regarded as key elements in financial crises that punctuated the era.⁴⁶ All the major banking

42. Although Chicago and St. Louis were important regional centers, New York held the lion's share of bankers' balances. National banks in central-reserve cities also held substantial correspondent balances of state banks, private banks, and trust companies.

43. The inverted pyramid was a natural outgrowth of the extensive correspondent network developed before the Civil War. See John James, *Money and Capital Markets* (Princeton, 1978), chap. 4; and Margaret Myers, *The New York Money Market* (New York, 1935), chap. 12. In the unit-banking system that arose earlier in the century, holding balances with city correspondents represented a valuable way in which a country bank could gain access to an interregional clearing mechanism (obtain domestic exchange and clear out-of-town checks), obtain additional sources of credit (by interbank loans and rediscounts, although rarely extended in this period), and earn interest on excess reserves. The city banks on their part had access to the interior and secured compensation for their services to the country banks. The national banks thus extended an existing framework.

44. Myers, *The New York Money Market*, p. 290.

45. Myers, *The New York Money Market*, p. 290; James, *Money and Capital Markets*, p. 304.

46. Oliver M. W. Sprague, *History of Crises Under the National Banking System*. National Monetary Commission, 61st Cong., 2d sess., S. Doc. 538 (Washington, D.C., 1910); Myers, *The New York Money Market*.

panics of the period (1873, 1884, 1893, 1907) were marked by withdrawals of bankers' balances (especially those representing excess reserves) by the country and reserve-city banks from the New York banks. The decline in bankers' balances in turn put pressure on the call loan market, causing call loan rates to rise and stock prices to fall—possibly inducing a stock market crash. The decline in New York bank reserves could on occasion be so severe as to precipitate a panic, which could only be stopped by the restriction of convertibility of deposits into currency.

The evidence is mixed on whether the combined incidence of stock market crashes and banking panics during the national banking era reflects causation from the banking system or vice versa.⁴⁷ Although there were twice as many crashes as there were panics, all of the major banking panics also occurred close to stock market crashes. On two occasions (1899 and 1901), syndicates of prominent financial institutions were able to reverse the pressure on the New York call loan market.⁴⁸ On other occasions, panic was averted by the issue of clearing-house certificates by the New York Clearing House and/or by Treasury intervention (1884, 1890). However, on three occasions (1873, 1893, 1907), this intervention was insufficient to prevent panic. Only a restriction of convertibility of deposits into currency sufficed.

This experience suggests that a potential source of volatility in bank loans may lie in call loans. If that is the case, this makes questionable the importance of credit rationing. To consider this possibility we examine more closely the composition of loans in New York City national banks and in national banks in the rest of the country.

Bank loans were either demand or time loans, some secured by different types of collateral: stocks and bonds, merchandise, and receivables. The latter two categories of secured loans were typically issued on the real bills principle that they would be self-liquidating.⁴⁹ The balance sheets of the New York City national banks had similar categories to those of the country national banks, but the composition was quite different, reflecting the absence of excess reserves in New York City.

Of the categories of assets just noted, credit rationing would refer to loans

47. Jack W. Wilson, Richard E. Sylla, and Charles P. Jones, "Financial Market Panics and Volatility in the Long Run, 1830–1988," in Eugene N. White, ed., *Crashes and Panics: The Lessons from History* (New York, 1990). According to Calomiris and Gorton, "The Origins of Banking Panics," however, banking panics happened only if there had been prior bad news in the stock market combined with increased commercial failures.

48. Myers, *The New York Money Market*, p. 286.

49. Other earning assets of the national banks were discounts and investments. Discounts were usually not secured by collateral, and differed from loans in that the interest charge was collected in advance. Discounts consisted primarily of commercial paper, either in the form of trade acceptances or lenders' acceptances. Commercial paper bore either two names or one name, with the latter eclipsing the former by the end of the period. These instruments usually traded in an active national market, and the commercial paper rate fluctuated widely, reflecting changing conditions in the money market. Investments consisted of eligible U.S. securities required to back the note issue and other U.S. securities held as a form of secondary reserves.

secured primarily by merchandise, since discounts and call loan rates were determined in active national markets. We show in Figures 6.5 and 6.6 data for one call date annually (usually in September), 1880 to 1914, two categories of national bank loans, as well as total national bank loans for New York City and for all national banks.⁵⁰ The two categories are loans secured by stocks and other loans.⁵¹

The pattern that emerges from these figures is quite striking. New York City loans secured by stock are highly volatile, exhibiting sharp declines in the panic years 1884, 1893, and 1907, and slight declines in two years with stock market crashes and no banking panics (1895 and 1899). Other New York City loans by contrast are distinctly stable, with a mild upward trend, and the movement of total New York City loans reflects that of loans secured by stock.⁵²

For the United States as a whole, the pattern of loans secured by stock is much less volatile than for New York City, but declines in the panic years can be discerned. Other loans have a stable upward trend. While total U.S. loans pick up some of the volatility of New York City loans, they are considerably more stable.⁵³

The stable pattern of other loans compared to loans secured by stock in New York City and, to a lesser extent, a similar difference in the composition of loans in the United States as a whole, in country banks, and in the United States minus New York City, suggest that whatever procyclical influence is exhibited by loans in New York City and for the United States as a whole can be explained by the behavior of the call loan market. On the face of it, this

50. The source is U.S. Comptroller of the Currency, *Annual Report*, 1880 to 1914.

51. For 1880–88, the Comptroller showed four categories of loans: (1) loans on U.S. bonds on demand; (2) loans on other stocks, bonds, etc., on demand; (3) loans on single-name paper without other security; and (4) all other loans. From 1891 to 1914, the Comptroller showed five categories: (1) loans on demand paper with one or more individual or firm names; (2) loans on demand, secured by stocks, bonds, and other securities; (3) loans on time, paper with two or more individual or firm names; (4) loans on time, single-name paper (person or firm) without other security; and (5) loans on time, secured by stocks, bonds, and other personal securities, or on mortgages or other real estate securities. For 1889 and 1890, the Comptroller showed different categories, not readily comparable to those of the preceding and subsequent periods, and they are consequently omitted from the figures.

The first category of loans that we show in Figure 6.5—loans secured by stocks—consists for 1880 to 1888 of categories (1) and (2), and for 1891 to 1914 of categories (2) and (5). The second category in Figure 6.5—other loans—consists for 1880 to 1888 of categories (3) and (4), for 1891 to 1914 of categories (1), (3), and (4).

We compared demand loans secured by stock (i.e., call loans)—category (2)—with the rest. The pictures are similar to those presented here. We also drew similar figures for country banks and total United States minus New York City. However, to save space we discuss but do not present the former, and the pattern of the latter, which includes country banks, reserve-city banks, and central-reserve cities other than New York, can be inferred from the figures we present.

52. Within the category of other loans, one of the subcategories exhibited more volatility than the total.

53. For country banks, loans secured by stock were also more volatile than other loans, but the difference between the two categories was not as marked as for New York City. Results are similar for the U.S. minus New York City.

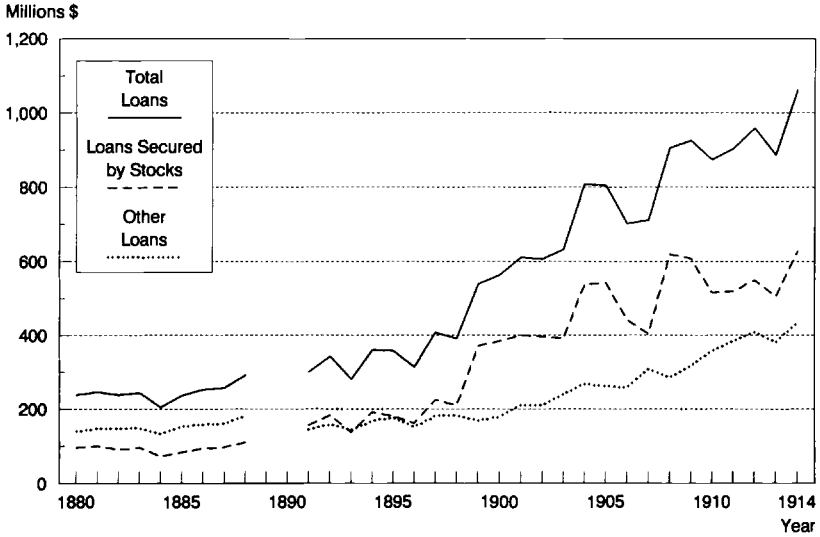


Fig. 6.5 Composition of New York City National Bank Loans, 1880–1914
 Source: See Appendix.

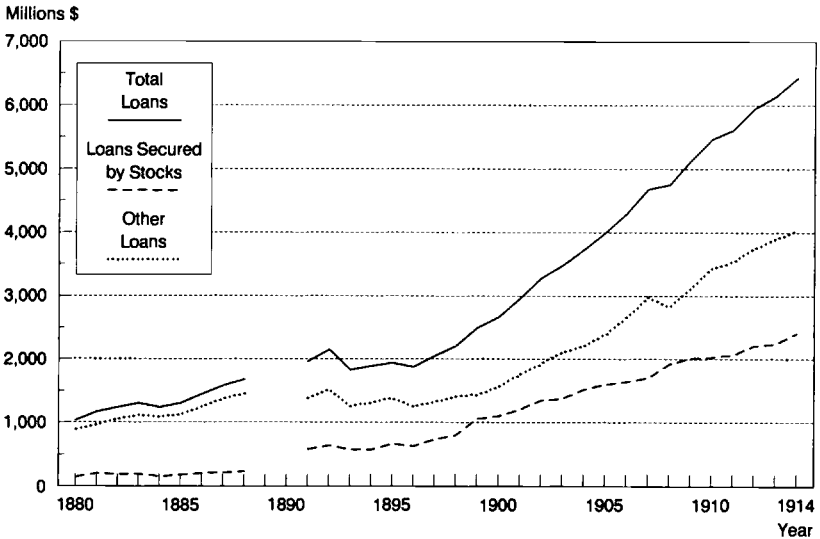


Fig 6.6 Composition of U.S. National Bank Loans, 1880–1914
 Source: See Appendix.

leaves little room for an independent influence on output variability of credit rationing.

There remains, however, the link between the decline in the valuation of firms reflected in a fall in stock prices and declines in real output. On the one hand, this does not impinge directly on the credit-rationing story, which is typically limited to borrowers who must resort to bank loans. On the other hand, some have argued that a stock market crash can increase agency costs, causing investment and real activity to decline.⁵⁴ To measure the importance of this channel of influence on real output, it is necessary to control for that part of stock price movements that is due to changes in fundamentals, a subject for possible future research.

To demonstrate the link between the stock market and loans secured by stock, we plot in Figure 6.7 annual data in natural logs of New York City loans secured by stock and the stock price index. Figure 6.8 makes a similar comparison between U.S. loans secured by stock and the stock price index. As can readily be seen in Figure 6.7, volatility in the stock price index is reflected in the New York City stock loan series. The relationship is somewhat less transparent in Figure 6.8 for U.S. loans secured by stock.

One inference that can be drawn from Figures 6.7 and 6.8 is that the significant results obtained for bank loans and other credit variables in the VARs reported in section 6.3 reflect stock market disturbances, where the principal stocks traded were railway stocks. These disturbances in turn could be reflecting earlier or contemporaneous monetary shocks, or future output shocks.⁵⁵ It is a mistake, however, to argue that the waves of railroad construction in the late nineteenth century were independent of financial markets, on the ground that "there was no central bank to mistakenly squeeze off economic activity by letting the money supply grow too slowly."⁵⁶ The stock market reflected banking panics and concerns about the stability of the gold standard in the United States from 1890 to 1897. External finance that the stock market provided either advanced or retarded railroad construction.

It appears from this discussion that the principal source of volatility in the series of total loans is the category of loans collateralized by stock, the effects of which are not part of the credit story. The collateral for these loans was publicly priced and not in any way idiosyncratic to the individual loan contract. Nor do the characteristics of the borrower of such a loan enter into the pricing and loan contract in any obvious way. Instead, it is the business loans represented by "other loans" that more faithfully relate to the credit view. This

54. See Jaffee and Stiglitz, "Credit Rationing," and Mishkin, "Asymmetric Information."

55. Sprague argues the former in *History of Crises*, while G. William Schwert takes the latter view in "Stock Returns and Real Activity: A Century of Evidence," *Journal of Finance* 45 (Sept. 1990), pp. 1237–57.

56. See J. Bradford De Long, "'Liquidation' Cycles: Old-Fashioned Real Business Cycle Theory and the Great Depression," NBER Working Paper no. 3546 (Dec. 1990), p. 29.

Natural logarithm of stock prices, loans

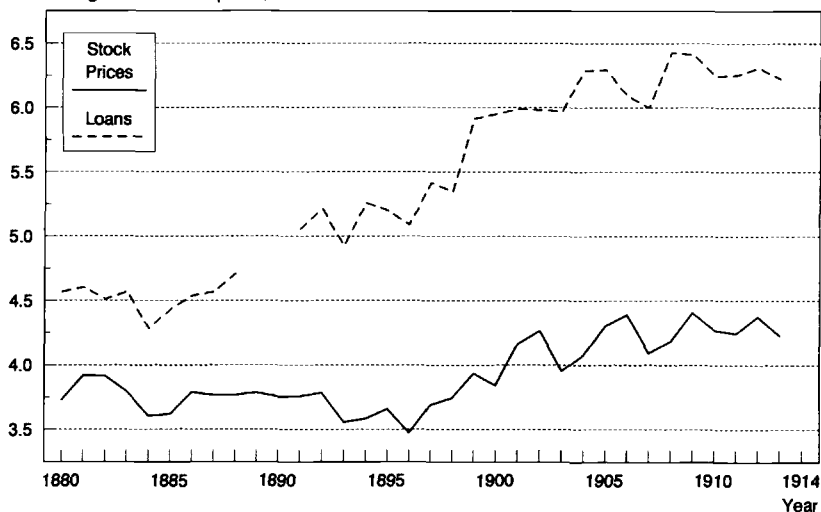


Fig. 6.7 Stock Prices and New York City National Bank Loans Secured by Stocks, 1880–1914

Source: See Appendix.

Natural logarithm of stock prices, loans

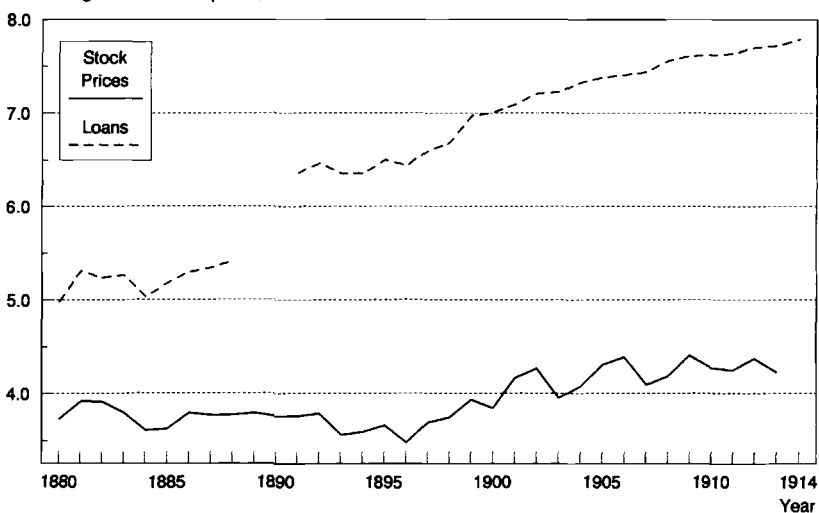


Fig. 6.8 Stock Prices and U.S. National Bank Loans Secured by Stocks, 1880–1914

Source: See Appendix.

is so even if loans collateralized by stock were not used for stock purchases but, as money is fungible, were applied to business use.

Ideally, instead of the aggregate loans series used in the estimation exercise of the preceding section, it would be desirable to rerun it with data on other loans. Unfortunately, quarterly data on disaggregated categories of loans are not available for this period. Instead, we have formulated a structural VAR model, which includes, in addition to the quarterly growth of aggregate loans, the quarterly change in stock prices and the call loan rate. The latter variables are proxies for the pattern of stock market loans, and so their inclusion should go some way toward “filtering” the stock market loans from the series of total loans.

The complete model, which also includes real GNP growth, real M2 growth, and the interest rate spread, is shown in Table 6.5. The call loan rate is, in effect, serving both as an instrument for stock market loans and as a proxy for the commercial paper rate. The exclusion of inflation and the rate of business failures is explained by the need to limit the size of the model. The results of the preceding section suggest that the omission of these two variables is of little consequence.

As Figure 6.9 shows, the response of output to real money shocks does not wash out in the long run, while the output response to loan innovations is more muted and transitory. The variance decomposition shows that 15.7 percent of the real loan forecast-error variance is accounted for by stock price and call loan rate innovations. While direct comparisons cannot be made rigorously between models that are not nested, it is nevertheless instructive to use the basic credit model of section 6.3 as a benchmark. In that model, 84.5 percent of loan variance comes from loan innovations; with the inclusion of money and the proxies for stock market loans, this proportion falls to 52.2 percent.⁵⁷ There is also a marked strengthening of the link between loans and the spread—19.1 percent of loan variability comes from spread innovations, and 30.3 percent of spread variability comes from loan innovations in the stock market model. In contrast, these proportions are 4.4 percent and 8.8 percent, respectively, in the basic credit model. These results are consistent with the discussion above of the significance of stock market loans: the loans variable needs to be purged of the effects of stock market loans in order to extract the essence of the credit interpretation.

The bottom line is surely the proportion of output forecast-error variance explained by loan innovations, which is 9.2 percent in this model, significantly lower than the 35.9 percent registered in the basic credit model and the 16.0 percent in the hybrid credit model. It is also of interest to note that, when the stock market model is run with loans by New York City banks—a series similar to that used by Calomiris and Hubbard (as noted above, with a far

57. Note that this also happens in the hybrid credit model, when money alone is included.

Table 6.5 Stock Market Model

Interactions among Contemporaneous Variables*						
Equation	Real Loans	Stock Price	Real GNP	Real M2	Spread	Call Rate
Real loans		0.15 ⁺		-0.063 ⁺	24.8 ⁻	-0.20 ⁻
Stock price			0.70 ⁺			
Real GNP	0.317 ⁺			-0.158 ⁺	0.17 ⁻	0.683 ⁻
Real M2	0.564 ⁺					-0.028 ⁻
Spread	-0.019 ⁻	-0.003 ⁻				0.003 ⁺
Call rate		0.029 ⁺				
Variance Decomposition (percent)						
Source of Innovation						
Equation	Real Loans	Stock Price	Real GNP	Real M2	Spread	Call Rate
Real loans	52.2	9.5	1.6	11.3	19.1	6.2
Stock price	4.9	70.3	5.8	11.4	2.5	5.0
Real GNP	9.2	14.0	54.1	16.8	1.7	4.1
Real M2	30.6	6.8	5.4	43.0	10.4	3.7
Spread	30.3	24.8	2.6	3.2	36.2	2.8
Call rate	6.3	12.3	2.2	8.2	2.7	66.3
<i>Addendum: Model Using Real NYC Loans</i>						
Real GNP	4.5	13.1	57.0	16.0	4.2	5.1

Notes: See Table 6.1.

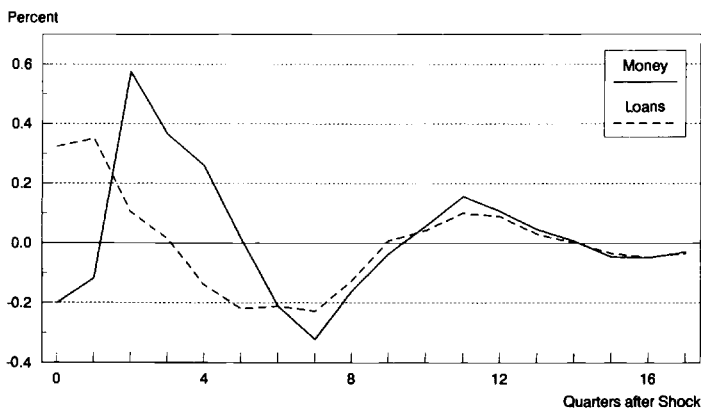
*While a number of starting values converged to those reported in the table, which corresponded to the maximum found for the likelihood function, numerical computation of standard errors proved infeasible, as it was not possible to invert the Hessian.

greater proportion of their loan volume in the call loan market than was the case for total U.S. loans)—the contribution of loan innovations to the output forecast-error variance drops to 4.5 percent.⁵⁸ Indeed a substantial fraction of the variability in total U.S. loans is accounted for by movements in New York City loans, which in turn are largely composed of stock market loans. While accounting for only one-sixth of total loans, the variance of New York City loans accounts for one-fourth of the variance of U.S. loans.

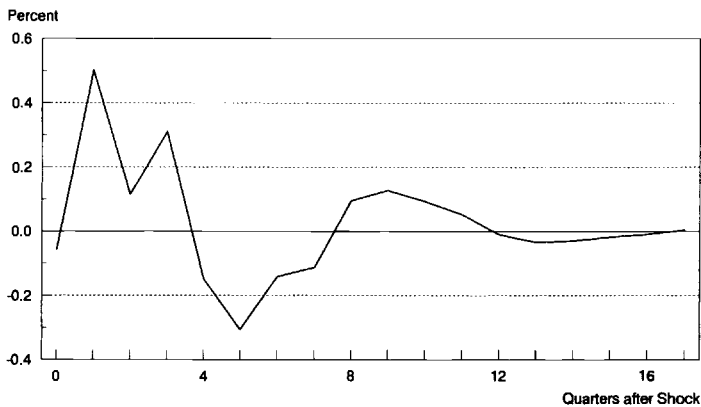
In summary, an examination of the breakdown of loans into their various categories reveals that loans other than stock market loans are not closely related to output fluctuations during the national banking period. In contrast, the contribution of money to output variability is consistently in the range of 12 to 18 percent, and the combined contribution of money and the base is about 25 percent.

58. In this specification, the spread and loans variables once again explain minimal proportions of each other's forecast-error variance.

a) Response of real GNP to a one-standard-deviation shock in real money and real loans



b) Response of real loans to a one-standard-deviation shock in real money



c) Response of real money to a one-standard-deviation shock in real loans

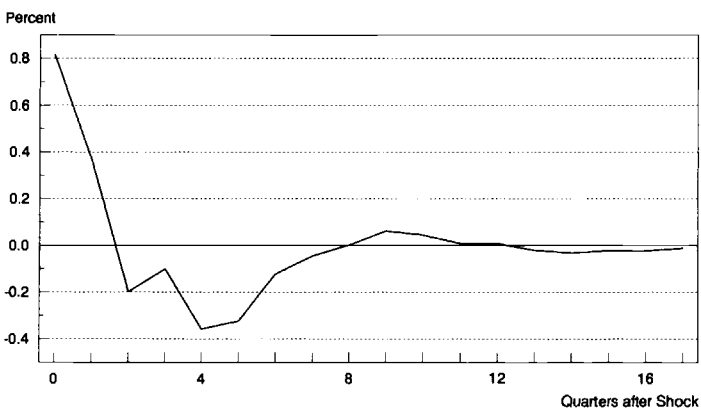


Fig. 6.9 Impulse Response Functions: Stock Market Model
 Source: See text.

6.5 Conclusion

A growing theoretical literature of the past decade assigns a major role to credit rationing by banks, defined as a reduction in bank lending with little change in interest rates, in influencing the course of the real economy. The theory, elaborated in the context of existing banking and monetary arrangements, is far more developed than empirical verification of its propositions. The most advanced efforts at empirical verification apply the method of structural VARs to a limited number of variables designed to show that credit variables account for a preponderance of output forecast-error variance. Our point of departure is the application of the method by Calomiris and Hubbard to the national banking period.

We broaden the inquiry to encompass not only credit but also money variables, and apply the structural VAR methodology to assess the relative merits of money and credit explanations of real activity during the national banking period. This approach requires identification assumptions to be made concerning the contemporaneous interactions among variables. Since this approach also implies that the resulting system of simultaneous equations contains no substantive misspecification, it is well to test the robustness of the conclusions drawn from any one model by changing the identification assumptions. Experience with the models used in this paper counsels that one place stock only in those conclusions that are consistent with all models.

Table 6.6 summarizes our findings by showing the decomposition of the output forecast-error variance attributable to each model. The salient feature of the estimation results is that the explanatory power of money and the base is moderate and robust to changes in that specification of the underlying model. Similarly, we repeatedly fail to find a sizeable output effect of the spread and business failures variables. Last, the effect of loan variability on output fluctuations is highly sensitive to changes in specification, and declines dramatically when money is introduced into the model and stock market loans are controlled for.

These results motivate the conclusion that there is little support during the national banking era for the “credit-rationing” view of the transmission mechanism, that the asset side of banks’ balance sheets is a significant determinant of output fluctuations. This inference, drawn from the variance decomposition of our structural VAR exercises, is supported by direct examination of the course of “other loans” (which we take to represent business loans) over the national banking period. Other loans exhibit little, if any, volatility, and so they cannot explain output fluctuations.

Our findings raise a number of issues that cannot be addressed within the confines of the present study. We have not examined whether interest rates flatten out instead of continuing to rise as output growth reaches a peak, which is a critical implication of the credit story. The VAR methodology is limited to an examination of short-run interactions among macroeconomic time series. The basis of the equilibrium credit-rationing story is microeconomic in

Table 6.6 Money versus Credit: Contributions to the Forecast-Error Variance of Real GNP (%)

Model	Real GNP	Monetary			Commercial		Interest			
		Base	M2	Loans	Paper Rate	GNP Deflator	Rate Spread	Business Failures	Stock Price	Call Rate
Monetarist	52.2	8.5	18.3		12.1	8.9				
Credit	37.2			35.9	3.4	16.8	3.3	3.2		
Hybrid monetarist	52.2	12.3	12.7		4.2	8.9	5.5	4.1		
Hybrid Credit	47.1		14.3	16.0	5.2	7.5	7.0	2.8		
Stock Market (U.S. loans)	54.1		16.8	9.2			1.7		14.0	4.1
Stock Market (NYC loans)	57.0		16.0	4.5			4.2		13.1	5.1

Note: Estimated from structural VAR models using quarterly data from 1880 to 1914. A forecast horizon of three years is used.

nature, and our data provide little that can directly address the question whether banks refrain from lending, beyond a certain point, irrespective of their reserve positions.

Similarly, we find striking the lack of fluctuation in "other loans," a series that seems to grow with GNP. This may reflect an extreme form of customer relations between lenders and borrowers, or it may be a consequence of the relative ease of acquiring loans in a growing economy whose banking sector more than quadrupled over the period of our study. It appears that these issues would most fruitfully be addressed by a study of banks' historical records.

Finally, we can ask whether it was the asset or the liability side of bank balance sheets that contemporaries during the national banking period regarded as problematical. For them, it was unquestionably the liability side, in particular, the inflexibility during financial crises of the banks' bond-secured note issues.

The policy conclusion that contemporaries reached was embodied in the Federal Reserve Act of 1913. That legislation provided for the issue of asset-backed Federal Reserve notes that were expected to vary with changes in demand. Credit rationing by banks was neither a concern nor a policy issue.⁵⁹ In the new regime, the prescription was once again for loans to be based on short-term self-liquidating bills. No essential change was made in the regulations prevailing under the national banking system with regard to credit.

59. Calomiris and Hubbard quote examples of "credit rationing and credit market segmentation" which they state "appear frequently in Sprague" ("Price Flexibility," p. 437); see his *History of Crises*. However, we interpret the relevance of these quotations somewhat less broadly than do Calomiris and Hubbard. All are drawn from Sprague's chapter on the panic of 1907 and are intended to illustrate the inability of reserve-constrained banks to lend freely.

Appendix

Data Sources

Annual Series

U.S. and New York City Loan Classification for one call date (usually September). U.S. Comptroller of the Currency, *Annual Report*, 1880–1914.

Quarterly Series

GNP, real and nominal; GNP deflator. N. S. Balke and R. J. Gordon, “Historical Data,” in R. J. Gordon, ed., *The American Business Cycle: Continuity and Change* (Chicago, 1986), app. B., app. table 2, pp. 790–93. *U.S. loans.* NBER Business Cycle tape, series 14,15, call dates interpolated to 3d month of the quarter. *New York City loans.* NBER Business Cycle tape, series 14,20, call dates interpolated to 3d month of the quarter. *M2.* M. Friedman and A. J. Schwartz, *Monetary Statistics of the United States: Estimates, Sources, Methods* (New York, 1970), table 2, pp. 61–66. *Base.* Friedman and Schwartz, *Monetary Statistics*, table 21, pp. 346–50; table 26, pp. 396–97, call dates interpolated to 3d month of quarter. *Net gold flows.* NBER Business Cycle tape, series 14,112, monthly, every third month. *Commercial paper rates in New York City.* F. R. Macaulay, *Some Theoretical Problems Suggested by the Movements of Interest Rates, Bond Yields and Stock Prices in the United States Since 1856* (New York, 1938), app. table 10, pp. A147–A156, monthly, every third month. *Call loan rates at the New York Stock Exchange.* NBER Business Cycle tape, series 13,01, monthly, every third month. *Spread.* Unpublished quarterly data from F. S. Mishkin underlying his paper, “Asymmetric Information and Financial Crises: A Historical Perspective,” in R. Glenn Hubbard, ed., *Financial Crises and Financial Markets* (Chicago, 1991). *Liabilities of business failures.* NBER Business Cycle tape, series 9,32, monthly, every third month. *Stock price index.* J. W. Wilson, R. E. Sylla, and C. P. Jones, “Financial Market Panics and Volatility in the Long Run, 1830–1988,” in Eugene N. White, ed., *Crashes and Panics: The Lessons from History* (New York, 1990).