Discussion of

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Bank Liability Insurance Schemes before 1865

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- Paper deals with period 1830 -1860 in U.S.
- No national bank
- Individual banks issued banknotes, redeemable in gold/silver
- Think of 1 or 2 stand-alone banks per town
- Not much government supervision, regulation, all at state level
- Free banking era

- WW has series of papers describing enormous variety of banking practices within and across states

- My only source of information on the period, so I hope he got it right

- Can we use this era as source of information on effects of supervision, regulatory policies on bank behavior?

- Free banking era decentralized, but imagine ultimate monetary decentralization:

- Suppose every family or business holds gold and silver coins for all transactions purposes

- No banks, no bank runs, no panics in this society

- But payments are not perfectly correlated across agents so there are gains to everyone from pooling cash flows economizing on specie: fractional reserve banking

- Also have bank runs, bank failures—inability to redeem notes

- Too big to fail? Apparently not.

- How bad was it when only bank in town failed?

- Did notes continue to circulate, have positive value? Did notes from other towns circulate?

- In any case, independent local banks did not exhaust gains from pooling of transactions risks

- These gains never exhausted: force for ever larger banks
- Captured in Baumol's inventory model of cash management; many successors
- Easy to see these forces in U.S. banking after 1980s liberalization
- In free banking era WW describes, bank sizes remained limited (by law? by offsetting diseconomies?)
- But scale economies can still be realized by **associations** of independent banks
- How? Paper discusses variety of ways

- Suffolk Bank System in New England discussed in detail, here and in earlier work
- Sophisticated, fully private association
- Large banking provided clearing services for many
- Offered overdraft privileges that permitted smaller reserve/banknote ratios
- Suffolk bankers monitored assets of system participants

- But main focus of paper on government operated or sponsored systems for pooling

- Mostly "public options", not government monopolies

- Insured banks competed with banks that opted out (Indiana the exception)

- Paper studies failure rates of banks involved in different arrangements

- Lots of variety: natural experiments?

- Do pool members fail less often than non-members?

- Hard to see systematic differences in failure rates across systems

- Systems where bankers monitor other banks, have a stake in their behavior (Suffolk, State of Indiana) seem to have lower failure rates than others

- Internalization of external effects?

- But don't want to view low failure rates as equivalent of improvements in welfare (nor does WW suggest this)
- Pooling arrangements enlarge opportunity set for coalition of banks
- Offer possibilities for reduced specie reserves, higher asset returns, lower service charges as well as more safety
- Which will banks, customers choose?
- Think we need more theory—probably more data, too—to answer this

- Clear message of examples from free banking era is that larger bank size is not the only way to realize scale economies in cash management
- Associations—private or government-run—among smaller banks offer practical alternatives
- Believe that today's repo market, involving limited number of banks and broker/dealers, fits right in with WW's examples
- Participants do huge volume of asset trading, requiring huge amount of settling or clearing
- Repo market lets them economize on reserves

- In yesterday's WSJ, Alan Blinder asks "Why swaps? Why don't they just use cash?"
- Good question, but it has a good answer:
- Cash is a low return asset and you want to hold as little as you can
- Bankers in the 1840s understood this well.