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Banking Without Deposit Insurance  
or Bank Panics: Lessons From  
a Model of the U.S. National  
Banking System (p. 3)

V. V. Chari

Bank Failures, Financial Restrictions,  
and Aggregate Fluctuations:  
Canada and the United States,  
1870-1913 (p. 20)

Stephen D. Williamson

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## *In This Issue*

### Financial Intermediation Research

In the last decade, economists have made major advances in the understanding of financial intermediary firms (especially banks)—what they do and why they matter to the economy as a whole. These advances have primarily been the result of applying new methodologies to an old subject. Specifically, advances have come from studying financial intermediation in general equilibrium economies in which economic agents are different. Particularly productive has been the study of economies in which agents have different information and in which these information differences are explicitly considered.

In spite of these advances, many knowledge gaps remain. For example, some facts in banking history have still not been adequately explained. Why, for instance, did the U.S. banking system have decades of instability—periodic bank panics, suspensions of convertibility of bank deposits into currency, and bank failures—whereas the British and Canadian systems had almost none of these problems? For another example, although many believe that an efficient financial intermediary sector is somehow important for overall economic activity, economists don't know much about how. What is the precise link between financial intermediation and the performance of the economy as a whole? The two papers in this issue of the *Quarterly Review* try to begin to fill these two gaps.

### The U.S. Banking System: Structurally Flawed?

In "Banking Without Deposit Insurance or Bank Panics: Lessons From a Model of the U.S. National Banking System" (p. 3), V. V. Chari asks if the differences in the structure of the banking systems in the United States, Great Britain, and Canada were responsible for the countries' disparate track records. According to this study, the answer is yes. Chari models the U.S. National Banking System (1864–1913), a system noted for its recurrent bank panics and suspensions. Two unique features of U.S. banking then were the restricting of geographic location (branching)—which, Chari assumes, restricted portfolio diversification—and the pyramiding of reserves in big city banks. In his model, Chari shows that bank panics could occur in such a system even though all economic agents were rational. However, such panics could not occur if banks held well-diversified portfolios and could not pyramid reserves.

Would the United States be better off with a system like that in Great Britain or Canada, with a much smaller number of much larger banks? Changing to a highly concentrated banking system like that could be costly, especially because of the potential for reduced competition. Fortunately, Chari's analysis suggests that such a drastic change is

unnecessary. In his model, bank panics can also be eliminated by the proper combination of reserve requirements, a central bank discount window policy, and occasional restrictions on cash payments by banks.

Chari's analysis does seem to question the need for a current policy, though. Recall that the U.S. banking system remained prone to bank panics well after the Federal Reserve System was created in 1913. The panics stopped only after federal deposit insurance was introduced in 1933. Still, as today's headlines attest, although deposit insurance can stabilize the banking system, it can also be costly. Chari's analysis suggests that those costs can be avoided. If his analysis is correct, a banking system does not require deposit insurance for stability.

### Banking and the Economy: Cyclically Related?

In "Bank Failures, Financial Restrictions, and Aggregate Fluctuations: Canada and the United States, 1870–1913" (p. 20), Stephen D. Williamson looks at the relationship between banking structure and economic activity, using episodes from Canadian and U.S. banking history as case studies. Williamson's goal is to show how banking regulation can influence the business cycle. To do this, he constructs a general equilibrium business cycle model in which banks arise endogenously and then uses the model to predict how some types of banking regulation affect business cycles.

Williamson focuses on two basic differences between Canadian and U.S. banking during 1864–1913. The first was that Canadian banks could establish branches nationwide, whereas U.S. banks were restricted from doing so. (Like Chari, Williamson assumes that this branch banking restriction inhibited the ability of U.S. banks to diversify; but in Williamson's analysis, this restriction affects *asset* diversification, whereas in Chari's it affects *liability* diversification.) The second difference between the two systems was that Canadian banks could issue private notes without being required to back them with government securities, whereas U.S. banks could only issue private notes that were fully backed.

Williamson's model predicts that as a result of these regulatory differences, the Canadian economy should have a lower rate of bank failures but larger fluctuations in real output than the U.S. economy. Combined, these two predictions contradict the conventional wisdom that bank failures increase the volatility of business cycles. Interestingly enough, both predictions are largely supported by an analysis of time-series data for the two countries.

This study thus suggests that policymakers could find themselves in a nasty bind: although a low rate of bank failures and reduced volatility of output may both be valid objectives, regulatory policies that achieve one may do so at the expense of the other. Williamson, however, emphasizes that this implication is tentative and that his model leaves out some important considerations that must still be addressed.

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