Discussion of “Banking Crises and the Role of Bank Coalitions,” by Daniel Sanches

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Key Questions

- Is central banking critical for efficient monetary arrangements and financial stability?

- Can private interbank arrangements ("coalitions" in Daniel’s model):
  - support an efficient payments system?
  - prevent financial crises or mitigate their negative effects if they occur?
Isolated examples in the U.S. of successful private interbank arrangements:

- Efficient payments: Suffolk Banking System (1818-1858) - clearinghouse arrangement for circulating notes during Free Banking era.
- Crisis intervention: New York Clearinghouse (post-1853) played an increasingly important role in National Banking era (1863-1913) panics – clearinghouse certificates.

But we wouldn’t want to point to the U.S. as a success story in terms of private financial arrangements.

On this, the publications of the National Monetary Commission (1910) are very useful.

In particular, Johnson (1910), “The Canadian Banking System,” is pretty interesting.
29 chartered banks in 1910, dominated by a few very large banks.

- National branching.
- Private circulating currency, issued by banks, that traded at par.
- A given bank would redeem notes of all other banks, and there was a clearinghouse.
- Double liability.
- Bank of Montreal served as a quasi central bank.
Efficient payments (see Champ, Smith, Williamson 1996).

No panics.

Johnson: 2 bank failures between 1890 and 1910.

- Appears to have been implicit insurance of the creditors, quick resolution of failed institutions, and recognition of, and correction for, moral hazard.

Note that, since 1910, there have been:

- 3 bank failures in Canada (one in 1922, two minor ones in the 1980s)
- no failures during the Great Depression or the Great Recession.

So, in Canada, the central bank was introduced in 1935, in a system that was already stable, in part due to self-regulation.
Daniel’s Model

- Three types of agents: consumers, merchants, and bankers.
- Three subperiods:
  - Consumers produce stuff, the banks take the stuff in exchange for claims on the bank, the bank stores some stuff, and the bank consumes some stuff.
  - Consumers meet merchants and exchange claims on banks for consumption goods.
  - Merchants redeem the claims on banks, get stuff, and consume it.
- Potential problems:
  - An efficient financial system will minimize the quantity of stuff that remains in storage at the end of the period - this is just postponed consumption.
  - Moral hazard: A bank can issue notes, consume the stuff, and default on its liabilities.
  - Aggregate shocks: Risk associated with return on storage should be efficiently allocated.
Banking coalition: Banks agree to redeem notes of other banks in the coalition, and agree to reserve requirements.

Coalition increases welfare by reducing reserves at the end of the period - more redemptions.

With aggregate shocks, the banking coalition shares risk with the noteholders – mitigates the effects of “crises.”
Maturity transformation?

Are the bank liabilities notes? Seems we could interpret them as deposits. The “notes” don’t circulate.

Does the model capture what seemed to have been important in the pre-1935 Canadian experience:

- Needs to model float.
- Clearing and settlement are important.
- Self-regulation important.

Model too focused on reserves – or the interpretation of bank assets as reserves.

Model captures something important: dynamic incentives that bind the coalition together.