INTRODUCTION

In this Module, the causes and consequences of major banking crashes will be discussed and the focus will be on the issue of contagion. We will touch upon some of the rules and regulations enacted after the Great Depression of 1929. Furthermore, a bank run, its history and consequences will be elaborated upon. We will discuss major preventive tools put in place to deter bank runs and financial panic. We will elaborate on some of the modern time financial crises and the role of the international regulatory and supervisory authorities such as the IMF.

OBJECTIVES

Upon successful completion of this module, the student should be able to:

• Discuss the history of bank crashes.
• Examine the causes, consequences and remedies of bank crashes.
• Articulate the contagion issue and bank runs.
• List rules and regulations enacted after the Great Depression and their objectives.
• Articulate the ripple effects of a bank run.
• Describe and define prevention tools available to deter bank crashes.
• Articulate the role of the IMF in relation to preventing bank crashes and financial panic.

With the inevitability of globalization of the financial market, economic system, and international trade, the possibility of bank failures becomes a major issue in formulating operational policies by the IB system. The crisis that can cause bank crashes is referred to as a form of contagious disease whose transmission does not recognize limitations or boundaries. A simple whisper from one entity to another entity concerning lack of reserves in one financial intermediary could have disastrous consequences throughout the financial market worldwide. The history of the banking system can bear testimony that on many occasions the world community experienced banking failures that caused contagion. In modern times, a good example of contagion occurred during the Asian banking crisis that affected many countries like a domino effect. Contagion begins with a bank run which is lack of liquidity by the bank to satisfy customers’ needs. For further information, please see Footnote #1.

We must not forget the condition of the banking system during the Great Depression that was caused by the stock market crash of 1929. Even though there are many arguments about the cause of the Great Depression, one cannot forget about the role of the Federal Reserve. The Federal Reserve was established in 1913 through the Act passed by the US Congress. The role of the Federal Reserve, also known as the Central Bank of the United States, is to conduct monetary policies to correct the deviations caused by macroeconomic variables, such as unemployment and inflation, which represent themselves through fluctuations in the normal economic growth path. This is known as the business cycle. By expanding the money supply (expansionary monetary policy), the Federal Reserve stimulates aggregate demand, and thus remedies the recession. By contracting the money supply (contractionary monetary policy), the Federal Reserve suppresses demand-pull-inflation, and thus economic growth slows down. Monetarists blame the Federal Reserve as a responsible agent for perpetuating the business cycle by their monetary policies. Whether this is
proven or not, there were decisions made by the Federal Reserve that exacerbated the Great Depression’s prolongation. For further information, please see Footnote #2.

To provide remedies for the country’s economic and financial condition of the time, the US Congress the Glass-Steagall Act. Through this Act, the banking system was prohibited from underwriting corporate securities, thus separating the investment operation of the banking system from the regular and normal functions of the bank. This simply prevented banks’ decision makers from tapping into customers’ deposits for speculative purposes. Through the Glass-Steagall Act, the Federal Deposit Insurance Corporation (FDIC) was also established to insure customers’ accounts up to $100,000.00. The sole purpose of this Act was to provide safety and security of deposits and establish and promote confidence in the financial market and the banking system. The Securities and Exchange Commission (SEC) was also established to provide checks and balances in the speculative segment of the financial market. For further information, please see Footnotes #3 and #4.

Empirical evidences indicate that bank crashes occur when a series of macroeconomic variables fail to perform in guiding economic activity to its general equilibrium. This can occur not only in emerging market societies, but the said failures can also inflict their consequences on major industrial nations.

Overall, a bank crash can be defined as a situation where a bank fails to pay the depositors, or a lack of liquidity that prevents its participation in its original orientation of taking deposits and packaging loans, and its participation in the securities market underwriting financial instruments.

Since a bank run, and the impending financial crisis, plays a consequential role in the operation of the banking system, it is imperative that students have a full and thorough knowledge of its history, causes and what can be done to prevent it. For further information, please see Footnote #5.

Empirical evidences suggest that any bank crash resulted from corruption in the financial market, accounting fraud, aggressive speculation by investors, and asymmetric information. In the case of the latter, the information that should be available in the financial market to investors for speculative purposes does not accurately represent the real health of the financial entities’ securities in which investors wish to speculate.

The consequence of the bank run and market crash of 1929 manifested itself financially and economically in the form of high unemployment and a drastic drop in the stock market.

Below is a brief summary of a few crashes in the U.S. financial market that one way or another impacted the banking system, their causes and the remedies that were put in place to reverse their effects. The most notable one was the crash of 1929.

The Crash of 2000 - For further information, please see Footnote #6.

The Crash of 1987 - For further information, please see Footnote #6.
The Crash of 1929 - For further information, please see Footnote #6. The Act was eventually

A bank run occurs when a bank experiences a liquidity problem, and it means it cannot satisfy its liability as far as demand deposits are concerned. Banks are in the business of collecting deposits and packaging loans. They pay interest to depositors and collects interest from borrowers. The difference between these two interest payments is the profit that the bank keeps. Therefore, banks always keep a fraction of the demand deposit liabilities and package the rest of the reserve in the form of loans. Bank runs create bank panic, which means depositors become suspicious of a banks solvency and want to withdraw their money from the bank, which only has a fraction of its deposits and cannot satisfy the depositors’ demand, before the bank fails and goes bankrupt. The economic and financial effect of a bank panic and subsequent bankruptcy on the part of the bank is enormous. Cash-starved financial institutions will make all the loans that they packaged up to that point due and payable immediately. But this may be pointless, especially if money that was borrowed has been invested in fixed assets by the borrowers. Furthermore, this may cause a domino effect in the form of further bankruptcies by the money borrowers.

As we mentioned before, in 1934, the Glass-Steagall Act was enacted to serve two purposes. First, it separated the traditional banking functions from the securities market involvement of the banking system. In other words, the bank manager was prohibited from using depositors’ money for speculative purposes. Second, it created the Federal Deposit Insurance Corporation (FDIC) that guaranteed every depositor’s account up to $100,000. This Act brought a significant level of calm and tranquility to the financial market in the midst of the Great Depression. Many attempts were made throughout the rest of the 20th century to repeal the Glass-Steagall Act, but they all failed and, in the late 1980’s, a modification to the Act was passed allowing the banking system to underwrite a limited amount of corporate securities. The Act was eventually sunset in 1999, allowing the banking system to enter into speculative ventures in the financial market, though the operation of the banking system itself is completely separate from securities market operation.

One remedy that has been historically effective for preventing contagion and the subsequent financial panic is the emergency bank closing known as a bank holiday. A bank holiday allows the regulators and policy makers of the banking system to formulate and implement the necessary economic tools to respond to the financial crisis while the domino effect of the panic is being prevented. The other positive impact of a bank holiday is that all banking transactions are on hold, and eventually public confidence will be restored, knowing that regulators are doing something about the bank run. For further information, please see Footnote #7.

It is imperative to know the history of all bank crashes and their economic and financial consequences in order to institute policies and regulations to detect and prevent them. For further information, please see Footnote #8.

Since financial panic caused by banking crises does not recognize limitations of national boundaries and the contagion can spread like wildfire throughout the globe, the International Monetary Fund (IMF) is an international agency responsible for responding to financial crises that are spreading in different parts and regions of the planet. One crisis that stands out in modern times is the Asian Financial Crisis that caused currency and business cycle fluctuation,
stock market crisis, and a decline in economic activity in Southeast Asia that required intervention by the IMF. The IMF’s involvement was not only to remedy the financial crisis caused by the contagion among the Asian Tigers, but its qualitative effect was to reinstitute financial confidence among the economic entities of the region. For further information, please see Footnote #9.

One must not forget the role that the U.S. Central Bank played during the Asian Financial Crisis in helping to restore confidence to nations affected by the banking crisis. At the time, the chairperson of the Federal Reserve, Alan Greenspan, in his speech addressing the Asian nations’ financial crisis promised to help the nations to gain financial stability. His timely remark is known to have helped the crisis significantly, like his other famous remark, “irrational exuberance,” that became legendary in the annals of the banking system. The U.S. banking system historically suffered many panics and crises. The most significant one in modern times is known as the Savings and Loan Association crisis that was caused by similar anomalies that caused previous bank panics in the U.S. The U.S. government established an entity known as the Resolution Trust Corporation to restore solvency into the Savings and Loan Association banking sector. For further information, please see Footnote #10.

Moral hazard is one of the biggest contributing factors to a bank’s mismanagement causing insolvency. The likelihood that a large bank experiences insolvency is much greater than that of a small community bank in our neighborhood. It is a known fact in the financial market that large banks are under the impression that they can take some risks and get away with it, since historical precedents indicate that the government usually comes to the rescue to ensure public confidence remains unchanged. This process is known as the “too big to fail” doctrine. There is an implied understanding that the collapse of a large bank may have serious economic and financial consequences in the financial market, causing interruption in many economic activities, thus legitimizing 100% deposit insurance. For further information, please see Footnote #11.

The bigger the bank, the bigger economic and social responsibility it possesses. International banks, through globalization, play an important role in the economic and financial life of everyone, since the very foundation of every economic model is based on the role that financial intermediaries play in bringing lenders and borrowers together in the international capital market. Please find some statistics concerning the ranking of international banks in Footnote #12. Even though these rankings may change, they give the reader some idea and indication of the reasons behind why many governments of industrial nations protect these behemoth financial intermediaries.

It is imperative that students at this juncture research and read about some of the major bank failures in detail, such as the Asian banking crisis, the Turkish banking crisis, the Argentine banking problem, and the recession of the Japanese banking system in the 1990’s.

**Conclusion**

In this module, you have learned the causes and consequences of bank crashes. You also learned about the reforms put in place by central bankers and the IMF to deter bank crashes. You were introduced to causes and consequences of each bank crash in the contemporaries and modern
times. Furthermore, you were introduced fully to what happened before, during and after the Great Depression to macroeconomic variables that perpetuated the recession at the time. You were also introduced to the role of central banking and the IMF, and their roles in preventing bank crashes and financial panic.
FOOTNOTES


(3) *Understanding How Glass-Steagall Act Impacts Investment Banking and the Role of Commercial Banks.*
http://www.ratical.org/co-globalize/linkscopy/GlassSteagall.html


(6) *Stock Market Crash History*


