When the Music Stopped: Transatlantic Contagion During the Financial Crisis of 1931

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“For it is, so to speak, a game of … musical chairs — a pastime in which he is victor who … secures a chair for himself when the music stops. These games can be played with zest and enjoyment, though all the players know that … when the music stops some of the players will find themselves unseated.” (John Maynard Keynes, 2006, pp. 139-140)

- Refers to the circular flow of funds between Germany, the US, France, and Britain stemming from reparation payments.
- This game of musical chairs stops during the crisis of 1931.
  - The circular flow of payments provides a mechanism to directly transmit the crisis from Germany to the U.S.
Did these direct links to Germany transmit the crisis of 1931 to the US?

Our answer is....no.
Banks in NYC had substantial exposure to events in Germany in 1931, several times that of the capital of the banks involved.

- Foreign deposits in NYC banks exceed $700 million.
- Acceptances in NYC banks on the account of German banks and firms over $300 million.
- Ninety-day loans to German municipalities totaled over $100 million.
- Long-term German debt originated by NYC banks totaled over $1 billion dollars.
Crisis on the continent forced Britain to abandon the gold standard.

- Britain’s departure from gold induced investors to withdraw funds from the United States.
Temin (1993) suggests three possible channels for transmission of banking crises internationally:

- Rush of domestic depositors to withdraw funds
- The impact on portfolios when values of foreign assets fall and patterns of financial flows change.
- The impact of capital flows on national economies and central bank policies, particularly in nations on the gold standard which raise interest rates to defend gold reserves.
An Alternative Hypothesis

- An intricate system of cross-deposits set up by the Austrian Central Bank directed funds via banks in New York City to the Creditanstalt to compensate it for taking over the bankrupt Bodencreditanstalt (Aguado, 2001).

- German and American macroeconomic aggregates appear correlated.
  - Negative shocks in German time series appear to trigger declines in economic activity in the United States (Hanan Morsy, 2002; Albrecht Ritschl and Samad Sarferaz, 2006).

- Bank failures in NYC peak during the crisis in Germany and before Britain abandoned gold (Gary Richardson and Patrick Van Horn, 2009).
Figure 1
Weekly Hazard for Liquidation and Consolidation Due to Distress
New York City, July 1930 through March 1933

- German panic begins
- Creditanstalt collapses
- Britain departs gold standard
- Federal Reserve raises discount rate

- Liquidations
- Consolidations Due to Distress
Our previous research indicates that the rise in failures was not related to the German crisis. But this raises other questions about the links to Germany: How did banks in New York react to the financial crisis in Europe?

- Did they restrict lending?
- Did they raise credit standards?
- Did they stop lending to foreign clients?
- Did they lose depositors?
- Did they hide large loan losses?
Qualitative Evidence

- Correspondence from bank field agents.
  - One report recommended not to do any further business with German clients.
- On July 3, ten bank presidents told Governor Harrison that they would not restrict withdrawals of German clients.
  - All German accounts would remain open for business.
  - Credit lines would be maintained at least in “their present position and in some cases … unused lines” would be reopened.
- On July 15, when the German crisis peaked, eleven presidents of New York banks met with Governor Harrison to discuss the situation.
  - Agreed to honor all checks and cable orders to the extent of available credit limits.
  - Agreed to maintain acceptance lines and accept new bills within existing lines.
  - Agreed to maintain all deposits in, advances to, and loans for German banks.
Qualitative Evidence

- On July 22, the same committee of eleven bank presidents met again and formally requested that the New York Federal Reserve handle all German acceptance credits, deposits, and etc.
  - Governor Harrison “indicated that this was impossible.”
  - Hoover administration decides to take no formal action.
  - Banks bear the brunt of the crisis in the U.S.
- On July 30, a group of German bankers submitted a proposal concerning German acceptance credits in New York. An expanded committee of seventeen New York bank presidents approved:
  - Present acceptance credits may be renewed as they fall due.
  - German firms/merchants for whom the original credits were established will be required to meet their obligations as they come due by paying marks to the Reichsbank.
  - The proceeds were not required to be remitted to the U.S. but could be utilized for further credits here for import purposes.
  - The New York banks communicated their plan to leading banks throughout the United States and received confirmation that they would conform to its conditions.
Qualitative Evidence

- Some banks do lose deposits in August 1931
  - NYC banks lose a total of $200 million in deposits in the previous year, most during the month of August 1931.
  - Bank presidents state “that recent bank failures have had their effect upon the psychology of small depositors in banks” referring to the actions of the State Superintendent of Banks.
  - The banks mention neither the German crisis nor foreign deposits when discussing the decline in deposits during August.
Aggregate Data

Assets of NYC Fed Member Banks at Call Dates, 1919-1935

German Bank Holiday, July 14
Creditanstalt Fails, May 11
England Abandons Gold, Sept 19
Caldwell Fails, Nov 7
Stock Market Crash, Oct 24
Composition of Assets, NYC Fed Member Banks at Call Dates, 1919-1935

Date

Share of Assets
0.00 0.10 0.20 0.30 0.40 0.50 0.60

Loans
Avg. Loans
US Government Securities
Other Securities
Reserves With Fed
Cash Items in Process of Clearing
Avg. Cash Items

Stock Market Crash, Oct 24
Caldwell Fails, Nov 7
Creditanstalt Fails, May 11
German Bank Holiday, July 14
Britain Abandons Gold, Sept 19
Lending by NYC Fed Member Banks at Call Dates, 1928-1935

- Stock Market Crash, Oct 24
- Caldwell Fails, Nov 7
- Creditanstalt Fails, May 11
- German Bank Holiday, July 14
- Britain Abandons Gold, Sept 19
Securities of NYC Fed Member Banks at Call Dates, 1928-1935

- Total Investments
- US Government Obligations
- Bonds, Domestic
- Bonds, State and Municipal
- Stocks, Domestic
- Securities, Foreign

- Stock Market Crash, Oct 24
- Caldwell Fails, Nov 7
- Creditanstalt Fails, May 11
- German Bank Holiday, July 14
- Britain Abandons Gold, Sept 19
Deposits of Weekly Reporting Banks in NYC, 1929-1934

Deposits of Weekly Reporting Banks in New York City

- Net Demand Deposits
- Interbank Deposits
- Time Deposits

Key Events:
- Stock Market Crash, Oct 24
- Caldwell Fails, Nov 7
- Creditanstalt Fails, May 11
- Britain Abandons Gold, Sept 19
- German Bank Holiday, July 14
Micro Data

- Create an index of foreign exposure from:
  1. Balances payable in dollars due from foreign branches of American banks
  2. Due from banks in foreign countries.
  3. Due to banks in foreign countries.
  4. Time deposits of other banks and trust companies in foreign countries.
  5. Foreign government bonds owned.
  6. Other foreign securities owned, including bonds of foreign municipalities.
  7. Number of foreign branches.

- Compare changes in deposits, profits, and cash.
Conclusions

- Previous paper eliminated one possible channel
- This paper eliminates two of the possible three channels Temin (1993) suggests can transmit banking crises internationally.
  - Domestic depositors did not succumb to a contagion of fear and rush to withdraw funds as the crisis in Germany peaked.
  - The impact on portfolios when values of foreign assets fall and patterns of financial flows change.
- We find that it was the third channel that Temin discusses that led to the transmission of the crisis to the United States.
  - Bank balance sheets changed dramatically after the Fed increased interest rates in October 1931 in order to defend domestic gold reserves.
  - “Golden fetters” remains the leading explanation as to what transmitted the German crisis to the U.S.