FEDERAL RESERVE BANK *of* NEW YORK *Serving the Second District and the Nation*

Liberty Street Economics

FEBRUARY 5, 2016

Crisis Chronicles: The Long Depression and the Panic of 1873

Thomas Klitgaard and James Narron

Source: Library of Congress Prints and Photographs Division

It always seemed to come down to railroads in the 1800s. Railroads fueled much of the economic growth in the United States at that time, but they required that a great deal of upfront capital be devoted to risky projects. The panics of 1837 and 1857 can both be pinned on railroad investments that went awry, creating enough doubt about the banking system to cause pervasive bank runs. The fatal spark for the Panic of 1873 was also tied to railroad investments—a major bank financing a railroad venture announced that it would suspend withdrawals. As other banks started failing, consumers and businesses pulled back and America entered what is recorded as the country's longest depression.

Westward Ho!

Formed in 1861, Jay Cooke & Co. was a bank that achieved fame and fortune by aggressively marketing government bonds during the Civil War. By 1869, it had expanded into financing railroads, specifically the Northern Pacific Railway that would link Duluth to Seattle. The line would be part of a transcontinental system that would carry goods from the Pacific Coast to the Great Lakes and then to Europe. Unfortunately, the project was plagued by mismanagement and construction challenges, and a growing funding gap made more challenging by the Credit Mobilier scandal.

In that case, the Union Pacific Railroad got caught using a shell company, Credit Mobilier, to inflate costs to maximize government subsidies for building the line. The revelation of this deception in 1872 damaged investor confidence in railroads and made Congress much less willing to support new railroad construction, including by the Northern Pacific.

Jay Cooke & Co. knew it was sinking at least a year before it suspended payments. "In the fall of 1872, the London partner Fahnestock observed that it was cruel to the depositors to use their money to support Northern Pacific bonds, and that the railroad should go to the market to borrow at any prices. The near panic in September 1872 made this impossible." (Kindleburger in *Crashes and Panics*, p. 80)

The firm kept bleeding money and on September 18, 1873, suspended deposit withdrawals from its New York and Philadelphia offices (houses) with the following announcement: "The immediate cause of suspension of Jay Cooke & Co. was the large drawing upon them by the Philadelphia house and their own depositors during the last fortnight. Both houses had suffered a large draw upon their deposits in consequence of the uneasy feeling which has recently prevailed, and which has affected, more or less, all houses closely identified with new railroad enterprises."

The announcement caused pandemonium on Wall Street:

> The first intimation which came into the Stock Exchange of any change in the programme was contained in a brief notice, which said authoritatively that Jay Cooke & Co. had suspended payment. To say that the street became excited would only give a feeble view of the expressions of feeling. The brokers stood perfectly thunderstruck for a moment, and then there was a general run to notify the different houses in Wall street of the failure. . . . The members of the firms who were surprised by this announcement had no time to deliberate. The bear clique was already selling the market down in the Exchange, and prices were declining frightfully. . . . Some of the men who were ruined swore, some of them wept, some went out of the street without saying a word; others talked of the trouble in a jovial way and went about trying to borrow money from friends. . . (New York Times, September 19, 1873)

The Fallout

The panic led to bank runs and bank failures, followed by commercial bankruptcies and unemployment so severe that the downturn was called the Great Depression at the time. It lasted so long, more than five years, that it is now known as the Long Depression. Those were miserable years for many, including veterans:

> Between 1873 and 1877, as many smaller factories and workshops shuttered their doors, tens of thousands of workers — many former Civil War soldiers — became transients. The terms "tramp" and "bum," both indirect references to former soldiers, became commonplace American terms. Relief rolls exploded in major cities, with 25-percent unemployment (100,000 workers) in New York City alone. ("The Real Great Depression")

The length of the Long Depression might reflect that it came at the end of an innovation cycle.

> Essentially, a set of innovations in technology and business organisation that were made in the later eighteenth and early nineteenth century had exhausted their potential to raise productivity. . . This, combined with mistaken policies, had led to a lot of malinvestment and a significant buildup of debt by the early 1870s. What followed, as Irving Fisher argued, was a crisis brought about by the realisation that many investments were not going to pay enough and the consequent need for sustained deleveraging. ("Lessons from the 'Long Depression")

Hard Money Wins a Close Battle

Congress initially responded to the collapse by trying to ease monetary conditions. A bill to add liquidity to financial markets passed Congress in March 1874, but was unexpectedly vetoed by President Ulysses S. Grant.

> Congress. . . called for the infusion of $400 million Greenbacks into circulation and the addition of $100 million into the nation's money supply. . . . Grant deliberated on the measure and initially wrote a message to Congress supportive of S.B. 617. The more he thought about it, however, the more he came to view the bill as an inflationary threat to the nation's long-term credit. . . . In his veto message, Grant feared that passage of the bill would lead to future efforts to print even more inflationary greenbacks ("President Ulysses S. Grant and the Panic of 1873").

The hard money view, with advocates in both political parties, moved Congress in the opposite direction of easier money with the passage of the Resumption Act in January 1875. The act required the Treasury to retire Greenbacks (currency not backed by gold) and committed the government to reinstate the gold standard in four years.

So, was the Long Depression just the industrial revolution peaking, with little that the government could do to offset defaults on a huge quantity of bad investments? Or was it unusually long because Washington pursued a hard money policy in the midst of recession in its quest to reinstate the gold standard? Let us know what you think.

Disclaimer

The views expressed in this post are those of the authors and do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System. Any errors or omissions are the responsibility of the authors.

Thomas Klitgaard is a vice president in the Federal Reserve Bank of New York's Research and Statistics Group.

James Narron is a senior vice president in the Federal Reserve Bank of San Francisco's Cash Product Office.

The comments to this entry are closed.