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Reallocating Liquidity to Resolve a Crisis: Evidence from the Panic of 1873

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Summary

We study financial stability with constraints on central bank intervention. We show that a forced reallocation of liquidity across banks can achieve fewer bank failures than a decentralized market for interbank loans, reflecting a pecuniary externality in the decentralized equilibrium. Importantly, this reallocation can be implemented through the issuance of clearinghouse loan certificates, such as those issued in New York City during the Panic of 1873. With a new dataset constructed from archival records, we demonstrate that the New York Clearinghouse issued loan certificates to member banks in the way our model suggests would have helped resolve the panic.

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