

A Hamilton

ALEXANDER HAMILTON

Central
Banker
and
Financial
Crisis
Manager

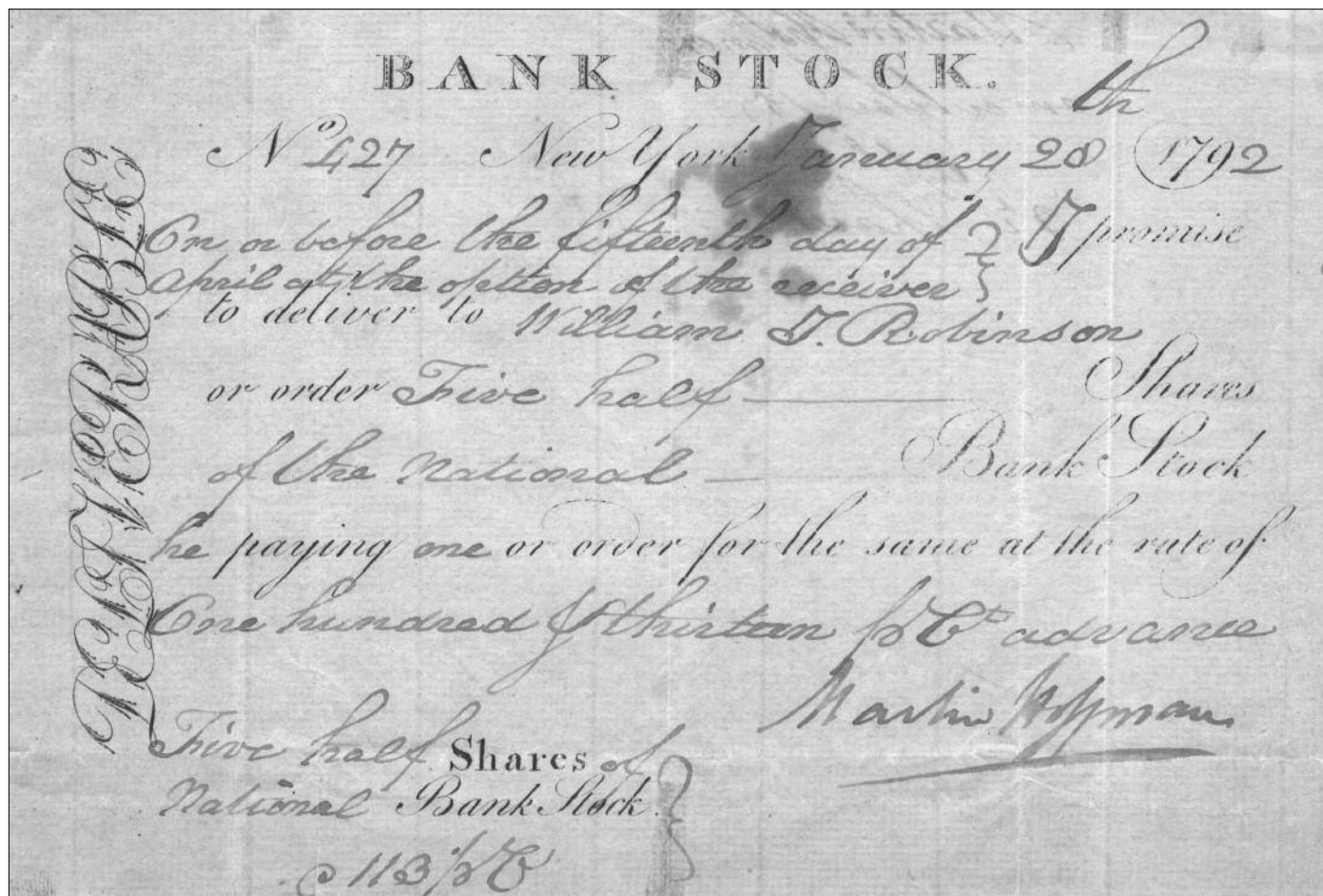
By Richard Sylla

WALL STREET SUFFERED its first crash in March, 1792. In a matter of weeks, U.S. government securities comprising the national debt lost a quarter of their value. Shares of the Bank of the United States, founded in 1791, fell 30 percent. Shares of the new Society for Establishing Useful

Manufactures fell 45 percent. A more seasoned issue, Bank of New York shares, declined just under 20 percent. Defaults and bankruptcies were numerous. As confidence and trust collapsed, a pall fell over New York and, to a lesser extent, the Philadelphia and Boston securities markets.

Apart from financial history specialists, few are aware of this

major crash and panic that came during the birth of U.S. capital markets. Our history books far more often mention similar events in the years 1819, 1837, 1857, 1873, 1884, 1893, 1907, 1929, 1987, and, more recently, the major market decline from 2000 to 2002. One reason for the difference is that the key dimensions of the 1792 crash have only recently



Certificate for stock in the Bank of the U.S., January 20, 1792.

been recovered. The price changes mentioned in the previous paragraph are part of a new securities price database compiled, mostly from old newspapers, by Jack W. Wilson, Robert E. Wright, and me.

A more important reason why 1792 is less than memorable is that it had no discernable economic consequences. There was no recession, much less a depression. Prices stopped falling by mid-April, the U.S. economy continued to grow vigorously as it had since 1789, and the events of March were soon forgotten. But why? Was this just an early example of that Divine Providence that is said to look after fools, drunks, and the United States of America?

No. Potentially damaging economic consequences of the panic were avoided, it is now quite clear, by very

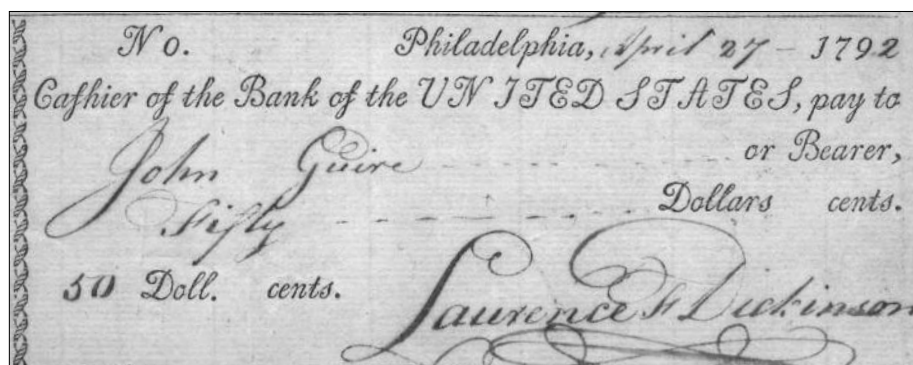
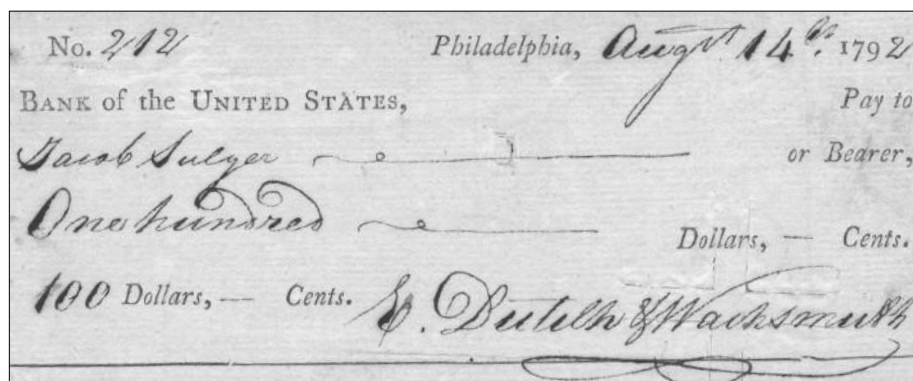
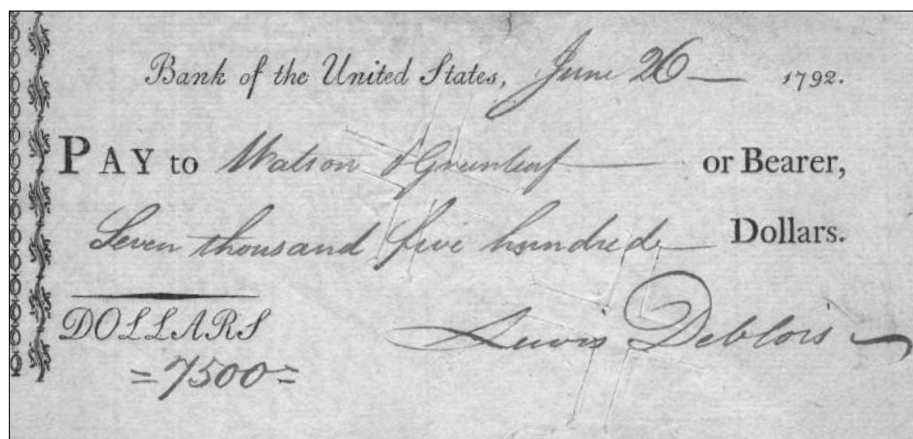
modern central-bank-like interventions orchestrated by Alexander Hamilton. Hamilton, Secretary of the Treasury, at the time was executing his grand plan to give the country a modern, state-of-the-art financial system. Hamilton, who knew his financial history, was well aware that a disastrous panic could defeat the plan. He had studied the 1720 collapse of John Law's Mississippi Bubble in France, which weakened France for decades, and the related collapse that same year of the South Sea Bubble, which had somewhat less damaging consequences for England's financial system.

Trial Run: The 1791 Bank Script Bubble

In 1791, during the crash of a bubble connected with scripts—rights to

buy full shares—issued in the IPO of the Bank of the United States (BUS), Hamilton wrote Senator Rufus King that “a bubble connected with my operations is of all the enemies I have to fear, in my judgment the most formidable.” So Hamilton then directed open market purchases of government debt to inject liquidity into panicky markets. It proved to be a test run for a wider range of interventions in the more serious crash of 1792.

Bank scripts were issued on July 4, 1791. For a \$25 down-payment, an investor received a script entitling the holder to purchase of a full BUS share after a series of further payments of \$375. Scripts doubled in price in July, and then really took off, reaching prices of \$264 (New York) to \$300 (Philadelphia) on August 11. The



Three checks from the Bank of the U.S. dated the year of the panic, 1792.

purchases were financed by loans from banks.

Over the next month, mid-August to mid-September, Sinking Fund records show the Treasury purchasing \$150 thousand of U.S. debt in Philadelphia and \$200 thousand in New York, where the money was borrowed from the Bank of New York and the purchases were executed by the bank's cashier, William Seton. The BUS, the national bank, had just had its IPO and would not open for business in Philadelphia until December, and would not have a New York branch until April 1792. Hamilton therefore had to work through the one bank then in New York, and it probably helped that he had been one of its founders in 1784.

By having the Sinking Fund purchase about two percent of the debt outstanding in 1791, Hamilton had nipped in the bud an incipient market crash. The liquidity injection calmed the markets. From New York, Seton in September wrote Hamilton in Philadelphia, saying, "You have the blessings of thousands here, and I feel gratified more than I can express, at being the dispenser of your benevolence." Markets are grateful to central bankers who intervene to prevent prices from collapsing by buying when everyone else wants to sell.

Causes of the 1792 Panic

Traditional accounts of rapid run up of securities prices in the first two months of 1792, followed by the crash of prices in March and April, blame it on an ill-fated plan of a cabal of New York speculators led by William Duer to corner the market for U.S. six percent bonds (6s). Under Hamilton's plan for capitalizing the BUS, investors holding Bank scripts could pay three-fourths of the full share price, \$400, by tendering 6s.

Duer and his associates plotted to borrow whatever money they could, often by offering very high rates of

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dotcom bubble of recent memory was hardly new or unique.

In the following days and weeks scripts lost more than half of their peak valuations—the bid price was 110 in New York on September 9—dragging down with them prices of U.S. debt securities. Sensing trouble, Hamilton on August 15 sprang into action. He convened a meeting of the commissioners of the Sinking Fund (himself and four other top officials of the federal government) and per-

suaded them to authorize open market purchases of \$300–400 thousand of U.S. debt at Philadelphia and New York. The Sinking Fund was a feature Hamilton had included in his 1790 national debt restructuring plan, ostensibly to assure investors that the U.S. government was committed to paying down its debt, but really—since it would be some time before federal revenues would allow any pay-down—to allow just such short-term open-market interventions. The



\$50 promissory note from the Bank of the U.S. issued August 1, 1792.

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post-notes as a way of temporarily conserving its specie reserves.

Third, Hamilton had the Treasury make open market purchases at Philadelphia, using the funds authorized to be spent by the Sinking Fund in 1791 that had not been expended then. And he called the Sinking Fund commissioners to meet on March 21 to authorize more open market purchases of U.S. debt. There were some delays in getting the authorizations, but over the next month Hamilton directed agents in Philadelphia and New York to purchase on the open market nearly \$250 thousand worth of U.S. debt to inject liquidity to the panicked securities markets.

Fourth, Hamilton learned in March that the U.S. minister in Amsterdam had arranged a loan to the Treasury from Dutch bankers of three million florins (\$1.2 million) at four percent interest. He directed his agents in U.S. markets to publicize news of the loan, to assure panicky investors that U.S. finances were in strong shape.

Fifth, Hamilton initiated a plan among the banks, merchants, and securities dealers in New York to cooperate in stemming the crisis. In a letter of March 22 (which became public only in 2005), Hamilton suggested to Seton at the Bank of New York that rather than dump their holdings on the market to meet liquidity needs, which would only exacerbate the crisis, the merchants and dealers instead use up to \$1 million of U.S. securities at *values specified by Hamilton* as collateral for credits at the bank. The dealers and merchants could then write checks against these credits to settle their accounts with one another, avoiding panic liquidation.

Anticipating what decades later would be called Bagehot's rules for proper central bank behavior in a crisis, Hamilton directed that the loans be made at the high discount rate of seven percent instead of the usual six percent. Walter Bagehot, a

interest, to buy up most of the 6s, and then sell at high prices to those who needed 6s to purchase Bank shares in 1792 and 1793. As the plot was implemented, 6s rose from 110 (percent of par) in late December 1791 to 125 by mid January 1792, to a peak of 126.25 in early March. But on March 9 Duer defaulted on his debts, triggering a chain of further defaults and liquidations that drove 6s down to a low of 95 on March 20. Government securities had lost a quarter of their value in about two weeks.

More recent research confirms that another factor besides the Duer cabal was at work in early 1792 to drive up prices and then drive them down. Price bubbles are almost always fueled by newly-created credit, and it happened that a new and large source of such credit became available at the end of 1791, namely the Bank of the United States. The Bank opened in Philadelphia in December 1791, and by the end of January 1792 it had issued \$2.2 million of notes and deposits (monetary liabilities) while discounting loan paper of \$2.7 million. Some of those loans found their way to Duer and other speculators.

The new central bank had been careless with its credit creation in its first weeks and months. By early February, holders of BUS notes and deposits were redeeming them for specie reserves, which fell from \$706 thousand on December 29, to \$510 thousand on January, to \$244 thou-

sand on March 9. It was a classic drain of reserves from a bank that had expanded credit too fast and too far. In February, Hamilton had to inform the Bank of New York, which itself was stressed, that the Treasury would have to draw funds from it to prop up the BUS in Philadelphia. At the same time he urged all banks to reduce their lending "gradually." Instead, the banks stepped hard on the brakes; BUS discounts, for example, declined nearly 25 percent from January 31 to March 9, the very day William Duer defaulted on his debts. Duer no doubt was a reckless speculator and plunger. But in the end he and others like him were done in by an abrupt tightening up of bank credit.

Hamilton Manages the Crisis

On March 19, the day before U.S. 6s reached their panic low of 95 in New York, Hamilton initiated a number of actions to alleviate the financial distress. First, he asked the nation's banks, still few in number, to lend money to merchants who owed customs duties to the Treasury. He promised the banks that the Treasury would not draw the money from them for three months.

Second, Hamilton reminded the Treasury's collectors of customs in the nation's port cities that they were authorized to receive post-notes of the BUS maturing in 30 days or less "upon equal terms with cash," and he encouraged the BUS to issue such

U.S. Sixes, Philadelphia Price



student of English central banking, publicized his rules in his book *Lombard Street* in 1873. The rules in essence said that a central bank in a crisis should lend freely on good collateral, such as government securities, but at a high rate of interest so borrowers would have an incentive to repay the loans as soon as the crisis had passed. Hamilton's creative financial mind had come up with Bagehot's rules nine decades before Bagehot.

But what if the crisis did not end and the Bank of New York got stuck with collateral that had fallen in value. Hamilton deemed that possibility "not supposeable," but to alleviate concerns on the part of the bank, he offered to repurchase from it up to \$500 thousand, *again at the values Hamilton had specified*. In other words, Hamilton combined a repurchase agreement with Bagehot's rules.

The plan was implemented. Five days later, an agent of Hamilton's in

New York wrote to him to report, "The dealers last night had a meeting & appointed a committee, to confer with the directors of the two banks [Bank of New York, and the BUS New York branch about to open in April]. The propositions they are to hold out I hear in general is to offer, funded debt, *at your price* [emphasis added] as pledges for their discounts – & they are to sign an agreement to bind themselves not to draw any specie from the banks, on account of the discounts they shall obtain and giving checks to each other..."

Together the combined effect of Hamilton's crisis management measures worked. By mid-April, the Panic of 1792, Wall Street's first crash, was over and the securities markets returned to routine trading activities. Despite many bankruptcies, there were virtually no negative effects on the U.S. economy. It continued to grow at higher rates than were common

before the financial reforms that began in 1789.

In the aftermath of the panic, 24 brokers and dealers met in May under a buttonwood tree on Wall Street, and subscribed to an agreement that is regarded as the origin of the New York Stock Exchange. Ten of the 24 had sold securities to the Treasury in the open market purchases of March and April. So it is possible that the spirit of cooperation in the financial community Hamilton encouraged during the panic carried over when Wall Street moved toward an improved trading system in May.

There was political fallout from the 1792 panic. The crisis appeared to confirm in the minds of leaders such as Jefferson and Madison that Hamilton's financial program was turning the United States into a nation of paper speculators and stockjobbers rather like England, instead of the nation of virtuous



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Alexander Hamilton, first Secretary of the Treasury, also acted as the nation's first central banker during the Crash of 1792.

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Republican farmers they hoped for. Jefferson and Madison redoubled their efforts in opposition to Hamilton's measures. Thus, the panic encouraged the formation of a two-party system of politics and government that was emerging in those early years, largely as a consequence of Hamilton's financial program.

Hamilton as Central Banker

We usually think of Alexander Hamilton as the country's first Secretary of the Treasury who successfully stabilized the new federal government's initially shaky finances. We also know that he was quite a soldier, lawyer, constitutionalist, and political essayist — among other things, he conceived of the Federalist Papers project and wrote three-fifths of the 85 Federalist

essays. We know that he conceived and founded the BUS, the nation's first central bank, but that he left the management of it to others. In 1791 and 1792, however, when the BUS — and indeed, the entire U.S. financial system — was new and inexperienced, it is clear that Hamilton acted as a central banker and crisis manager.

Thus, as we approach the 250th (or some say, 252nd) anniversary of Hamilton's birth on January 11, 2007, we can add another feather to Hamilton's cap. He was one of the very first central-bank-like managers of a financial crisis. As in so many other areas of his endeavors, despite having few precedents to guide him, as a central banker Hamilton acquitted himself quite well. **FH**