Key Findings from the Working Paper:

Clearing Arrangements in the United States before the Federal Reserve System

In order to provide insights to the progression of banking systems in emerging market countries, this paper examines clearinghouse arrangements in the United States before the establishment of the Federal Reserve System.

Two different clearing arrangements for bank liabilities are studied. One was a profit-maximizing private entity, the Suffolk Banking System (SBS). It cleared notes for virtually all New England banks between 1827 and 1858. The other was a nonprofit collective, which were clearinghouses organized in many cities beginning in 1853. The paper specifically focuses on how well these arrangements performed along two dimensions: bank failure rates, which can give a sense of the safety and soundness of the system, and the extent to which the two arrangements acted as lenders of last resort during bank panics by making available “reserves” to member banks.

The paper finds that the two arrangements performed differently, and that these differences were related to the incentives of the banks involved. SBS had lower rates of bank failures than clearinghouses. It argues that this is because SBS could potentially suffer large losses should a member bank fail, so it had a great incentive to monitor member banks. Under the clearinghouse arrangement, no bank would suffer a loss from the failure of another bank simply as a result of being a member of the clearinghouse.

With regard to acting as a lender of last resort, the paper finds that the clearinghouses appeared to provide more reserves in terms of financial distress than did the SBS. This, the paper argues, was also due to greater reserves, due to the incentive effects of potential losses. If a bank in the SBS that received those additional reserves failed to pay them back, the Suffolk Bank suffered the entire loss. In the clearinghouse arrangement, however, such losses would be shared by all the surviving banks, so the clearing house banks as a whole could afford to provide more reserves.
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