Banking and Financial Fragility

Case Study: Deposit Freezes

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May 2017

Deposit freezes

- Almost every major banking crisis involves some sort of deposit freeze

- Terminology has varied over time:
  - an individual bank may suspend payments
    - or "suspend convertibility" of deposits into specie (i.e. gold) or currency
    - common in the U.S. 19th and early 20th century
    - some deposit contracts explicitly included this option
  - government may declare a banking holiday
    - close all banks for some time period
  - money market mutual funds may now erect gates
    - prevent redemptions and/or impose a redemption fee

Theory vs. practice

- Diamond & Dybvig (1983) show that self-fulfilling bank runs will not occur if the freeze policy is:
  - quick: implemented soon after the run is discovered
  - strict: no further withdrawals allowed
- The deposit freezes we observe in reality tend to be:
  1. implemented relatively late
     - after a crisis has intensified and other efforts have failed
     - not at the first sign of trouble (as in the theory)
  2. only partial freezes
     - allow some additional withdrawals by investors
     - which requires liquidating some additional bank assets

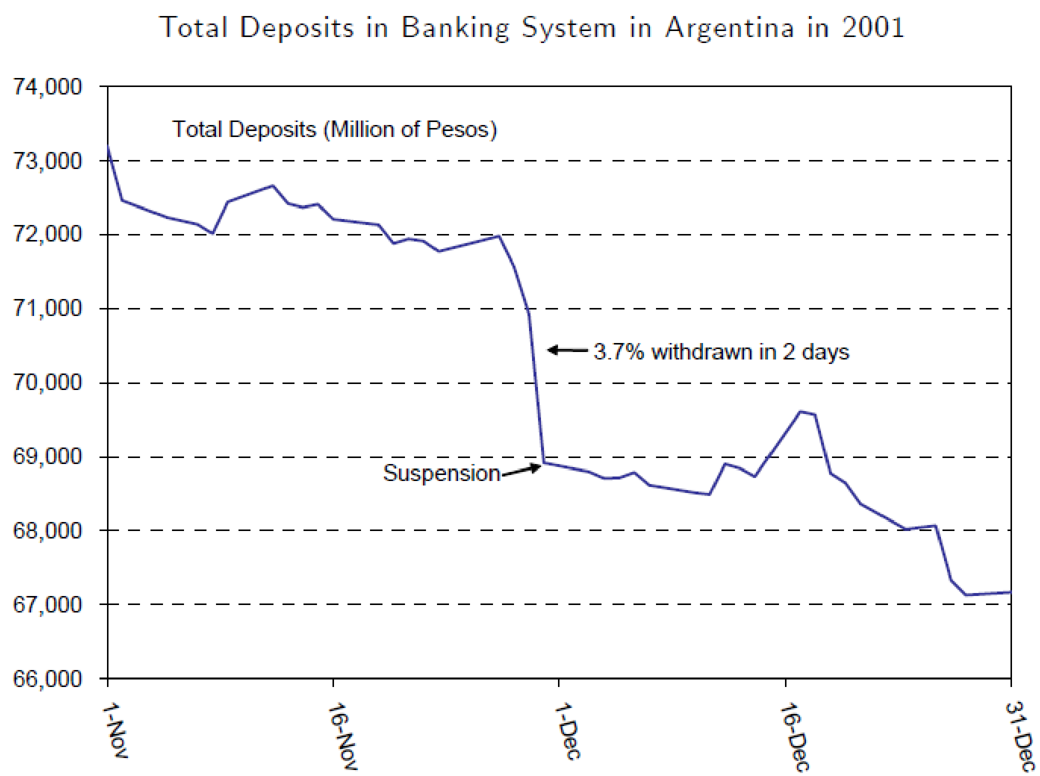
U.S. in 1933

- Growing banking crisis in late 1932 – early 1933
- Policy makers seemed reluctant to freeze deposits as crisis unfolded
  - fear that doing so would further disrupt real activity
  - directors of NY Fed urged President Hoover to declare a banking holiday, but he did not
- A banking holiday was eventually declared …
  - by President Roosevelt immediately after his inauguration
- … but:

  "Suspension occurred after, rather than before, liquidity pressures had produced a wave of bank failures without precedent." (Friedman & Schwartz, 1963)

Argentina in 2001-2

- Major banking (and fiscal) crisis in 2001
  - currency board was in place; 1 peso = 1 US$
  - full-fledged run occurs in late November

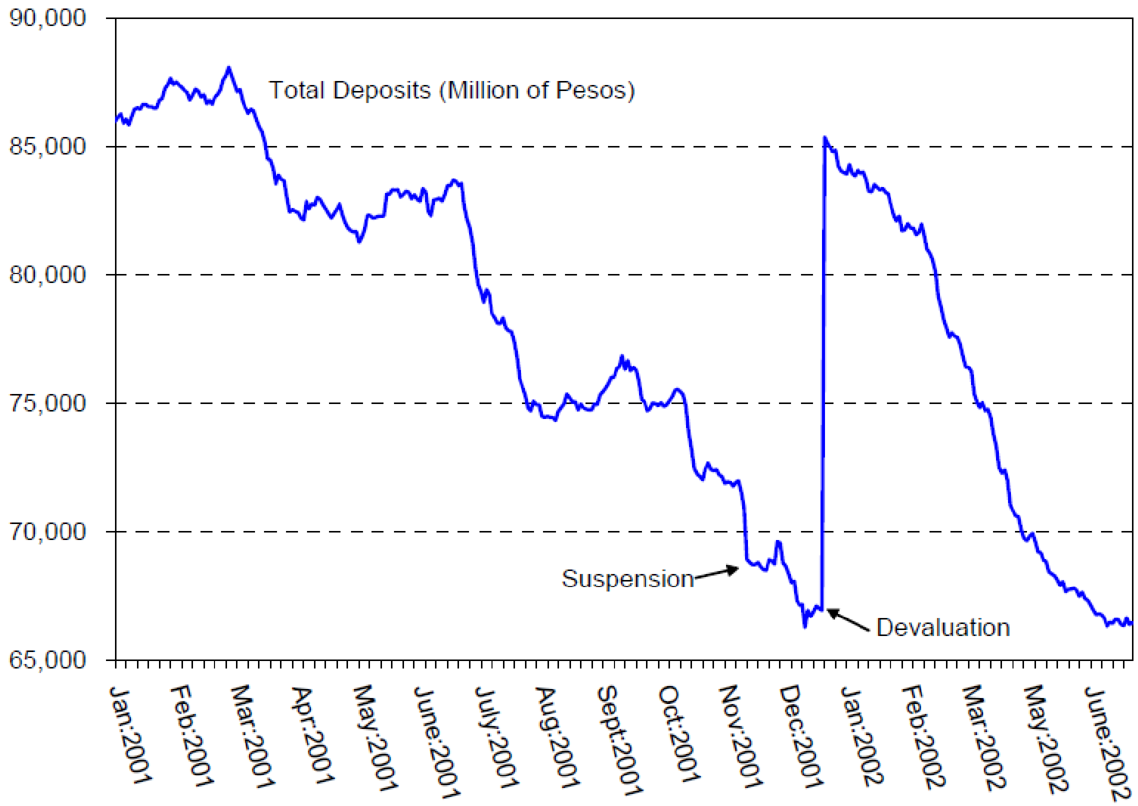


"el corralito"

- Deposits are not completely frozen, however
  - people need access to some money, after all
- Depositors could withdraw up to 1,000 pesos per month from each account
  - and some managed to divide their money across multiple accounts …
- In addition, some depositors filed lawsuits claiming urgent financial needs
  - examples: illness, hospitalization, etc.
  - nearly 200,000 cases filed between Dec. 2001 and June 2003
  - courts awarded over 14 billion pesos to depositors

The end result:

Total deposits in banking system, January 2001 – June 2002



Deposits fall by 25% in the 6 months <u>after</u> the freeze

More recent examples of deposit freezes

Florida Local Government Investment Pool (2007)

Cyprus:

- banks closed in March 2013 as financial crisis worsened
- contentious debate over imposing losses on deposits
- capital controls restricted access to deposits until 2015
  - transfers/payments within Cyprus allowed
  - but limits on money flowing out of banking system, country

Greece:

- banks closed for three weeks in June-July 2015
- ATM withdrawals initially limited to 60 euros/day
- capital controls to restrict flows out of country

Takeaways

- In order to remove the incentive for investors to run …
  - … a deposit freeze must be <u>quick</u> and <u>strict</u>
- Freezing investors' deposits is costly, however
  - authorities are often reluctant to freeze, do so relatively late
  - *and* are lenient with additional withdrawals
- When investors expect a late and/or lenient freeze …

Question:

- How does a late/lenient freeze affect patient depositors' withdrawal incentives?

References and further reading

Dominguez, Kathryn M. E., and Linda L. Tesar (2007) "International Borrowing and Macroeconomic Performance in Argentina," in *Capital Controls and Capital Flows in Emerging Economies: Policies, Practices, and Consequences*, ed. Sebastian Edwards, University of Chicago Press, 297-342.

Ennis, Huberto M. and Todd Keister (2009) "Bank Runs and Institutions: The Perils of Intervention," *American Economic Review* 99:1588-1607.

Friedman, Milton, and Anna J. Schwartz (1963) *A Monetary History of the United States, 1867–1960*. Princeton University Press.

- see especially the section on The Banking Panic of 1933 in Chapter 7, pages 327-331