Déjà vu All Over Again:
Agency, Uncertainty, Leverage and the Panic of 1857

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Summary

In this paper we revisit the panic of 1857 in light of the more recent financial crisis. In our detailed analysis, we present new evidence regarding the failure of the financial institution—the Ohio Life Insurance and Trust Company, or OLITC—that triggered the panic. Previous literature simply blames embezzlement instigated by the head cashier, implying that OLITC's demise was an idiosyncratic event that was not linked with the real economy and the broader financial system. We instead find that Ludlow engaged in a systematic gamble to resurrect the declining fortunes of OLITC's major investment partners, and therefore his own firm. Relative to the existing literature, we place great importance on the collapse of OLITC as a signal information event that caused a convergence of opinion amongst the public that in turn triggered the panic.

To substantiate our conclusions, we conduct a detailed analysis of 17 representative railroads for the four years leading up to the panic. We are able to show how high leverage (which was typically underreported to begin with) and a rapidly depreciating capital stock combined to create an unsustainable business model in the face of weakening demand and significant overcapacity.

As a final exercise we analyze three prominent Wisconsin railroads that were located at the northwestern frontier of the U.S. in the 1850s, and which were instrumental in developing a new financial innovation—the farm mortgage-backed security. Analysis reveals similarities to certain sub-prime mortgages and their securities issued prior to the most recent panic.

In the face of uncertainty and measurable factors that can predict a banking panic and subsequent recession, we ask the following question: Why don't markets self-correct in an incremental fashion rather than wait for triggering events that result in dramatic downward adjustments and market failures? In other words, why are financial systems fragile? Our analysis of the panic of 1857 in relation to recent events provides support for "rational bubble" proponents that emphasize agency and information as explanations. Suppliers of securities and informed investors will have clear short-term incentives to possibly start and then to perpetuate trading and asset prices that get out ahead of fundamentals (see, e.g., Allen and Gorton (1993)). Along the way, investors exhibit tendencies to neglect certain risks that are new or that may have been unimportant in recent years, but which are now relevant and assume increasing importance (Gennaioli, Shleifer and Vishny (2010)). A dramatic event or series of linked outcomes cause investors to reassess their beliefs and redefine their information sets, resulting in a panic as assets held by financial intermediaries become information sensitive.