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The Financial Crisis: Government Bailouts -- A U.S. Tradition Dating to Hamilton

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The bubble pops. Lenders freeze. Depositors lose faith. Panic spreads. And the government steps in because nobody else will.

Today it is Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke putting together the rescue package for a financial system rocked by falling home prices and a wave of defaults on subprime mortgages.

But a short walk through U.S. history demonstrates the point made by Alex J. Pollock of the American Enterprise Institute: "If you would like an empirical law of government behavior, it is that in a panic or threatened financial collapse, governments intervene -- every government, every party, every country, every time."

The Panic of 1792

The nation's first president was in his first term when the U.S. ran into its first financial panic.

In 1791, the federal government assumed obligations that such states as Massachusetts and South Carolina owed from the Revolutionary War, part of a larger deal that included moving the national capital from New York to Philadelphia to Washington. Taking on the states' obligations added about $18 million to a total U.S. domestic debt of $65 million -- debt securities that proved attractive to financial speculators.

Primary among them was William Duer, a well-connected New York businessman who schemed to start a New York bank to drive down the price of Bank of New York stock and win control of BONY on the cheap. He and his colleagues also intended to corner the market on government 6% bonds, so-called Sixes.

Treasury Secretary Alexander Hamilton, the founder of BONY, watched the developments with alarm. "I have learnt with infinite pain the circumstance of a new Bank having started up in your City," Mr. Hamilton wrote to a New York associate, according to research by economic historians Richard Sylla, Robert E. Wright and David J. Cowen. "Its effects cannot but be in every view pernicious," because of the damage they caused to "the whole system of public Credit, by disgusting all sober Citizens and giving a wild air to everything."

The price for Sixes in New York jumped markedly from early December to mid-January. By March, the bubble had burst, with the price of the bonds dropping 25% over two weeks.

Working without a historical blueprint, Hamilton engineered an innovative response. The Treasury borrowed money from the banks and used it to buy government bonds, lifting the market price. He also told banks to accept bonds as collateral for loans to securities brokers, with the government guaranteeing the collateral.

"What Hamilton did in 1792 is just like what Paulson and Bernanke are doing now," said Mr. Sylla, who teaches at the Stern School of Business at New York University.

The financial system stabilized in April, and not a single bank failed until 1809. Mr. Hamilton's improvisation did the trick, or at least so concludes Mr. Wright, also at NYU. He named his son Alexander Hamilton Was Wright.

The Panic of 1907

The century that followed was punctuated by financial instability. There was the panic of 1819, during which states passed laws delaying foreclosures on real estate and personal property.

In 1841, another bout of financial volatility sent land values plummeting. States that had been depending on land taxes suddenly found themselves short of cash; nine of them defaulted on their debts. There was talk of a federal bailout, but Congress balked. Some states raised taxes and paid up; others swapped canals or other assets with their creditors.

"There were banking panics all of the time," said Princeton University economist Alan Blinder, former vice chairman of the Federal Reserve Board. "The banking panic of 1907 was particularly pernicious."

One immediate cause of the panic involved a failed attempt to corner the market on stock in a particular copper company. That led to a run on banks and trusts that had made loans for the plot, starting with the Knickerbocker Trust Co. Public confidence in other financial institutions soon evaporated.

The Treasury injected millions of dollars into the banking system. But it was really J. Pierpont Morgan, the banking magnate and undisputed king of New York financial markets, who saved the day. He had been in Virginia for a church conference when the panic hit, and he took an overnight train back to New York City. He dispatched his lieutenants to figure out which banks were in the worst trouble, then he called the bankers to his home. Working through the night, he browbeat the others into forming a joint pool of capital that they would use to pay depositors at banks that faced runs.

Once depositors saw that they were going to get their money, the panic eased. "Where's J.P. Morgan when we need him?" joked Mr. Blinder.

Six years later, Congress established the Federal Reserve system, creating a lender of last resort for the country's financial system.

The Great Depression

By 1933, four years after the infamous stock-market crash, about 1,000 American homeowners a day were losing their houses to the bank. President Franklin Delano Roosevelt and Congress created the

Home Owners' Loan Corp., an ambitious government agency designed to prevent foreclosures on an enormous scale.

The agency bought defaulted mortgages from banks, then refinanced them at lower rates for fixed, 15-year terms. Over the three years it accepted applications, the agency was swamped with 1.9 million requests; about half of the applicants had monthly incomes of between $50 and $150.

Ultimately, the agency issued mortgages, averaging $3,039 apiece, to some one million homeowners. About one in 10 Americans with nonfarm, owner-occupied dwellings secured aid from the agency, according to a 1951 paper by C. Lowell Harriss of Columbia University.

The current mortgage crisis involves securities backed by subprime home loans. But during the 1930s, there was no secondary market for securitized mortgages. So the agency had to hold the mortgages for the full terms. It finally closed up shop in 1951, with about 80% of borrowers having paid their loans off on time or early.

The agency earned the government a small profit. "You save 80% of the people from being tossed out of their homes, and it didn't end up costing the government a dollar," said Lee Davison, a historian at the Federal Deposit Insurance Corp., another Great Depression creation.

Savings and Loan Crisis

It used to be that savings-and-loan associations were staid institutions that stuck to home loans and lured savings-account depositors with blankets and toasters. But during the 1980s, the industry expanded wildly into commercial real-estate lending, spurred by deregulation and poor regulation, according to Mr. Blinder.

The business model worked as long as the S&Ls made more money on their loans than they had to pay for deposits. But the model broke down when interest rates rose, and the institutions found themselves paying more for deposits than they earned from fixed-rate loans in their portfolios.

"In addition," said Mr. Blinder, "they went into a lot of what could only be called stupid real-estate investments."

From 1986 through 1995, about half of the 3,234 S&Ls in the U.S. closed, leaving federal insurers stuck with tens of billions of dollars in bad loans. In 1989, after eight months of debate, Congress created the Resolution Trust Corp. to make depositors whole, investigate allegations of wrongdoing and deal with the husks of the S&L industry.

At the time, skeptics warned that government was reaching too far into the marketplace, and predicted darkly the RTC would be saddled with bad assets for generations.

Indeed, the government ended up owning shopping centers, homes and resorts, along with an odd collection of assets put up as collateral for S&L loans, including Picasso and Warhol paintings, a 30-horse merry-go-round, a Colonial-era whiskey distillery, a drawstring made from Martha Washington's gown and 800 units of semen from a registered Brahma bull.

By the time the S&L cleanup was over, it had cost U.S. taxpayers about $124 billion in non-inflation-adjusted dollars, according to FDIC research. Mr. Davison, the FDIC historian, wrote in a 2006 journal article: "Perhaps a measure of the RTC's success is that little more than a decade after it closed, this agency that provoked so much debate is now largely forgotten."

Greg Hitt and Louise Radnofsky contributed to this article.