

Economic SYNOPSES

short essays and reports on the economic issues of the day



2009 ■ Number 7

Bagehot on the Financial Crises of 1825...and 2008

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Over the past two years the Federal Reserve, FDIC, and the U.S. Treasury have created numerous programs to sustain the economy's flow of credit. Some analysts have criticized these programs as "scattershot," as lacking focus, or as desperate attempts to be perceived as "doing something." Others have argued that care must be taken so that these programs do not violate Walter Bagehot's (1826–1877) maxim that central banks must lend only against good collateral and at penalty rates (Thornton, 2008).

"Bagehot's principal message is that the first task of a central bank during a financial panic is to end the panic."

Historians are fond of the maxim "Those who cannot learn from history are doomed to repeat it." Perhaps critics of recent policies are unaware of the long history of such efforts in central banking theory and practice. Macroeconomists continue to find use in Bagehot's *Lombard Street* (1873), a book that prescribed behavioral rules for the Bank of England when Great Britain had no statutory central bank but the Bank, by the evolution of institutions and markets rather than statute, held the nation's gold reserve and special statutory authority with respect to the issuance of banknotes. Started in 1870 in response to the Panic of 1866, completion of the book was delayed by Bagehot's ill health. Bagehot, a banker's son, was educated at University College London and joined his father's banking and shipping firm in 1852. Later, Bagehot became editor-in-chief of a small newspaper founded by his father-in-law—*The Economist*—and greatly expanded both its influence and his own. The newspaper provided him an outpost to watch the Panic of 1866 unfold.

Bagehot's principal message is that the first task of a central bank during a financial panic is to end the panic. He defined a "panic" as a period when the public desired to hold only gold coin, bullion, or Bank of England banknotes. Quelling a panic required satisfying the public's demand for these assets. Bagehot maintained that the "natural" order of a banking system was that each bank must maintain its own reserve of liquidity such that it can fulfill such demands; he disliked the British system in which a single bank—the privately owned Bank of England—evolved to that role. Outside London, banks heavily promoted payment by check and, as a consequence, the use of Bank of England banknotes had

diminished throughout the country such that no bank held enough to redeem even a modest share of its deposits in Bank of England notes. Rather, in times of crisis, the country banks looked to the London city banks, and the city banks in turn looked to the Bank of England to extend necessary credit (via discounts) and banknotes.

The Bank of England loaned aggressively during panics, and several times before Bagehot's writing had nearly exhausted its reserves. Further, lending could not always be against "good" collateral since the panic itself harmed the market value of assets. Bagehot advised a lending rate sufficiently high to avoid exhausting the Bank's reserves and accepting good collateral to ensure that the Bank would not itself become insolvent. In the Panic of 1825, for example, the Bank discounted freely against bills of exchange; at its peak the Bank had loaned more than £25,000,000. Early in the panic, the Bank did not lend freely, seeking to ration its discounts and reserves (Clapham, 1944). Discounts increased rapidly after November 26, reaching £926,000 on December 1 when *The Times* [London] described the rush to discount at the Bank as resembling "the pit of a theater on the night of a popular performance." Clapham reports that the week of December 11–17 was the worst. On Monday, the Bank purchased £500,000 of [Exchequer Bills](#) and increased its discount rate to 5 percent from 4 (the rate had been at 4 percent since 1822). Despite the rate increase, during the week the Bank did "no less than" £5,977,000 in discount business—almost exhausting its reserves. The increase in the discount rate had been too small to stem demand. Clapham writes: "The ordinary non-discounting public was clamouring, through its banks, for money—Bank notes or gold. Neither notes nor sovereigns could be made fast enough; it was the literal physical limit that impeded. By the evening of Saturday, the 17th, the Bank had run out of £5 and £10 notes; a supply arrived from the printers on Sunday morning." The Bank's reserves had fallen to approximately £1 million, less than half in gold coin. On the 16th, embarrassment had been avoided by locating a misplaced box containing more than 400,000 £1 notes.

During the crisis, at the urging of Prime Minister Lord Liverpool¹ and Chancellor of the Exchequer Robinson,² the Bank lent against other than good collateral directly to merchants, largely on personal credit. The Bank's directors, Clapham reports, resisted but "reluctantly consented." Within the Bank, it was feared that reserves might be exhausted before the panic could be stemmed, reducing the economy to barter. Clapham notes that the situation was saved, in part, by Paris sending more than £400,000 in gold coin. The precise circumstances under which

the Bank of France sent the gold to the Bank of England were later the subject of rumors because it was not a direct transaction between the Bank of England and the Bank of France. Clapham reports that Foreign Secretary Canning³ “absolutely refused” to allow the Bank to suspend cash payments. Rumor suggested that the foreign secretary might have been involved in the transaction—Clapham notes that Horsley Palmer⁴ was asked during 1832-34 hearings on the Bank’s charter whether he had heard such rumors. The following week the panic cooled, and the Bank’s discounts were £2,622,000. By December 24th, “people began to be satisfied.”

The Crisis of 1847 was the next test. An act of Parliament in 1844 had separated the Bank into two departments—the Issue Department that placed currency into circulation up to statutory maximum, and the Banking Department that conducted traditional banking business, including lending via discounts. Between September 15 and October, 25, 1847, the Bank loaned “in all sorts of ways, usual and unusual.”⁵ Among the more unusual collateral was a copper works at Swansea, which it came to own. During “the week of terror” of October 16-23, despite discount rates as high as 9 percent, the Bank’s reserve fell dangerously low at £726,000. During the Crisis of 1857, the Bank’s Banking Department exhausted its reserves despite lending rates as high as 10 percent—the Issue Department transferred £2 million of Bank of England banknotes (“illegal” notes because they were in excess of the legal ceiling) to the Banking Department so that it might continue handing banknotes to customers (a special “Chancellor’s letter” absolved the Bank’s management from legal consequences). Later, the Panic of 1866 brought a similar test, although no illegal note issue was made. Instead, a 10 percent offering rate on gold deposits kept adequate bullion flowing to the Bank, despite a heavy demand for coin and banknotes via discounts. Bagehot notes that during the worst of the panic, “fresh money” could not be borrowed on the best security (even British government consols) except at the Bank of England. Bagehot wrote “in a panic, the holders of the ultimate Bank reserve should lend to all that bring good securities quickly, freely, and readily.” To him, “good securities” included those that, while easily traded in normal times, may have no market value during a panic.

Most economists who are concerned with monetary policy today have learned a variant of Bagehot’s advice that a central banker in times of crisis should lend freely against good collateral. But, in fact, the applicability of Bagehot’s advice is limited today. Modern central banks in [fiat money](#) economies do not face the constraints that concerned Bagehot—their right to issue high-powered money cannot be exhausted, nor can they become legally insolvent. Modern research suggests, instead, two pieces of advice. The first is that panics tend to follow periods during which new financial securities and instruments have been introduced. New instruments tend to increase [asymmetric information](#) between borrowers and lenders, resulting in the underpricing of risk. During the panic, information becomes more uniform, asset prices change, and some investors become insolvent. The central bank’s role is to assist markets in this price discovery process; see

Kindleberger (1978), Mishkin (1991), and Neal (1998). The second piece of advice is that preserving the banking system is essential because banking firms, more so than other firms, process private information and monitor borrowers. Sustaining the banking firms does not preclude imposing losses on the firms’ owners and debtors—indeed, so doing is essential if banks are to exercise prudence *after* the panic.

Friedman and Schwartz (1963), in their monumental *A Monetary History of the United States, 1867–1960*, argue that the Federal Reserve’s efforts during the Great Depression were inadequate. They quote approvingly Bagehot’s summary of how the Bank of England halted history’s first modern financial panic (*Lombard Street*, pp. 51-2):

The way in which the panic of 1825 was stopped by advancing money has been described in so broad and graphic a way that the passage has become classical. “We lent it,” said Mr. Harman [one of the Bank’s more senior directors] on behalf of the Bank of England, “by every possible means and in modes we have never adopted before; we took in stock on security, we purchased Exchequer bills, we made advances on Exchequer bills, we not only discounted outright, but we made advances on the deposit of bills of exchange to an immense amount, in short, by every possible means consistent with the safety of the Bank, and we were not on some occasions over-nice [to the borrowers].”

Interpreting Bagehot’s advice today is eased with a knowledge of history. ■

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¹ Robert Banks Jenkinson (1770–1828), Second Earl of Liverpool, prime minister, 1815-27.

² Frederick John Robinson (1782–1859), chancellor of the exchequer, 1823-27.

³ George Canning (1770–1827), British foreign secretary, 1822-27.

⁴ Horsley Palmer (1779-1858), governor of the Bank of England, 1830-33.

⁵ Figures and quotations in this paragraph are from Clapham (1944), pp. 206-7.

Posted on January 23, 2009

Views expressed do not necessarily reflect official positions of the Federal Reserve System.