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Floating a "lifeboat": The Banque de France and the crisis of 1889

Pierre-Cyrille Hautcoeur [a,b], Angelo Riva [c,a], Eugene N. White [d,e,*,1]

[a] *Paris School of Economics, France*
[b] *École des Hautes Études en Sciences Sociales, France*
[c] *European Business School, France*
[d] *Rutgers University, United States*
[e] *NBER, United States*

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ABSTRACT

When faced with a run on a "systemically important" but insolvent bank in 1889, the Banque de France pre-emptively organized a lifeboat to ensure that depositors were protected and an orderly liquidation could proceed. To protect the Banque from losses on its lifeboat loan, a guarantee syndicate was formed penalizing those who had participated in the copper speculation that had caused the crisis bringing the bank down. Creation of the syndicate and other actions were consistent with mitigating the moral hazard from such an intervention. This episode contrasts the advice given by Bagehot to the Bank of England to counter a panic by lending freely at a high rate on good collateral, allowing insolvent institutions to fail.

1. Introduction

In this paper, we recover the history of the Crisis of 1889, when the Banque de France (BdF) quickly intervened, ensuring that a run on the Comptoir d'Escompte (CdE), one of the largest banks in France, did not turn into a general panic. The remedy for this banking crisis, the most severe in late nineteenth century France, was not a pure British Bagehot-style

* Corresponding author at: Department of Economics, Rutgers University, 75 Hamilton Street, New Brunswick, NJ 08901, United States. Tel.: +1 848 932 8668; fax: +1 732 932 7416.

E-mail address: white@economics.rutgers.edu (E.N. White).

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lender of last resort operation (LOLR) but a divisive and contested intervention, resembling more a modern “lifeboat” or “bailout” operation, supplemented by additional liquidity for the market. By providing loans to the insolvent CdE, the BdF guaranteed that depositors would have continued access to their accounts while the bank was liquidated in an orderly fashion and a new bank was formed and capitalized. Similar modern interventions, such as the rescues of Long Term Capital Management in 1998 or Bear Stearns in 2008, have led critics to complain that central banks that deviate from Bagehot's rule create moral hazard, inducing greater losses in subsequent crises. Yet, in contrast to the modern experience with lifeboats the BdF and the Ministry of Finance, backed by the contemporary French legal system, took prompt actions in 1889 that had the potential to mitigate this problem. Banks, including their management and directors, that had contributed to the debacle were quickly compelled to absorb losses arising from the collapse of the CdE; many officials were purged; and other penalties imposed. This strong response may have contributed to the absence of major crisis in France for the next quarter century.

This type of central bank intervention would appear to be ruled out in the U.S. today. In reaction to the Federal Reserve's lending programs during the financial crisis of 2008, the Dodd-Frank Act of 2010 altered Section 13(3) of the Federal Reserve Act that had, since 1932, given the Fed discretionary authority to lend to “any individual partnership, or corporation” in “unusual and exigent circumstances.” The Fed used this authority beginning with the Great Depression through the Crisis of 2008 (Fettig, 2008), though there were long-standing complaints that it had been misused (Schwartz, 1992; Goodfriend, 2012). Emergency assistance in Section 13(3) now requires that the Board of Governors consult with the Secretary of the Treasury, before implementing a new lending program, which should provide liquidity to the financial system, not aid an insolvent or failing firm and be collateralized sufficiently to protect taxpayers (U.S. Senate, 2010; Office of Inspector General, Board of Governors of the Federal Reserve System, 2010). While this policy shift implies that there is no case to be made for pre-emptive intervention with insolvent firms, the French experience in 1889 may suggest otherwise.

After reviewing the extant literature, we describe the origins of the crisis, arising from an effort to control the world copper market and measure the damage inflicted on the CdE. In the third section, we examine whether the run on the bank had begun to spread before the authorities intervened and detail the debate at the BdF over the plan to rescue the CdE. Next, we show that the BdF's intervention was primarily a lifeboat operation with modest extra liquidity supplied to other banks and the markets. Fifthly, we analyze the determinants of membership in and contributions to the guarantee syndicate, intended to absorb losses from the lifeboat operation, finding that, in addition to capacity to pay, responsibility for the debacle was an important factor. In the final section, we discuss the penalties imposed in the aftermath of the crisis that may have minimized the moral hazard arising from the BdF's actions.

2. A lost episode

Our article seeks fill an important gap in the literature of the evolution of the lender of last resort (LOLR) function of central banks, drawing on archival materials at the BdF and other primary sources. Often influential in contemporary policy debates, historical evidence on how a central bank should operate as a LOLR is primarily informed by the classical view of the Bank of England (BoE), first put forward by Henry Thornton (1802) and reaffirmed by Walter Bagehot (1873). They ordained that a central bank should respond to a financial crisis by lending freely at a high rate of interest on all good collateral, preventing illiquid but not insolvent banks from failing. Summarizing this view, Humphrey (1975) and Bordo (1990) point out that it was not the duty of the LOLR to prevent financial shocks but neutralize them once they had occurred by preventing the spread of a panic from failing insolvent institutions to sound ones. To be successful, a central bank must clearly state its policy in advance and follow through consistently.

Recent research on the BoE has identified when and how it became a LOLR. Before the Overend–Gurney Crisis of 1866, the Bank rationed credit, exacerbating panics. Afterwards, it set the bank rate above the market rate, providing loans to all that had good collateral, as determined by the Bank's meticulous bookkeeping (Bignon et al., 2012; Flandreau and Ugolini, 2013). With more limited data, Bignon et al. (2012) also find that after the 1850s, the BdF's discount policy followed a similar evolution. But, central banks did not simply follow Bagehot's advice in the late nineteenth century. Unfortunately, the secondary literature on the BoE has paid little attention to the lifeboat operation during the 1890 Barings crisis. Clapham's (1945) classic history provides the most detailed but still very limited account. Calomiris (2011) correctly recognized its importance in a brief passage, with Giannini (2011) suggesting that support for the CdE in 1889 was a model for the BoE's action the following year. In France, the first major lifeboat was launched to rescue the Paris Bourse in 1882 (White, 2007). Contemporaries were aware of the dangers of such actions, and the 1889 lifeboat provoked an intense debate by policy makers on the proper role for a LOLR.[2]

Researchers curious about the BdF as a LOLR might reasonably turn to the studies of the U.S. National Monetary Commission (1909–1912), prepared as the U.S. Congress considered the establishment of the Fed. Two volumes treat the BdF; yet, the first (Liesse,1909) gives only a cursory description of the 1889 rescue and the second (Patron, 1910) omits it entirely, which may have led modern authorities on central banking (Goodhart, 1988; Grossman, 2010) to offer only brief comments on the 1889 episode. Direct evidence on the BdF as a LOLR is found in the Commission's interview with the

[2] See for example, Banque de France, Conseil Général, procès-verbaux, March 1889. These are the minutes of the Council of Regents, the BdF's board of directors. Debate also broke out in the Chambre de Commerce et d'Industrie de Paris (Procès-verbal, March 20, 1889, Archives de la Chambre de Commerce et d'Industrie deParis., Box 2ETP/1/A 25).