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Discussion

Comment on: "Floating a "lifeboat": The Banque de France and the crisis of 1889" by P.C. Hautcoeur, A. Riva, and E.N. White

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After the calamitous events of 2007–8, US regulators appear to have taken for granted that central banks' "lifeboats" of insolvent financial institutions are necessarily a bad thing. This paper argues that such an assumption might be wrong. According to the authors, it is possible to single out at least one historical episode – the 1889 bailout of Comptoir d'Escompte (CdE) by Banque de France (BdF) – showing that "good" lifeboats may exist. In their view, this bailout was a success because it allowed for an orderly management of the troubles of a systemically important financial institution (SIFI) while providing the right incentives to prevent the rise of moral hazard.

The authors must be praised for bringing back to our attention this very interesting episode, which is perfectly representative of the difficulties and ambiguities inherent to the evaluation of lifeboats. What do the French events of 1889 actually tell us about this kind of intervention?

1. Bagehot on the continent?

According to Bagehot (1873), lending of last resort (LoLR) is a synonym for support *to the money market*, aimed at protecting the payments system. In Bagehot's view, the central bank's reaction to a crisis should merely consist of the continuation of ordinary standing-facility lending on a much grander scale (Bignon et al., 2012). Maintaining such a stance

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allows the monetary authority to remain – in Giannini's (1999) words – "enemy of none but a common friend of all": as a matter of fact, providing market support along pre-established rules is a policy that is supposed to be neutral with respect to money market participants. Conversely, support *to specific money market institutions* is explicitly ruled out by Bagehot (1873, p. 104) on the grounds that 'any aid to a present bad bank is the surest mode of preventing the establishment of a future good bank' – meaning that bailouts always engender socially undesirable distributional effects (from the good to the bad). For instance, the Bank of England (BoE) really abided by Bagehotian rules in 1866 (when it supported the money market while letting Overend-Gurney fail), but not so in 1890 (when it set up a bailout of insolvent Baring Bros: Flandreau and Ugolini, 2014). There is no doubt that BdF's reaction to the 1889 crisis belonged to the sort of operations Bagehot would have disapproved of.

If one is to justify resorting to a lifeboat, then, the powerful case made by *Lombard Street* against this type of intervention needs to be addressed specifically. First, one must show that ordinary LoLR would not be enough to prevent the default of the given institution from generating large negative externalities on the payments system. Second, one must demonstrate that the operation is designed so as to offset all obnoxious distributional effects. As we shall see, both propositions are indeed difficult to prove.

2. Rescuing a systemically important bank?

Since 2008, academics and policymakers alike have struggled hard to understand what a SIFI actually is and how to recognize it. The issue is of the utmost importance, as systemicness is an argument that may be unduly brandished by interested parties lobbying for subsidies during a crisis. How can central bankers know whether a lifeboat is really indispensable in order to prevent money market dislocations? Unfortunately, no consensus has yet emerged on how to address this thorny question. To date, mainly two different approaches have been adopted. The first one focuses on *destructive potential*: systemicness is seen here as directly proportional to the negative externalities engendered by an eventual failure. The alternative approach focuses on *replaceability*: in this context, systemicness is interpreted as inversely proportional to the financial system's capability of finding substitutes to the failing institutions (Bongini and Nieri, 2014). In the absence of a clear-cut methodology for measuring whether CdE really was a SIFI, it might be useful to try to estimate its degree of systemicness by both yardsticks.

As far as destructive potential is concerned, an obvious indicator is market capitalization. At the beginning of 1889, CdE was France's third biggest joint-stock bank (BdF excluded) and the twelfth company by market capitalization. This may have provided the case for central bank support. In 1882, however, Union Générale (UG), France's biggest joint-stock bank (BdF excluded) and the sixth company by market capitalization, had not been deemed large enough for justifying a lifeboat.[2] On that occasion, BdF had formally abided by Bagehotian principles: it had let UG go bust and provided market support by discounting eligible paper to eligible counterparties, thus preventing a meltdown of the payments system (White, 2007).[3] Of course, it might be possible that the long-term effects of the 1882 crisis had made central bankers change their mind about lifeboats in the meantime. As far as we know, however, BdF never regretted not having rescued UG. In any case, it seems difficult to argue that a collapse of CdE in 1889 would have had more destructive potential than that of UG in 1882, in the event of which the French payments system did *not* eventually collapse (except for one provincial bourse, which was closed down).

Size may not be a good indicator of systemicness, as relatively small institutions sometimes happen to play a very crucial role for money market functioning because of their irreplaceability. That was the case, for instance, of Baring Bros in 1890: the merchant bank was a major issuer of the standard money market instruments of the time (i.e. acceptances), and its default would have put the English payments system into disarray (Flandreau and Ugolini, 2014). And in fact, the London interbank market reacted nervously to rumors about Barings' difficulties, and really panicked when the prospect of a default materialized; as soon as the BoE set up a lifeboat, however, trust recovered and interbank rates went down.[4] No such signs of nervousness could be observed, on the contrary, in 1889 Paris: before and after the outburst of CdE's crisis, interbank rates remained more or less flat and well below the central bank's standing facility rate, as if nothing serious had been happening in the meantime (see below, Fig. 1).[5] As a matter of fact, unlike Barings, CdE was not an important originator of money market instruments. In its 1888 end-of-year balance sheet, the French joint-stock bank displayed less than fr.33 m

[2] I warmly thank David Le Bris for generously sharing this information from the database he has assembled. It must be acknowledged that UG's capitalization was severely inflated by the fact that nearly one-third of its equity had not actually been issued (White, 2007). The fact remains, however, that in 1882 UG was remarkably bigger than any other French bank except BdF, while in 1889 the size of CdE was lesser than that of Crédit Foncier and roughly in line with that of its three main competitors (Crédit Lyonnais, Paribas, and Société Générale).

[3] White (2007) talks about a "bailout of the Paris bourse" by BdF after UG's crash. Unlike in 1889, however, BdF did not engage in non-statutory operations in 1882. In fact, it was a syndicate of bankers who formally bailed out the bourse; bankers were then able to refinance themselves through the central bank by originating paper eligible for discount. It would be interesting to understand why this apparently efficient solution, which did not infringe upon BdF's statutes, was not taken into consideration when the rescue of CdE was designed.

[4] This is the opposite of what happened with Lehman Bros: in fall 2008, interbank rates remained flat in the weeks preceding the crisis and skyrocketed afterwards. As Lehman and Barings were both SIFIs, such different patterns are probably explained by differing market expectations. In all likelihood, the bailout of Barings had not been anticipated in 1890 (as no such interventions had ever been put in place by the BoE), while that of Lehman had been incorrectly anticipated in 2008 (as a number of financial institutions had already been rescued in the preceding months).

[5] Note that in the 19th century central banks typically did not implement open market operations in order to steer interbank rates (Jobst and Ugolini, 2014). As a result, the spread between the interbank rate and the central bank's standing facility rate can be taken as an indicator of money market pressure (Bignon et al., 2012).