Monetary Trends

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# Bagehot on the Financial Crises of 1825…and 2008

Recently, several federal agencies, including the Federal Reserve, FDIC, and Treasury, have created numerous programs to support credit flows.[1] Some analysts have criticized these programs as "scattershot," as lacking focus, or as desperate attempts to be perceived as "doing something."[2] Others have argued that care must be taken so that these programs do not violate Walter Bagehot's maxim that central banks must lend only against good collateral and at penalty rates (Thornton, 2008). Here, I argue that these programs are appropriate and consistent with lessons learned from two centuries of monetary history.

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 held the nation's gold reserve and special statutory authority to issue banknotes. Bagehot's principal message was that the first task of a central bank during a financial panic is to end the panic—a message that remains true today. He defined a panic, in his day, as a period when the public wished to hold only gold coin, bullion, or Bank of England banknotes. Quelling a panic required satisfying the public's demand for these risk-free liquid assets. It was the practice of the Bank to lend aggressively during panics, and several times before his writing the Bank 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 adequate collateral to ensure that the Bank, a private institution, would not itself become insolvent.[3]

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 insolvent. Modern research suggests, instead, two pieces of advice. The first is that panics tend to follow periods of increasing *asymmetric information* between borrowers and lenders, leading to an underpricing of risk associated with new financial securities and instruments. During the panic, information becomes more uniform, asset prices change, and some lenders/investors become insolvent. The central bank's role is to assist markets in this price discovery process by keeping them as orderly as possible. This mechanism has been explored by Kindleberger (1978), Mishkin (1991), Neal (1998), and others. The second piece of advice is that preserving the banking system through the panic is essential because banking firms, more so than other institutions, process private information and monitor borrowers. Sustaining the banking firms does *not* preclude imposing losses on the firms' owners and debtors, but maintaining the firms may require lending on questionable collateral. Friedman and Schwartz (1963) argue that such efforts during the Great Depression were inadequate, and they quote approvingly Bagehot's summary of how the Bank of England halted history's first modern financial panic (*Lombard Street*, pp. 51-52):

> 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 [a senior director] 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 borrowers]."

It is clear in the historical record that the Federal Reserve's founders expected all Fed lending to be repaid; doing otherwise would be to conduct fiscal rather than monetary policy. Further, Bagehot's first advice to central banks remains: In a financial panic, quell the panic by every possible means, mindful that an effective monetary policy during a panic cannot be risk free.

—Richard G. Anderson

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[1] A summary and timeline are available at http://www.stlouisfed.org/timeline/.

[2] Examples include Leonhardt (2008) and the testimony of Mark Zandi, chief economist of Moody's Economy.com, before the U.S. Senate Budget Committee, November 19, 2008.

[3] The Bank of England at this time was a private bank with shareholders and dividend payments.