Bagehot's Lender of Last Resort

A Hollow Hallowed Tradition

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The lender-of-last-resort function of central banks frequently is defended by reference to Britain's financial stability following Walter Bagehot's persuasion of the Bank of England to "distinctly acknowledge that it is its duty" to support the market in times of panic (1873, 61). For example, Michael Bordo and Lars Jonung suggest that the smooth operation of the gold standard "for close to four decades" was facilitated by the practice that "In most cases when faced with both an internal and external drain, the Bank of England and other central banks followed Bagehot's rule of lending freely but at a penalty rate" (2000, 6). Anna Schwartz (1986) and Allan Meltzer (1986) also have attributed the absence of severe crises during this period to the Bank's newfound "precommitment": "Knowledge of the availability of credit was sufficient to allay alarm" (Schwartz, 1986, 21). Frank W. Fetter called it "The victory of the Bagehot Principle" (1965, 257–83). The New York Federal Reserve Bank's Benjamin Strong represented the "free extension of credit to institutions that need it" to be in the tradition of "Bagehot's golden rule which forty or fifty years ago effected a real revolution in banking thought in London and has since, more or less, determined the Bank of England's policy under conditions similar to the present" (1921 [1958], 174), and policymakers have invoked Bagehot's name on many subsequent occasions, including the crisis of 1931 and the bank failures of the 1970s and 1980s.[1] The International Financial Institutions Advisory Commission

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1. The Federal Reserve Bank of New York informed the Open Market Policy Conference of November 30, 1931, that it had applied Bagehot's method to September's emergency (Wicker 1966, 165). For a popular interpretation of Federal Reserve behavior on Bagehot lines, see Mayer 2001, 106–11.

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recommended the "hallowed traditions of lender-of-last resort operations" to the International Monetary Fund (IMF) (Meltzer and Sachs 2000).

Several writers have criticized Bagehot's rule for its self-defeating creation of moral hazard (Dowd 1993, Hirsch 1977, Rockoff 1986). My purpose in this article is not to criticize the rule itself, but to call attention to the absence of any basis for a "Bagehot tradition" in nineteenth-century practices. The Bank of England had long been viewed as more than just another "intermediate body, or power; there is no resource on their refusal, for they are the *dernier resort*" (Baring 1797, 19–20). Nonetheless, the Bank made no explicit commitment to unlimited support of the market. Such a policy had been debated for a generation before the publication of Bagehot's 1873 *Lombard Street,* was rejected from the outset, and made no headway in official policy or practice until after World War I. "Time inconsistency" and "moral hazard" were well understood in the nineteenth century, and modern policymakers appealing to the Bank of England's application of Bagehot's rule had better look elsewhere for precedents.

In the next section, I summarize the commitment debate of the 1840s and the Bank of England's responses to Bagehot's renewal of the issue. In the second and third sections, I discuss central banking after Bagehot and offer plausible reasons, unrelated to *Lombard Street,* for the progress of financial stability in the nineteenth century.

To Commit or Not to Commit

The Bank Charter Act of 1844 tied the Bank of England's notes to its gold reserve in the belief that although paper money was convenient and efficient, it tended to excesses if left to bankers and their customers, and it should be made to vary as a pure metallic money might vary. The currency rule soon was tested by harvest failures and the collapse of a railway boom. The loss of gold, which forced an equal reduction in Bank notes, brought a crisis, and, as usual, borrowers flocked to the Bank. But it refused credit, even to checking accounts because of their potential for conversion to notes. The government finally authorized the Bank to exceed the limit, and the panic ceased. The knowledge that Bank credit and notes were available ended the rush for them.

Might the Bank have extended credit when needed without the irresolution and suspense that promoted panics? A House of Lords committee of inquiry questioned the desirability of a "fixed and inflexible rule" for the management of the currency. Even if the rule had been defensible at its inception, its "hold on opinion" must "have been materially impaired" by the recent suspension:

> The precedent is established, and its application will inevitably be called for on other occasions; and it may so happen that the principle of relaxation will be applied under circumstances less urgent and less justifiable than

> those which occurred in 1847. The Committee are therefore of the opinion that it is expedient for the Legislature to provide specifically for the manner and the responsibility of relaxing these restrictions in times when it can be done consistently with the perfect [gold] convertibility of the note—an obligation which should never be forgotten. (House of Lords [1848] 1969, xlv)

The possibility of explicit provisions for contingencies had arisen during the debates leading up to passage of the 1844 act. Henry Bosanquet of the London and Westminster Bank had warned the prime minister, Robert Peel, that the limit on notes would interfere with the Bank's ability to assist the market. Bosanquet sympathized with the long-term objectives of the bill, "But I feel confident that in the practical working of the system . . . there will be moments when sudden voids will be created in the circulation . . . , which if not in some way provided for, may be the cause at times of a total suspension of business throughout the country." He proposed that "during the first five years of the new system, whenever the rate of interest at the Bank of England shall have risen to eight percent, it shall be lawful . . . to make advances at that rate of interest on the deposit of Exchequer Bills; the loans to be repaid and the bills sold whenever the rate of interest shall have fallen below eight percent" (qtd. in Parker 1899, 140–41). But Peel remained convinced

> that we are taking all the precautions which legislation can prudently take against the recurrence of a monetary crisis. It *may* occur in spite of our precautions, and if it does, and *if it be necessary* to assume a grave responsibility for the purpose of meeting it, I dare say men will be found willing to assume such a responsibility. I would rather trust to this than impair the efficiency and probable success of those measures by which one hopes to control evil tendencies in their beginning, and to diminish the risk that extraordinary measures may be necessary. (Parker 1899, 140, emphasis in original)

Even after the crisis of 1847, the government stuck to the position that not all contingencies could be anticipated by law, and attempts to do so would only bring them about. Chancellor of the Exchequer Charles Wood told the House of Commons: "Should a crisis ever arrive 'baffling all ordinary calculations' and not amenable to the application of any ordinary principle, the remedy must be sought not in the previous provisions of the law, but 'in the discretion of those who may then be at the head of affairs, subject to their own responsibility, and to the judgment of Parliament'" (*Hansard's Parliamentary Debates* 1847, 379). Wood quoted from a statement of the principles of the Bank Charter Act by Samuel Jones Loyd (later Lord Overstone), who had argued that a contingency plan for the suspension of the currency rule under pressure would make it "a nullity."

> A general conviction that [the rule] will not be suspended on such occasions [of pressure on the money market] is essential for producing throughout the community that cautious foresight and that healthy tone of self-reliance upon which the safety and utility of the measure must materially depend. Any special provision . . . for suspending its application at critical periods must prove mischievous by weakening the conviction that the measure will be adhered to, and thus checking the growth of the feelings and habits which are intimately connected with its success. (Loyd 1844, 284)

Further crises in 1857 and 1866 prompted the debate between Bagehot and Thomson Hankey, a director and former governor of the Bank of England. Notwithstanding the Bank's undoubted responsibility, as trustee of the nation's reserve, to support the financial markets, Bagehot wrote:

> If we ask how the Bank of England has discharged this great responsibility, we shall be struck by three things: *first,* . . . the Bank has never by any corporate act or authorised utterance acknowledged the duty, and some of its directors deny it; *second,* (what is even more remarkable), no resolution of Parliament, no report of any Committee of Parliament (as far as I know), no remembered speech of a responsible statesman, has assigned or enforced that duty on the Bank; *third* (what is more remarkable still), the distinct teaching of our highest authorities has often been that no public duty of any kind is imposed on the Banking Department of the Bank; that, for banking purposes, it is only a joint stock bank like any other bank; that its managers should look only to the interest of the proprietors and their dividend; that they are to manage as the London and Westminster Bank or the Union Bank manages. (1873, 153–54)

Although the Bank usually in the end supplied the market, its "faltering way" caused needless uncertainty and more severe panics than if it communicated clearly that it could be counted on (Bagehot 1873, 64). According to Bagehot, the rules—to lend freely at penalty rates on sound collateral—under which assistance would be provided should be stated also.

> The public is never sure what policy will be adopted at the most important moment: it is not sure what amount of advance will be made. The best palliative to a panic is a confidence in the adequate amount of the Bank reserve, and in the efficient use of that reserve. And until we have on this point a clear understanding with the Bank of England, both our liability to crises and our terror at crises will always be greater than they would otherwise be. (1873, 196–97)

The Bank could not have disagreed more. Its directors recognized "the Bagehot problem," as Fred Hirsch (1977) called it. After the panic of 1866, Bagehot's earlier proposal of this policy in *The Economist* (Bagehot 1866) had been attacked in Hankey's banking text as "the most mischievous doctrine ever broached in the monetary or banking world in this country; viz., that it is the proper function of the Bank of England to keep money available at all times to supply the demands of bankers who have rendered their own assets unavailable" ([1867] 1887, 25). Hankey thought that all banks should observe sound principles. They should keep their own reserves instead of relying on the Bank of England for the performance of that elementary duty. Another Bank director, George Warde Norman, supported Hankey in a letter to *The Economist* (Clapham 1945, 285). On the other side, in 1873 Chancellor of the Exchequer Robert Lowe introduced a bill "to provide for authorizing in certain contingencies a temporary increase of the amount of Bank of England Notes issued in exchange for securities" subject to the conditions that the chancellor and the prime minister were satisfied, first, that the Bank rate was not less than 12 percent; second, that the foreign exchanges were favorable; and third, that "a large portion" of outstanding notes was "rendered ineffective for its ordinary purpose by reason of internal panic" (qtd. in Clapham 1945, 289). The bill got nowhere. Bagehot and Lowe had no more influence on legislation in the 1870s than Bosanquet and the House of Lords committee had in the 1840s.

Central Banking after Bagehot

Parliament and the Bank of England did not take up the explicit contingency plan proposed by Bosanquet, the House of Lords committee, Bagehot, and Lowe until the 1920s. Bagehot had recommended a larger reserve to support an expanded and credible role of lender of last resort. However, the Bank's reserve ratio was virtually the same in the three decades after *Lombard Street* as it had been between 1844 and 1873. Governor William Lidderdale begged another chancellor, G. J. Goshen, to say nothing in a forthcoming speech "that might imperil our 'very inadequate Banking Reserves.'" Goshen had been pressing for a larger reserve, but Lidderdale noted that "the larger the Bank's own reserves, the less the bankers like to keep *their* money unused." Lidderdale had scolded the bankers publicly after the 1890 Barings episode, and he "almost regretted having prevented the panic threatened" by his "assault"—"they are a stiffnecked and rebellious race, each caring only for his own corporation." He later observed that the banks sensed danger when the Bank of England's reserve fell below £10 million and called in loans. When the reserve approached £9 million, "the demand on the Bank of England was *very* heavy." The governor asked the chancellor to press the banks to keep greater reserves. If they would not keep more, he would "look round for compensation in other ways, and these ways must produce the same result (less profit to the bankers, more to the Bank) as their leaving more money here" (all Lidderdale quotations from Clapham 1945, 344–45, emphasis in original). R. H. I. Palgrave pointed out that "the reserve which the Bank of England keeps is now smaller in proportion to its own liabilities than it was forty or fifty years ago [and] far smaller in proportion to the liabilities of the other banks in the United Kingdom at the present time than formerly" (1903, 7). The Bank had less gold in 1902 than in 1879, a situation made possible by the public's increasing use of deposits relative to notes. The "ultimate answer to Bagehot's problem," according to R. S. Sayers, "was a powerful Bank Rate weapon" protecting a "thin film of gold" (1951, 116).

It is conceivable that the market came to rely on the Bank to behave as Bagehot had advised, but any such confidence was not put to a test.[2] The Bank had come to the support of the market before 1890 and under more difficult circumstances. It had determined that Barings, despite a heavy bet on Argentine securities, was solvent. Such had not been the case for Overend Gurney in 1866, when "there was so much unsound business . . . that something like a crisis was probably in any case inevitable; the trouble could hardly have been got over with such smoothness as that of 1890" (Hawtrey 1938, 110).

In any case, Bagehot was uncertain how the Bank should respond to a crisis. He admitted that it is not easy to know when to build the reserve and when to use it. "The practical difficulties of life often cannot be met by very simple rules: those dangers being complex and many, the rules for encountering them cannot well be single or simple" (1873, 300–301). Hankey never abandoned the circumspection that Bagehot had criticized. He thought Bagehot's advice too simple and insufficiently qualified. The offending passage in the first edition of Hankey's book (1867) was unchanged in the fourth edition (1887). That Hankey was, as Bagehot believed, representative of the directors is supported by Palgrave's complaint of the lack of any system in the determination of Bank lending rates: "A distinct statement of policy on the part of the Bank as to the course of action they would follow in any time of business pressure, as well as on many other points, is now greatly needed" (1903, 61). But we have seen that Governor Lidderdale almost regretted the Bank's assistance, and in 1875 the *Bankers' Magazine* thought the Bank might reasonably refuse assistance to "a deputation from Lombard Street, which, after having turned their backs on the Bank for perhaps several years, might come on any day like the Black Friday of 1866, with a message like this, 'our reserve is nearly exhausted, what can you do to help us?'" (qtd. in Clapham 1945, 343).

We might note that the eventual incorporation of the House of Lords' 1848 contingency plan in the Currency and Bank Notes Act of 1928 was followed in three years by the suspension of the gold standard.[3]

Financial Stability after Bagehot

What explains the absence of financial crises after 1866? Given that every decade from the 1820s to the 1860s had experienced a serious crisis, it is natural to wonder why

2. Feavearyear (1931, 285) suggested such a view, but neither Clapham (1945, 286–90) nor Sayers (1976) shared it; Sayers thought the development of central banking "hardly conscious" (11).

3. See Gregory 1929 for documents related to the commitment debate.

none occurred during the next half-century. We cannot know for sure, of course, but there are several possibilities related to the balance of trade, government finance, and the structure of banking.

The three main instigators of crises between the founding of the Bank and the middle of the nineteenth century were crop failures, government war finance, and fragile financial institutions. The first problem ended with the repeal of the Corn Laws in 1846, the decline in shipping costs, abundant North American wheat, and improvements in domestic agriculture. Crop failures became less common, and when they occurred, they were less important. The proportion of wheat consumption supplied from abroad rose from one-twelfth before the repeal of the Corn Laws to one-half in 1870 and four-fifths in 1914 (Ó Gráda 1981, 195). The development of international finance and the credibility of the gold standard also made it possible to finance trade deficits without resort to gold shipments and credit restrictions.

The small country banks, limited to six partners, had exerted great and variable pressures on the London money market in the decades leading up to the panic of 1825. Parliament responded by legalizing joint-stock banks of issue within sixty-five miles of the metropolis, and they were followed by the spread of large deposit banks throughout the country, including London. Bagehot observed that "The joint-stock banks of this country are a most remarkable success" (1873, 230). And they were just getting started. In the half-century following the crisis of 1866, the number of banks fell from nearly four hundred to sixty-six, and failures virtually ceased (Feavearyear 1931, 292). Fiscal prudence and professional management in government finances also contributed to financial stability and the security of the Bank. Government surpluses meant that the government did not press the Bank as it had in the years before 1815. Peace, a good credit rating, and alternative sources of funds through the Post Office Savings Banks opened in 1861 and the regular issue of Treasury bills beginning in 1877 contributed to Gladstone's goal of making the chancellor "independent of the Bank and the City power" (qtd. in Clapham 1945, 274). Any or all of these factors might have contributed to the improvement in economic stability after 1866. One thing of which we can be certain is that the stability was not a consequence of the Bank of England's conversion to Bagehot's rule.

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