

Thoughts on Future Histories of Central Banking
a presentation in honor of the publication of

Gianni Toniolo's
Storia della Banca d'Italia

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Comments by

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Essential Elements for a Central Bank History

- Question: What is the Mission of the Central Bank in period studied
- Price Stability, Financial Stability, Consumer Protection, Social/Political Stability [Financial Repression]
- Ingredients: Political and Economic Background
- Statistical History—what should be included---all features of central banking even if not formally in the central bank, e.g. deposit insurance
- External and Internal Data---money, credit, but also budgets and staffing, covering the full reach of the central bank both geographically and socially
- Narrative history—published and archival information from diaries to minutes of meeting and correspondence. Importance of open archives
- Should be able to reconstruct the decision-making process

Essential Questions for Central Banking

- Rules v Discretion
 - Conduct of Policy Ordinary Times
 - Conduct of Policy Extraordinary Times
 - Monetary Standard
 - Microprudential and Macroprudential policy
- Only the official Central Bank or all Agencies
- Bottom Up v Top Down histories
- Personnel and Incentives
- What is Independence?
- Direct Parliamentary Supervision v. Delegated supervision

The Triumph of Bagehot Rules v. Discretion in Times of Crisis Lessons for Lehmans of the Future?



- Lombard Street (1873): Lend freely at a high rate on good collateral. Permits solvent but illiquid financial institutions to obtain liquidity. Short-term borrowing limits moral hazard. Automatic exit strategy, attracting liquidity broad
- Modern Version: (Goodfriend and King 1988). Central bank only uses open market operations, market allocates liquidity
- **Censoring Success:** Rules-Based Policy triumphs as histories focused “Major Crises” ignoring “Minor Crises” where Discretionary Interventions prevented Minor morphing into Major

Evidence for Bagehot's Rule?

- Governor, Banque de France, testimony to U.S. National Monetary Commission (1910)
 - “In periods of crisis in 1830, 1848, in 1870 in 1889, the general council of the Bank did not hesitate to come to the assistance of establishments which were in difficulties, which held assets of unquestioned character and value, by extending to them the largest possible credits.”
- Bignon, Flandreau, & Ugolini (2012) find Bagehot's Rule in discount policy of how Bank of England and Banque de France
- Bordo (1990):
 - Bank of England followed Bagehot's rule and prevented incipient crises in 1878, 1890 and 1914 from developing into full-blown panics.
 - Between 1870 and 1970, European countries' observed Bagehot's prescription.

Contra Bagethot:

Theoretical Case for Preemptive Discretionary Intervention

- Significant information asymmetries: i.e. the interbank market---market won't reallocate liquidity efficiently because bank assets are opaque. Interbank market seizes up with a big shock.
- Systemic risks from the interbank market, the payments system, and the market for derivatives (Freixas and Parigi, 2014).
- Banks, unable to access the interbank market dump assets on the market→fire sale, assets sold below fundamental prices→cascade of bank failures, a panic (Shleifer and Vishny, 2010). Problem is acute if (1) SIFIs are present or (2) “many” smaller banks hold similar portfolios.
- Solution: Pre-emptive intervention or creation of novel discounting facilities by the LOLR though literature silent on how to avoid moral hazard---one time events

Archives of central banks, major banks, and daily data tell a different story.

“Minor” 1889 Crisis of the Comptoir d’Escompte (Hautcoeur, Riva and White, 2014)

- Virtually no historical attention
- Second largest bank in Paris, highly interconnected universal bank.
- Joined syndicate to corner copper market using forward contract that bank guarantees
- Copper price collapses bank president commits suicide March 5—run begins on insolvent Comptoir and spreads
- Minister of Finance summons heads of banks to meeting. BdF to provide 100 million FF loan to CdE against “all its assets” with syndicate of banks + board of CdE providing guarantee for losses to BdF up to 20 million FF
- Comptoir d’Escompte split into “Bad Bank” where there is an orderly liquidation of assets to cover liabilities and “Good Bank” recapitalized as Comptoir National d’Escompte.
- Moral hazard managed as Board and managers of Comptoir forfeit all assets.
- Discretionary intervention becomes standard method for handling large bank failures

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“Minor” 1890 Barings Crisis (White, 2022)

- Clapham (1945) and following histories “only a liquidity crisis”
- Barings 2nd largest bank in UK, dominates trade acceptances and challenges Rothschilds as biggest sovereign debt managers by promoting Argentina. New issues supported by borrowing around the market—highly interconnected
- Argentinian boom busts, Barings insolvent, panic begins
- BoE takes over Barings, pays out creditors and attempts orderly liquidation of assets backed by guarantee syndicate of banks for losses. Unable to sell all, BoE absorbs £500,000 loss after seizing properties of Barings partners
- No macro effects on the economy
- Discretionary intervention becomes standard method for handling large bank failures

Preemptive Discretionary Interventions method in Europe for managing large failures

- Italy 1907
- U.S. 1907? “It was a great mistake....not to have adopted the course which was adopted at the time of the Baring Crisis, namely to guarantee complete solvency of the Knickerbocker.”

----Nathaniel Rothschild

letter to his French cousins, October 23, 1907

- Why? Unit bank structure makes the European approach inappropriate.
- Federal Reserve actions during Covid in 2021
- Bank of England managing the 2022 “Truss Shock”

Federal Histories for Federally Structured Central Banks

Lessons from the Federal Reserve for the European Central Bank

- Friedman and Schwartz (1963) obtain materials to create data to measure policy and employ diaries & minutes to reconstruct policy discussions
- Meltzer (2003) Hetzel (2020) a deeper dive into the policy making at the Board and the Federal Reserve Bank of NY
- Richardson and Troost (2009), Carlson, Mitchener & Richardson and (2011) from Reider (2020) Tracking easier discount policy that reduced bank failures and credit contraction that moderated the 1930s depression
- White (2015) Roberds and White (2019) 1920-1921 FRB Boards' minutes reveal battle over conflicting policies pursued by FRBs with different regional conditions—one size policy doesn't fit all regions.
- Tallman and White (2022) easy discount policy of FRBs in distressed agricultural regions v. tight discount policy of the Board and the FRBs industrial regions prevents otherwise certain banking panic from erupting.

All Relevant Central Bank Activities—Price Stability, Financial Stability, Consumer Protection, Industrial Policy

- Supervision—Microprudential Policy (Toniolo and White, 2016)
- Wendschlag (Sweden) Giddey (Switzerland) Alvarez (Mexico and Brazil)
- Study of Federal Reserve, FDIC OCC significant differences over the business cycle
- Supervisory Forebearance Common before Crisis, Revolving Door
- Funding for Federal Reserve, FDIC, OCC, SEC determines capacity to fulfill mandate
- Rules v. Discretion
- The Political Economy of Microprudential Policy