The Descent of Central Banking:

Bagehot, Darwin, and the Foreign Debt Market

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My intention is to provide some reflections on the dilemmas of policy making for a central bank and, because we currently undergo a delicate evolution of the European debt crisis in the shape of the latest Greek difficulties, I wanted it to be an attempt to put some perspective to the excitement of the moment – we are, after all, historians. This is why the title I communicated to Oyvind was what it was: "The Central Bank in the Foreign Debt Food Chain: Evidence from Victorian Britain." In writing it, it became something slightly different, with the original title serving as a starting point rather than as a conclusion.

I had originally thought of drawing from the book I am currently writing – on the evolution of the market for foreign debt in London. I wanted to articulate a number of insights pertaining to the role of the central bank in the "ecology" of foreign debt. This book is arguing that the market for foreign debt is not only a place where borrowers and lenders meet. There are many other actors involved in what it suggests to describe as a food chain: There are to name just a few, intermediaries, who have reputations to protect, there are media who report on

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[1] Background article for the policy session at the Third CEPR Economic History Symposium. Oslo, 19-20 June 2015. I am grateful to Øyvind Eitrheim and Jan Qvistadt for the invitation to present my views at the policy panel.

the prospects of a country, there are economists who tell you whether a given policy stance is sustainable, etc.

The talk was intended to underline that the central bank, too, becomes part of its ecology. Whether it does something or does nothing, the central bank is a stakeholder of any debt crisis, not only domestic, but foreign too. Let me first illustrate what I mean by this, but before I do that, let me mention that the question cannot be better timed: Yesterday morning, BBC news Paul Kirby asked "Is Greece close to Grexit?" and the subtitle of the article read: "If the ECB pulled its support for Greece's banks, the banking system and economy would collapse."

When you consider the record of the Bank of England during the 19th century, you find three key episodes of foreign lending that went bad. The first was in 1825. It came as a credit boom petered out. Regardless of the exact causes of the boom, the restrictive policy of the Bank of England played a role in affecting the dynamics of the collapse. Back in those days, as I have shown in my work with Vincent Bignon and Stefano Ugolini, a crisis would typically be met through credit rationing, the bank trying to limit its losses. This was due to a number of reasons, one being that central banks were initially primary lenders, and worried about their losses in a down turn. They thus limited their exposure, preferring first class borrowers, and taking substantial collateral. The effect on the market was powerful and the credit squeeze could even be seen on risk free government bonds, which cash hungry borrowers dumped on the market to settle their debts. Thus all speculative investments went in jeopardy: Mines, banks, and foreign bonds. Seeing that the supply of capital had dried up and for some, discovering that over-zealous agents and plenipotentiaries had borrowed money without

authorization, the governments of many foreign borrowers declared themselves unable or unwilling to pay. The Bank of England could, and did, plead not guilty. And it was probably not guilty: But, willy-nilly, it was part of the food chain.

Incidentally, the episode deserves a special mention these days, since among the defaulters was Greece. This and a few other similar events have earned Greece the disgrace of being dubbed a “serial defaulter.” However, if you look at the conditions of this one Greek default, you may come to reconsider. As far as it came to be known, that Greek debt has a strange nature. It had been issued without Greek even being a nation, to provide the Greeks fighting for independence from the Ottoman Empire with the elements of a Navy. As it seems, of the two boats that were supposed to be sold (once hefty fees, commissions and their likes had been pocketed by agents in London) only one was ever constructed and it arrived too late anyway. “Greeks” saw very little of the money, although Lord Byron’s friends did. Not incidentally either, the whole episode had displayed an economist – since Jeremy Bentham was one of the leaders of the so-called “Philhellenes.” One could draw interesting parallels between this case and the more recent Siemens scandal. But let’s go back to the central bank.

The second major episode of distress that manifested the existence of an ecological relation between the central bank and the foreign debt market in London took place during the protracted foreign lending boom of 1860-1873. Foreign loans hit the market with increasing celerity as credit again expanded and universal banks were created. The formerly prudent Overend, Gurney went joint stock to enjoy the delights of leverage. So did a number of other so-called “finance” companies. In the serious financial world, and in particular in the

columns of Bagehot's *The Economist*, finance became an ugly word and some of those companies eventually swapped it for "discount." The day of reckoning came in May 1866, after a few weeks during which speculators began a bear attack on those finance companies. Overend, Gurney, went bankrupt as did a few other such companies who spent their after-life in the purgatory of courts of justice.

As we know now, however, the consequences of the "Overend Gurney crisis" were limited, owing, as the story goes, to the generous supply of liquidity, which the Bank of England poured into the market. As Bagehot theorized in a succession of articles published in *The Economist* (and later in his famous *Lombard Street*), the reason why the Bank of England had contained the crisis was because it had poured generous liquidity in the market, lending only on good collateral (and there was plenty of it). It had certainly not lent the legendary unlimited amounts of capital ("lent freely", to use the technical term), Bagehot imagined and successors repeated. It kept rating books and registers that helped it monitor its exposure to the market. But the point it, that it accepted lending to a much wider spectrum of institutions it normally did, including those infamous bill brokers and finance companies, which it had so vehemently criticized. The point however, was that to the extent that they showed good bills, they were not denied access. Owing to recent research by Stefano Ugolini and I, we know what good bills were While the customers who came to the Bank of England were far more numerous and diverse than in any normal month before, the securities that the Bank accepted looked similar to what it usually took. To unusual clients, usual collateral: This was the revolution of 1866: the birth – in practice, then in theory -- of lending of last resort, and it

was quite a distance from more recent experience of the Fed or ECB when the usual clients have brought less usual instruments, such precisely as foreign debt.

What about foreign debt in 1866? It could be characterized as a debt crisis that was not – or rather, that was postponed till 1873-5. The monetary crisis of 1866 having been met with generous liquidity and high interest rates, originators put many projects on hold. The market for foreign debt watched with anxiety the moves of the Bank of England. As the crisis unfolded, the father of Liberal politician, financial “expert” and future Secretary of Treasury George Joachim Goschen, manager of the merchant bank Frühling and Goschen, which had originated several high-grade debts to Egypt, reported nightmares. He feared the crisis would spread to the foreign debt market and was anxious of the consequences this would have on the career of his son (there are reasons to believe that the hefty Egyptian loan fees had purchased George Joachim political advancement).

Goschen’s father was probably like those many contemporaries who knew about the crisis of 1825 and used it to read current events. Still in 1875, Lord Rothschild could describe the lesson his ancestor had taken from this crisis – that it was necessary to shoulder your client when the market dried up, and this implied that serious underwriters had to keep tons of capital and buy into the securities they had issued, the acting as a kind of lender of last resort of their own deals. Contemporaries also knew that the best way to keep speculative borrowers (such as Egypt) on leash was the promise or bait of future money. If the London Stock Exchange stopped lending abroad, defaults would take place, followed by re-pricing, etc.

And thus, one of the unintended consequences of the Bank of England's response to the crisis of 1866 was that by preventing the crisis to spread and subsequently enabling the normal functioning of markets to resume, the Bank of England did permit the investment boom to restart. This was in particular so for foreign debt, as increasingly speculative deals hit the floor of the exchange after 1866. New borrowers tried to take advantage of a flourishing market. Yield spreads as large as 600 basis points (and larger if one factors in the underwriter's commission) were observed. To use Keynes' famous metaphor, another round of musical chairs had started and the Bank of England had put the tone-arm on the turntable.

This may explain why, almost immediately after the crisis of 1866 did not spread to foreign debt, discussions began to take place as to how one could create an institution that would monitor the quality of foreign issues. In July 1866 (as the dust of the Overend, Gurney Crisis of May 1866 settled) a number of London capitalists began to float the idea of a bondholders council, that would act as a kind of certifier of foreign debts. The politics and origins of these men were diverse and complex – they are the subject of the book I am currently working on – but for the present purpose suffice to say that they soon came to include a prominent London financier who had been a governor of the Bank of England in 1855-1857, Thomas Matthias Weguelin, a merchant banker and a Liberal MP. When the Corporation of Foreign Bondholders was finally created in 1873 as a not-for-profit organization Weguelin was Vice-Chairman. The other Vice-Chairman was John Lubbock, another Liberal MP and the recognized representative of the banking lobby in Westminster: He was nicknamed St Lubbock for having invented and have Parliament vote the "bank holiday." Both

commanded enormous power and in effect dwarfed the Chairman, stockbroker Isidor Gerstenberg, of whom the corporation had been the brainchild.

The subtle ecological link that was being evolved between the foreign market and the central bank – to quote the classic study of Jenks, the corporation [of foreign bondholders] had "found a specialized function to perform in the investment market"[2] – thus resulted from the fact that monetary policy, and in particular the responses to financial crises, had spill overs on to speculative markets and they could not be ignored. In fact, as an agency of the London money market, the Bank of England's stakeholders included individuals directly interested in the origination of sovereign debt, as the Weguelin example recalls. The liquidity of the London money market, the level of interest rates, the level of collaterals and repos, all were variables that affected the timing and pricing of foreign debt issues, creating a demand for consistency – or at least articulation, between the two markets.

Thus indirectly, as the presence of individuals close to the inner circle of British monetary policy making in the council of the corporation of bondholders attests, the Bank of England kept an eye on the foreign debt market just as the foreign debt market kept an eye on the Bank of England's policy rate. This ecology became visible to the historian – that is, through archive, although this may have escaped from the view of contemporary observers – in the context of the Baring crisis. In the late 1880s, the Bank of England was among the first to notice that Barings was leveraging itself out of the usual proportions. In 1890, as data reported by Chapman shows, their signature was affixed to an amount of bills that was a multiple of what the next best merchant bank house did. They

[2] Jenks, *Migration of British Capital to 1875*, 1927, p. 290

also sponsored the creation of investment trusts that would carry the securities they originated. Finally, as Juan Flores as described, Barings ran after the market and underwrote large amounts of Latin American debt, in particular, that of Argentina.

Long before the Baring crisis erupted, and even before the Argentine crisis occurred, the Bank of England was admonishing Barings in private letters, asking them to rein in their lending. The Bank knew that something was wrong, because it saw that the amount of bills ("acceptances") that flowed back to its discount window was larger than had been the case in the past. Since this was not enough to tame Barings, reports started appearing in the more austere financial journals (*The Times* and *The Economist*), echoing the concerns at Threadneedle. Whether the articles had been directly commissioned or inspired by the Bank of England, we cannot be sure, but the timing suggests at least a convergence of views within segment of the City. It would be interesting to know the extent to which increasing antagonism between the Bank of England and Barings in 1890 – just as the increasing antagonism between the Bank of England and Overends in 1866 – was a factor that "caused" the fall of Barings. Barings fortune helping, Barings could be reconstructed although the old firm was dead, and its prestige dented, leading many economic historian to use a but lightly the expression of "bail out." If anything, Barings was bailed in and so was Argentina, since eventually, the restructuring of the Argentine debt left the hypothetical long term investor without a significant loss. The presence of the Bank of England in both the management of the money market during the Baring crisis and through various agencies, in the restructuring of the Argentine debt manifests the existence of what I call the foreign debt food chain. To repeat, whether it ignored

the foreign debt market as in the early 19^{th} century or if it recognized its existence as in the late 19^{th} century, the Bank of England was involved with foreign debt crises – as the egg with the omelet.

It is interesting, given that the key difference perhaps between the past "lessons from history" and the present crisis revolves around the range of financial instruments that the central bank accepts as collateral in an emergency – narrow then, wide now – and especially with the early concern of central banks to deal with foreign debt at arm's length to go back to the kind of ideas that the prominent theoretician of lending of last resort entertained towards debt crises. While he argued in *Lombard Street* that monetary crises could and should be dealt with, because one could and should recognize what a good collateral looked like, he was not optimistic regarding the foreign debt market. In an article published in *The Economist* in 1875, he sought to explain why such segments of the stock market as the foreign debt market were likely to produce recurrent crises.

His argument tied the existence of crises to fraud and misrepresentation, and asked "Why the Stock Exchange Is Likely to Have More and Greater Frauds in It Than Any Other Market." His answer was that such instruments as were traded in the stock exchange did do not abide by the laws of supply and demand in the conventional way. Instead, the stock exchange presided over what Bagehot described as "the inception of the value." It appears that Bagehot had in mind a kind of present value model. As a result, the pricing of an asset involved an irreducible element of imagination. Value, he explained, was a "fancy." In the case

of a loan to a new state or railway or distant mine, the “article is worth just what the public can be made to believe that it is worth.” [3]

His exposé then developed the consequences of this situation. He identified, using a language that todays economists would recognize as “modern,” the existence of two types of agents – informed and uninformed. Then, this was processed in a Darwinian framework (Bagehot was writing only a few years after Charles Darwin published his *Descent of Man*) where the “unskilled outsiders” (portrayed as a greedy but incompetent investor) were being devoured by the “insiders.” For a Darwinian mind, the main problem with the foreign debt market was therefore the greediness of the unskilled for it fed the skilled and kept “alive the group of skilled machinators at head-quarters.” And thus the only way to cure the tendency of the stock exchange to “fraud” and thus bubbles, was to educate the unskilled. Financial losses was the best teacher as it deterred the prey from venturing into the territory of the predator (the “machinator” at the stock exchange headquarters). The less prey there would be within reach of the predators, the less scope for crises there would be. So to speak, predators would become extinct from starvation.

I have just alluded to Darwin, and indeed, Victorian society put the Darwinian sauce on every plate. The relevance to this for the history of central banking has already been acknowledged in title of what remains one of the most inspiring essay on the history of central banking – Charles Goodhart’s Evolution of central banks, where evolutionism is in plain sight, though perhaps not as conscious of the implication this has than I am trying to be here. Indeed, perhaps as

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[3] Walter Bagehot, “Why the Stock Exchange Is Likely to Have More and Greater Frauds in It Than Any Other Market,” *The Economist*, March 27, 1875, 361.

importantly, Darwin himself confessed having been impressed by the *Economist*'s editor own experimentation of social Darwinism, which was articulated before Darwin published *Descent of Man*. Charles Darwin actually devoted several pages to the application of his ideas to the development of human societies in his *Descent of Man* and partly as a response to a series of papers Bagehot -- whom Darwin knew well and rubbed shoulders with in the rooms of various learned societies -- published in the period that immediately followed the Overend Gurney crisis. The series of essays, published initially in the *Fortnightly Review* were eventually edited under the title *Physics and Politics*.[4] They acknowledged the importance of the ideas in Darwin's *Origin of Species*[5]

The familiar Darwinian logic, which Bagehot relied upon for advancing his arguments about society's evolution, can be easy to identify from the many statements this book contains regarding the role of conflict and competition in human advancement. Natural selection played on human tribes, just as it had played on human specie and enabled to understand mysteriously surviving traits. As he put it in the context of language and the competition of local dialects, "a national character is but the successful parish character; just as the national speech is but the successful parish dialect, the dialect, that is, that came from the district which came to be more influential than other districts, and so set its yoke on books and on society." (p. 37). But as a student of politics and political economy (which he conceived as tightly bound with one another) Bagehot was

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[4] Walter Bagehot, *Physics and Politics, Thoughts on the Application of "Natural Selection" and "Inheritance" to Political Society*, New York: Appleton, 1873.

[5] For a good second hand source, see Geoffrey M. Hodgson, Thorbjørn Knudsen, *Darwin's Conjecture: The Search for General Principles of Social and Economic Evolution*, Chicago: University of Chicago Press, 2010.

interested primarily in the possibility to use such reasoning to draw lessons from history and inspire policy making. In the first pages of the essay Bagehot stated his purpose. Recent Darwinian and other developments from anthropological and ethnological advances were revolutionizing the science of history, he explained making it a more exact body of knowledge and, he conjectured, a more useful too: "We thus perceive how a science of history is possible, [...] – a science to teach the law of tendencies – created by the mind and transmitted by the body – which act upon and incline the will of man from age to age." (p. 11)

As Bagehot's argument unfolded, however, it took increasingly anxious overtones. From the familiar and reassuring territory of natural selection, which always ensured the prevalence of the superior type, Bagehot gradually moved to recognizing the existence of situations which he characterized as being of "arrested development":

> "No doubt history shows that most nations are stationary now; but it affords reason to think that all nations once advanced. Their progress was arrested at various points; but nowhere, probably not even in the hill tribes of India, not even in the Andaman Islanders, not even in the savages of Terra del Fuego, do we find men who have not got some way. They have made their little progress in a hundred different ways; they have framed with infinite assiduity a hundred curious habits; they have, so to say screwed themselves into the uncomfortable corners of a complex life, which is odd and dreary, but yet is possible. And the corners are never the same in any two parts of the world." (p. 42)

In other words, he interpreted the different level of developments arrived at in different part of the world – the advancing West and the arrested Rest, to

speak like Douglass North – as reflecting as many political, social, and economic equilibria, some feeding progress, others feeding stagnation: In Bagehot's history of the world, not every equilibrium was an optimum.

Turning now to the West, Bagehot's great question was to understand what would replace the former mechanism or warlike conflict in a new world of pacified relations. As Bagehot put it: "Since war has ceased to be the moving force in the world, men have become more tender tone to another, and shrink from what they used to inflict without caring; and this not so much because men are improved…, but because they have no longer the daily habit of war – have no longer formed their notions upon war, and therefore are guided by thoughts and feelings which soldiers as such – soldiers educated simply by their trade – are too hard to understand." (p. 78) And the solution that he found was in the creation in the new world of policy mechanisms that would somehow mimic or at least produce the results that used to obtain in the old, through tradition and selection. In other words both tradition and selection were to be reinvented, or as he put it at one point, how to "imagine a rule that is obligatory, but not traditional." (p. 143)

It comes naturally to use this in order to interpret – reinterpret – Bagehot's "rule" for lending of last resort as one such attempt. Indeed, the celebrated emphasis on lending freely but on good collateral can be likened to an attempt at using the financial crisis as a manner to restore the ways of nature. The conventional (and perhaps moot) transcription of Bagehot's rule as one that would sort liquidity from solvency appears to me to have captured exactly this impression, of the hand of the central bank playing mother nature, and taking advantage of a special moment of the business cycle to achieve the kind of

weeding that the normal functioning of the capitalist economy could not achieve by itself. In summary, the extent to which Bagehot and Darwin influenced one another in the 1860s should not be underestimated. And this gives us an etymology for the modern dilemma on whether central banks should prick bubbles. Cast in these terms, the question becomes: Can central banks play Mother Nature?

While Bagehot's rule affirmed they could in the case of bills and other short-term instruments, his discussion of the necessary recurrence of foreign debt crises in the stock exchange implies that he would have denied this possibility to central banks inasmuch as the foreign debt was concerned. Part of the reason was that short-term instruments matured very quickly, so that information as to their quality was always secured very soon. This provided a reality check that prevented the central bank from running aloof. But when it came to instruments with long maturities, the value, as he said, was a fancy. While the central bank may have had views as to their intrinsic quality, and while those views undoubtedly informed monetary policy, as we saw, there was no way one could devise – imagine – an obligatory rule to govern lending on such instruments.

But speculating on what Bagehot said on might have said is perhaps less interesting than pointing the finger on the complication that evolution had reached by then: Against the fancies sold by predatory insiders at head-quarters to unskilled outsiders apt at being cheated at least once, the central bank had to fancy it own rules, them as well just as artificial and arbitrary. This explains most probably why Bagehot ran for cover and when he formulated his rule, tried to tie down the banking system to the most tangible of the intangible assets, these bills or acceptances which were themselves the counterpart of real commercial

transactions, a flow of immaterial money going the other way and on a similar boat, as the commodity whose shipment it had purchased. Thus tied to the global trading system, a material core was given to the immateriality of world finance. The surrounding dangerous fancies could appear, at least for an instant, domesticated by a superior fancy that imagined the international money market as circumscribed – the modern word is "ring-fenced" – by a retinue of commodities.

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This exploration of the historical context of the development of ideas on central banking – in effect a digression on the intellectual history of policy making – has brought to the fore the Darwinian origins of "modern" central banking. There are evidently many lessons to be derived from this short tale. But if I were to single out but one, it would be the critical role of imagination. I believe that the new fashion, according to which reliance economic history is useful to policy making is too limited and indeed perhaps misleading. After all what were those who computed inefficient default rates for mortgage loans doing, except relying on history – albeit perhaps on too short a time span and thus a faulty history? Yet they were, as many economists are without knowing it, historians. That there were bad historians is a different matter.

What discussion of Bagehot and Darwin brings to the policy conversation is a new twist that economists may not be prepared to recognize, though I know that policy makers are already up in arms clamoring for it. It is a reintroduction of a dose of fancy, and the realization that our information economy is, despite attempts to tie down those fancies to fundamentals and the endless discussion

on the existence of bubbles, much more open ended and in fact interesting than it is conventionally realized.