Luca Azuma

Cooking the Books and Frying the Economy: The Discounted Impacts of the Panic of 1866 in the United Kingdom

ABSTRACT: *This article studies the misinterpretations of nineteenth-century economist Walter Bagehot's analysis of financial systems following the financial crisis of 1866 in the United Kingdom and attempts to clarify the meaning of Bagehot's work. It begins with context of the crisis, otherwise known as the Panic of 1866, following the story of Overend, Gurney & Co., the bank at the center of the crisis analyzed by Bagehot in his 1873 work "Lombard Street: A Description of the Money Market." It argues that Bagehot, contrary to scholarship stating otherwise, did not condone free lending regardless of circumstance in times of financial crisis, but only suggested lending on the basis of acceptable collateral for the central bank.*

KEYWORDS: *European history; nineteenth century; United Kingdom; Panic of 1866; financial crisis; central banking; Bank of England; Walter Bagehot; Overend, Gurney & Co.; lender-of-last-resort principle*

Introduction

Only a small percentage of the Earth's population has ever heard or cares about the name Walter Bagehot (1826-1877). Fewer still are aware of an event known as the Panic of 1866, an economic crisis in industrializing England. This obscurity has had governments driving their financial institutions without a map, and many economic crises later, the powerful tools that a knowledge of Walter Bagehot and the Panic of 1866 could provide still gather cobwebs in the basement of economic history. Widely considered the founder of the "lender-of-last-resort" principle in central banking, the nineteenth-century economist Walter Bagehot emerges as the focus of most studies on the Panic, but his work has been subject to interpretations that do not accurately reflect his intentions with regard to financial policy in times of economic crisis. This article first sets the stage for Bagehot's work by outlining the causes of the Panic of 1866, which featured rapidly developing technology, novel and complex financial instruments, and a woefully inadequate regulatory system. It then shows how the writings of Bagehot, the great assessor of the panic, have been interpreted and, in many cases, misunderstood.

I. The Crisis

In order to better comprehend Bagehot's work, one must first review the Panic of 1866. Economic conditions in the late nineteenth century were strikingly similar to those in the early decades of the twenty-first century. Swiftly evolving technology, increasingly complex financial instruments, and the unpreparedness of central banks to deal with their evolving financial system featured prominently both during the Panic of 1866 and the 2008 financial crisis. In addition, following the Panic of 1866, a number of serious economic policy questions emerged that dealt with technological advancements in industrializing England. At the time, England operated on the gold standard, meaning the currency was pegged to the value of gold. This tactic prevented rapid inflation but also limited the number of notes the

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Bank of England could issue, as too many notes would effectively push the pound off the gold standard as established by the Bank Charter Act of 1844.[1] This presented a major problem at the time of the crisis, for the Bank of England soon realized that the scope of the financial system was larger than they had first thought and that their reserves were inadequate to deal with the lack of confidence that was permeating the market.

To better understand the state of the English economy at this time, economist Walt W. Rostow's model for Western economic development is useful. While it has not remained without its critics, this model's broad descriptive framework sketches the progression of Western capitalist economies in a way that is devoid of excessive jargon. Rostow defines the thriving capitalist economy as "the period when a society has effectively applied the range of [then] modern technology to the bulk of its resources."[2] For England, this period ranged from the 1850s to the 1930s,[3] meaning that—by 1866—the English economy had already dwelled in this stage for over a decade; indeed, Rostow notes that the economy had attained a state of near-technological maturity by this point in time.[4]

To keep up with this technological expansion, the economic and financial systems, too, had become increasingly complex. England, at this time, already operated within the parameters of the discount house system, which was to take them all the way to the end of the twentieth century.[5] Thus, the Bank of England dealt with discount houses exclusively instead of dealing cash directly to most commercial banks. Founded in 1800, Overend, Gurney & Co. (henceforth shortened to "Overend Gurney") was a discount house and a consumer bank. They conducted money market transactions with the Bank of England, facilitated deals, bought or sold bills of exchange, and held deposits for individual consumers. Overend Gurney played a central role in the economy through its primary business of providing cash for short-term loans so that businesses could meet their everyday needs, while the bulk of their value was tied up in investments that could not be liquidated quickly.[6]

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[1] Bank Charter Act 1844 (United Kingdom). Shortly afterwards, the great English economist William Stanley Jevons (1835-1882) called for taking the pound off the gold standard entirely, but of this even Walter Bagehot was skeptical. See Walter Bagehot, "A New Standard of Value," *The Economist,* November 20, 1875.

[2] Walt W. Rostow, "The Stages of Economic Growth," *The Economic History Review*, second series, 12, no. 1 (1959): 1-16, here 8.

[3] Rostow, "Stages of Economic Growth," 8, 11.

[4] Rostow, "Stages of Economic Growth," 10: "[I]n the sixty years before the First World War, Britain had moved, in terms of income levels, from being a relatively poor mature society to being a relatively rich, mature society."

[5] Jill Treanor, "Old Mutual Eyes Gerrard: £540m on the Table for UK's Last Discount House," *The Guardian,* January 14, 2000. Bills of exchange and discount houses are still operating in today's world economies, for example in India.

[6] For context, see *Investopedia*, s.v. "Discount House;" *Britannica*, s.v. "Central Bank."

Overend Gurney had been struggling financially for some time before May 9, 1866—the day this once venerable institution began to collapse. They turned to the Bank of England for assistance, only to be turned away because they could not provide any decent collateral.[7] This led to a wave of panic, not just from businesses relying on Overend Gurney's loans but also from consumers, for this was before the time of deposit guarantees,[8] worsening Overend Gurney's liquidity crunch.[9] The following afternoon, the bank failed entirely, causing suspicion of further failures of other financial institutions to spread amongst the public.[10] The Bank of England's decision not to lend to Overend Gurney continues to be controversial to this day, for while some regard this choice merely as standard practice,[11] others see a conflict of interest. At the time, the Bank of England served not only as a central bank for the country but also as a private-sector institution, leading Walter Bagehot in his post-crisis work, *Lombard Street: A Description of the Money Market* (1873), to remark on the conflict of interest this created:

> The directors of the Bank are […] trustees for the public […] and it would naturally be expected either that they distinctly recognized this duty and engaged to perform it, or that their own self-interest was so strong in the matter that no engagement was needed. But […] many of them would scarcely acknowledge it, and some altogether deny it.[12]

Bagehot was not the only one to see the potential problems in a central bank being asked to keep its competitors afloat. Modern-day financial historians Rhiannon Sowerbutts, Marco Schneebalg, and Florence Hubert have noted a prior spat between Overend Gurney and the Bank of England: in 1860, Overend Gurney had retaliated against the Bank of England when it unexpectedly raised interest rates

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[7] Rhiannon Sowerbutts, Marco Schneebalg, and Florence Hubert, "The Demise of Overend Gurney," *Bank of England, Quarterly Bulletin*, Q2, July 5, 2016.

[8] Deposit guarantees are government-backed assurances that a certain amount of an individual's money is insured in a regular bank account. In the United States, this is exemplified by Federal Deposit Insurance Corporation (FDIC) insurance, typically up to $250,000 per person. They are designed so that, if a bank fails, consumers will not panic and attempt to withdraw their money from their bank and worsen the bank's situation and the financial system in general.

[9] Liquidity refers to how much money a bank has in useable cash ("cash on hand"). For example, if a bank holds $2 trillion in deposits, this usually does not mean that they have $2 trillion available to give out to customers. Most deposits are tied up in investments, loans, or the like. Hence, liquidity refers to the money the bank has "liquid" or ready to give out to account holders.

[10] John Lewis, "Unto Us a Lender of Last Resort Is Born: Overend Gurney Goes Bust in 1866," *Bank Underground* (blog), December 21, 2016.

[11] Marc Flandreau and Stefano Ugolini, "The Crisis of 1866," Graduate Institute of International and Development Studies, Geneva, Working Paper No. 10/2014, 1-19, here 10-11. John Lewis also appears to see this as ordinary practice; see Lewis, "Unto Us a Lender of Last Resort Is Born."

[12] Walter Bagehot, *Lombard Street: A Description of the Money Market* (first published 1873; London: Kegan Paul, Trench, Trübner & Co., Ltd., 1896), 36-37. Bagehot is considered the father of last-resort lending by central banks and is regularly cited, to this day, in numerous business and financial circulars.

and collaborated with other banks in an attempt to cause a run on the Bank of England.[13] Thus, while the Bank of England certainly had cause to reject Overend Gurney in 1866 and rendered a decision in accordance with common practice, the mere fact that there was the shadow of a doubt as to their motivations highlighted a serious moral hazard in the English financial system, and this would remain an issue until the Bank of England's nationalization in 1946.[14] It was not until this point in the mid-twentieth century that the Bank of England no longer had any conflict of interest in its role as a central bank and lender to other financial institutions in times of need.

Bagehot, the once editor-in-chief of the still-extant weekly newspaper *The Economist* (established 1843), candidly described and assessed the state of central banking and the lending system at large, reviewing the success of last-resort lending while recognizing the precariousness of English fiscal and monetary policy at the time. In his work, Bagehot offers an insightful description of the effects of bad credit, explaining that smaller dealers rely on "time and brains" to make profits; in their precarious position, these risk-takers living on the edge of profitability ask banks for loans, but this kind of business "always fears that he may be the person on whom current suspicion will fasten."[15] Thus, banks prop up the operations of smaller businesses who have their money tied up in assets that have a higher potential for return than on-demand cash.[16] When one such bank fails, so does everyone who relies on them.

Stephanos Theodoros Xenos (1821-1894), an executive of the Greek and Oriental Steam and Navigation Company and a Lombard Street titan, offered the perspective of a businessman during the crisis, lamenting in his 1869 memoir, *Depredations; or, Overend, Gurney, and Co., and the Greek and Oriental Steam Navigation Company,* that "you could no longer distinguish the good shares and bills of exchange from the bad, because many of these worthless concerns were under the covers of the names of noble dukes, earls […] and eminent insolvent merchants and bankers" such as Overend Gurney.[17] In times of such uncertainty,

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[13] Sowerbutts, Schneebalg, and Hubert, "Demise of Overend Gurney." Before deposit guarantees existed, when word spread that a bank was failing, depositors ran to the bank and stood in line to withdraw all their money, hoping to do so before the bank ran out of funds to pay them all back for the money they kept there. Hence the event is known as a "run" on the bank.

[14] Bank of England, "Our History." Moral hazard is a term used in the economics and finance world to refer to a conflict of interest. Here, the conflict was that a central bank—tasked with saving the economy and having the power to do so—was being asked to save its competitors from bankruptcy, even though the failure of other financial institutions benefited the Bank of England.

[15] Bagehot, *Lombard Street*, 52.

[16] Bagehot, *Lombard Street*, 32: "They do not waste capital and lose profit by keeping [money] idle" (the same issue central banks always have in requiring banks to keep a reserve).

[17] Reminiscent of Lehman Brothers and Bear Stearns in 2007. Stephanos Theodoros Xenos, *Depredations: or, Overend, Gurney, and Co., and the Greek and Oriental Steam Navigation Company* (London: published by the author, 1869), 335. The owner of a fleet of ships and a newspaper in Greece, Xenos felt so strongly about his treatment at the hands of Overend, Gurney & Co. that he

banks are more hesitant to lend, knowing that they may not receive repayment of funds loaned out, creating a crunch for funds as all scramble to solidify their position atop mountains of cash. Thus, these smaller businesses, who rely on short-term loans to fund their daily obligations, often must default, freezing the economic system and creating losses, unemployment, and so forth.

The spreading Panic of 1866 required an immediate solution, otherwise the entire economy would topple like a row of dominoes. Thus, the Bank of England immediately began lending operations, choosing those with appropriate collateral to receive emergency loans at a penal interest rate (higher than usual loan rates). The money-printing restriction imposed by the Bank Charter Act of 1844 loomed larger and larger as the crisis continued and the Bank of England continued to lend. The bank depleted its reserves to a point at which this institution at the center of the entire world economy had but three million pounds left in liquid form.[18] There was only one solution, namely, to break the law, and that they did, but, of course, with permission. At the last moment, Parliament temporarily suspended the Bank Charter Act, allowing the Bank of England to issue notes off the gold standard, and while the bank never utilized these funds, "the suspension of the Bank Charter Act had the desired effect of restoring confidence in the money market,"[19] making the actual use of the funds unnecessary.[20] It is doubtful that the Bank of England could have survived without this lawful suspension; in fact, it had relied on the suspension of the Act twice before, in 1847 and 1857, a fact which led Bagehot to remark that "in none of these years could the Banking Department of the Bank of England have survived if the law had not been broken,"[21] all but proving that, while it was effective in lowering inflation, the Act's adherence to the gold standard was a dangerous obstacle in times of crisis.

The Panic of 1866 was especially serious because it caught the Bank of England unprepared. Crises are usually unexpected, but the severity of the crash was exacerbated by its unprecedented scale. Writing in retrospect, Bagehot observed that "there was never so much borrowed money collected in the world as is now collected in London […] in a panic some [lenders] […] do ask for some of it. If any large fraction of that money really was demanded, our banking system and our industrial system too would be in great danger."[22] Bagehot further noted the scale of the danger, remarking, "there is no country at present, and there never was […]

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self-published a nearly four-hundred-page book on life in corporate England in the nineteenth century that exposed the workings of Overend, Gurney & Co.

[18] Bagehot, *Lombard Street*, 29.

[19] Sowerbutts, Schneebalg, and Hubert, "Demise of Overend Gurney."

[20] In the context of the 2008 financial crisis, this was the kind of result U.S. Treasury Secretary Hank Paulson had hoped for when he asked Congress for "unspecified" authorities.

[21] Bagehot, *Lombard Street*, 29.

[22] Bagehot, *Lombard Street*, 17.

before, in which the ratio of the cash reserve to the bank deposits was so small"[23] and that "the collection of these immense sums in one place and in few hands is perfectly new."[24] Bagehot showed an uncommonly clear recognition that the modern capitalist system was built on a foundation of "ghost money" which relies on a mixture of confidence and speculation to keep running. This interpretation of macroeconomics was ahead of its time and was precisely what drove Bagehot to advocate for the innovative lender-of-last-resort principle.

However, the drama was not yet over. A heated debate arose in the years after the crisis that still aggravates lawmakers to this day, namely, the argument over corporate responsibility. In an unprecedented move, the management of Overend Gurney were brought to court by shareholders for their mismanagement of the company, and a parliamentary debate ensued over the level of responsibility the government shared in prosecuting the bank and protecting individual investors.

With Overend Gurney and select other discount houses providing the bedrock for the system, business and financial instruments continued to develop thanks to the "recognition that technological advances had produced opportunities of scale that could only be obtained by forming much larger businesses."[25] The invention of the Limited Liability Company (abbreviated "LLC" or "Ltd.") in the latter half of the nineteenth century[26] coincided with this recognition, as "[t]he greater amounts of capital that this implied required the involvement, and support, of investors who, generally, had limited or little understanding of the businesses they were financing."[27] Thus, requiring the protection offered by becoming an LLC,[28] this new world of intricate legal agreements and maze of financial instruments understandably created an uncertainty as to the safety and efficacy of such instruments, which has been demonstrated by Paul Barnes and Ron Firman in their paper on the effect of Overend Gurney's collapse on the use of the LLC in England. They report that "Victorian entrepreneurs and investors" not only found it difficult to establish companies due to their inexperience with this new financial instrument,[29] but that the irresponsible conduct of the directors of Overend Gurney cast a pall upon the instrument in general—even though the instrument

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[23] Bagehot, *Lombard Street*, 18.

[24] Bagehot, *Lombard Street*, 20.

[25] Paul A. Barnes and Ron J. Firman, "Difficulties in Establishing a Limited Liability Company in Great Britain during the 1860s and the Role of Financial Information: A Case History," *Financial History Review* 8, no. 2 (October 2001): 143-161, here 146.

[26] Barnes and Firman, "Difficulties in Establishing a Limited Liability Company," 143.

[27] Barnes and Firman, "Difficulties in Establishing a Limited Liability Company," 146.

[28] An LLC protects—to a certain extent—the owner's personal assets by forming a separate legal entity in the LLC. If consumers feel wronged by the company, they can only sue the LLC, not the person who owns the LLC, for their assets. Prior to the emergence of the LLC, owners carried a much higher legal risk. In addition, the forming of an LLC also resulted in different taxation.

[29] Barnes and Firman, "Difficulties in Establishing a Limited Liability Company," 159-160.

itself was perfectly fine, which caused hesitancy and a noticeable dip in LLC formations in England in the years immediately following 1866.[30]

The lawyers of Overend Gurney had no such uncertainties regarding the legal jargon surrounding the status of the LLC. Shortly before the panic, before their situation was known to the general public or even to the government, the bank had been "losing at the rate of $500,000 per year,"[31] quite possibly more. Due to primitive accounting methods, "cooking the books" was a more expeditious way of balancing finances in the nineteenth century than it is in the age of computers. We may never know the extent of Overend Gurney's insolvency, though Xenos estimated that the bank, as far back as 1863, was insolvent to the tune of at least three million pounds.[32] The tactic of hiding insolvency in order to convert to an LLC and then pass losses on to shareholders was apparently popular in the nineteenth century. According to Xenos, Lombard Street witnessed a "[paroxysm] of turning insolvent businesses into 'limited companies'"[33] during his time.

It remained to be seen, however, whether this irresponsibility constituted criminality or merely bad faith. In 1869, after the crisis had subsided and Overend Gurney's conversion to an LLC become public knowledge, a lawsuit was filed against Overend Gurney for shifting responsibility for their actions to shareholders when, in fact, they had already been insolvent. The prosecution ran out of money and reached out for government assistance, sparking a series of debates in Parliament as to whether the government ought to take part in the prosecution. Consumer defenses were scant at this time, and these debates represented milestones in their slow emergence in law. One parliamentarian commented that, should the government fail to join the prosecution, "it might be truly said that there was one law for the rich and another for the poor," pointing out that "in most other countries there was a public prosecutor" for exactly these circumstances.[34] On the other side of the argument, another member of Parliament though it a great irony that "those who went into this concern hoping to make large gains, but who made instead great losses, were to come to that House and ask them to supply the funds of the country to carry on a prosecution."[35]

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[30] Barnes and Firman, "Difficulties in Establishing a Limited Liability Company," 143-144, citing H. A. Shannon, "The Limited Companies of 1866-1883," *The Economic History Review* 4, no. 3 (October 1933): 290-316.

[31] Supplement to *The Bankers' Magazine: Journal of the Money Market, and Commercial Digest* 30 (1870): 3; from the trial of Overend Gurney, day 1.

[32] Xenos, *Depredations,* 215. This figure is corroborated by the "Committee of the Defence Association" who calculated the insolvency at $3,423,868: Overend, Gurney, & Co., Ltd., *Report of the Committee of the Defence Association: Truth is Stranger Than Fiction* (London: Standidge, 1867), 28. This source needs further investigation, as no record of the nature of this group or its activities has been found; its report, however, is exhaustive to a fault.

[33] Xenos, *Depredations,* 335.

[34] United Kingdom, *Hansard Parliamentary Debates*, 3d ser., vol. 197 (1869).

[35] United Kingdom, *Hansard Parliamentary Debates,* 3d ser., vol. 197 (1869).

Parliament ultimately decided against taking action,[36] and—in yet another conflict of interest—the solicitor general was allowed to take as his private clients the defendants of the case (i.e., Overend Gurney) and represent them in court.[37]

The plaintiff, a certain Mr. Adam Thom, then put forth what amounts to an early complaint of "crony capitalism"—described by Guillermo Rosas as "cozy, nontransparent relations between politicians and entrepreneurs"[38]—by lambasting the prime minister and cabinet for "ducking aside from the vindication of truth and justice."[39] That the solicitor general was allowed to take on a private client while in office is problematic all by itself, but the decision to defend high-profile clients whom he might have been called upon to prosecute reeks of crony capitalism. While there is no definitive proof of wrongdoing, the interaction's "nontransparent" and "cozy" nature only strengthened the parliamentarian's claim that there was collaboration between the government and the rich. In their study on banking crises and politics, Jeffrey Chwieroth and Andrew Walter astutely observe that, over the past 150 years, "large segments of society in modern democracies [have come] […] to demand that governments provide protection from economic downturns," and that this "growing 'pressure from below' to protect […] wealth helps to explain both the increased propensity for government bailouts and the increasingly powerful political effects of these crises."[40] Thom's lawsuit against Overend Gurney illustrates this very "pressure from below," and the fact that "the proceeding […] excited great interest"[41] shows a strong demand for the protection of individual wealth even earlier than Chwieroth and Walter suppose. Thus, while the Panic of 1866 provides valuable insights into modern consumer behavior, it is in this case—once again—overlooked.

Indeed, the problems of today's central bankers and policymakers and those of the late nineteenth century are not so different. As financial columnist Greg Ip has observed, "business cycles in the future might resemble those of the 19th century, when monetary policy didn't exist."[42] While Ip is referring to the United States,

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[36] *The Law Journal* 7 (May 10, 1872): 318. A record of the actual motion was not found, but a clear reference to its outcome is presented here.

[37] Supplement to *The Bankers' Magazine* 30 (1870): 1; Adam Thom, *Overend and Gurney Prosecution: In Its Relation to the Public as Distinguished from the Defendants* (London: Effingham Wilson, 1869), 12-13.

[38] Guillermo Rosas, "Bagehot or Bailout? An Analysis of Government Responses to Banking Crises," *American Journal of Political Science* 50, no. 1 (January 2006): 175-191, here 175.

[39] Thom, *Overend and Gurney Prosecution,* 12.

[40] Jeffrey M. Chwieroth and Andrew Walter, "Banking Crises and Politics: A Long-Run Perspective," *International Affairs* 93, no. 5 (2017): 1107-1129, here 1108.

[41] "Overend, Gurney, and Co," *Times*, January 2, 1869, 5. Great interest is also reported in the Supplement to *The Bankers' Magazine* 30 (1870): 1; and Thom, *Overend and Gurney Prosecution*, 12.

[42] Greg Ip, "The Era of Fed Power is Over. Prepare for a More Perilous Road Ahead: Central Banks Have Long Exercised Influence Over Booms and Busts, but Their Ability Is Shrinking," *Wall Street Journal (Online)*, January 15, 2020.

the situation fits England with little modification. A monetary policy of sorts existed in the English central banking system in the nineteenth century, as the bank could raise and lower rates. However, this was not applied during financial crises as one would expect: the Bank of England actually *raised* rates to combat the Panic of 1866.[43] According to Bagehot, it was the prevailing thought at the time that "loanable capital […] comes where there is most to be made of it," thus creating the expectation that raising rates would help resolve liquidity issues.[44] This is a classic example of supply-side economics and Say's Law, which indicates that increased supply will create increased demand, while current central bankers *lower* rates in times of crisis because they emphasize the deterrence to borrowing caused by high interest rates.[45] The central bankers' subscription to supply-side economics certainly diluted the effectiveness of monetary policy during the Panic of 1866, which explains its back-seat role in Bagehot's observations. This left the government with only one tool, namely, flooding the market with cash. Ip considers this the strongest tool left to central banks even today, as they struggle with the opposite problem of low, sometimes even negative interest rates, which allows little room for rate cuts in the event of a crisis, as demonstrated by the European Central Bank (ECB) during the first quarter of 2020. Despite the world-wide COVID-19 health crisis, the ECB did not lower rates because they had nowhere to go and, instead, resorted only to fiscal policy since the deposit rate already stood at negative one-half percent as of September 2019.[46]

The parallels do not end there. As the twentieth century drew to a close, discount houses declined because of the novel exchange of new technologies and because of financial instruments like the derivative.[47] Derivatives are complex, multi-party interactions which often involve large sums provided by institutional investors and hold a place comparable to that of the LLC in a mid-revolution economy. The technological revolution driven by the rise of the internet led to an increased complexity of financial markets and the widespread use of derivatives, but, similar to the late nineteenth century, rapidly-changing environments produce hiccups. Derivatives contributed to large losses worldwide as far back as the 1990s,[48] and poor regulations and the use of derivatives precipitated the 2008 financial crisis.[49] As if this were not enough, in that crisis, too, governments once

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[43] Flandreau and Ugolini, "Crisis of 1866," 20.

[44] Bagehot, *Lombard Street*, 47-48.

[45] Emery Kay Hunt and Mark Lautzenheiser, *History of Economic Thought: A Critical Perspective*, 3rd ed. (New York: Routledge, 2015), 137.

[46] European Central Bank, "Key ECB Interest Rates."

[47] *Investopedia*, s.v. "Discount House;" Steve Kummer and Christian Pauletto, "The History of Derivatives: A Few Milestones," EFTA [European Free Trade Association] Seminar, Staatssekretariat für Wirtschaft/SECO [Secrétariat d'État à l'économie], Zurich, May 3, 2012.

[48] *Britannica*, s.v. "Derivatives."

[49] *The Concise Encyclopedia of the Great Recession, 2007-2012*, s.v. "Derivatives."

again faced questions of consumer protection, and investment bankers around the globe were hauled into hearings over their irresponsible behavior in making investments with other people's money. In short, despite the fact that the lender-of-last-resort principle emerged from the Panic of 1866, nothing else was gleaned from it. Had economists and policymakers paid it its just deserts, they could have seen the next crisis coming.

II. Walter Bagehot and the Panic of 1866

The Panic of 1866 is most famous for Walter Bagehot's treatise on the lender-of-last-resort principle. Thus, the second part of this article addresses the common misperception that Bagehot was somehow involved in the creation of the principle itself, as well as the scholarly conversation and widespread misinterpretations with regard to Bagehot's work.

While the Panic of 1866 as a whole is often overlooked, Bagehot's work is not. Yet, the issue with the scholarly discourse on Bagehot is the wide range of opinions concerning what exactly he had actually recommended for the central banking system. It is imperative, firstly, to dispel a common misconception regarding Bagehot's contribution to macroeconomics. Statements like the one by Michael Bordo in his 2007 "Brief History of Central Banking" that "the Bank began to follow Bagehot's rule, which was to lend freely on the basis of any sound collateral offered,"[50] are inaccurate or at least reductionist: as Denis O'Brien has pointed out in his 2003 article, "The Lender-of-Last-Resort Concept in Britain," "by the time that Bagehot published his justly celebrated *Lombard Street* in 1873, the position of the Bank as lender of last resort was widely recognized."[51] Bagehot's *Lombard Street* commented on the crisis, observing what actions succeeded and which did not, and from there offered recommendations. Bagehot made many insightful observations on the crisis and the state of the modern economic system outside of the last-resort lending practice that have been overlooked, but his work on lending principles in *Lombard Street* is not original.

To be fair, Bordo did comprehend a crucial part of Bagehot's recommendation that not everyone understands, namely, that Bagehot only recommended lending on "the basis of any sound collateral."[52] A curious example of misunderstanding this recommendation can be found in Laurence Krause's 2019 article, where the author concludes that "economists and policymakers do not understand Bagehot […] [i]n an obvious Bagehot Moment in 2008, the Federal Reserve blundered a run-

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[50] Michael D. Bordo, "A Brief History of Central Banks," *Federal Reserve Bank of Cleveland*, December 1, 2007.

[51] Denis O'Brien, "The Lender-of-Last-Resort Concept in Britain," *History of Political Economy* 35, no. 1 (2003): 1–19, here 16. In this article, O'Brien seeks to weaken the spotlight on Bagehot and turn the argument back to the origins of the lender-of-last-resort concept in Britain, correctly highlighting economic crises earlier in the nineteenth century as the beginnings of lender-of-last-resort practices.

[52] See Bagehot, *Lombard Street*, 199.

of-the-mill bailout by refusing to rescue Lehman Brothers, unleashing an epoch-making financial crisis."[53] In fact, Bagehot would not have advocated lending in such situations, precisely because Lehman Brothers lacked salvageable collateral. In his 2006 article, "Bagehot or Bailout? An Analysis of Government Responses to Banking Crises," Rosas emphasizes this important distinction and bifurcates a "Bagehot" government response, in which institutions without good collateral are *allowed* to fail, from a "Bailout" response, in which governments allow "insolvent banks to continue operations, in effect subsidizing the losses of bankers and depositors and shifting the burden of bank insolvency to taxpayers."[54] Technically speaking, Krause's observation that the Lehman-Brothers scenario was a "Bagehot Moment" is correct: allowing Lehman Brothers to fail is exactly what Bagehot would have recommended given the institution's insolvency.

A second area of misinterpretation pertains to the *extent* of the Bank of England's lending. In an otherwise superb 2013 article tracking the battle between the currency and banking schools of economic thought and the history of the gold standard in England, Jérôme de Boyer des Roches claims that, according to Bagehot, the central banker "responds to a demand for credit, not for money […] Bagehot advocates an increase in the capital of the Banking Department in order to increase its reserve, thereby furnishing it with the tools for lending of last resort. The Lender of Last Resort does not take a liquidity risk."[55] Boyer des Roches's observation that credit, not money, is the underlying demand and that Bagehot recommends building a reserve to lessen risk for the bank is a distinction of brilliance. The issue is that, while Bagehot was flabbergasted that the Bank of England "never laid down any clear and sound policy on the subject" of last resort lending, he nowhere championed that raising the reserve meant a lack of "liquidity risk."[56] The entire enterprise of lending during a market-wide liquidity crunch is inherently risky, a fact Bagehot gravely recognized when offering his remedy: "The best way for the bank […] to deal with a [currency] drain arising from internal discredit is to lend freely. The first instinct of everyone is to the contrary."[57] In short, Bagehot recognized that the Bank of England needed to keep up appearances to calm the economy, even if it thereby ran the risk of insolvency. As Bagehot observed, the bank had done a marvelous job of following this premise: "[F]ortunately or unfortunately, no one has any fear about the Bank of England. The English world at least believes that it will not, almost that it cannot

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[53] Laurence Alan Krause, "Walter Bagehot's *Lombard Street*: An Interpretation," *Review of Radical Political Economics* 51, no. 4 (July 2019): 572-580.

[54] Rosas, "Bagehot or Bailout," 175.

[55] Jérôme de Boyer des Roches, "Bank Liquidity Risk: From John Law (1705) to Walter Bagehot (1873)," *European Journal of the History of Economic Thought* 20, no. 4 (2013): 547-571, here 567.

[56] Bagehot, *Lombard Street*, 208.

[57] Bagehot, *Lombard Street*, 50.

fail."[58] The reality, of course, was very much the opposite. At one point in 1866, as Bagehot noted, the Bank of England had only three million pounds left to its name, and during previous years of crisis (1847 and 1857) the bank had fewer than two million pounds left and this only because the Bank Charter Act of 1844 had temporarily been suspended.[59] There was always the lingering possibility that Parliament would not suspend the Act—a possibility that became very real in 2008 when the U.S. Congress failed to pass TARP (Troubled Asset Relief Program) legislation on its first try. Without the Act's suspension, the Bank of England itself would have been rendered insolvent.

The final area of disagreement between Bagehot's thoughts and those of his interpreters comes in the area of moral hazard with regard to the Bank of England. In a 2014 paper, Marc Flandreau and Stefano Ugolini refute Forrest Capie's claim that the Bank of England was not particularly interested in who they were lending to, as long as Bagehot's requirement of good credit was met.[60] To this, Flandreau and Ugolini reply that "the Bank was prepared to provide credit only to the extent that it liked what it saw. This meant that the counterparty had to abide by a number of behavioral norms: At the same time the Bank lent generously, it also performed strict monitoring over the banking system *and thus protected itself against moral hazard*."[61] The difference between Capie's position and that of Flandreau and Ugolini seems minute, but this difference has real-world consequences. Capie, Flandreau, and Ugolini all fully understand Bagehot's recommendation that central banks lend generously upon the condition of workable collateral. However, in reality, the situation is more complex, especially during the reality of 1866 when the Bank of England was still operating as a private, for-profit company. Only by combining Capie's, Flandreau's, and Ugolini's positions do we come to a more comprehensive understanding of Bagehot's recommendations. Flandreau and Ugolini are right to criticize Capie's "closed-window" position, as there is no denying that the Bank of England's risk evaluators could see who it was they were evaluating, which is not something that can merely be turned on and off, or raised and lowered, to use these authors' analogy. Flandreau and Ugolini argue in contrast that "Britain's actual recipe for financial stability was the Bank of England's adoption of a principle of generous provision of non-anonymous lending. In other words, the Bank's window was fully raised so that the Bank could see the face of the discounter."[62] Thus, with regard to seeing and

[58] Bagehot, *Lombard Street*, 41.

[59] Bagehot, *Lombard Street*, 29.

[60] Forrest Capie, "The Emergence of the Bank of England as a Mature Central Bank," in *The Political Economy of British Historical Experience, 1688-1914*, ed. Donald Winch and Patrick K. O'Brien (Oxford: Oxford University Press, 2002), 295-315, cited by Flandreau and Ugolini, "Crisis of 1866," 2, 3, 10, 18.

[61] Flandreau and Ugolini, "Crisis of 1866," 3.

[62] Flandreau and Ugolini, "Crisis of 1866," 3.

choosing who to lend to Flandreau and Ugolini are entirely correct. However, they are not right in saying that picking and choosing who to lend to protected the Bank of England from moral hazard, precisely because the bank was asked to lend to its competitors. Flandreau and Ugolini even acknowledge the 1860 spat between Overend Gurney and the Bank of England,[63] but they do not take into consideration that this rivalry may have affected the Bank of England's 1866 decision not to lend to Overend Gurney. As long as the Bank of England remained in competition with other banks, there was opportunity for picking and choosing, which is why Bagehot questioned the Bank of England's intentions and place in the financial system.[64]

Conclusion

The Panic of 1866 clearly has much to offer to scholars of various disciplines, as it exhibited many characteristics shared by economic crises of the twenty-first century, including a rapidly changing technological environment and a subsequently increasingly complex financial system; a central bank struggling to keep up with the novel environment; and questions about the extent of corporate responsibility for irresponsible—though admittedly uninsured—investments. The main significance of Bagehot's analysis of these trying times is that it resoundingly moved the conversation about central-bank policy from the question "Does the lender-of-last-resort concept work?" to the question "To what extent should the central bank lend?" While this did not create any novel ideas, it has been enough to endear Bagehot to economists, central bankers, and financiers to this very day. However, as this article has demonstrated, Bagehot's ideas have been subject to confusion. He did not advocate for unequivocal bailouts, but rather for lending against sound collateral, and he did not see lending as a low-risk solution, but rather as a necessary and risky game to stabilize the economy. While it is important to package information in quickly comprehensible form for the benefit of future generations, it is essential that the fundamental message not be altered, as has unfortunately been the case with Walter Bagehot's observations on so relevant and important a topic.

ABOUT THE AUTHOR: *Luca Azuma of Rancho Santa Margarita, California, earned his B.A. in History and Political Thought at Concordia University Irvine (2019) and is an M.A. candidate in History at California State University, Fullerton (CSUF), where he is a member of the Theta-Pi Chapter of Phi Alpha Theta (History Honor Society). His article printed above originated in a graduate research seminar offered by CSUF's History Department.*

[63] Flandreau and Ugolini, "Crisis of 1866," 5-6.

[64] Bagehot, *Lombard Street,* 36-37.