The Lessons of Monetary and Financial History

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Economic crises have occurred repeatedly in the past—and will continue to occur in the future. This history holds valuable lessons for us today, especially as we continue on the slow road to recovery. Before becoming Federal Reserve Chairman, Ben Bernanke was a noted scholar of economic history, and there is little doubt that his insights on the Great Depression and other crises were a great advantage. In June, the Federal Reserve Bank of Atlanta and Emory University invited leading experts to a workshop to present new research on monetary and financial history. (During the four-day event, 17 presentations were made, many of which are available on the Federal Reserve Bank of Atlanta's website at frbatlanta.org.)

Something old, something new

Barry Eichengreen, a professor of economics and political science at the University of California, Berkeley, delivered the conference's keynote presentation, "Mutual Assistance between Federal Reserve Banks as Prolegomena to the TARGET2 Debate in Europe."

In his talk, Eichengreen focused on the parallels between the relatively decentralized structure of TARGET2 (the large-value payment system of the euro) and the settlement arrangements among the Federal Reserve Banks in the early days of the Federal Reserve System. The crises of the Great Depression ultimately resulted in greater unification of the Federal Reserve's settlement system. Eichengreen argued that TARGET2 today is experiencing the same types of strains that the Fed underwent in the 1930s.

Eugene White of Rutgers University and the National Bureau of Economic Research presented a coauthored paper on the French financial crisis of 1889 that explored the role of moral hazard in central bank interventions and the extent to which a financial crisis can be contained. In 1889, the central bank of France (Banque de France) discovered that a leading commercial bank, Comptoir d'escompte de Paris, was highly leveraged and taking huge off-balance risks by guaranteeing payments for forward contracts of copper as part of another firm's attempt to corner the world copper market. When a run on the bank began after the scheme failed, the minister of finance forced the central bank to intervene with a rescue operation to avoid a general panic.

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Bagehot's dictum—named for the 19th-century British businessman Walter Bagehot—calls for central banks during times of financial crisis to lend without limit to solvent firms at high rates and against good collateral. But political circumstances forced the Banque de France to modify Bagehot's dictum by requiring private participation in its bailout of the troubled Comptoir d'escompte de Paris.

Curbing bad behavior

Any bailout necessarily raises concerns about moral hazard: rewards in the form of bailouts might encourage additional future risk-taking behavior. (Professor White and his coauthors draw comparisons between the 1889 French crisis and the Federal Reserve's 1998 role in the rescue of Long-Term Capital Management.) In an attempt to mitigate moral hazard risk in the wake of the 1889 crisis, the Banque de France purged the banking system of officials and board members who had conflicts of interest, nullified contracts that would have rewarded risk-taking speculators, and levied large penalties against managers and directors of the commercial bank at the center of the crisis. These actions deviated from the accepted central banking practices of the time, the authors note, but they seemed to have worked. No more French financial crises occurred in the pre-1914 era.

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Eichengreen, White, and the other scholars at the recent Atlanta Fed–Emory workshop showed that both the recent and not-so-recent past may provide valuable lessons. While "history is not a perfect guide," as Fed Chairman Ben Bernanke noted in an April 2010 speech, monetary and financial history can give us direction today. ∎