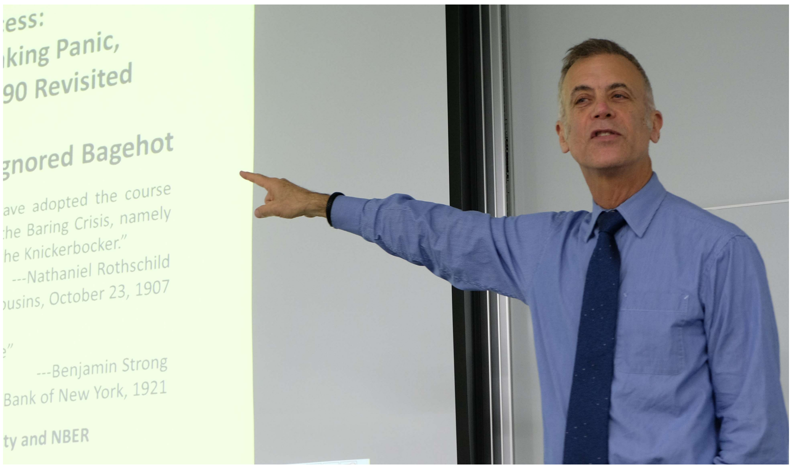
On the 24 November 2018, the Waseda Institute of Social and Human Capital Studies (WISH), the Financial History Group of Japan Society of Monetary Economics (JSME) and the Waseda Institute of Political Economy (WINPEC) co-hosted, a lecture "Censored Success: How to Prevent a Banking Panic, the Barings Crisis of 1890 Revisited" by Dr. Eugene White, Professor of Economics, Rutgers University, and Research Associate of the NBER. Drawing on archival documents to address key issues in the economics literature on financial crises, the lecture revealed how a major European banking crisis in 1890 was averted.



Dr. White asked the participants to consider how to best respond to an incipient panic. Is the best course of action to (1) react to a panic only once it has occurred, as per the Bagehot-rule of provision of liquidity, or (2) to preemptively intervene to intercept the panic and using discretionary authority to rescue certain failing banks? The choice is not a simple one as there may be a trade-off where in the first case one avoids increasing moral hazard but at the potential cost of a deeper recession, while in the second case one may counter the recession but increase moral hazard.

Walter Bagehot, sometime editor of *The Economist*, was a proponent of what has become known as the "Bagehot rule." It has been claimed that banking crises in Europe during the late nineteenth century were averted due to this rule. Current policy debates have been heavily influenced by this rule, and, after Crisis of 2008, the U.S.'s Dodd-Frank Act of 2010 restricted the ability of the Federal Reserve to exercise its discretionary authority as a lender of last resort (LOLR) in future crises

To examine the policy that was successfully deployed in 1890 to prevent the failure of Baring Brothers from creating a panic, Dr. White poses ten questions: (1) Was Barings a threat to the financial system? (2) Why did the bank of England not have early warning? (3) How was policy formulated? (4) Was Barings a liquidity problem or a solvency problem? (5) Is there proof of an incipient panic? (6) Where did the Bank of England learn of the idea of a discretionary rescue? (7) Why did the bank of England not rescue Barings by itself? (8) How did the Bank of England liquidate Barings in an orderly way? (9) How did the Bank of England mitigate moral hazard? (10) What was the effect on the economy?

Barings was indeed a threat to the financial system. Barings was a giant bank which had 51 percent of the market share of trade acceptances; it aimed to become a key player in the market for sovereign debt. To do this it had to borrow money from other banks to hold sovereign debt while it was distributed to the public. Thus, if Barings collapsed it would bring down other financial institutions because it was highly interconnected. The Bank of England did not want another recession like the one that followed the failure of a big bank in 1866, so it arranged a swap of bonds for gold with the Banque de France and the Russian government to provide liquidity in case of a run on the banks. In addition, other banks were organized to create a syndicate to help cover any loss from the acquisition of Barings' "toxic assets," the Argentinian debt that Barings was trying to sell. The Bank of England and the Treasury split Barings into two, one part was taken on to the balance sheet of the Bank. It held the toxic assets, that were to be sold off slowly to minimize any loss. The other part of Barings was recapitalized to continue with its still profitable trade acceptance business.

Previously, the Bank of England's successful management of an incipient panic was been overlooked because the Bank had claimed that Barings was only illiquid not insolvent and subsequent literature did not challenge this assertion. However, Barings only appeared to be solvent because the Bank of England auditors assessed the assets at face value. Exploring the Bank's archives, Dr. White found that Bank of England's calculations showed that Barings was insolvent because of its holdings of Argentinian sovereign debt. The losses to the Bank were hidden because they were primarily covered by assessments against the Baring's personal wealth. Dr. White viewed this action as attempt to mitigate any moral hazard, arising from the rescue of Barings.

Where did the Bank of England learn about how to successfully rescue a large bank? Eight months before the Barings crisis, the second largest bank in France failed. Having experienced a disastrous financial crisis in 1881-1882 followed by a long and deep recession, the Banque de France and the Ministry of Finance did not strictly follow a Bagehot-rule and created an innovative rescue package take over the bank and split it into a good bank and a bad bank that the Banque de France would slowly liquidate. No recession ensued. The most persuasive voice that induced the Bank of England to follow this example was that of the Rothschilds. Letters between the Rothschild cousins in Paris and London show a push by the Rothschilds to get the Bank of England to adopt the French policy.

While the successful containment of the failure of Baring Brothers has some lessons for the twenty-first century, Dr. White pointed out some limitations. Perhaps most importantly, failures occurred in the nineteenth century because there were idiosyncratic incentives to take risk. Poor governance or fraud might cause one or a few important institutions to fail, from which the damage might be limited with a major effort. However, beginning in the mid-twentieth century, systemic incentives to take risk began to cover whole financial systems, including deposit insurance and the Too-Big-To-Fail doctrine. Now, as in 2008, a central bank may face the failure of most of its large institutions, which it does not have the resources to save, requiring cooperation and assistance from the Treasury. Furthermore, the systemic incentives to take risk strongly encourage moral hazard. However, the penalties against fraud and excessive risk taking appear to have declined over time, limiting the ability of the authorities to punish bankers.