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Banking crises in the late 19th century in France and Germany: lessons for today

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Bruegel Economic Policy Seminar

On the 9th of June 2011, Bruegel hosted an Economic Policy Seminar chaired by Guntram Wolff (BRUEGEL) about the banking crises experienced by Germany and France during the of 19th century and the lessons to be drawn for the present. Speakers were Carsten Burhop (University of Cologne and Max Planck Institute), Pierre-Cyrille Hautcoeur (Paris School of Economics) and Marie Donnay from the European Commission (who was speaking under Chantham House rules).

First to speak, Mr. Burhop presented the German financial crisis of 1873, highlighting its causes and consequences and pointing out some aspects that might be relevant for today. The crisis of 1873 came after an upswing phase during which the German economy underwent a massive wave of deregulation in the stock market. In the early 1870s incorporation rules were relaxed and the 2 years before the crisis saw the establishment of 800 new joint stock companies and 400 IPOs. A similar wave of IPOs was unprecedented and not seen again in Germany until the late 1990s. French indemnity payments allowed the German government to pay back almost entirely its debt and the years before the crisis were characterised by a shortage of risk-free assets, so that investors rearranged their portfolio buying shares of the new joint stock companies. The early 1870s also saw a boom in financial intermediation with the establishment of 140 new joint stock banks (among which Deutsche Bank and Commerzbank) whose main business was allocating to investors the shares of new companies. On top of new financial products and new financial intermediaries, the newly established German Empire set up a new monetary system (in place until 1875) in which the Central Bank of each German State was allowed to print money. The abundance of liquidity was increased by the mismanaged shift from Silver to Gold Standard (in 1871): Germany started coining new gold coins without withdrawing the old silver ones that remained in circulation. Adding also the paper printed by the central banks, the overall monetary supply increased by about 45% between 1871 and 1873. Mr. Burhop stressed that the emergence of new financial products and new intermediary vehicles combined to a huge amount of liquidity available to the financial markets is a feature that the German crisis and the recent financial crisis have in common. When the stock market suddenly turned down – due to the emergence of frauds – the repercussions on the financial system were amplified by the fact that Germany had mark-to-market accounting rules. Total losses in banks account were about 20% of total banks assets until 1878, the Return On Equity of banks dropped from 12% to 1.5% and 71 banks went bankrupt between 1873 and 1878. In response to the crisis the German government adopted both a bank and a corporate law reform. The New Joint Stock Companies Act (1884) was intended to address the huge problem of asymmetric information between investors and newly established companies, induced by the very weak level of corporate governance. From 1884 investors received an incorporation report specifying relevant information about the company (e.g. detailed asset valuation and use of money raised), all shareholders were awarded the right to attend the annual meeting and to vote (previously limited to investors with shares larger than 10%), new accounting rules were introduced and the mark-to-market was replaced by strict lower value principle. The speaker pointed out that the asymmetric information problem might have been less disruptive, had the financial intermediaries selling companies' stocks been trustworthy. Unfortunately, dealers were newly established banks – with no reputational capital yet – that had invested themselves a large fraction of their assets into shares (28% of total assets in 1872). This second problem was addressed by the Bank Reform Act that centralised money supply and established more transparency for bank issue: It imposed the weekly publication of Central Bank's balance sheet, it allowed the Imperial Account Office to check the account of the

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Central Bank and it imposed a tax on banknotes issuance. Remarking that many big German banks operating today survived the hard financial crisis of 1873, Mr. Burhop concluded with a (to some extent) provocative question: are banks today too big to fail or also too big to save?

Pierre-Cyrille Hautcoeur presented two very different French crises, in order to highlight what Banque de France gained in terms of crisis-resolution experience during these episodes. In particular, Hautcoeur stressed that the French Central Bank acted to some extent in an "unconventional" way (compared to the benchmark for that time, i.e. Bank of England) by intervening in stock exchange prices, involving the financial sector in the rescue operations and imposing harsh sanctions on the people found responsible. The first episode occurred in 1882, and involved both a large banking crisis and a stock exchange bubble burst (with bankruptcy of the stock exchange itself) that had severe and long-lasting consequences on real activity. The crisis was similar to the German one in its set up: France had experienced a decade of low interest rates and high investment, during which the financial sector developed considerably with the creation of many investment banks and new companies. The bank crisis was triggered by the bankruptcy of one leading investment bank – Union Générale – whose accumulated risky positions became completely illiquid when the stock market crashed. The characteristic feature of 1882 crisis was the role played by the French stock market, which was at the same time very risky (due to the importance of derivative products) and very fragile (as the law was giving no legal status to forward contracts). As more banks that had provided substantial credit to the forward market started to suffer from their illiquid exposures, the entire stock exchange went on the edge of collapse. Banque de France decided not to bail-out Union Générale but provided instead liquidity to other banks that were considered solvent but likely to be affected by panic. Moreover, the Central Bank engaged in the rescue of the stock exchange itself, although not in its entirety (the Lyon stock exchange was denied credit whereas in Paris loans were given to a small group of banks). The second crisis (1889) is very different in terms of background context, evolution and consequences. It developed at the end of a stagnation decade –no bubble in the stock market – and the crisis concerned only one major bank (important but isolated) with limited repercussions on the stock market and the real economy. The bank concerned was Comptoir d'Escompte, which took sensible risk by providing funds and guarantees to a speculative operation of cornering on the copper market. When the copper price felt (due to a combination of higher supply and lower demand) Société des Metaux (the company organising the scheme) failed, the head of Comptoir d'Escompte committed suicide and there was a deposit run to Comptoir agencies that was halted only by a 100 millions emergency loan from Banque de France. The decision to rescue Comptoir proved to be a difficult one and the discussions revealed the existence of sensible conflict of interest within the board of Banque the France (6-7 out of the 15 bankers member of the board had relevant interests in the copper scheme). The solution of the 1889 crisis is peculiar because of the extent of private involvement: Banque de France imposed the financial sector to participate substantially to the rescue, all banks involved in the scheme were taxed substantially and harsh sanctions were imposed on people held responsible.

Silvia Merler