Study Questions—Bagehot

1) Explain Bagehot's account of the business cycle. Why do periods of depression lead to periods of prosperity? Why do periods of prosperity lead to periods of depression? What is the role of Lombard Street in this process?

2) Bagehot talks about two states of the world with a banking system: times of good credit and times of bad credit. According to Bagehot, why does credit cause booms and depressions? What happens to credit in the expansion and in the contraction? Why is credit liable to change in this way? (cf. “The peculiar essence of our banking system is an unprecedented trust between man and man: and when that trust is much weakened by hidden causes, a small accident may greatly hurt it, and a great accident for a moment may almost destroy it.”)

3) What do “bill-brokers” do? In our modern terminology of brokers and dealers, are “bill-brokers” as Bagehot describes them brokers or dealers? What is the main difference between the bill-broker of Bagehot's day and the bill broker in the traditional sense of the word (described in Mr. Richardson's report to the Bullion Committee in 1810)?

4) What happens when a firm “discounts” a bill at a bank? What happens when a bank “accepts” a bill? Explain using balance sheets. That is, use balance sheets to illustrate the following operations:
i). A firm discounts a bill at a bank.
ii). A bank accepts a bill.

5) Why do bill-brokers lend out most of their money, rather than keeping reserves? How do bill-brokers add instability to the financial system? What would the balance sheets of bill-brokers and banks look like under Bagehot's “natural state of banking”? What do they look like under the actual system? How does this difference make the economy more vulnerable in times of crisis?