THE FAILURE OF THE FIRST ROMANIAN CENTRAL BANK: BAD DESIGN, BAD LUCK, OR BOTH?

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Abstract: *In this paper we will analyze the failure of the National Bank of Moldavia, a bank that was chartered by the Principality of Moldavia in 1856, to act primarily as a privileged source of liquidity for its economy. Although the project of a state chartered, privileged bank was planned many years in advance by the princes of the Romanian Principalities, the National Bank of Moldavia suspended payments shortly after its establishment, in early 1858, and had its charter revoked. We will discuss, from the point of view of modern monetary thought, the ideas that were advanced in the justification of its creation, and in the rationalization of is failure. We will analyze the structure of the credits and other problems in its balance sheet. Also, we will study the role that the Crisis of 1857, and the already emerging European economic integration, had in its demise.*

Keywords: central banking; international relations; government policy; crisis
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Introduction

The National Bank of Moldavia was a first attempt at central banking the in the emerging Romanian State. It was a resounding and scandalous failure that was analyzed back in its time and by later scholars. We are going to point out in this article that, besides being marred by political problems, it was badly designed and it had the worst timing possible.

In the first section, we are going to describe and discuss the official motives that were advanced for its establishment. In the second section, we present and analyze key elements of the statute of the bank. In the third section, we depict the operation of the bank. In the fourth section we mention the world-wide crisis as a source of bad luck for the bank.

1. Rationale for establishment of the bank

Since the relative liberalization of economic and political life in the Romanian Principalities through the Adrianople Treaty of 1829, there were periodical projects and petitions for the establishment of a state chartered bank in both Moldavia and Wallachia. We can see such initiatives in 1832, 1834, 1838, 1845, 1847, 1848, and 1851 from foreign investors and local elite members (Romascanu, 1932; Baicoianu, 1932; Murariu, 2010).

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Since 1850, the German businessmen and bankers Nulandt and Oeschlager started discussions about the idea of a national bank with both Prince Barbu Stirbey of Wallachia and with Prince Grigore Alexandru Ghica of Moldavia. For various political reasons (Smirna and Topan, 2015), their attempts and negotiations did not succeed until 1856, and then they received only a charter from the government of Prince Ghica of Moldavia.

From the charter and from the previous projects for the bank we can see the rationale for its establishment (Romascanu, 1932). The principal official reason for the establishment of the bank is the elimination of the ruining effect of high market interest rates that were four and even eight times greater than in the West.

According to Craciun (1996), the interest rates asked on the unofficial market by private money-changers, lenders and proto-bankers (*zarafi*), were as high as 24% and even 30%, while the official interest rate was regulated at 8% to 12%. The reason of this high level was the uncertainty of property rights and the whimsical results of litigations. It was argued that the high level of uncertainty existent on the market was adding a considerably high component to the "true" interest rates. We can understand how these institutional factors were boosting the entrepreneurial premium of the market interest rate (Mises, 1998, p. 536). This fundamental fact was acknowledged and discussed at the time by the initiators of the bank.

It was considered at the time that the remedy of this situation should come from the state, through an official bank endowed with a monopoly of note issue. By such a bank, the supply of money and credit could increase and the level of interest rates could be brought down. This extra capital could spur industrial activities and it could help with the development of agriculture and commerce. It would increase the local incomes and it would save the wealth of the indebted locals by aiding them in repaying the loans taken from usurers. Also, it could help the government with affordable financing.

While we can understand the local interest in such a source of cheap capital, we have to give an answer as to what was the motivation of foreign investors which were interested and were petitioning for its establishment. Again, we can find the answers in the argumentation included in the various bank plans that were discussed up to its chartering.

The reasons for the prospective investors to get involved was the high interest that the bank promised to pay on their capital, an interest even higher that the present conditions offered. This paradoxical situation, in which the bank would charge interest rates lower than in the present, but would offer its investors benefits higher that those justified by present loan market conditions, was explained by the power to issue money substitutes in excess of the commodity money existent in the vaults of the bank. Thus, by the doubling of the “capital” invested, the creditors could be rewarded with an interest of 16% or even 20%, although the bank would only charge 8% or 10% on its loans (Romascanu, 1932, p. 51).

2. The bank’s statute

We are going to present here what we consider to be the economically relevant stipulations from the 28 articles of the bank statute that was approved by the government in May 7, 1856 (Romascanu, 1932, p. 65-69; Baicoianu, 1932, p. 81-85).

According to the statute, the bank’s initial capital was 10,000,000 Prussian thalers. After two years, the bank’s issue of paper substitutes could increase to 20,000,000 thalers. The bank substitutes would be covered 1/3 in metallic reserves and the rest up to 100% in short term (up to three months) financial instruments (art. 4).

A special provision stipulated that the value of the lowest-denominated paper money 40 zwanzigers (*scoroveti*) should never exceed 1/7 of total initial capital. This stipulation reflected the idea, held by economists popular at the time, such as Coquelin (1834), that low denomination paper money substitutes were more easily demanded and circulated by the large masses and were thus more prone to be used for poorly judged investments (art. 5).

The bank had to redeem its money substitutes in specie, on demand (art. 6). It was authorized to make a virtually unlimited spectrum of banking operations, covering both what we now consider commercial banking and investment banking (art. 9). Moreover, the bank could act as a tax farmer (art. 10), and pawn broker (art. 11). The bank was legally mandated to use 3,350,000 thalers of its capital for mortgages at an annuity of 10%, for 17 years. Other details related to the mortgaging activity were stipulated (art. 14-20). The interest that the bank could ever ask was capped at 8% and, if its annual profits exceed 10%, the interest should descend below 7%. For the governmental loans that bank could not use more than 375,000 thalers at an interest higher than 6% (art. 24). The bank was allowed to open a branch in Galati and, upon government approval, in other locations (art 25). The charter was valid for 25 years, to be automatically extended by 10 years, every 2 years prior to the expiration of the term (art. 26).

3. The short life of the bank

After the authorization of the bank, the capital of 10,000,000 thalers was quickly subscribed, mainly by foreign investors: 48,000 stock titles of 200 thalers each were allocated for foreign investors and only 2,000 for local investors. In July-August 1856, the directors and clerks of the bank were brought from Germany. It is in this incipient phase that the bank is affected by the first of its problems.

In August 1856, Prince Ghica is replaced by Caimacam Teodorita Bals, a personal political enemy of the prince and ally of the Austrians. He suspended the bank's activity in August 1856 and thus dealt a blow to the bank stock that traded at 120% of initial value on foreign stock exchanges. A struggle for the resumption of activity ensued and it ended only with the sudden death of Bals, who was replaced by Conachi Vogoride. The latter reauthorized the activity of the bank on March 9, 1857. However, in the meantime, other important source of troubles for the bank hit: the crisis of 1857 that we will discuss below.

Nulandt coordinated the bank and its branches from Dessau. His other financial firm, Credit-Anstalt Dessau, a type of mutual fund, subscribed 4,000,000 thalers of the National Bank of Moldavia, and only paid 1,000,000. The National Bank of Moldavia quickly opened one branch in Galati, and franchised one in Bucharest to the Prussian General Counsul Meusebach.

Nulandt also made convoluted financial schemes in order to fund the bank. He created ex nihilo 5,000 plenary stock titles that he discounted with different other financial institutions. With the funds he then paid the drafts drawn by the bank on fictitious firms. The directors then bought 5,000 partial (10%) shares and converted them in plenary shares, proceeding in the same manner as with the former batch of shares (Romascanu, 1932, p. 77). At the second and third terms for the payment of capital, only a fraction of the payments were made and the direction in Dessau approved the payment to be made in previously paid stock, thus lowering the initial capital endowment of the bank.

A significant amount of the liquidity of the bank, for which it was liable within 8 days from demand for redemption, was loaned long term. We can see that the bank did what is today known as maturity mismatching. 2,000,000 thalers were offered by the bank as mortgaged loans immediately after beginning operations.

The local investors and the government have helped the liquidity of the bank by making deposits. The locals made deposits to the sum of 160,000 ducats. The government entrusted the bank with the keeping and investment of 120,000 ducats from funds of the orphans and of defendants that were held by different judiciary entities in the country, and also 100,000 ducats of other public funds.

However, these deposits were not very effective for the general solvency of the bank, that had at this time a failed attempt made by the direction to raise funds on the London financial market (Romascanu, 1932, p. 82).

After one local member of the direction has made his concerns about its situation public, a run on the bank has started. On March 11, 1858, the direction resigned and the bank suspended payments. In June 14, 1858, the charter was officially withdrawn and the bankruptcy was declared, until November 6, 1858, when the bank was again allowed to function, this time only as a common financial institution, with the goal of avoiding liquidation.

The unprofessional conduct of the directors was accused at the time. The bank had bought advance rights on tax farming at prices that made the competitors withdraw. There is a significant episode related to the Galati branch, whose director I. Hamburger has offered a Jewish businessman from Bucharest a credit of 25,000 ducats for tax farming in Bagdad province. Spit Goldberg disappeared with the money and, when found later in Constantinople, he claimed that he lost the money when he bought camels for the English Army in India and, because the counterpart did not fulfill the contract, he was later forced to free them in the desert because he went out of fodder.

The Iasi branch was accused of offering loans on political considerations to a few privileged, instead of financing the masses, as avowed. Many members of the political elite can be found as beneficiaries in the books of the bank (table 1) and many of them were notorious for their insolvency and did not fulfil the conditions for being granted the loans.

It is significant to see who the beneficiaries of the mortgages were. The following list reveals the low granularity of the structure of mortgages and that the beneficiaries were as a rule members of the political elite. The nominal sum total of the mortgages in 1858 was 633,776 ducats (*galbeni*).

Table 1 – Structure of mortgages offered by the National Bank of Moldavia

Mortgages	Ducats	Mortgages	Ducats
A. C. Sturdza	60,000	G. Ghica	8,000
Rucs Rosnoveanu	49,000	M. Arghiropol	7,500
B. Sturdza	38,000	G. Dimitriu	6,500
A. Aslan	34,000	A. Romalo	6,000
C. Costachi	31,800	M. Negri	5,700
G. Rosnovanu	27,000	Ev. Caligari	5,500
G. Ghica	25,000	G. Cilibiu	3,500
Cat. Ghica	25,000	I. Cantacuzino	4,000
A. Ghica	25,000	D. Dascalescu	3,500
Anus	25,000	A. Cuza	3,500
St. Dascalescu	20,000	C. Stamatin	3,500
A. Florescu	20,000	G. Clopotel	2,769

G. Giurgea	20,000	I. Sacheti	2,500
G. Sturdza	20,000	H. Seltin	2,000
A. C. Catargiu	18,000	C. Bonciu	1,527
P. Docan	17,000	G. Dimitriu	1,500
P. Mavrogheni	16,000	A. Cuza	1,500
C. Dascalescu	15,000	M. Kogalniceanu	1,000
C. Anus	14,000	C. Bonciu	750
M. Jora	12,900	G. Glaise	700
M. Negri	10,300	P. Petit	600
N. A. Mavrocordat	10,200	A. Ber	300
C. Cotebue	9,000	D. Purgia	200
A. Crupensky	9,000	E. Corlateanu	200
E. Plitos	8,180	L. Helenbold	150

Source: The report made for the shareholders assembly by the administrative committee (Romascanu, 1932, p. 90-95, Baicoianu, 1932, p. 140-151). Conversion rates: 1 Ducat = 31 Lei = ~3 Thalers; 1 Leu = 40 Parale.

We can see from the balance of the bank in 1858 that the long term investments in mortgages were much higher than intended by statute. While the mortgages were indeed nominally within the statutory limits, because the capital of the bank was in fact almost three times less than initially projected, the weight of the long term credits was consequently larger. Instead of a third of the capital being used for mortgages, more than a half of it was used in this manner (table 2).

Also, the NBM offered 40,000 ducats loans to the government that were not repaid at the six months maturities, but were cleared later with the funds that the bank received as deposits from the state.

Table 2 – The Balance of the Bank at December 23, 1858

Assets				**Liabilities**			
Accounts	Ducats	*Lei*	*Parale*	Accounts	Ducats	*Lei*	*Parale*
Motgages	626,916	9	-	Shares	513,570	10	-
Investments	25,152	29	30	State deposits	47,927	20	-
Effects	44,065	25	-	Creditors in country	11,095	-	-
Cash, different money	1,136	16	2	Creditors abroad	555,431	17	25
Bank headquarters furniture	12,000	-	-	Preferential Creditors	7,422	9	-
Government: 2 loans	40,000	-	-				
Debtors in country	63,325	33	27				
Debtors abroad	151,581	16	9				

Lombard-conto	5,926	26	10				
Losses	165,338	11	27				
TOTAL	1,135,446	19	25	TOTAL	1,135,446	19	25

Source: The report made for the shareholders assembly by the administrative committee (Romascanu, 1932, p. 90-95, Baicoianu, 1932, p. 140-151). Conversion rates: 1 Ducat = 31 Lei = ~3 Thalers; 1 Leu = 40 Parale.

4. The crisis of 1857

In mid-XIX century, international trade was growing at an accelerated pace and the world was increasingly integrated. According to Evans (1859), English exports more than doubled from £60,110,110 in 1848, to £122,155,000 in 1857. The increase in trade was accompanied by an increase in monetary influx and in credit expansion: “The deposits in the joint-stock banks of London, alone, which in 1847 amounted to £8,850,774, had risen in 1857 to £43,100,724, and the increase in other quarters was proportional.” (Evans, 1859, p. 32)

This exponential growth was also being echoed in the economy of the Romanian Principalities (Hitchins, 1992). But is has temporarily changed into sudden collapse and contagion in 1857. J.R.T. Hughes cites Tugan Baranowsky and others in order to state that

> The crisis of 1857 [was] the first world-wide commercial crisis in the history of modern capitalism […] Within weeks of the initial American crisis which culminated in New York in October 1857, the major industrial and commercial centres of the world were paralysed. By 12 October 62 of New York City's 63 commercial banks had suspended payments. A month later, after a series of bank and mercantile failures, demands on the Bank of England for assistance so reduced the Bank's reserve of notes that the government was obliged to intervene and the Bank Act of 1844 was suspended for the second time since its enactment. On the Paris Bourse the British Government's action detonated a financial panic which was likened to the days immediately following the 1848 revolution, and other Continental centres were shaken from Vienna to Stockholm. Within eight days of the British Government's action, banks and commercial houses in Northern Europe (mainly centred in the old Hanse trading area) were closing their doors, and State intervention was required in all the major money capitals of Northern Europe to keep financial and trading channels open. Thus, in the period from 12 October to the middle of December 1857, the crisis spread over half the world and finance, trade, and industry floundered in depression. (Hughes, 1956, 194-195)

The crisis and contagion have continued word-wide until February-March 1858, with business and growth resuming after the period. It is remarkable that the life of the National Bank of Moldavia has almost exactly coincided with the development of the world crisis of 1857. It seems clear that, besides the more fundamental political and structural problems, the activity of the bank was adversely affected by the crisis. We can understand that the problems at the Dessau bank of Nulandt and the scarcity of credit in London – then as today a leading financial center – made it impossible for the subsequent tranches of the subscribed capital to be paid.

Conclusion

We can say that the bank had design and operational flaws. We can see that the commentators at the time made the claim that the scope of the bank offered in the statute was too large. We can find in this discussion the same arguments that we encounter today in the literature that accuses deregulation as the source of the 2008 crisis (FSB, 2013). We hold that it was not so much the deregulation that was the cause of its demise, as was the wrong institutional incentives and design of the bank.

While the bank did not have the time to issue its own banknotes, thus making the fractional reserve principle work through the issue of fiduciary media, it did take deposits on demand and acted as if the double availability of funds was effective, using those demand deposits for long term loans (Mises, 1980).

Some contemporary commentators accused the bank of lacking "national" character because the bank was initially designed to be 96% funded by foreign capital and only 4% by local capital. We assert that for a growing economy, and especially an underdeveloped economy like Moldavia was, influx of capital is essential. The raw resources and the human resources need a multitude of intermediate goods in order to start and complete the complex processes of production that are possible in more developed economies. These intermediate goods can be produced gradually by local saving, but this process takes a much longer time that the available alternative. Foreign investors that are looking abroad for increased profitability have an interest to invest just as much as local owners of primary resources are interested in the inputs necessary for new and improved production (Rothbard, 2004).

Therefore, the problem of the National Bank of Moldavia was not the foreign character of the injected capital, but that it was fictitious. The financial schemes of Nulandt were not a novelty, but were rather the rule for the speculation frenzy that led up to the climax of the word-wide business cycle in 1857.

We can conclude by saying that the National Bank of Moldavia was another instantiation of the basic flaw of institutional development of modern Romania: the importation of “forms without substances” (Maiorescu, 1868). In this case, the principle is indeed very clearly apparent: the bank was ultimately a phantom without a body, a form without funding, a failed attempt to create growth with formal capital that lacked its essence: real savings.

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