

# Souza Franco and Banks of Issue as Engines of Growth\*

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## Abstract

*Brazil experienced three moments of exuberance and extreme optimism during the nineteenth century: Independence, Abolition of the Slave Trade, and Abolition. At each of these moments, contemporaries felt that a major obstacle to progress had been removed and that the country would finally be able to capitalize on its enormous potential. Around each event, politically active individuals, including professionals, merchants, and civil and military officials, sought to emulate the institutions of the more “advanced” economies now that this obstacle – political dependence, the inhuman and expensive slave trade, and slavery itself – would no longer interfere with progress. This article deals with the period of the abolition of the slave trade and a visionary politician, Bernardo de Souza Franco (1812-1875), who strove to utilize banking reform as an engine of growth.*

*Brazil's first privately-controlled Banks arose in various provinces during the 1840s and early 1850s. In 1853, the Conservative ministry in power forced the merger of the two privately-controlled banks headquartered in the capital and soon after absorbed all the provincial banks into this government-controlled Banco do Brasil. Souza Franco, as minister of finance in 1857-'58, granted licenses to six new privately-controlled institutions to establish themselves as banks of issue and competitors of the Banco do Brasil. Although Conservatives subsequently curtailed issue privileges, several of these banks had distinguished careers, one of which still exists today. In addition to bank reform, Minister Souza Franco played a fundamental role in the foundation of Brazil's four major railroads and advocated gradual abolition, European immigration, provincial autonomy, limited liability, industrial protection, and enhanced education.*

## Resumo

*O Brasil experimentou três momentos de exuberância e otimismo extremo durante o século XIX: Independência, Abolição do Comércio de Escravos e Abolição. Em cada um desses momentos, os contemporâneos sentiram que um dos principais obstáculos ao progresso havia sido removido e que o país finalmente seria capaz de capitalizar sobre suas enormes potencialidades. Em torno de cada evento, os indivíduos politicamente ativos, incluindo profissionais, comerciantes e autoridades civis e militares, procuraram imitar as instituições das economias mais “avançadas”, agora que este obstáculo - a dependência política, o comércio de escravos desumano e caro, e a própria escravidão - já não interferiam com o progresso. Este artigo trata do período da abolição do tráfico de escravos e de um político visionário, Bernardo de Souza Franco (1812-1875), que tentou utilizar a reforma do sistema bancário como um motor de crescimento.*

*Os primeiros bancos controlados por particulares do Brasil surgiram em várias províncias, durante a década de 1840 e início de 1850. Em 1853, o ministério conservador no poder forçou a fusão dos dois bancos controlados por particulares com sede na capital. Logo depois, esse Banco controlado pelo Governo do Brasil absorveu todos os bancos provinciais. Souza Franco, como ministro das Finanças em 1857-58, concedeu licenças para seis novas instituições controladas por particulares para se estabelecerem como bancos de emissão e concorrentes do Banco do Brasil. Embora os conservadores posteriormente reduziram o volume das emissões, vários destes bancos tiveram distinguidas carreiras, um dos quais ainda existe hoje em dia. Além da reforma dos bancos, o ministro Souza Franco desempenhou um papel fundamental na fundação de quatro grandes ferrovias no Brasil e defendeu a abolição gradual, a imigração europeia, a autonomia provincial, sociedades anônimas de responsabilidade limitada, a proteção industrial e a educação aprimorada.*

**B**razil experienced three moments of exuberance and extreme optimism during the nineteenth century: Independence, Abolition of the Slave Trade, and Abolition. At each of these moments, contemporaries felt that a major obstacle to progress had been removed and that the country would finally be able to capitalize on its enormous potential. Around each event, politically active individuals, including professionals, merchants, and civil and military officials, sought to emulate the institutions of the more “advanced” economies now that this obstacle – political dependence, the inhuman and expensive slave trade, and slavery itself – would no longer interfere with progress<sup>1</sup>. This article deals with the period of the abolition of the slave trade and a visionary politician, Bernardo de Souza Franco (1812-1875), who strove to utilize banking reform as an engine of growth.

Everything in Souza Franco’s world related to slavery. In terms of finance, slaves were simultaneously the “commodity” in greatest need of credit and the most popular form of collateral. The elite’s devotion to slavery made it impossible for a mainstream politician to advocate immediate abolition prior to 1880. Within this context, Souza Franco belonged to a small though significant group of prominent statesmen who favored abolition within one generation accompanied by measures to stimulate European immigration. During his entire career, he strongly advocated broader autonomy for the provinces, including a larger apportionment of local tax collections as well as the founding of banks headquartered in the provinces. He also supported legislation to introduce limited liability for corporations, wider, if still limited, protection for industry, and enhanced, if modest,

investments in education.<sup>2</sup> Souza Franco led the movement to establish Brazil’s first railroads. All of these objectives, including even railroad construction, met with fierce opposition from the more reactionary political and social groups, notably the “Saquarema” coffee planters of the province of Rio de Janeiro.<sup>3</sup>

The son of a successful merchant of Belem in the province of Pará, Souza Franco graduated from the law school of Olinda and entered the Chamber of Deputies in 1838 at a time when his home province was in the midst of a civil war. While he entered the Chamber as a Conservative, he switched to the Liberals under a Conservative ministry in 1842. Souza Franco governed his home province of Pará in 1840 as a Conservative and that of Alagoas in 1844 already as a Liberal. A number of leading politicians changed parties at this time in both directions. Precisely in 1848, he emerged as a national political figure, becoming foreign minister and acting finance minister in the government presided over by Francisco de Paula Souza e Mello. That year he published “*Os Bancos do Brasil*” in which he analyzed the existing Brazilian banks while suggesting that the Empire adapt the New York banking law of 1838 to the reality of Brazil. (SOUZA FRANCO, 1848) When the Saquaremas, ironically with the marquess of Olinda, Souza Franco’s future colleague and supporter, as prime minister, replaced the Liberals in September of that year, Souza Franco became the principal voice of the opposition in the Chamber of Deputies. He served continuously

<sup>2</sup> Education and the protection of industry did not consume as much of Souza Franco’s energies as did banks of issue or railroads. For a position on education, see *Anais da Câmara*, August 21, 1846 and on protection, see *Anais da Câmara* of June 30 of the same year.

<sup>3</sup> From 1848 to 1862, from 1868 to 1878, and again from 1885 to 1889, the governments were Conservative with the exception of the Olinda-Souza Franco cabinet of 1857-’58. The Saquaremas may be considered as ultra-Conservatives, and they ruled from 1848 to 1853. Their leader, the viscount of Itaboraí, also held power from 1868 to 1870 but without his most important colleagues of the earlier period. For a history of the Saquaremas, see Needel (2000).

<sup>1</sup> In previous studies, the author has discussed the optimism surrounding the abolition of the slave trade and the final abolition of slavery. See: SCHULZ. 1994, 2008 and 2013.

in this body from 1838 until his election to the Senate in 1855 with the exception of 1853-'54 when the Conservatives managed to have him excluded. Under the Empire, Senator was a lifetime office. From 1857 to 1858, he occupied the finance ministry in another of the marquess of Olinda's cabinets. The following year, the emperor appointed Souza Franco to the Council of State, also with life tenure. The 12 Councilors of State opined over all legislation as well as government initiatives and were considered to be the most powerful politicians of the country. Literally, until the month he died, May 1875, Souza Franco remained an active participant of both the Council of State and of the Senate, often serving as one of the three Councilors on its finance section and as one of three members of the Senate Finance Committee. Both in terms of offices held and in respect to his progressive stance, Souza Franco was regarded as the leading Liberal voice on finance of his time.

Dom Pedro created Souza Franco a viscount and allowed him to use his own name, a signal honor. The viscount of Souza Franco was a close friend of the viscount of Mauá, Brazil's foremost banker and entrepreneur of the nineteenth century. Although both men resided in Rio de Janeiro, they identified with the provincial elites against the centralizing Saquaremas. Mauá represented his home province of Rio Grande do Sul in the Chamber of Deputies from 1857 to 1875 and never lost sight of its interests. He had bank branches and other businesses both in Rio Grande and in São Paulo. Souza Franco, for his part, encouraged the organization of banks in the major provinces including Pará. Both men led the original burst of railroad building in Brazil. Mauá built the railroad which gave him his title, the Mauá-Petrópolis, and financed a major portion of the São Paulo Railway. As minister, Souza Franco played a prominent role

in the financing of the Dom Pedro II Railway between São Paulo and Rio, issuing Brazil's first international railway loan on behalf of this endeavor. He also participated in the financing of the São Paulo Railway as well as the lines from Salvador and Recife to their sugar-producing hinterlands. Mauá organized companies for municipal utilities, the transatlantic cable, and naval construction, among others. Souza Franco decreed corporate by-laws for banks that included limited liability and granted Mauá the right to organize his bank as a limited partnership (*Sociedade em Comandita*) in which only Mauá remained exposed to unlimited liability while his limited partners could not lose more than their original investments.

Although no member of the elite dared support immediate abolition until Joaquim Nabuco did so in 1880, a number of Councilors of State of the 1860s, including Nabuco's father José Thomaz Nabuco de Araújo, and Souza Franco wished to set a time, even if 20 years away, for final abolition.<sup>4</sup> Most of the individuals with whom Souza Franco and Mauá dealt politically or financially depended upon slavery for their livelihood. In this environment, trying to set a date for abolition marked the politician and the banker as members of a small progressive set. Partisans of gradual emancipation advocated European immigration as the means to provide planters with labor after abolition. As minister, Souza Franco aggressively subsidized immigration while Mauá took part in colonization enterprises. For colonization to succeed, provisions had to be made in the land law to give immigrants at least the hope that they could eventually come to own their farms. The Land Law of 1850, enacted by the Saquaremas, restricted the poor man's access to the land and initiated a struggle of over half a century to provide a more equitable legislation in

<sup>4</sup> Joaquim Nabuco emphasizes Souza Franco's leadership in the struggle for emancipation in his classic, *O Abolicionismo* (2003, 123).

favor of the immigrants.

Slaves constituted the principal security for mortgages obtained by masters both in Brazil and in the United States. Creditors considered planters' land an inferior guarantee in both countries. While in the United States (KILBOURNE, 2006, 127), it was relatively easy to foreclose a mortgage either on slaves or on land, Brazilian institutions favored the debtor to such a degree that execution of a contract was almost impossible. In this respect, Souza Franco and Mauá sided with creditors, but all attempts at mortgage reform, prior to the twenty-first century, failed.

Souza Franco's major contribution to finance was his attempt to stimulate the economy through the issue of banknotes. Although accused of being inflationary (VIANA, 1926, 17, 27-29), he demonstrated ample concern for proper backing for the banknotes and abhorred irresponsible banking practices. In fact, one of the main points of this paper is that Souza Franco's policies as minister resulted in less monetary expansion than that of his principal opponent, the Saquarema viscount of Itaboraí.

To conduct an analysis of Souza Franco's thoughts and actions, we must first introduce a brief history of banknotes up to 1848, the year of his book, "*Os Bancos do Brasil*". The story of banknotes begins in the seventeenth century with two different types of institutions, the Bank of England and the British private banks. The Bank of England received its original charter in 1694 in return for a loan of £ 1.2 million to the government. This charter included the privilege of issuing banknotes up to the amount of the loan. As the Bank obtained interest both on the government loan and on the commercial advances made with the banknotes, it found itself earning interest twice, clearly a brilliant

proposition. Armed with this privilege, and with the government's custom, the Bank of England prospered through a number of charter extensions (CLAPHAM, 1945, 183). In 1844, a new Bank Charter Act gave the Bank the privilege of issuing £ 14 million in banknotes backed by its existing portfolio of government bonds. Beyond this £ 14 million, any additional banknote must be backed 100% by gold in the Bank's vaults. All other banks were prohibited from issuing notes in excess of those already outstanding. Thus the Bank of England found itself with two types of security for its banknotes – bonds and gold. Brazilian politicians considered the Bank Charter Act to be an extremely important piece of legislation and would, on various occasions, try to imitate it.

Private banks in England and Scotland had also begun to issue banknotes during the second half of the seventeenth century. Bankers advanced the banknotes to merchants upon the security of bills of exchange which arose from the sale of merchandise. Like the Bank of England, the private banks had to redeem their banknotes, when presented, in gold or be declared insolvent. Unlike the Bank of England, the private bankers only earned interest once on their banknotes. If the Bank of England would have become insolvent, creditors holding its banknotes would have received the proceeds of the sales of the government bonds. If a private bank went bankrupt, holders of banknotes would have to collect the bills of exchange, a much more difficult process (CLAPHAM, 1945, 167).<sup>5</sup>

Although well aware of the two British forms of banknotes, Souza Franco looked to an American model for Brazil. In 1838, the State of New York, already the United States' financial center, allowed banks to organize with the benefit of limited liability without requiring a specific

<sup>5</sup> For a general financial history, see Charles Kindleberger (1993).

act of the state legislature, as had previously been necessary. The New York act permitted banks to issue up to 100% of their capital secured by the state bonds held in portfolio. As in the case of the Bank of England, bankers found their resources earning interest twice, once on the state bonds and once on the commercial loans generated by the banknotes. Unlike the restriction of the Bank Charter Act, the New York banks could increase their issues beyond their current levels simply by raising new funds and purchasing state bonds with these additional resources (HAMMOND, 1957).

The British and American banks had another source of lendable funds besides recourse to banknotes: deposits. By this time, deposits had already surpassed banknotes as a source of funds in England as well as the eastern states of the United States (HAMMOND, 1957, 79-82). Souza Franco observed correctly that deposits in Brazil were less plentiful so banknotes would be essential to promoting growth in his country. His book, published in 1848, praised the New York model and wished to apply it to Brazil. In the book, Souza Franco told the story of Brazil's few small banks, one each in Rio de Janeiro, Salvador, Recife, São Luiz, and Belem. With the possible exception of the Banco Commercial do Rio de Janeiro, none of these institutions had a significant impact upon its local economy. None of these institutions enjoyed the privilege of note issue. Brazil's only experience with banknotes thus far had been with the Banco do Brasil from 1808 to 1829. Forced by Dom Pedro I to issue unbacked banknotes in order to finance his war in the Plate, this bank collapsed and had to be liquidated.

The year 1848 proved to be eventful both in Brazil and outside it. Europe witnessed a series of revolutions that year prompting Finance Minister Souza Franco to declare that Brazil

was safer than the old continent.<sup>6</sup> Following the overthrow of Louis Philippe in France, this country became the first great power to establish a monopoly of banks of issue forcing the departmental banks of issue to merge into the Banque de France (SMITH, 1990, 33). Private banks of issue continued all over the rest of Europe, as well as in Australia, Canada, and in the United States. During the same momentous year of 1848, gold appeared in California providing a monetary stimulus to the world economy while temporarily raising the value of silver relative to gold, as Souza Franco repeatedly reminded his fellow members of the Chamber of Deputies.<sup>7</sup> In Brazil, the Saquarema ministry, including Minister of Justice Eusebio de Queiroz, Foreign Minister Paulino de Souza (viscount of Uruguai), and Finance Minister Joaquim Jose Fernandes Torres (viscount of Itaboraí), assumed power replacing the Liberal ministry where Souza Franco held the foreign and finance portfolios. The rise of the Saquaremas provoked a major revolt, the Praieira in the province of Pernambuco, 1848-'49. After the defeat of the Praieira, central forces were never again challenged during the duration of the Empire. The year 1848 also saw the establishment of a Stock Exchange in the capital of the Empire.

Since the 1820s, successive British governments had pressured Brazil to abolish the slave trade, which the European monarchies and the United States had already eliminated (BETHELL, 1970). In 1845, the Royal Navy began to seize slavers wherever they could be found. Souza Franco claimed that the government in which he participated in 1848 tried to combat the trade,<sup>8</sup> but statistics reveal this administration had little success. As the leader of the opposition in the Chamber of Deputies, on July 1, 1850,

<sup>6</sup> *Anais da Câmara, August 30, 1848*

<sup>7</sup> *Anais da Câmara, July 8, 1851.*

<sup>8</sup> *Anais da Câmara, September 5, 1848 (as minister) and January 18, 1850 (as leader of the opposition).*

while the Saquaremas reluctantly made preparations to suppress the trade, Souza Franco proclaimed that the Liberals could neither be accused of favoring the continuation of the slave trade nor of demanding immediate abolition. Furthermore, he pledged the opposition's support for the government in case of war with Britain. At the same time, he could not resist the temptation to remind the Saquaremas that they had criticized his government for allowing Brazilian slavers to be taken on the high seas while the present ministry suffered empty slave ships to be appraised in the middle of Guanabara Bay.

In September of 1850, the Saquaremas terminated the international slave trade. Large sums of capital were immediately redirected from this business to other activities including the domestic slave trade, coffee plantations, coffee factoring, banking houses, and investment/speculation in real estate, foreign exchange (via international drafts and gold coins), bonds, and shares. By June 5 of the following year, Souza Franco was denouncing the speculation in the Chamber of Deputies. Other contemporaries rapidly understood the negative aspects of the investment frenzy that provoked a boom on the recently-established Rio de Janeiro Stock Exchange.<sup>9</sup>

The Saquaremas perceived that the abolition of the slave trade required accompanying reforms in order for the economy and the society to adjust to the new circumstances. The year 1850 saw a major reform of recruitment and advancement within the military (SCHULZ, 1994) as well the Empire's first general land law, in theory but not in practice, to encourage immigration, as well as the first commercial

code. Significantly, Irineu Evangelista de Sousa, whom we shall henceforth refer to as Mauá, and already Brazil's foremost entrepreneur, drafted this measure in cooperation with three prominent politicians (VIANA, 1926, 320-321).

The year after the abolition of the slave trade, Mauá established the second Banco do Brasil, a privately controlled institution with the right to issue banknotes (incorporated by Decree 801 of July 2, 1851 signed by the Saquarema Finance Minister viscount of Itaboraí, later Mauá's nemesis). At the bank's inauguration, Mauá expressed his desire to emulate the spirit of association prevalent in England and the United States (VIANA, 1926, 324-327). Following best international practices, he managed to have 80 percent of the subscribed capital paid in within the two years that he directed this bank. Furthermore, under his conservative administration, banknotes issued remained no higher than 25 percent of paid-in capital compared to 100 per cent in the United States (VIANA, 1926, 356-359). Two years later, in 1853, the government, in which Itaboraí continued as finance minister, obliged the two private banks in the capital, the Banco do Brasil and the Banco Commercial do Rio de Janeiro, to merge forming the so-called "third" Banco do Brasil. Within another two years, the Brazilian authorities caused the four commercial banks in the North to surrender their charters and become branches [caixas filiais] of the Banco do Brasil. A further year later, in 1856, the Banco do Brasil established branches in São Paulo and Ouro Preto consolidating its national network which included the branch in Porto Alegre established by Mauá before the forced merger. By reserving the right to nominate the president and vice president of this institution, Itaboraí assumed control of the country's largest source of credit. This bank proved to be an indispensable grantor of favors to the friends of the successive

<sup>9</sup> For example, the newspaper *O Militar*, published by members of the garrison of Rio de Janeiro, denounced the speculation on April 15, 1855. Concerning the accumulation of wealth through slave trading, see FRAGOSO, 1998.

ministries. Itaboraí left office shortly after the merger decree and was later appointed president of the new institution by his successor.

In opposition to this arbitrary merger, Mauá and his associates founded the Banco Mauá MacGregor, the following year, 1854, as a banking house. As such, Mauá and his partners did not enjoy limited liability. At this time, the United States remained the only country that automatically granted limited liability to its banks. In the United Kingdom, limited liability became generalized later in the decade, in 1858; France followed in 1863, and Germany only made this type of organization freely available after 1870. The Brazilian elite closely monitored developments in all four countries, and in 1857, Souza Franco, when finance minister, obtained a charter of limited partnership [*sociedade em comandita*] for Mauá's bank in line with the French law of July, 23, 1856.<sup>10</sup> As the general partner [*socio ostensivo*] of a limited partnership, only Mauá had unlimited liability. His limited partners [*socios comanditarios*] had limited liability just like shareholders of corporations, although they did not enjoy voting rights. The limited partnership allowed Mauá to raise capital from non-executive partners and thus represented a major improvement over the banking house structure. One must remember that even in England and the United States, leading merchant banks like the Rothschilds and the Morgans continued as partnerships without limited liability until well into the twentieth century. Mauá's bank established a branch network that included São Paulo, Rio Grande do Sul, the Plate, and after 1864, Recife and Belem. The Banco Mauá MacGregor in time rivaled the Banco do Brasil in stature if not in size.

The 1853 act establishing the third

<sup>10</sup> *Pareceres do Conselho de Estado, Secção de Fazenda, 1856-'60, page 220.*

Banco do Brasil authorized it to issue banknotes up to twice its net paid-in capital. These notes had to be convertible into gold at a par of 27 pence or into government paper money. Although the milreis continued to be worth around 27 pence, frequently rising above this level, it would be less than accurate to claim that Brazil adhered to the gold standard. Under the gold standard, the value of a currency generally fluctuated within the "gold point" or rate where it became profitable to transport bullion from one market to another. In fact, during the four years following the 1853 act, the milreis traded between 22 and 30 pence (CARREIRA, 1980, 729-731). This broad band, reaching 25 percent below parity, indicates that mid-century Brazil did not quite achieve membership in the club of gold-standard nations. During the fifties, the early sixties, and again in 1889, at those times when the milreis traded above par, banks sought to convert their banknotes into gold coins at par so gold comprised a significant portion of the circulating medium. When the milreis fell below par, gold coins enjoyed a premium and traded at their metallic value. To show the government's interest in attaining a fully convertible currency, the 1853 act directed the Banco do Brasil to gradually retire the paper money in circulation commencing in two years. The bank was to replace 10,000 contos (a conto is 1000 milreis), equivalent to one third of its capital, of paper money with its banknotes and deliver this paper money to the treasury as an interest-free loan. As the government allowed the bank to issue notes up to twice its capital—double the international standard—this obligation seemed rather minimal in its impact. At the completion of this replacement process, Brazil would in theory have only convertible banknotes in circulation.

In spite of the government's gestures in the path of the gold standard, the act of 1853

proved in fact to be inflationary. The Banco do Brasil could issue banknotes up to twice the value of its net paid-in capital. The act defined this term as paid-in capital less fixed assets like bank premises and less amounts used to retire government paper money--an obligation to start only in two years' time. As stockholders could pay in their capital with paper money or the notes of the Banco do Brasil, the law set rather loose limits on the growth of banknote issue and thus did not mandate the adoption of conservative banking practices in effect elsewhere. In contemporary Britain, the Bank Charter Act of 1844 had restricted the Bank of England to issuing notes backed 100 percent by gold in its vaults. The banks in the United States after 1838 generally had to provide 100 percent backing in government bonds. In fact, within two years, the Banco do Brasil increased the circulating medium by half. In 1855, only one year after the merged institution began conducting business, the authorities permitted Itaboraí, the bank's president, to raise its issue from twice to thrice its net paid-in capital, or three times what was considered prudent in the advanced economies (VIANA, 1926, 346). In this instance, Itaboraí distorted conservative thinking abroad, which dictated that banks maintain one third cash against demand liabilities, primarily deposits, into an understanding that a bank which redeemed its notes in gold could issue three times its capital. Although regarded by his contemporaries as the financial conservative, Itaboraí, clearly was not so at all. As the Banco do Brasil availed itself of this new limit to issue, the twin dangers of inflation and inconvertibility threatened.

Although the hardcore Squaremas lost office in 1853, a Conservative-dominated "Conciliation" cabinet succeeded them and ruled until May of 1857 at which time the emperor summoned a government led by the marquess

of Olinda with Souza Franco as finance minister. The new ministry had to face a Chamber of Deputies elected by its predecessor. In this body, forces favorable to progressive legislation proved evenly matched against their opponents. Shortly after assuming office, the new finance minister had to explain to the Chamber of Deputies why the cost of living had risen so briskly in the years following the abolition of the slave trade.<sup>11</sup> He informed the deputies that inflation had multiple causes beginning with the discovery of gold in California and Australia which had lifted prices all over the world. According to Souza Franco, the second most important factor was purely domestic, the concentration of (slave) labor in cash crops leaving few hands available for local food production. His solution to this problem was to encourage immigration. The third cause he saw was the lack of transportation which his railroad policy did address. The fourth and final cause of inflation that Souza Franco cited was the cost of interest. Interest, he observed, is an important component of the final price. While he felt commercial interest rates themselves were high, funds for longer term investments in the industrial and agricultural sectors simply did not exist. Souza Franco felt that the circulating medium was insufficient for the size of the economy. Whereas the Brazilian treasury had not printed new paper currency for some time, the circulating medium only grew if new gold entered the country in moments of prosperity or if the Banco do Brasil issued banknotes. The Banco do Brasil issues, he noted, did not help agriculture or industry. The increase of credit and of the circulating medium would become Souza Franco's major initiative during his term of office.

Before describing Souza Franco's banking measures, let us quickly turn to his support of railroads. He obtained from the

<sup>11</sup> *Anais da Camara, June 17, 1857.*



legislature guarantees for both equity and debt invested in the four principal railways of Brazil: the Dom Pedro II from Rio to São Paulo, the São Paulo Railway from the port of Santos through the city of São Paulo to Jundiaí, and the railroads connecting Salvador and Recife to their respective sugar-producing hinterlands. He also foresaw the imperial government purchasing one third of the equity in each of these lines (VIANA, 1926, 356). While in office, he realized the country's first international financing on behalf of a railroad, the Dom Pedro II. Given that many in the elite opposed public participation in the railroads, Souza Franco's initiatives proved vital to Brazil's development.

As noted above, one of Souza Franco's first acts was to grant his friend Mauá's banking house the legal status of a limited partnership. This decree gave Mauá's partners limited liability and made capital raising easier for the banker. Souza Franco generally encouraged limited partnership as a vehicle to promote economic growth.

Immediately upon assuming office, Souza Franco set out to transform the ideal of provincial banks of issue, as set forth in his book, into reality. The banks described in his work had all subsequently been incorporated into the Banco do Brasil. In all of Brazil, there existed but one privately-owned limited liability bank in addition to the Banco do Brasil, the Banco Rural e Hypothecario, established in the capital in 1853. Outside Rio de Janeiro, there were only caixas filiais (branches partially owned by local investors) of the Banco do Brasil. Through a series of decrees starting in August of 1857, he authorized the establishment of one bank of issue each in Porto Alegre, Salvador, Recife, and São Luiz as well as the Banco Agricola in the capital. He also permitted the existing Banco Rural to transform itself from a deposit bank into a bank

of issue. By the time Souza Franco left office in December of 1858, together these six banks of issue had issued 14,000 contos of banknotes compared to 40,000 contos each of government paper money and Banco do Brasil banknotes.

During the period the viscount of Itaboraí had occupied the finance ministry, from 1848 to 1853, Souza Franco had been his harshest critic. Now positions were reversed. Itaboraí resigned the presidency of the Banco do Brasil two months after his rival took office and attacked the government continuously in the Senate and in the Council of State. Many directors of the bank followed Itaboraí's in opposing a government that eliminated the bank's monopoly on banknote issues. Conscious of the strength of his enemies, and generally concerned with probity, Souza Franco took care that his new banks would be tightly regulated. On October 8, 1857, the financial section of the Council of State, presided habitually by the finance minister, recorded the following suggestions concerning banks of issue:

1. commence business and transfer shares only after 25 percent of capital is paid in
2. banknotes backed by two-name commercial paper with tenors to four months and one third reserve in metal
3. two thirds of capital must be used to finance paper up to 180 days, the remaining third on security of shares or long-term government bonds
4. dividends to be paid only out of profits
5. a bank that fails to honor its note is to be liquidated
6. subscribers of shares are responsible for the full amount subscribed even if they transfer their shares

7. balance sheets must be published within eight days of month end
8. corporations authorized to exist for up to ten years
9. no loans secured by shares of the lending bank
10. authorized corporations must raise initial capital within a stipulated period
11. government authorized to appoint inspector for each bank

The combination of items one and six provided for reserved liability, a feature that continued in subsequent Brazilian legislation including the important corporation laws of 1882 and 1890. Reserved liability, a contemporary British commercial practice, held a subscriber of shares in a limited liability corporation liable to the full extent of his subscription. If he paid in one quarter of subscribed capital and the company failed, he would have to pay the remaining three quarters or see his assets seized and auctioned.

Item two marks a departure from the 1838 New York banking act that utilized government bonds as backing for banknote issues. In this case, the Council of State appeared to prefer short-term commercial paper to long-term government bonds. The use of commercial loans as backing for banknotes prevailed among private banks in Britain prior to the Bank Charter Act and was permitted by several German states during the 1850s and 1860s (SMITH, 1990, 58-69). In fact, Souza Franco's decree authorizing the establishment of the Banco da Bahia, the only one of his banks still in existence, foresaw an issue backed half by government bonds and half by commercial paper (article ten of Decree

2140 of April 3, 1858).

The aim of items 4, 5, 6, 7, 9, and 11 is to limit common abuses the Councilors of State detected in the market.

On October 8, 1857 also the Council of State opined specifically on a charter application of the Banco Industrial e Hypothecario. The Council conceded issue rights but denied the bank's request to engage in colonization, commerce, and mortgages, as well as railroad and tramway development.<sup>12</sup> Souza Franco and his associates wished banks to limit their activities to commercial banking, continental European examples to the contrary notwithstanding.

Six months after Souza Franco came to power, long before the banks he authorized had time to affect the size of the circulating medium, Brazil faced a major financial crisis. The panic of 1857 began with the suspension of banks in the United States (that had become over exposed to loss-making railroads) and spread rapidly to England and the Continent. The British government authorized the Bank of England to issue in excess of the amount permitted by the Bank Charter Act. This permission proved to be sufficient to restore confidence, and the Bank of England did not actually have to violate its limit. Many banks and commercial houses had to be liquidated, especially in the States. When the merchants of Rio heard of the crisis, the exchange fell in one day from its par of 27 pence to 23 pence.<sup>13</sup> Souza Franco immediately allowed the Banco do Brasil to expand its note issue to over three times its capital and suspended convertibility into gold making these notes legal tender. Accordingly, Souza Franco became the first Brazilian finance minister to invoke a lender of last resort during a financial crisis.

<sup>12</sup> *Pareceres do Conselho de Estado, Secção de Fazenda, 1856-60, pages 213-214.*

<sup>13</sup> *Anais do Senado, May 28, 1858.*

As always occurred in times of panic, foreign merchants, requiring specie to settle their obligations at home, ceased to extend credit in Brazil and repatriated whatever gold they could obtain. Without the Banco do Brasil's notes, many Brazilian houses would have gone bankrupt. These instruments provided the necessary means for business to continue, replacing the gold that the foreigners removed from circulation. The decree of inconvertibility made the young Banco do Brasil invulnerable and avoided a run on that institution. Although at first, it may appear that inconvertibility should have provoked inflation and furthered the devaluation of the milreis, in fact the reverse happened. After the new issues, the milreis rose in value because of the restoration of confidence. During the crises, foreigners as well as Brazilians sent their gold abroad not only to discharge obligations, but also to defend themselves against commercial failures in Brazil. After the decree of inconvertibility, the second reason for capital flight diminished, and funds flowed back into the country. Contemporaries appreciated this phenomenon.<sup>14</sup>

Although Itaboraí maintained his influence upon the directors of the Banco do Brasil, they cooperated with Souza Franco during the acute stage of the crisis, from November of 1857 to February of 1858. Senator José Pedro Dias de Carvalho, an ally of Souza Franco, had been vice president under Itaboraí and served as acting president after the latter's withdrawal. In December and January, the Banco do Brasil sold drafts on London, guaranteed by the government, in order to help stabilize the exchange.<sup>15</sup> The sale of drafts had the desired effect of driving up the milreis from 23 pence to 25.5 pence. With the termination of the sales, the exchange fell slightly below 23 pence. As the panic began to calm down in February, the directors declined to

<sup>14</sup> *Amaro Cavalcanti* (1890, 169) cites a speech of the viscount of Ouro Preto shortly after the crisis of 1875.

<sup>15</sup> *Anais do Senado*, May 12, 1858.

make further sales, a rare act of rebellion against both their acting president and the finance minister.<sup>16</sup> Thus rebuffed, Souza Franco turned to his friend Mauá who sold drafts in March and April at a greater pace than the Banco do Brasil had earlier, also with a guarantee from the Brazilian authorities. As it happened, Mauá made a significant profit, selling 90-day sterling drafts on London at exchange rates between 22 and 23 pence – his purchase price for milreis—settling them for over 26 pence—his sales price for milreis in terms of sterling—on maturity. Mauá's sales, like those of the Banco do Brasil in previous months, provided liquidity to the Rio market for merchants who required sterling either to repay debts or to acquire merchandise. These sales helped the market return to normal following the period of stress. Souza Franco's support of the sales of drafts reflects his desire to maintain the Brazilian currency at or near its parity of 27 pence, and therefore shows that this statesman, accused of being a "papelist" (advocate of paper currency) in fact defended Brazil's quasi gold standard.

When the legislature convened in May of 1858, Souza Franco came under severe attack from Itaboraí and his allies. They denounced him for granting special privileges to Mauá and blamed the crisis on the increase of the circulating medium by his banks of issue. The second charge was preposterous as the issues of the new banks between August of 1857, the date of the first decree, and November, when the crisis arrived in Brazil, was almost nil while even the most casual observer realized that events outside Brazil brought on the panic. Furthermore, over the past three years, the bank presided over by Itaboraí had increased the circulating medium by some 50%. The accusation regarding Mauá has some merit in that the government's guarantee

<sup>16</sup> For the relationship of the Banco do Brasil to the government, see *Viana* (1926) as well as *Wilson Rodrigues de Oliveira* (2008), and *Cláudio Pacheco* (1973).

permitted a private institution to take a position larger than it could have taken trading with its own resources. At this moment, with Mauá's transactions not yet concluded, Souza Franco was understandably not forthcoming regarding the amounts guaranteed in favor of the banker. Speaking a decade later in the Council of State, Souza Franco admitted that the government guaranteed £ 820,000 while Mauá drew an additional £ 500,000 for his own account.<sup>17</sup> Accordingly Maua utilized a substantial amount of his own funds at a time when the directors of the Banco do Brasil refused to utilize a penny of theirs. And one must remember that the Banco do Brasil was privately-owned at this time. By present standards of governance, we would find it more appropriate if the bankers, both in the case of the Banco do Brasil and the Banco Maua, had simply intermediated the sale of drafts which would have left the opportunity for profit in the hands of the government (assuming the London market would have accepted government paper, which cannot be taken for granted). As Souza Franco acted during a grave crisis when the government of England had declared the privately-owned Bank of England's banknotes to be legal tender without the necessity of conversion into gold, we can comprehend his willingness to guarantee Maua in order to bring the exchange closer to par. That this intervention proved to be a success, with the exchange remaining close to par during the second semester, did not deter the Saquaremas from continuous attacks on the Olinda-Souza Franco ministry as long as the parliament remained in session. In July, Itaboraí orchestrated an attempt by the directors of the Banco do Brasil to oust acting president Dias de Carvalho, the only such event during the Empire.<sup>18</sup>

Souza Franco's attempt to bring the

<sup>17</sup> Council of State, June 30, 1868.

<sup>18</sup> *Anais do Senado*, July 21, 1858.

milreis back to its 27 pence parity as soon as possible speaks to his dedication to a modified version of the gold standard. England enjoyed a true gold standard from 1821, when it resumed the convertibility of Bank of England banknotes, subsequent to the suspension of convertibility in 1797, until 1914. The difference between the value of sterling and gold never varied by more than the gold point, the cost of importing gold from the least expensive market, generally that of Paris. In Brazil, as we have seen, the milreis fluctuated significantly in value and, in fact, differed from city to city by as much as five per cent, for example between Rio de Janeiro and Porto Alegre.<sup>19</sup> Souza Franco appreciated that Brazilian exchange required flexibility in times of stress. During the crisis of 1857, the United States abandoned the gold standard, and even the Bank of England obtained a bill of indemnity allowing it to disregard the limitations set by the Bank Charter Act of 1844. Souza Franco wanted the provincial banks' banknotes to remain stable in terms of gold although these banks could redeem their issues in government paper money. He argued that the quantity of paper money, which much exceeded that of the provincial banks of issue, determined the value of the milreis in conjunction with the balance of trade.<sup>20</sup> His six banks of issue added 14,000 contos to the circulating medium by the time he left office compared to 40,000 contos each of government paper money and Banco do Brasil notes. Souza Franco in fact expanded the circulating medium by much less than Itaboraí had. The former turned out to be the true financial conservative in the good sense.

Souza Franco's drive for provincial banks of issue received widespread support from merchants and politicians from the larger

<sup>19</sup> *Mauá Correspondence*, Instituto Historico e Geografico Brasileiro, Lata 513, Document 10, letters of January 8, 1860 and January 20, 1861.

<sup>20</sup> *Anais do Senado*, May 18, 1858 and July 6, 1860.

provinces that established these banks of issue. The banks proved important in the economic development of their cities, and several proved to be the local lenders of last resort during the next crisis, that of 1864. Had these banks continued under the strict convertibility requirements that Souza Franco imposed, and had they been allowed to expand, their contributions could have been even more significant for the growth of Brazilian commerce.

Many of Souza Franco's allies wanted the establishment of mortgage banks which would accommodate planters as the banks of issue resolved the needs of merchants. The Banco Rural e Hypothecario, founded in 1853, in fact granted mortgages on urban real estate rather than on plantations.<sup>21</sup> Current legislation protected planters to such a degree from their creditors that few lenders cared for mortgages. The planters' credit came only in the form of short-term advances from their factors who, controlling the cash from the sale of coffee and sugar, were positioned to obtain repayment.<sup>22</sup>

During the attacks on Souza Franco, one criticism of the time may be considered a great praise today: he is alleged to have spent the improbably large sum of 6000 contos (compared to an annual budget of 36,000 that year) to promote colonization.<sup>23</sup> This action shows him again in the role of "developmentalist", to use an anachronism, taken in conjunction with his promotion of banks of issue and railroads.

By the end of 1858, the world economy had recovered from the scare of the previous year, and the United States had returned to convertibility and growth. The milreis traded

close to is par value. Souza Franco appeared vindicated while his six banks of issue had begun their operations. Foreign capital had acquired most of the stocks and bonds of the four principal railroads, and building was set to commence (VIANA, 1926, 356). Souza Franco enjoyed widespread support from politicians and merchants especially from the larger provincial capitals. The Saquaremas, however, remained an even stronger force than the Liberals controlling the Banco do Brasil even against the government. Itaboraí and his friends induced the emperor to remove the Olinda-Souza Franco cabinet in December and replace it with one to their liking. The viscount of Abaete presided over the new ministry with Francisco Sales Torres Homem (future viscount of Inhomirim) as finance minister.<sup>24</sup> Itaboraí himself resumed the presidency of the Banco do Brasil.

Torres Homem spent the legislative session of 1859 trying to pass restrictive measures that would require the banks of issue to redeem their banknotes exclusively in gold and would also oblige them to obtain charters from the legislature. Souza Franco had authorized his banks through executive decrees. The new minister's bill would also require other types of companies seeking limited liability to seek legislative charters, as was the practice still in France and Prussia, though no longer in the English-speaking powers. As usual in debates within the imperial parliament, the participants displayed considerable understanding of foreign models. Itaboraí so detested his foe's six banks of issue that he proposed the Banco do Brasil surrender its unique legal tender status and that all banks receive the privilege of issuing up to twice their capital in banknotes redeemable only in gold. Ironically, Souza Franco defended the Banco do Brasil's privilege of legal tender

<sup>21</sup> Relatório da Comissão Nomeada para Examinar o Estado da Escrituração dos Bancos Rural e Agrícola, Rio de Janeiro, 1860, page 21.

<sup>22</sup> For a fine analysis of the role of the coffee factor, see Joseph Sweigart (1987).

<sup>23</sup> Anais do Senado, May 10, 1858

<sup>24</sup> For a discussion of Brazilian politics from the Olinda government to that of Zacarias in 1862, see Sergio Buarque de Holanda (2010, 62-78).

status.<sup>25</sup> On June 15, 1859, Souza Franco spoke in the Senate in praise of Senator Nicolau Vergueiro's colonization initiatives. During this speech, Itaboraí called Souza Franco a proponent of paper money and financial irresponsibility. The latter counter-attacked characterizing Itaboraí as the lover of paper money for allowing his bank to issue three times capital while Souza Franco's institutions could issue only up to once their capital. Souza Franco and his supporters had sufficient strength in the Chamber of Deputies to block Torres Homem's bill. In August of 1859, after only eight months in office, the emperor replaced the Abaeté-Torres Homem cabinet with one where Angelo Moniz da Silva Ferraz (future baron of Uruguiana) occupied both the presidency of the council of ministers and the ministry of finance.

Silva Ferraz continued his predecessor's restrictive financial agenda although he personally remained on excellent terms with Souza Franco and later served in a Liberal cabinet. While Dom Pedro pushed the new minister to pass the legislation that would undermine Souza Franco's provincial banks, the emperor gave Souza Franco an important consolation prize at this time, appointing him to the 12-man Council of State. From 1859 until his death in 1875, Souza Franco was the most liberal voice within this body.

During the 1860 session, Souza Franco led a spirited defense of his banks of issue in the Senate receiving the support of the marquess of Olinda and other colleagues of Olinda's cabinet as well as that of future finance ministers Carneiro da Cunha (future viscount of Caravelas) and Dias de Carvalho. Souza Franco told the Senate on June 28 that Brazil should look to its trade surplus in order to bring gold into circulation and not be preoccupied

<sup>25</sup> *Anais do Senado*, May 26, 1859.

exclusively with the volume of banknotes. Souza Franco asked why, if the 42,000 contos of paper money was not convertible into gold, should private banknotes be convertible. He felt, as did many planters, merchants, and politicians that Brazil needed capital and workers (capital e braços) and that the government should work to provide these inputs. Itaboraí questioned him if paper money could buy items from abroad, and Souza Franco replied no but paper can stimulate local production. Souza Franco argued for three liberties: political liberty, civil liberty, and commercial or credit liberty. On July 6, he delivered another speech attacking Silva Ferraz' legislation for making two false assumptions: "*The people of this country do not know how to run a business and they are not sufficiently honest to run a business*". Souza Franco also found himself defending the limited partnerships from Silva Ferraz who wished to take a step backwards and abolish them.<sup>26</sup> Finally, at the end of the debates on the new bank and corporation law, Souza Franco noted that the leading British economists now questioned the Bank Charter Act of 1844 claiming that it had proved too restrictive in light of the crises of 1847 and 1857 when the government had to issue bills of indemnity.<sup>27</sup>

With the emperor's active distribution of favors, Law 1083 (called the Lei das Entraves or Law of Obstacles) passed both houses of parliament and became law on August 22, 1860. This legislation required all new limited liability companies to obtain individual charters from parliament, a difficult and expensive process, which was to remain in place until partially rescinded by a law of 1882. The six banks of issue received three options: redeem their banknotes in gold within one year, surrender their issue rights, or go out of business. In Rio,

<sup>26</sup> *Ibid.*, July 14, 1860.

<sup>27</sup> *Ibid.*, July 16, 1860

the Banco Rural sold its issue rights to the Banco do Brasil while the Banco Agrícola merged into that bank. Immediately, the Banco do Brasil regained its monopoly on banknote issues in the capital of the Empire. Three of the provincial banks of issue reduced significantly their issues while the fourth ceased issuing altogether. These institutions remained in business as deposit banks contributing in a reduced manner to the economies of their cities. The Law of Obstacles terminated the Banco do Brasil's period of inconvertibility which Souza Franco had decreed during the crisis of 1857. Law 1083 also reduced the bank's privilege to issue banknotes to twice its capital rather than three times that Itaboraí had achieved while president in 1855. Two months after the passage of the law, in October, the Banco do Brasil began in fact to redeem its banknotes in gold. The outbreak of civil war in the United States in April of 1861 provoked capital flight in Brazil as the United States was this country's predominant coffee market. As the milreis fell below par, the Banco do Brasil quietly suspended convertibility.

One of the negative consequences of the passage of the Law of Obstacles was that the circulating medium of Brazil shrank from 96,000 to 84,000 contos between 1860 and 1864 at a time when the economy expanded rapidly (SCHULZ, 2008, chapter 3). Already in 1861, Souza Franco recognized this tendency and denounced it in the Senate.<sup>28</sup> The following year, the Liberal-Progressive alliance assumed office. In April of 1864, with this friendly government in power, Souza Franco proposed the Banco do Brasil's area of operation be limited to Rio de Janeiro, São Paulo, and Minas Gerais while the branches in the other provinces become independent institutions to complement and compete with his four provincial banks.<sup>29</sup> No

<sup>28</sup> *Anais do Senado, June 1 and September 11, 1861*  
<sup>29</sup> *Ibid., April 2, 1864*

important financial measures came out of the 1864 session prior to the crisis.

In September of that year, Brazil experienced one of its two most profound crises of the nineteenth century, this one set off by the failure of A. J. Souto, the largest banking house of its time. In another study (SCHULZ, 2008, chapter 3), we have analyzed the causes of this event—which included the restrictive monetary policy brought on by the Law of Obstacles, a tightness in the London money market, the onset of Brazil's war in the Plate, the illiquidity of planters, and the impossibility of foreclosure, among other factors. As in 1857, the government acted with vigor, allowing the Banco do Brasil to issue well beyond its limit and expanding the circulating medium by 40%. As an extreme measure, the government requested the Council of State to approve a 60-day moratorium on all debts, which this body ratified with Souza Franco's enthusiastic vote. Two weeks after the onset of the crisis, the Liberal government appointed Souza Franco as the liquidator of Souto while nominating Silva Ferraz and Paranhos (the future viscount of Rio Branco) as liquidators of two each of the smaller banking houses. These appointments provoked a storm of protests from the commercial community as all of these individuals had served as finance minister and were a sign that the liquidations would be handled in a political rather than in a commercial manner.<sup>30</sup> The liquidations proved controversial, to say the least, and Souza Franco resigned after just five weeks to assume the presidency of the Province of Rio de Janeiro. This nomination was unusual as provincial presidencies generally went to younger men who had never held ministerial positions. Further research is necessary to evaluate Souza Franco's performance as liquidator and provincial president during these

<sup>30</sup> *Relatório da Crise do mês de Setembro de 1864, Rio de Janeiro, 1865, pages E-80 and E-100*

months of stress. In his defense to the Senate, on June 26, 1865, Souza Franco stated that he had paid himself in government bonds while distributing cash, slaves, securities, merchandise, and real estate to creditors. Always concerned with limiting opportunities for fraud, Souza Franco suffered under these personal affronts. Paranhos, incidentally, also resigned after only two months as a liquidator. The liquidators who replaced Souza Franco and Paranhos were from the commercial community—although charges of favoritism continued. The liquidations proceeded quickly by modern standards with the bulk of the distribution resolved by March of 1865. Souto's creditors received 25% while other banking houses repaid between 5% and 43%. Total losses sustained during the crisis reached 70,000 contos, a sum that exceeded the government budget of that year (CARREIRA, 1980, 413-416).

The banks of issue established under Souza Franco in Pernambuco and Bahia acted as lenders of last resort in those two provinces helping to prevent greater harm to their respective commercial communities.<sup>31</sup> Meanwhile, the branches of the Banco do Brasil in these provinces only complicated events there. In Salvador, the branch was already in liquidation before the outbreak of the crisis while the branch in Recife suffered a run.<sup>32</sup> Contemporaries thought the Banco do Brasil would not bail out its branches which were joint ventures with local capitalists.

São Paulo did not suffer during the crisis, and the local Banco do Brasil branch, a venture with the Prado family, did not come under attack. Workers lined up outside Mauá's branch in Santos for fear it would collapse. When it repaid all of the depositors, they turned around

and re-deposited in the bank. Mauá's head office came under pressure, as did all the other institutions in Rio de Janeiro, including the two recently-inaugurated British banks, the Banco Rural, and the surviving banking houses. The Banco do Brasil saved all of these. Even though Mauá was the strongest house after the Banco do Brasil, the banker's activities in Uruguay, partially on behalf of the Brazilian government, had placed him in a vulnerable position. Mauá at this time owed the Banco do Brasil 6290 contos, making him the third largest debtor after the failed Souto and the banking house of Bahia & Irmãos, which was to declare bankruptcy in 1866. On November 9, 1864, Finance Minister Caravelas asked the Council of State whether the Banco do Brasil should increase its limit to the Banco Rural, its fourth largest debtor, from 5870 contos to 10,000 contos. Itaboraí, Abaeté, and three other councilors voted against while Souza Franco, Olinda, and three other councilors voted in favor. The minister authorized the increase.

The Souto Crisis accelerated the momentum for mortgage reform. In the midst of the crisis, the government decreed such a measure which, however, did not resolve the crucial problem of foreclosure. In January of 1865, the Council of State met to discuss the Banco do Brasil's first large mortgage applicant under the new rules, the firm of Vergueiro & Company. Souza Franco, who had supported the company's colonization efforts in the past, strongly advocated granting the mortgage, arguing that this sizeable commercial enterprise would provide several plantations with 1100 slaves and free workers as collateral. This time Itaborai had the votes, and Souza Franco's ally, Minister Dias de Carvalho, had to instruct the bank not to extend the mortgage.<sup>33</sup>

In fact, the panic of 1864 broke the

<sup>31</sup> *Relatório da Crise do mês de Setembro de 1864, pages 37 and C-111-5.*

<sup>32</sup> *Ibid.*, pages E-31 and C-111-4

<sup>33</sup> *Conselho de Estado, June 23, 1865.*



Banco do Brasil. It had to absorb a large number of doubtful loans to planters placed through the factors and the banking houses that failed during the crisis. Only the government's implicit guarantee kept the bank running. To exacerbate the situation, the exchange rate collapsed in January of 1865 as a consequence of Brazil's invasion of Uruguay followed by the war with Paraguay. As the Law of Obstacles determined that the Banco do Brasil must redeem in gold or be declared insolvent, the institution fell completely under the hand of the government. Gradually a consensus developed within the elite that the Banco do Brasil must be reorganized, must limit its issues, must deliver its gold to the government to finance the war, and must establish a mortgage portfolio to provide long-term financing for the planters. In early 1866, the marquis of Olinda, once again prime minister, nominated three former ministers to draft the reform legislation: Souza Franco, Itaborai, and Caravelas, who had managed the Souto Crisis.

While the three former ministers prepared their bill, Brazil suffered the effects of another external financial crisis. In May of 1866, Bismarck went to war with Austria, and the Bank of England raised its discount rate to 10%. England's largest bill broker, Overend and Gurney, succumbed provoking a major crisis in which the Bank of England once again had to secure a bill of indemnity for violating the terms of the Bank Charter Act of 1844. Italy was forced into inconvertibility. The brunt of this crisis in Brazil fell upon the two British banks. Mauá broke off merger talks with the London and Brazilian Bank which had to borrow 500 contos from the Banco do Brasil in June to avoid suspension (JOSLIN, 1963, 73). The Banco do Brasil also sustained the Banco Mauá and the Banco Rural at this time but allowed Bahia & Irmãos, the largest banking house to survive the

Souto Crisis, to fail. Bahia & Irmãos owed the staggering sum of 33,000 contos to the Banco do Brasil, which, nevertheless, managed an orderly liquidation. (PACHECO, 1973, 128-129) This crisis made the already vulnerable Banco do Brasil even more so.

In August, as Souza Franco, Itaborai, and Caravelas presented the final draft of their Banco do Brasil reform, Olinda resigned to be replaced by Zacarias de Goes e Vasconcellos. The latter supported the reorganization as fervently as his predecessor and nominated former minister Torres Homem as president of the Banco do Brasil with a mandate to execute the terms of the reorganization as fast as possible. The consensus bill contained the following provisions: the Banco do Brasil would cease further issues of banknotes and would redeem in paper money five per cent of its outstanding banknotes each year, although the existing notes would continue to enjoy legal tender status without the obligation to redeem in gold; the bank would sell its gold to the government; the bank would take 35,000 contos of its commercial loans and transform these into long-term mortgages; and the president of the bank would henceforth be elected by shareholders rather than appointed by the government.

During the debates over the reorganization, Souza Franco argued that the branches, other than the ones in São Paulo and Minas Gerais, should be converted into independent provincial banks, and he charged that the head office of the Banco do Brasil had drained resources from the provinces.<sup>34</sup> He lost this fight as the directors resolved, in the months following the reorganization, to close Porto Alegre, São Luiz, and Belem in addition to Recife and Salvador, already in liquidation

<sup>34</sup> Conselho de Estado, February 19, 1866 and Anais do Senado, August 14, 1866.

since 1864. In fact, in 1869, they also terminated Ouro Preto leaving the profitable branch in São Paulo as their only facility outside of Rio. On all the points of the reorganization other than the question of the branches, Souza Franco agreed with Itaborai and Caravelas. In the final stages of the debate, senators heard the unfamiliar “here, here” uttered by Itaborai in favor of Souza Franco’s speeches.<sup>35</sup>

In the midst of the war, financing the struggle became the priority for both men. The two rivals also realized that the country depended upon the survival of the Banco do Brasil, that something had to be undertaken to develop a mortgage market, and that the bank had lost control over its banknote issues made on behalf of the government in moments of crisis and of war. Prime Minister Zacarias set the tone of the agreement when he expressed the hope that, when the situation returned to normal, banks could again issue notes.<sup>36</sup>

The reorganization, Law 2400, passed on September 12, 1866. The momentum continued. Within a month, the Banco do Brasil sold its gold to the government and thereby decreased significantly its outstanding banknotes. The remaining banknotes would provide an important source of lendable funds and profits for the bank throughout the period of prohibition of new issues which prevailed until the year of abolition.<sup>37</sup> Within the next four months, the Banco do Brasil began to establish its mortgage portfolio while curtailing expenses. The shareholders reduced the number of directors from 15 to nine and resolved to close the branches in Porto Alegre, São Luiz, and Belem in addition to those of Recife and Salvador already in liquidation. As noted above, only São Paulo

and Ouro Preto remained; the latter would in fact be phased out in 1869.<sup>38</sup> Although the law of September 12 left the shareholders free to elect their president, they re-elected Torres Homem two months after the law’s promulgation. The Banco do Brasil thus remained the government’s bank in fact. Witnessing the bank’s cost reductions and intensified attempts at loan collection, contemporaries called it a bank in liquidation. In September of 1867, Zacarias felt compelled to deny in parliament that this was the case.<sup>39</sup> Contemporaries also profoundly felt the disappearance of gold from circulation following the government’s assumption of the Banco do Brasil’s bullion; even novelists decried the metal’s absence (AZEVEDO, 1881, 73).

The emperor chose Zacarias to head his government not only because of his financial acumen but also because of his partiality to the cause of abolition. In May of 1867, for the first time in the annual Speech from the Throne, Zacarias mentioned emancipation. Save for military officers, few individuals in or close to the elite advocated immediate abolition. Zacarias, Mauá, Souza Franco, and Dom Pedro himself wished to follow the examples of other former slave societies, including continental Portugal and the state of New York, which freed slaves’ children born after the promulgation of a free womb law. Souza Franco, in the Senate and the Council of State, supported this ministry suggesting that in ten years from the law’s approval Parliament should set a date for the final extinction of slavery.<sup>40</sup> The failure of the expeditionary force to take Humaitá during Zacarias’ incumbency delayed emancipation and provoked perhaps the major political crisis of the Empire.

#### The emperor and most politicians

<sup>35</sup> *Anais do Senado*, August 11, 1866.

<sup>36</sup> *Ibid.*, August 14, 1866

<sup>37</sup> For the importance of the banknotes to the Banco do Brasil’s earnings, see Pacheco (1973, 235).

<sup>38</sup> *Ibid.*, volume IV, page 332

<sup>39</sup> *Anais da Camara*, September 17, 1867

<sup>40</sup> *Conselho de Estado*, April 2 and April 9, 1867

believed that the marquess of Caxias was the general with the greatest chances of bringing the war to a conclusion. From May 1866, the army had been stalled before the fortress of Humaita on the Paraguay River. Not only was Caxias a general but also he was a senator who had on more than one instance served as a Conservative president of the council of ministers. The month of the banking reform, September of 1866, Zacarias invited Caxias to take command of the Brazilian forces. As his condition for acceptance, the general made Zacarias fire his minister of war, none other than Silva Ferraz, author of the Law of Obstacles. In July of 1868, after almost two years in command and still unable to proceed up the Paraguay River, Caxias resigned making it known extra-officially that the government did not enjoy his confidence. Dom Pedro called the Council of State to decide whether the general or the cabinet should go. Four councilors, including Souza Franco and Nabuco de Araujo, the two most emancipationist of the Council, preferred to maintain Zacarias even if this meant losing Caxias' services (HOLANDA, 2010, 151). Four others voted in favor of retiring the cabinet in order to retain the commander. Dom Pedro decided for Caxias even though Zacarias enjoyed a strong majority in the Chamber of Deputies. The emperor's decision reflected his confidence in Caxias and his unwillingness to push the slavery question in the face of fierce planter resistance during the course of an undecided war. Pedro II chose Itaboraí as prime minister, as violent an opponent of emancipation as could have been found. Members of the opposition unfairly branded the replacement of Zacarias by Itaboraí as a military coup while accusing Dom Pedro of dictatorship. In fact, like all alternations of political parties during the Empire, the decision was the monarch's, and then duke of Caxias considered himself offended when, in 1878, the emperor substituted a Liberal

cabinet for the one he presided. Until abolition undermined the throne, Dom Pedro continued to personally select his prime minister and to insure that the chosen individual would find a favorable Chamber. Itaboraí financed the war with little hindrance from the opposition while Caxias went on to win the decisive battles.

With the victory over Paraguay and the death of Lopez in early 1870, Dom Pedro found it possible to resume his campaign for the Law of the Free Womb. His first emancipationist prime minister from the Conservative Party, the marquess of São Vicente, who replaced Itaboraí in October, failed against determined resistance from within his own party. The emperor then chose another Conservative, the viscount of Rio Branco, who succeeded with the help of Souza Franco and a group of Liberal senators, to pass this law on September 28, 1871. No slaves would be born after this date. During the debates, Souza Franco would have liked to go further and establish a date, in ten or 15 years, to abolish slavery altogether.<sup>41</sup> The original draft of the law seemed to offer an opportunity for masters to obtain money from the government for relinquishing the labor of these 'ingenuos' (children born to slaves after the passage of the law). Souza Franco calculated this sum to be 600,000 contos, an amount greater than the existing national debt.<sup>42</sup> Rio Branco agreed with Souza Franco's reckoning and altered the text. During the 1871 session, Souza Franco also had the satisfaction of seeing the success of his two remaining banks of issue which had not surrendered their issue rights, those of Bahia and Maranhão (the former of which is still in existence as a deposit bank). And he heard voices in the Senate proposing to amend the Law of Obstacles—an event he would not live to see as this occurred in 1882.<sup>43</sup>

<sup>41</sup> *Anais do Senado*, May 17, 1871.

<sup>42</sup> *Ibid.*, May 17, 1871.

<sup>43</sup> *Ibid.*, August 21, 1871.

Prime Minister Rio Branco, though a Conservative, was a friend both of Souza Franco and of Mauá, and was sensitive to the needs both of merchants and of planters. With good coffee sales and the exchange approaching its parity of 27 pence, after striking a war time low of 17 pence under Itaboraí, Rio Branco saw an opportunity to make the mortgage law work. During the 1872 and 1873 sessions of the parliament, members debated another reform of the Banco do Brasil. The directors of the bank recognized that they had only created 27,000 contos in mortgages of the 35,000 contos they had contracted for in 1866. Of this sum, 3000 contos had been for urban real estate. By 1872, after write offs and collections, only 15,000 contos of rural mortgages were outstanding.<sup>44</sup> The origin of these mortgages had been advances made by factors to planters which the former had pledged as collateral to banking houses which in turn had used these loans as security for loans from the Banco do Brasil. With the collapse of the banking houses in 1864 and 1866, the Banco do Brasil found itself as a direct creditor to planters who could not or would not pay. Contemporaries estimated that two thirds of this mortgage portfolio was uncollectible (VIANA, 1926, 513). The directors proposed reducing the interest on these mortgages from nine per cent to six per cent while lowering the amortization from eight per cent to five per cent. As the Banco do Brasil paid more than six per cent for its funds, this renegotiation appears to be an attempt to encourage debtors to pay something.<sup>45</sup> In return for this reduction in interest and amortization, the directors asked that the total mortgage portfolio be scaled down to 25,000 contos, the bank's charter be extended from 1886 to 1900, and the bank's amortization of the outstanding banknotes be reduced from five per cent to two

and a half per cent per annum. Banknotes were still a major source of revenue for the bank even at the current level of 30,000 contos. There were also minor changes in the (ineffective) mortgage execution process. The Senate committee that recommended this law was composed of Souza Franco, São Vicente, and José Joaquim Teixeira Junior (future viscount of Cruzeiro), an ex-director of the bank. The law passed on September 17, 1873.

Although Brazil enjoyed four years of prosperity under Rio Branco, the world economy entered into its "Great Depression" in between the Krach of the Berlin Stock Exchange in May of 1873 and the failure of J Cooke in the United States in September. Effects in Brazil were delayed as coffee exports to the United States held up in the year following Cooke's bankruptcy. On April 9, 1875, Souza Franco told the Senate that the crisis was not coming to Brazil, and in fact the government should actually be decreasing the volume of paper money. It was his last appearance as he passed away at the beginning of the next month. Just four days after his death, Mauá suspended provoking a major crisis in Rio taking down the German bank, the Banco Nacional, and the largest banking house, Gavião Peixoto, in São Paulo. Rio Branco could not permit the Banco do Brasil to issue banknotes, as Souza Franco and Caravelas had done in 1857 and 1864 respectively, due to the law of 1866. As an alternative, the prime minister lent paper money to the Banco do Brasil which used this currency to discharge its role as lender of last resort.

Rio Branco had sustained Mauá as long as he could lending £ 726,000 of government funds directly to the banker in addition to very substantial loans from the Banco do Brasil (OLIVEIRA, 2008, 110). Mauá's problems originated in Uruguay where his banknotes

<sup>44</sup> *Parecer da Comissão da Fazenda do Senado sobre a proposição numero 319 de 1873, page 15.*

<sup>45</sup> *Parecer da Comissão da Fazenda do Senado, page 3*

circulated as money and where hostile governments obliged him to redeem in gold notes that were worth considerably less (JOSLIN, 1963, 54). His second error was to trust the English directors of the São Paulo Railway who swindled him out of a fortune. To Mauá's fame, he paid off all of his creditors.

As Souza Franco remained active in politics until his death, his disappearance certainly weakened Mauá, who of course was already quite vulnerable. In any case, the collapse of Maua marked a defeat for Souza Franco and his progressive allies. Fortunately, this set-back did not long delay the course of progress. Within two decades of his death, four measures for which Souza Franco had advocated throughout his political career came into being: 1882, a limited liability corporation law that overthrew the Law of Obstacles; 1888, the final abolition of slavery; 1888, a return to banknote issues under a law at least partially inspired by his 1857 decrees; and 1891, a major transfer of resources from the central government to the provinces. Unfortunately the execution of the banking reform proved to be a disaster at the hands of men less honest than either Souza Franco or his great rival, Itaboraí.<sup>46</sup> That banknotes proved a useful tool for expanding commerce is attested to by the survival of these instruments in advanced economies such as Australia and the United States well into the twentieth century. Another reform for which Souza Franco fought, foreclosures, had to await the twenty-first century. Even today, the lack of protection of creditor rights in Brazil retards the development of this country from reaching its full potential.

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<sup>46</sup> One of the major points in my study, *The Financial Crisis of Abolition*, is that Rui Barbosa and the baron of Lucena, the first two finance ministers of the Republic, did not honestly regulate banks of issue. They allowed banks to issue without backing and thus provoked a major inflation as well as a grave financial crisis. Souza Franco's banks covered their notes with government bonds while Itaboraí, when he realized that his creation, the Banco do Brasil, could not honor its notes in gold, voted to cancel its issue privileges through the Law of 1866.

During his lifetime, Souza Franco did in fact make three significant contributions to Brazilian growth: the financing of the four principal railroads, the use of the Banco do Brasil as a lender of last resort during Brazil's first international crisis, and especially, a scientific well-studied attempt to create a modern banking system in Brazil in line with best practices in the United States. Souza Franco also played a major supporting role in the passage of the Free Womb Law and the struggle to substitute free labor for that of slaves. From his position in the Council of State and the Senate, he encouraged industry and modern corporation law.<sup>47</sup> Had the country a larger number of leaders with his vision, development could have come earlier. In this suggestive article, I hope to have called attention to the political actions of Souza Franco who now awaits his biographer.

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<sup>47</sup> *Anais do Senado*, September 27, 1869.

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