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Fed Credit Policy: What is a Lender of Last Resort?

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ABSTRACT

Discussions of the Fed's financial crisis lending – and its role as "Lender of Last Resort" more generally – often overlook the distinction between monetary policy and credit policy. Central bank actions constitute monetary policy if they alter the quantity of the bank's monetary liabilities, but constitute credit policy if they alter the composition of the bank's portfolio without affecting the outstanding amount of monetary liabilities. In the 19th century, Henry Thornton and Walter Bagehot advocated Lender of Last Resort policies as a means of expanding the money supply when the demand for money surged in a crisis. In contrast, the Fed's recent crisis lending for the most part left its outstanding monetary liabilities unaffected, and thus represented credit policy, not Lender of Last Resort activity. Credit allocation in a crisis is potentially costly because it affects market participants' beliefs about the likelihood of future central bank rescues, which in turn reduces their incentive to protect themselves against financial distress and thus exacerbates financial instability. Credible limits on credit policy thus are critical to central banks' core policy mission. One path to establishing such limits is to create "living wills" that detail how to resolve large, complex financial firms without government support.

A conference devoted to central banking in the coming century would be woefully inadequate without a session devoted to central bank lending. Credit extension arguably has been the most problematic and contentious aspect of central banking, and it seems likely to remain so for the foreseeable future. Michael Bordo has provided us with a learned and useful review of the idea of the "Lender of Last Resort" (LOLR), both in history and as it relates to recent practice here in the United States. I say useful because even among prominent economists and policymakers, there is a good deal of confusion about the historical meaning of the phrase, not to mention what it implies about current practice. So it's helpful to clear away the underbrush of misconstrued traditions.[1]

There are two distinctions that strike me as critical for thinking about central bank lending policy. The first is between monetary policy and credit policy, which Marvin Goodfriend discussed yesterday.[2] Central bank actions constitute *monetary policy* if they alter the quantity of its monetary liabilities, often referred to as high-powered money. Central bank actions constitute *credit policy* if they alter the composition of its portfolio – by lending, for example – but do not affect the

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[1] I would like to thank Jessie Romero for assistance in preparing these remarks. The views expressed are my own and may not be shared by colleagues in the Federal Reserve System.

[2] Marvin Goodfriend, "Lessons from a Century of Fed Policy: Why Monetary and Credit Policies and Need Rules and Boundaries," Paper prepared for the conference Frameworks for Central Banking in the Next Century, Hoover Institution, Stanford University, Stanford, Calif., May 29–30, 2014. See also Marvin Goodfriend and Robert G. King, "Financial Deregulation, Monetary Policy, and Central Banking," Federal Reserve Bank of Richmond *Economic Review*, May/June 1988, pp. 3–22; and Anna Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis *Review*, September 1992, pp. 58–69.

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outstanding amount of monetary liabilities. An open market purchase, in which the Fed buys government securities by crediting a bank's reserve account at the Fed, is monetary policy. It's true that Fed lending also results in an addition to a bank's reserve account. But under the Fed's pre-crisis interest rate targeting regime, the added reserves would be automatically drained through offsetting open market operations to avoid driving the funds rate below target. In this case, the lending is effectively "sterilized" and the Fed can be thought of as selling Treasury securities and lending the proceeds to the borrower. This is clearly fiscal policy, and it qualifies as credit allocation in the sense that the borrower obtains funds on terms that are presumably preferred to the terms available in the market. Sterilized central bank lending is credit policy; unsterilized lending is a combination of monetary policy and credit policy.

This distinction is essential to understanding the historical origins of the LOLR idea. Michael Bordo defines a Lender of Last Resort – correctly, in my view – as a central bank willing to supply high-powered money to satisfy increased demand in a panic. Walter Bagehot, and before him Henry Thornton, advocated *unsterilized lending* to accomplish this, though neither man used the phrase "Lender of Last Resort" in print. But note that the supply of high-powered money can in principle be increased equally well through open market purchases of government securities. What was essential during a 19th century panic was expanding the supply of paper notes; how that expansion was accomplished was less important.[3]

The phrase "Lender of Last Resort," along with Walter Bagehot's name, were often invoked, like Holy Writ, during crisis policy discussions in 2007 and 2008. But with the distinction between monetary and credit policy in mind, it's clear that the Fed's lending, which was sterilized prior to very late in 2008, had very little to do with what Thornton and Bagehot had in mind.[4] Under the Fed's federal funds rate targeting regime, the supply of bank reserves expanded automatically through open market operations when demand increased, as occurred in August of 2007. No lending programs were required.

The distinction between monetary and credit policy also illuminates the Fed's policy actions during the Great Depression, another frequently cited chapter of Holy Writ. The Fed's failure to prevent waves of bank failures in the early 1930s often has been cited as evidence that 2008 crisis lending was essential to preventing a "Great Depression 2.0." The critical development during the Depression, however, was the decline of nearly 30 percent in the money stock from 1930 to 1933; as a result, the average price level collapsed by the same amount.[5] Certainly, bank failures contributed to the decline in the money stock. But as Milton Friedman and Anna Schwartz noted, had the bank failures occurred without a drastic decline in the stock of money, "they would have been notable but not crucial," while a collapse of the money stock without the bank failures would have produced a contraction "at least equally severe".[6] So yes, the Fed failed in its LOLR responsibilities, as Bordo notes, but the Great Contraction was a failure of monetary policy, not credit policy.

We should also recall the distinction between monetary and credit policy when thinking about the Fed's founding 100 years ago. Some have justified the Fed's credit market interventions in the recent crisis by noting that the Fed was founded to respond to banking panics. It is certainly true that the banking panics of the late 19th century motivated the creation of the Federal Reserve. But the central issue at that time was legislative restrictions that limited the extent to which the supply of currency could expand elastically to satisfy the demand for withdrawals. These defects gave rise to a broad banking reform movement focused on what was called "The Currency Problem." The primary goal in establishing the Federal Reserve was "to furnish an elastic currency" that would expand and contract appropriately with the needs of the economy.[7]

Reform advocates debated how the new note issues would be backed. In their thinking, currency backed by government bonds was associated with episodes of inflationary wartime finance. Moreover, the bond collateral requirement under the National Bank Act had helped make note issue cumbersome and inelastic. The short-term commercial paper that the Act envisioned as the main collateral for advances to banks represented the least risky non-government asset class available.[8] Another motive for commercial paper as backing for Fed lending was to support shifting international trade finance business from Europe to the United States, a somewhat parochial interest championed by the New York banker Paul Warburg.[9] I know of no evidence that taking on counterparty credit risk, as in sterilized lending, was an important objective for the founders. In fact, they rejected proposals to include a deposit insurance scheme in the Federal Reserve Act because experience with state schemes had been plagued by moral hazard and excessive losses.[10]

There is a second important distinction that I believe is critical for thinking about central bank lending. An ex-post perspective on these issues takes an instance of financial distress as given and considers possible central bank responses. In contrast, an ex-ante perspective focuses on how financial market participants, taking expected central bank behavior as

[3] See Renee Haltom and Jeffrey M. Lacker, "Should the Fed Have a Financial Stability Mandate? Lessons from the Fed's first 100 Years," Federal Reserve Bank of Richmond *2013 Annual Report*, May 2014, pp. 4–25; and Marvin Goodfriend, "The Elusive Promise of Independent Central Banking," Speech at the Institute for Monetary and Economic Studies, Bank of Japan, May 30, 2012 (published in the Bank of Japan *Monetary and Economic Studies*, November 2012, pp. 39–54).

[4] In October 2008, the Federal Reserve Banks obtained authority to pay interest on reserves, which would limit the extent to which unsterilized lending drove down the funds rate. Then, in December 2008, the Federal Open Market Committee reduced the target for the federal funds rate to a range from 0 to 25 basis points, which further obviated the need to sterilize lending.

[5] Gary Richardson, "The Great Depression," Federal Reserve System History Gateway, April 2, 2014.

[6] Milton Friedman and Anna Schwartz, "A Monetary History of the United States", Princeton, N.J.: Princeton University Press, 1963, p. 352.

[7] Jeffrey M. Lacker, "A Look Back at the History of the Federal Reserve", Speech at Christopher Newport University, Newport News, Va., August 29, 2013.

[8] Goodfriend (2012).

[9] Paul M. Warburg, "The Discount System in Europe," National Monetary Commission, Senate Document No. 402, 61st Congress, 2nd Session, 1910.

[10] Carter Glass, "An Adventure in Constructive Finance," New York: Doubleday, 1927.