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Monetary Stability and Liquidity Crises: The Role of the Lender of Last Resort[1]

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We evaluate the desirability of having an elastic currency generated by a lender of last resort that prints money and lends it to banks in distress. When banks cannot borrow, the economy has a unique equilibrium that is not Pareto optimal. The introduction of unlimited borrowing at a zero nominal interest rate generates a steady state equilibrium that is Pareto optimal. However, this policy is destabilizing in the sense that it also introduces a continuum of nonoptimal inflationary equilibria. We explore two alternate policies aimed at eliminating such monetary instability while preserving the steady-state benefits of an elastic currency. If the lender of last resort imposes an upper bound on borrowing that is low enough, no

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inflationary equilibria can arise. For some (but not all) economies, the unique equilibrium under this policy is Pareto optimal. If the lender of last resort instead charges a zero *real* interest rate, no inflationary equilibria can arise. The unique equilibrium in this case is always Pareto optimal. *Journal of Economic Literature* Classification Numbers: E31, E42, E58, G21. © 2001 Academic Press

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1. INTRODUCTION

Recent developments in a number of countries have renewed interest in the role of a lender of last resort. According to Fischer [7, p. 86], "there is considerable agreement on the need for a domestic lender of last resort," even though there is some disagreement about exactly what this lender should do. However, several recent papers have identified the lender of last resort as a cause of excess volatility in emerging economies' financial markets and of the currency crises that have plagued many of these economies in the 1990s.[2] In response to these crises, proposals have been made in a number of countries to either establish a currency board or abolish the national currency altogether and adopt some other country's currency as legal tender (this second arrangement is often called *dollarization*). While adopting such policies may be successful in eradicating excess volatility stemming from speculation against a domestic currency, they clearly do not come without cost. In particular, both of these arrangements severely limit the ability of the central bank to act as a lender of last resort. In light of these proposals, it is important to understand the implications (both benefits and costs) of having a lender of last resort that is able to freely print money and lend to the banking system.

One of the important roles of a lender of last resort is the provision of an elastic currency, that is, the adjusting of the money supply in response to transitory changes in liquidity demand. This role was important enough to merit high billing in the act establishing the Federal Reserve System in the United States, "An act to provide for the establishment of Federal Reserve Banks, to furnish an elastic currency, ... and for other purposes." Beginning with Sargent and Wallace [17], several papers have examined the effects of having an elastic currency supply.[3] These papers focus on stationary equilibria and show how an elastic currency promotes a more efficient allocation of resources in these equilibria. In the present paper, we show that when nonstationary equilibria are considered, the picture can

[2] See, for example, Chang and Velasco [5], Mishkin [13], and Fischer [7].

[3] Among them are Champ *et al.* [4], Williamson [24], and Freeman [8].

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