20.4: Lender of Last Resort (LLR)

Learning Objectives

- What is a lender of last resort and what does it do?

As noted above, financial panics and the de-leveraging that often occur after them can wreak havoc on the real economy by decreasing the volume of loans, insurance contracts, and other beneficial financial products. That, in turn, can cause firms to reduce output and employment. *Lenders of last resort try to stop panics and de-leveraging by adding liquidity to the financial system and/or attempting to restore investor confidence*. They add liquidity by increasing the money supply, reducing interest rates, and making loans to worthy borrowers who find themselves shut off from their normal sources of external finance. They try to restore investor confidence by making upbeat statements about the overall health of the economy and/or financial system and by implementing policies that investors are likely to find beneficial. After a stock market crash in 1987, for example, the Federal Reserve stopped a panic merely by promising to loan liberally to temporarily strapped banks.

Stop and Think Box

In a single day, October 19, 1987, the S&P fell by 20 percent. What caused such a rapid decline? Why did the panic not result in de-leveraging or recession?

According to a short history of the event by Mark Carlson ("A Brief History of the 1987 Stock Market Crash with a Discussion of the Federal Reserve Response"),www.federalreserve.gov/Pubs/feds/2007/200713/200713pap.pdf "During the years prior to the crash, equity markets had been posting strong gains.…There had been an influx of new investors.…Equities were also boosted by some favorable tax treatments given to the financing of corporate buyouts.…The macroeconomic outlook during the months leading up to the crash had become somewhat less certain.…Interest rates were rising globally.…A growing U.S. trade deficit and decline in the value of the dollar were leading to concerns about inflation and the need for higher interest rates in the United States as well." On the day of the crash, investors learned that deficits were higher than expected and that the favorable tax rules might change. As prices dropped, "record margin calls" were made, fueling further selling. The panic did not proceed further because Federal Reserve Chairman Alan Greenspan restored confidence in the stock market by promising to make large loans to banks exposed to brokers hurt by the steep decline in stock prices. Specifically, the Fed made it known that "The Federal Reserve, consistent with its responsibilities as the Nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system."

Lenders of last resort partially emulate three rules first promulgated by U.S. Treasury Secretary Alexander Hamilton (1789–1795) but popularized by *Economist* editor Walter Bagehot in his 1873 book *Lombard Street*. As Bagehot put it, during a banking panic an LLR should make loans:

at a very high rate of interest. This will operate as a heavy fine on unreasonable timidity, and will prevent the greatest number of applications by persons who do not require it. The rate should be raised early in the panic, so that the fine may be paid early; that no one may borrow out of idle precaution without paying well for it; that the Banking reserve may be protected as far as possible. Secondly. That at this rate these advances should be made on all good banking securities, and as largely as the public ask for them. The reason is plain. The object is to stay alarm, and nothing therefore should be done to cause alarm. But the way to cause alarm is to refuse some one who has good security to offer…No advances indeed need be made by which the Bank will ultimately lose. The amount of bad business in commercial countries is an infinitesimally small fraction of the whole business…The great majority, the majority to be protected, are the 'sound' people, the people who have good security to offer. If it is known that the Bank of England [the LLR in Bagehot's time and country] is freely advancing on what in ordinary times is reckoned a good security—on what is then commonly pledged and easily convertible—the alarm of the solvent merchants and bankers will be stayed. But if securities, really good and usually convertible, are refused by the Bank, the alarm will not abate, the other loans made will fail in obtaining their end, and the panic will become worse and worse.

This is usually translated as LLRs lending freely on good security at a penalty rate. Today, central banks acting as LLR usually lend freely on good collateral but only to banks, not the public. Moreover, they typically reduce interest rates in order to stimulate the economy. The unfortunate result of the latter change is to increase moral hazard, or risk taking on the part of banks that "bank on" cheap loans from the LLR should they run into difficulties.

The most common form of lender of last resort today is the government central bank, like the European Central Bank (ECB) or the Federal Reserve. The International Monetary Fund (IMF) sometimes tries to act as a sort of international lender of last resort, but it has been largely unsuccessful in that role. In the past, wealthy individuals like J. P. Morgan and private entities like bank clearinghouses tried to act as lenders of last resort, with mixed success. Most individuals did not have enough wealth or influence to thwart a panic, and bank clearinghouses were at most regional in nature.

KEY TAKEAWAY

- A lender of last resort is an individual, a private institution, or, more commonly, a government central bank that attempts to stop a financial panic and/or postpanic de-leveraging by increasing the money supply, decreasing interest rates, making loans, and/or restoring investor confidence.