

CRISIS LENDING BY THE FEDERAL RESERVE COULD UNDERMINE FINANCIAL STABILITY

In 2007 and 2008, the United States was gripped by a financial crisis, to which the Fed responded by making extensive use of its emergency-lending powers. This crisis came a century after the Panic of 1907, the event that prompted the establishment of the Federal Reserve in 1913. Now, as we mark the Fed's centennial, and as many countries revisit their central banks' missions in light of the global financial crisis, it is fitting to examine the Federal Reserve's purpose and ask: what is the central bank's role in promoting financial stability? More specifically, is crisis lending an essential component of a stable financial system? In this year's essay, Renee Haltom and I argue that it is not—and that government intervention might actually lead to more financial instability, not less.



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Chastened by the Great Depression, when it allowed one-third of the nation's banks to fail, the Fed in subsequent decades appeared eager to expand its lending to troubled financial institutions, including nonbanks, during times of crisis. Beginning in 1970, the Fed, in conjunction with other regulators, initiated a series of rescues that protected the creditors of large, distressed firms: Penn Central Transportation in 1970, Bank of the Commonwealth in 1972, Franklin National Bank in 1974, Continental Illinois in 1984, and Long-Term Capital Management in 1998, among others. The rescues continued during the recent crisis with the creation of a variety of emergency lending programs and support for a few select institutions and markets.

Many policymakers and observers have looked to history to justify the Fed's actions before and during the crisis, for example by claiming that the Fed was created to promote financial stability. But as stated in the preamble to the Federal Reserve Act of 1913, the explicit purpose of the Fed was to “furnish an elastic currency.” At that time, it was difficult for banks to respond to sudden increases in the demand for cash. As a result, interest rates were subject to seasonal spikes, and bank panics were frequent because depositors sought to withdraw funds before payments were suspended. But by lending directly to banks through the discount window, the Fed could help ensure that the supply of currency expanded in accord with demand. The Fed's founders designed the Fed to play a stabilizing role by improving the general circulation of currency, not via the targeted channeling of funds to firms that private markets had deemed less than creditworthy.

Policymakers also described the central bank as the “lender of last resort,” an idea that comes from the writings of Henry Thornton in the early 1800s and Walter Bagehot in the

1870s regarding the Bank of England. In the 19th century, lending was the primary way the central bank managed the stock of coins and banknotes in circulation. When Bagehot advocated central bank lending during a crisis, he was advocating an expansion in the supply of currency to meet the increase in demand. But the Fed's emergency lending programs during the crisis were not undertaken to increase the net supply of liquid assets to the economy. Instead, they simply reallocated credit. In other words, the Fed's lending performed a fiscal function, not the monetary function Thornton and Bagehot had in mind.

As long as the Fed's actions increase the stability of our financial system, one might ask, why do modern misinterpretations of history matter? The answer is that the Fed's interventions by themselves can contribute to instability. Those who believe government backstops are necessary subscribe to a view of the financial system as inherently fragile. But an alternative view—and in my opinion a more plausible view—is that government policy actually induces fragility. When the government expands its “safety net,” it conveys that market participants can take excessive risks without bearing the full costs. On the margin, funding flows are tilted toward markets that seem most likely to receive government support. The expectation of that support reduces the monitoring efforts of creditors in those markets, allowing borrowers to take even greater risks. Then, when firms fail, government support is invoked again—a cycle we saw play out during 2007 and 2008.

How do we end this cycle? As Haltom and I point out, more regulation is hardly a foolproof way to counter moral hazard. Instead, we must realign the incentives that encourage excessive risk-taking in the first place. One promising avenue is the creation of “living wills,” detailed plans that describe how a large, complex financial firm could be wound down within the bankruptcy code without government support. In addition, certain reforms of the bankruptcy code could improve prospects for creating credible resolution plans. Even then, expectations of government support may persist as long as there is the legislative authority to provide that support—which argues for rescinding that authority, including the Fed's emergency lending powers.

What lessons should be drawn from the Fed's first 100 years? One option is to look at the history of financial crises in this country and conclude that central bank intervention is the necessary salve for the financial system's inherent fragility. But as you read the essay, I encourage you to consider instead that an overly broad interpretation of the Fed's role in fact undermines financial stability—and that the best contribution we can make during the next 100 years is to provide monetary stability.



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