

What Economists Get Wrong About the Lender of Last Resort

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This presentation draws heavily on:

*Political Foundations of the
Lender of Last Resort:
A Global Historical Narrative
(forthcoming JFI)*

By

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LOLR an Old Idea => Lots To Learn from!

Rome in 33 A.D.

Caisse d'Escompte in France (1776)

Hamilton (1792)

Thornton (1802)

Central role initially of special banks of issue

Adequate powers?

Fairness and impartiality?

Prudence: stabilizing or opposite?

Complex contingent contract b/w govt. + bank

Explicit and implicit parts

Five Important and Pervasive Errors

1. LOLR design requires economic, not political, thinking.
2. Proper LOLR interventions provide liquidity without subsidizing bank insolvency risk, or offering bailouts.
3. Legitimate LOLR always can be achieved with collateralized lending following Bagehot's Rule.
4. Given the many diverse exigencies LOLR must face, it's undesirable to make rules constraining LOLR.
5. Central banks should act exclusively and independently as the LOLR.

ERROR 1

LOLR design requires economic,
not political, thinking.

Political Underpinnings

1. Capacity: legal tender authority (Smith's Wealth of Nations).
2. Public Interest Authority / Legitimacy: Mandate to guide actions and authority to discipline bank's actions, improve stability (Charters, public announcements).
3. Public Interest Authority / Legitimacy: Legality of charging high interest rates (usury law relaxation).
4. Public Interest Authority / Legitimacy: Taxing windfall profits to ensure proper tradeoffs during crisis.
5. Public Interest Authority / Legitimacy: Procedures to avoid excessive favoritism (use of a rating book).

UK: 1833 Act: 1-3; 1844 Act: 4; 1858-66: 2, 5; 1826-1850s increasing competition pushes the BoF into specialized interbank role: 2

ERROR 2

Proper LOLR interventions
provide liquidity without
subsidizing bank insolvency risk,
or offering bailouts.

What Are “Liquidity” Crises, How Do They End?

1. Insolvency risk *increase* alongside insolvency risk *intolerance* is always at the heart of liquidity crises. Banks and other money market borrowers that cannot borrow are not “mistaken” as insolvent; they are just not regarded as eligible for roll over (e.g., Panic of 1907).
2. Given that all crises stem from heightened insolvency risk and difficulty of speedily resolving this by banks’ raising new equity (rather than deleveraging and contracting lending, or suspending convertibility), there is no effective LOLR response that avoids subsidizing default risk somewhat.
3. Mechanisms for doing so vary. Bagehot: “lend on good (not riskless) collateral at a high (not penalty) rate.”

ERROR 3

Legitimate LOLR always can be achieved with collateralized lending following Bagehot's Rule.

Limits of Collateralized Lending

1. Bagehot's Rule is not the only legitimate LOLR type. Other choices reflected both the economic limitations of collateralized lending, or political limits on ability to follow Bagehot approach (U.S. pre-Fed).
2. Economic limits on collateralized lending:
 - Counterproductive subordination of deposits.
 - Debt overhang limits lending, preferred stock.
 - Some combination of collective action, subsidies or equity.
3. Nevertheless, pre-World War II LOLRs generally followed what can be called "*Bagehot's Principles*."
 - Solve systemic problem with least moral hazard, risk to LOLR.
4. Recently, however, we have wrongly substituted ex ante insurance for effective, disciplined LOLR.

Bagehot's Principles in LOLR History

Coordinating banking coalitions through the use of tranching and guarantees: UK in 1890 Barings Crisis (prior Paris Bourse, and U.K. Secondary Banking Crisis of 1970s).

Autocracies (Mexico and Russia): necessarily more limited, not CB, discretionary, but often innovative (securitization in Mexico).

Canada: Is a government LOLR really needed? Nationwide branch banking combined with discretionary collective action.

RFC preferred stock in Great Depression (big shocks with limited equity make collateralized lending undesirable). Note that debt overhang also limits preferred stock (which may justify raising capital requirements).

These all satisfied “*Bagehot's Principles*”:

Systemic stability rather than preventing particular failures
(*Acharya and Thakor 2016*)

Limiting risk absorption by LOLR as much as possible

Choosing the most senior form of claim possible

Recent Decades

End of Bretton Woods has an analog in banking policy: blank check safety nets (deposit insurance, bailouts, credit guarantees)

From 1970 to 2000, a dramatic expansion of deposit insurance worldwide (*Demirguc-Kunt et al. 2014*)

Coincides with an unprecedented global pandemic of banking crises with high bank losses relative to GDP (*Laeven and Valencia 2014, Calomiris and Chen 2016*).

These reflect fundamental political changes in the spread of populist democracy, labor movements. Governments are more generous with safety nets, more reluctant to close banks, especially at politically sensitive moments.

Heterogeneity in deposit insurance has been shown to reflect political influences (domestic and international).

ERROR 4

Given the many diverse exigencies
LOLR must face, it's undesirable to
make rules constraining LOLR.

Rules Are Crucial for *Capacity* and *Legitimacy*

Who is eligible to receive assistance?

What sorts of instruments can LOLR deal in?

How much latitude LOLR have in packaging loans?

Mandate for crisis assistance?

Guarantee authority?

Crisis-broadening of Who, What or How powers?

Sunshine disclosure rules of normal assistance?

Sunshine disclosure rules of crisis assistance?

Countries differ:

Australia, UK, N. Zealand, S. Africa have *high* scores.

Japan, Egypt and Thailand are in *middle*.

U.S., Canada, Kenya and India have *low* scores. (But ad hoc deviations.)

Saudi Arabia has virtually *no* LOLR authority.

ERROR 5

Central banks should act
exclusively and independently as
the LOLR.

Central Banks Can't Do Heavy Lifting

1. It's convenient for central banks to provide quick LOLR assistance through collateralized lending with small subsidies, following clear rules.
2. At some point, however, the risk involved, and the judgment involved, require direct government involvement (even if managed with central bank); otherwise legitimacy of central bank as a non-political, non-fiscal authority is undermined, with wide-ranging adverse consequences.
3. Canada's staging is a good model. This is superior to categorical prohibition, which necessitates ad hoc interventions (delays and legitimacy questions surrounding TARP). Unfortunately, U.S. learned wrong lessons about LOLR in recent crisis. We got more deposit insurance and less LOLR. We needed more LOLR authority, staging, and a roll back of deposit insurance.

Conclusions

Politics has always governed, and must always govern, the powers of an effective LOLR.

Ending crises means taking (some) risk.

Collateralized lending is not adequate when shocks are big: Follow Bagehot principles rather than Bagehot's Rule (*systemic threats, effective responses that min govt risk*).

Rules give accountability, which is crucial to preserve capacity and legitimacy.

Central banks should not perform all LOLR policy in isolation. Staging authority to involve government is wise. U.S. approach invites ineffective and illegitimate ad hoc interventions.

Growth of blank check LOLR via deposit insurance and bailouts since WW II has been undesirable.