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Myths about the Lender of Last Resort

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Agenda

- Introduction
- ‘High rates‘ are not ‘Penalty rates‘
- Distinction between illiquidity and insolvency
- National LOLRs have unlimited capacities, in contrast to ILOLRs
- Moral hazard is always present
- A total dispersion of LOLR is possible

Introduction

- Goodhart, C.A.E. (1999): Myths about the Lender of Last Resort. In: International Finance 2/3. 339-360.
- Research topic: Myths about LOLR
- Introduction and dispersion of four myths regarding the role and abilites of national and international institutions acting as LOLR
- Thorton and Bagehot

High rates are not Penalty rates

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- Bagehot‘s proposals:

  - Lend freely
  - At a high rate of interest
  - On good banking securities

- Thorton‘s proposals:

  - Extraordinarly high liberality
  - Reliefs of distress should not be directly translated to rates
  - Bills are favourable

- Misinterpretion of Bagehots proposal for high rates as penalty rates (higher than the market rate)

- Penalty rates lead to a vicious circle

- Different meaning of ‘high‘ in the 19th century (6% - 7%)

Myth 1

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On the possibility of a distinction(murky) between illiquidity and inslovency

- Consider the possibility of large shocks:

>>For eg. Large jumps (⬇) in asset prices in crisis era → multiple equilibra.

>>Panic conditions →Insovency of viable firms (may be temporary).

>>Serious among commercial banks due to their interconnectedness (Allen & Gale, 1998,1999)

Myth 1 Cont.

- Central Bank faced with LOLR application has no quick or accurate way of ascertaining this.
- Misinterpretation of Bagehot’s proposal.
- Wrong description of LOLR operations.

>>Practically impossible to distinguish between LOLR-OMO and non-LOLR-OMO

Eg. Bank of Japans aggressive ↑ in MB in recent year.

Myth 1 Cont.

- Only the distinction between CB lending to an individual institution and OMO dealing with the market as a whole is practical.
- Only CB lending to an individual institution is LOLR.
- Illiquidity implies a suspicion of ultimate insolvency (generality-)failure of the Bank to adjust to its liquidity on the open market.

>>Bank of New York case.

- CB evaluation of the validity of such suspicion of solvency problem and its extent almost impossible at least within the relevant time scale.

National Central Banks as LOLR

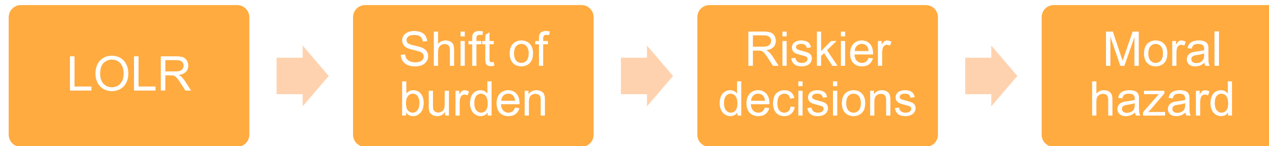
- CBs have much better capacity to help since end of Gold Standard;
- Central Banks' resources are still limited;
- In systemic cases, CBs must have the government behind them;
- Economies need Foreign Currency -> National CBs and Governments won't be able to act as LOLR in those cases.

IMF as ILOLR

- Governments turn to the IMF;
- IMF is capable of sustaining much larger losses, although it usually doesn’t suffer any;
- Even so, IMF prefers to act as guarantor;
- Losses won’t be absorbed by Governments;
- Slow decision making;

	Central Banks	IMF
Resources	Limited	Limited
Sustainable Losses	Large	Very Large
Currencies	National	Any
Backing	Government	None
Decision Making	Fast	Slow

And the moral hazard?



And the moral hazard?

Why consider LOLR/ILOLR

Systemic risk

Decision makers “punished”

Harsh IMF ILOLR

And the moral hazard?

Who shall pay the price?

- Equity/bond holders-up to the extent of their limited liability
- Depositors-protected
- Interbank creditors?

It is possible to dispense with LOLR

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Financial Crises are unpleasant - Actors will want to soften the worst effects

- Unthinkable that Governments or Central Banks of today would not act through LOLRs
  - not politically acceptable
- Possibility of going back to private alternatives

If the IMF could not play an effective ILOLR

- Not a free market but rather an ad hoc system of regional subsystems centered around a major currency and major power.

It is possible to dispense with LOLR

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“Financial crises are all too common, painful and potentially contagious. Faced with such dangers, all agents will try to insure against it. The weak will look to the strong for support. The question is not whether to have a lender of last resort, either nationally or internationally, because it is vain to think that such a mechanism can be abolished on the altar of free market doctrine. The more relevant and interesting question is how best to organize the LOLR function that will continue to exist both nationally and internationally.”