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Central Bank Management: an "Art" not a "Science"?

Masters in Monetary and Financial Economics

Monetary and Financial History

Professor Rita Martins de Sousa

Joana Sousa Leite (Nr 47461)

Telma Frutuoso (Nr 46272)

Framework

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- ✓The Lender of Last Resort (LOLR): Definitions and Controversies
- ✓The evolution of the Bank of England as LOLR
- ✓Bagehot's *Lombard Street* (1873)
- ✓The Great Depression and the absence of a LOLR in the U.S.
- ✓The impact of the Great Depression on the LOLR doctrine
- ✓One example of a Rescue Operation
- ✓Conclusions

The Lender of Last Resort (LOLR): Definitions and Controversies

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- **Humphrey (1992):** “The term ‘lender of last resort’ refers to the central bank’s responsibility to accommodate demands for high-powered money in times of crisis, thus preventing panic induced contractions of the money stock.”

- **Kindleberger (1978):** “the lender of last resort stands ready to halt a run out of real and illiquid financial assets into money by making more money available.”

The Lender of Last Resort (LOLR): Definitions and Controversies

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- Imply the idea of **“panic”.**

- **Fractional** reserve banking (Diamond and Dybvig, 1983).

- **Definitions of LOLR** differ in terms of which events warrant intervention:
  - Thomas Humphrey: financial sector, specially the banking system; main goal to maintain the stock of money.
  - Kindleberger: financial sector, including “real and illiquid financial assets”.

The Lender of Last Resort (LOLR): Definitions and Controversies

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- The contagion of **fear** (Friedman and Schwartz, 1963).
- **Financial crises:** associated to severe economic contractions.
- Decrease of **money stock**.
- Other institutions playing the **role of LOLR**.
- **Monetary** regime.

The evolution of the Bank of England as LOLR

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- Founded in 1694 - **1st Institution to act as the LOLR** (1870).

- **Private institution** with limited responsibility.

- Conflict between the adherence to gold standard and the **action as LOLR**.
  - Negative impacts during the crises of 1793 and 1797.

The evolution of the Bank of England as LOLR

- **Bank Act of 1844** - *Peel´s Act*
  - Emerged a new pattern;
  - Exceeding its fiduciary limits in time of emergency.

Peel´s view: “the LOLR should be constrained in its note issue in normal times, but should have the flexibility to expand its note issue during an emergency”.

The evolution of the Bank of England as LOLR

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- Second half of the 19th century: financial perturbations.
  - E.g.: Overend, Gurney, and Company and Baring Brothers, and Company.

  Baring Brothers
  - Crisis erupted in 1890 when the firm failed.
  - Request for assistance.
  - Bank of England created a guarantee fund.
  - Prevent a situation of panic.
  - Bank of England acts as LOLR to avoid a banking crisis.
  - Financial and monetary stability.

Bagehot’s *Lombard Street* (1873)

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- The most **influential text** on LOLR.

- **“Bagehot’s rule”**, was “that in time of panic, the Bank of England must advance lend freely and vigorously to the public out of the reserve.”

- Different **types of crises** lead to a different policies/results.

The Great Depression and the absence of a LOLR in the U.S.

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- During the Great Depression, operations of more than a fifth of the commercial banks in the US was suspended due to **financial difficulties**.

- The New York Federal Reserve reacted by **suppling additional funds** to commercial banks so they could make loans to brokers and dealers.

- The **LOLR failed** and the American banking system suffered from thousands of bank failures.

The impact of the Great Depression on the LOLR doctrine

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- Central Bank should use the LOLR to lend freely in a financial panic and proposes the creation of an **international LOLR** (Hawtrey, 1932)**.**

- Central Bank should **inject sufficient high-powered money** to the banking system to offset the decline in the deposit-reserve and deposit-currency ratios and maintain the stock of money (Friedman and Schwartz, 1963).

- LOLR must **preserve important lending institutions** and provide credit to borrowers who could not utilise their normal sources to obtain credit (Bernanke, 1983).

One example of a Rescue Operation

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- **The Baring crisis (1980)** is the typical example of a successful intervention to prevent a potentially failure.

- The practice of central banks had been extended by the Baring Crisis to include the rescue of banks that were not “hopelessly insolvent”, in order to **prevent crises**.

- The Bank of England’s response to the Baring crisis did not fit the fit the **classical LOLR operations**.

Conclusions

- The theory of **LOLR was developed in response to financial crisis**. Thus, Economists analysed the recent crises to formulate guidelines that would have prevent them and so might prevent the next one.

- However, although there are some guidelines that could respond or even prevent a financial crisis, the **LOLR can be considered an art**, as each financial crisis requires a specific response.

References

- Grossman, Richard S., Rockoff, Hugh (2015). Fighting the Last War: Economists on the Lender of Last Resort. *Working Paper 20832, NBER*.