

## Rethinking the 'Lender of Last Resort'

Many people have come to think of central banks as a necessary, almost inherent, part of a healthy financial system. But for some functions the Fed has adopted since it was created in 1913, there is no reason, in principle, that they must be performed by a central bank. An example is the function of “lender of last resort,” a phrase often used to describe how central banks have tended to respond to financial crises. When many market participants withdraw funding at once, it can mean financial distress for fundamentally solvent borrowers, a situation often called a “run.” Temporary central bank lending to sound institutions can, therefore, prevent unnecessary failures.

Two articles in this issue of *Econ Focus* explore alternatives to a central bank as lender of last resort. One discusses the little-known Panic of 1914, which occurred before the Fed had officially opened its doors. To end the crisis, the Treasury issued fully collateralized emergency currency, and private clearinghouses extended loan certificates to their members. Both helped banks meet depositors' demands. While the Treasury played a strong role in this response, the episode demonstrated that fast access to an asset-backed currency — which need not come from the central government — could stem a run.

Another article in this issue explores why Canada has been able to fend off financial crises almost entirely, while the United States has been especially prone to them. Part of the answer is that, from Canada's inception, its banking system was structured to be less vulnerable to shocks. Banks could establish wide networks of branches to diversify their portfolios. They were also allowed to issue new currency backed by their own general assets to meet the demands of depositors. Both features enabled banks to lend reserves to one another in emergencies and expand the supply of currency elastically.

These responses were effectively ruled out by laws in the United States, as the articles discuss. The lack of diversification and reliable access to reserves made banks rather vulnerable to local economic shocks and seasonal shifts in currency demand — which often led to the very bank runs that our currency and branching restrictions left the banking system ill-equipped to handle.

The Fed was given lender of last resort powers in order to provide a more elastic currency to stave off panics in a way that existing laws prevented the banking system from doing on its own. Thus, the Fed was founded to ameliorate the destabilizing effects of other policies.

There is a parallel to today. The Fed's functions have evolved, now with a much larger role in setting monetary policy, the core mission of the Fed and other central banks. But its lender of last resort powers remain. Many people

have argued that the Fed's “emergency” lending powers under section 13(3) of the Federal Reserve Act — which enables the Fed to extend broad-based loans to troubled markets — must be preserved to enable a response to all manner of “runs” in the financial system.

But one important source of excessive risk, in my view, is the government safety net itself, which includes the lender of last resort. A government backstop reduces the borrowers' incentives to design contracts and credit market instruments that are less vulnerable to runs. It also diminishes the incentives of lenders to monitor borrowers. That makes crises more likely and the government's liquidity support more likely to be called upon. As a result, the government's financial “safety net” only grows over time. Estimates by Richmond Fed researchers show that 57 percent of the entire financial sector is either explicitly guaranteed by the government or market participants can reasonably expect guarantees based on past statements and actions. To the extent that the safety net results in excessive risk-taking, the Fed's present-day lender of last resort powers exist to counteract instabilities created by flawed policies, just as they did when the Fed was founded.

A better way to deal with financial instability would be to scale back the incentives for excessive risk-taking. A smaller government safety net would give markets greater incentive to adopt their own protections against runs. This may not rule out runs entirely. But history has convinced me that the self-fulfilling nature of government backstops cannot reliably prevent runs either and can in fact cause instability. The experiences of 1914 and Canada force one to consider that there could be alternatives to a centralized role of lender of last resort, some which could conceivably be devised by markets themselves under the right set of incentives.

In American history, we have often treated financial system instabilities with reforms that don't address the fundamental problem. My hope is that the Fed's second century will prove that policymakers are willing to take a harder look at the true sources of instability in our financial system. **EF**



JEFFREY M. LACKER  
PRESIDENT  
FEDERAL RESERVE BANK OF RICHMOND