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- **THE LENDER OF LAST RESORT MECHANISM FROM A CENTRAL BANK'S VIEWPOINT IN THE RECENT FINANCIAL CRISIS**

by Efstathia Korkou, Doctoral Candidate

The services of the Central Bank (CB) were originally conceived as the services of a Lender of Last Resort (LOLR). These were offered to commercial banks which were essentially solvent but which faced a temporary liquidity problem. Thus, the central bank provided emergency short term lending but at a penalizing high interest rate and only against collateral of high quality, thus driving said commercial banks back to the interbank lending market.

However, the recent financial crisis of 2007-2009 and research seem to consent that "liquidity and solvency shocks cannot be disentangled". So CBs in charge of the conduct of monetary policy had to break almost every conventional rule of the LOLR mechanism, trying a great gamut of new tools and intervening to the financial system and the economy to an unprecedented extent.

Traditionally, one of the most powerful weapons in the arsenal of a CB in its war for controlling money supply has been the conduct of Open Market Operations: "the buying or selling of short-term government bond which effectively adds or removes money from the national banking system".

In this way, the CB is in position to manipulate its policy rate, the interest rate banks charge each other for overnight loans for funds on deposit at the CB. In normal times, the policy rate is "a proxy for the cost of borrowing at any number of levels of the economy". A low policy rate implies an effort to inject liquidity in the system, whereas the opposite occurs in cases of overheating of the economy where the CB imposes higher rates.

A "liquidity trap" occurs when Open Market Operations no longer work. In the case of the recent financial crisis for instance, CBs such as the Federal Reserve Bank (Fed) of the United States, the Bank of England and the European Central Bank (ECB) have slashed their interest rates towards zero but this collective cut was unable to stimulate the market as a whole: CBs were willing to lend at low rates but the actual market rates at which banks lend to one another –e.g. the LIBOR- remained high given the fear and uncertainty among banks, firms and households.

John Maynard Keynes's metaphor about "pushing on a string" could not describe better the exercising monetary policies of the period; in other words, conventional monetary policies served to nothing. But when conventional monetary policies fail to work and the fear of deflation is apparent, this leaves plenty of room to unorthodox and experimental measures and tools to take action. And this is exactly what happened over the course of the recent financial crisis.

Ben Bernanke, the head of Fed as well as several other central bankers "sought to counter the effects of the financial crisis with three kinds of tools. Most traditional was the provision of liquidity to a host of financial institutions, including banks, broker dealers, and even foreign central banks. Less conventional was the creation of the special facilities that purchased (or financed the purchase of) specific kinds of short-term debt. Then the Fed began to play the role of "investor of last resort", which culminated in the most radical programs of all: its commitment to intervene in markets for long-term debt (various asset-backed securities and long-term government debt)."

At the very moment, when economists all over the world are concerned about the "exit strategy" from all these special facilities, fundamental questions about the very functionality of the LOLR mechanism arise. Whenever a CB transforms from the lender of last resort to the lender of first and unique resort, fears about moral hazard are logical to arise. And unavoidably, in their effort to save the financial system, CBs could not discriminate with certainty between solvent and illiquid institutions.

Furthermore, the mentality of Too-Big-To-Fail institutions enters into the debate, since some would argue that if an institution is Too-Big-To-Fail, maybe it is Too-Big-To-Exist. In the aftermath of the recent financial crisis, the challenge for policy makers is historic. The "Volcker Rule" in the United States, designed to inhibit banks' speculative activity seems like a promising first step but a lot of work needs to be done in order to see things under the right perspective.

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