Economics focus

What would Bagehot do?

Should central banks act as buyers of last resort?

Aug 16th 2007 | From the print edition

HOWEVER much marble they lay in their foyers, banks have typically been brittle institutions. They borrow short (collecting deposits or short-term loans that might have to be repaid quickly) and lend long (making loans that cannot easily be converted into cash at anything close to their value to the bank).

A bank is solvent if its assets are worth more than the money it owes to its depositors and creditors. As long as its depositors believe that their money is safe, their faith is rewarded. But even a solvent bank can be broken by a bank run. If depositors fear that others will withdraw their money, making claims on the bank's reserves of cash, nobody will want to be last in line. Since a bank cannot redeem more than a fraction of its deposits at any one time, the depositors' rush to escape with their money paradoxically ensures that some of them will lose it.

The damage may not stop there. A run on one bank can shake faith in another, if only because depositors have no reliable way to distinguish between sound and unsound institutions. As the banking system comes under threat, the supply of credit to businesses and households will be interrupted. And since cheques and other payments are often drawn on bank accounts, the payments system can come under strain.

In "Lombard Street", his 1873 account of the money markets, Walter Bagehot urged the Bank of England to stave off such panics by lending "quickly, freely and readily", at a penalty rate of interest, to any bank that can offer "good securities" as collateral. When this newspaper laid out these principles in September 1866, they were described by a director of the Bank of England as "the most mischievous doctrine ever broached in the monetary or banking world in this country".

But as Bagehot pointed out, by lending liberally, central banks make it less likely that their money will be needed. By demanding good collateral, the central bank can try to distinguish insolvent banks from illiquid ones; and by charging a penalty rate of interest, it ensures that it is truly the lender of last resort.

Bagehot's mischievous doctrine is now conventional wisdom among central banks, as last week's events dramatically demonstrated. First the European Central Bank and then the Federal Reserve intervened liberally, lending against good collateral. They departed from Bagehot only in not charging a penalty rate.

Bank architecture has moved on since Bagehot's day: neo-classical columns giving way to glass atriums. Their position in the financial architecture has also changed. Companies that would once have turned to a bank for an overdraft or a loan now sell paper or bonds to the market. Home mortgages are now bundled into securities and sold on.

financing from multiple sources. If a fund starts to show losses, its backers may lose faith in its trades. But even if they believe it will eventually make money, they might grow nervous about the fund's other backers. Just like a nervous depositor eyeing the queues in front of a bank, one hedge-fund creditor may demand its collateral before everyone else grabs theirs. If, to muster collateral, a fund is forced to sell assets into a falling market, a profitable trade can quickly become unprofitable. In this way, seasons of alarm "beget the calamities they dread," as Bagehot put it.

Should anyone else care? Some of the buyers of CDOs are big enough that their failure can hit the banks that sponsor or finance them. It could also cause the credit markets to seize up, interrupting the provision of finance to the economy. What would Bagehot do in such circumstances? Making it cheaper for banks to lend to each other is a rather indirect method of intervention. The Fed's rate cuts in the autumn of 1998, as Long-Term Capital Management, a big hedge fund, neared collapse, allowed banks to pick up the pieces as the capital markets came unstuck. But such tactics might not always do the trick.

The new mischief-makers

Willem Buiter of the London School of Economics and Anne Sibert of Birkbeck College, London, have advocated their own mischievous doctrine*. They think central banks should become "market-makers of last resort", setting a price for securities that can no longer be sold on "orderly" markets because distress sales are pushing prices far below their fundamental value.

The central bank could make a market in CDOs, say, either by accepting them as collateral or by buying them outright. In either case, it would have to make up its mind about the underlying risk of such instruments and an appropriate penalty price. If it gets its calculations wrong, the central bank may lose money and face. But, the two authors say, preserving financial stability is more important than "covering the central bank's posterior".

The bigger danger is that the central bank might make the next crisis more likely if it goes too far to protect investors' posteriors in this one. After all, they should anticipate that a security might not be easy to trade. But they won't deal with this "liquidity risk" if they can rely on the central bank to create a liquid market in whatever security has got them into trouble.

Banks, in return for the protection offered by a lender of last resort and by deposit insurance, accept restrictions on how far they can extend themselves. Mr Buiter thinks that hedge funds should not enjoy the protection of a central bank until they too are willing to accept analogous restrictions. In the meantime, perhaps they should lay more marble in their foyers.

* maverecon.blogspot.com/2007/08/central-bank-as-market-maker-of-last.html.

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