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Rules for a Lender of Last Resort: An Historical Perspective

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Summary

The Federal Reserve was established in 1913 to be a lender of last resort. Paul Warburg, its principal architect had in mind that a U.S. central bank would follow Bagehot׳s strictures 'to lend freely at a penalty rate' in the face of a scramble for high powered money. Yet the Federal Reserve Act never spelled out how the Fed was supposed to act as an LLR. This omission came to the fore in the Great Contraction 1929 to 1933 when the Fed failed to prevent four banking panics which turned a serious recession into the Great Contraction. Reforms in the 1930s corrected some of the Fed׳s failures but clamped down on financial activity for 40 years. The financial crisis problem returned in the 1970s with financial liberalization. The Fed abandoned Bagehot׳s strictures and adopted the 'Too big to fail' doctrine and 'creative ambiguity'. This policy shift contributed to moral hazard and created new threats to financial stability with the rise of the 'shadow banking system'. The subprime mortgage crisis prompted the Fed to take unprecedented LLR activities which have opened up a Pandora׳s box of perils. The Fed has moved away from rules based policy in its LLR function.

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