Lending of last resort? A European perspective

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Apparently, I was invited to participate in this workshop on the strength of my experience in managing the liquidity operations of the ECB between 2007 and 2012. The brief was to "reflect on the usefulness (or practicability) of the classic pre-crisis LOLR principles and lessons for the design and conduct of liquidity support operations".

The first thing to be said about my ECB experience is that I did not think much about LOLR at the time. This could be due either to my difficulties in conceptualising about it during the thick of the action, or to the fact that the LOLR concept was not very helpful in managing the ECB's liquidity operations. Perhaps I would give more weight to the second of those explanations: LOLR was not the most useful concept in those circumstances, for two reasons:

(i) LOLR is affected, as Goodhart argued in 1999, by ambiguities and misunderstandings that make the concept difficult to use in practice,[1] and

(ii) if taken to correspond in ECB terms to bilateral Emergency Liquidity Assistance (ELA), LOLR is only a very small part of the ECB's overall activities and, indeed, those of other leading central banks.[2]

Let me expand on the second point and explain why I prefer a narrow definition of LOLR and why, therefore, ECB action amounted to much more than LOLR. As defined by Goodhart, LOLR refers to bilateral funding for banks that are experiencing liquidity difficulties, and this has more to do with financial stability than with monetary policy. However, a broadly defined LOLR would be indistinguishable from monetary policy and would therefore lose its specific significance. If I have to think about an umbrella concept for what the ECB and other central banks did during the crisis, I am more persuaded by this quotation from the Fed: "The System, then, was to provide not only an ***elastic currency*** – that is, a currency that would expand or shrink in amount as economic conditions warranted…".

For someone like myself, who learnt his central banking catechism from the Bundesbank, if only indirectly, the idea of a currency expanding or shrinking looked odd the first time I read it on the wall of the New York Fed's vestibule. But I later came to understand that the concept of an elastic currency is totally consistent with

1 See Goodhart (1999, p 339): "There are few issues so subject to myth, sometimes unhelpful myths, that tend to obscure rather than illuminate real issues, as is the subject of whether the central bank (…) should act as a lender of last resort (LOLR)."

2 I take here clearly a narrower definition than the very wide one adopted by the issue note, which basically subsumes under the concept of LOLR the entire balance sheet expansion by central banks during the crisis: "From mid-2007 until early 2009, central banks extended the equivalent of about 4 trillion dollars in major currencies in liquidity support to banks and nonbanks, to individual institutions and markets, and in domestic and foreign currency." I agree with Goodhart: "the distinction between lending by the central bank to an individual institution and OMO dealing with the market as a whole is simple, practical and self-evidently justifiable. In my view only the former should be described as LOLR."

the essence of monetary policy as conducted by the Bundesbank or the ECB – as independent central banks devoted to price stability, which in no way requires a constant or constantly growing money supply.

In my opinion, the ECB's actions were much closer to the macro concept of an "elastic currency" than to an LOLR action. Basically, I take the concept of providing "an elastic currency" as deriving from the idea that demand for liquidity, which is always variable to some degree, becomes extremely unstable in crisis conditions, and that central banks have been created to buffer this instability and thus reduce the intensity of crises, if not their frequency.

Lest you accuse me of lèse majesté towards two titans of central banking such as Thornton and Bagehot, let me say that I find little to disagree with in their writings, at least as I read them second-hand in Caruana's preface.[3] Indeed I do not believe that they were writing about a restricted LOLR concept, namely bilateral lending to banks in difficult conditions. Their references to merchants in addition to bankers show that, in my view, they were not thinking only of banks as needing comprehensive support from central banks in times of crisis.

The way I interpret the provision of an elastic currency by the ECB explains two extraordinary facets of the crisis: the reduction in the turnover and outstanding stock of the interbank market as well as the unprecedented expansion of the ECB's balance sheet.

In the book that I published with Paul Mercier three years ago on the implementation of monetary policy in the euro area, there is a table that compares the two above-mentioned developments. The updated version of that table, as reproduced here, shows a nearly one-to-one relationship between the evaporation of liquidity in the money market and the corresponding expansion of the Eurosystem's balance sheet during the crisis.

Contraction of money market and corresponding expansion of Eurosystem balance sheet, 2008–11 — Table 1

Fall in unsecured turnover (EUR bn)	Increase in secured turnover (EUR bn)	Net fall in turnover (EUR bn)	Increase in Eurosystem balance sheet (EUR bn)	Substitution between Eurosystem and market intermediation (%)
(1)	(2)	(3) = (1) – (2)	(4)	(5) = (4) / (3)
327	212	115	113	98

On this interpretation, the ECB used its balance sheet to carry out the intermediation that the private sector was no longer capable of providing. And the ECB offered that liquidity at a non-punitive price, thus providing the required elastic currency.

Of course, if a central bank has to provide liquidity in order to replace an impaired market, it follows that not only short-term intermediation in the domestic

[3] See Caruana (2012) preface to the new Spanish translation of Lombard Street.

currency is needed, but also intermediation over longer maturities and in other currencies. And this fits very well with the facts that the ECB has lengthened the maturity of its lending up to three years, and has also provided liquidity in US dollars through its swap agreement with the Fed.

The idea that central banks provide intermediation to substitute for impaired market functioning can be extended to encompass the first phase of the Fed's response to the crisis, ie before its Large-Scale Asset Purchases (LSAP). It also applies to the ECB's asset purchases (under its Covered Bond Purchase and Securities Markets (SMP) programmes). But the idea does not extend to the Fed's LSAP, which had a different logic and methodology.

From what I have said, you have already gathered that I do not find it useful to describe as LOLR for governments either the ECB's SMP, or the action it promises under its Outright Monetary Transactions (OMT). First, I have tried to give a restricted interpretation of the LOLR term, where the limitation to banks and to bilateral relationships is essential. Second, and more importantly, LOLR for sovereigns sounds to me like fiscal dominance, and I have seen too much of this in Italy during the 1970s and 1980s not to be dismayed.

There is one other point I would like to make: the provision of an elastic currency inevitably produces a certain amount of moral hazard – probably a significant amount, although perhaps less than commonly thought and further contained by new regulations. This risk needs to be managed and controlled, and the best way to do this is to make those that are incurring the risk pay for at least some of the consequences. As applied to banks, this means making shareholders, managers and lenders accountable for their decisions before the central bank lends to the troubled bank in question. As applied to countries, this means requiring them to correct past policy errors. One may question whether such "conditionality" was always appropriately applied to banks and sovereigns during the crisis. Still, it is fair to say that there has always been an awareness of the need for conditionality.

My penultimate point is about the international dimension of LOLR or, in my preferred concept, of an elastic currency: I find that this is just part of monetary policy and should be decided like all other monetary policy moves, with the only difference being that two or more central banks need to reach an agreement: the lender and the borrower(s). This implies that no permanent agreements should hamper the freedom – or independence – of the relevant central banks in deciding whether or not to engage into this particular form of monetary policy. I leave it open whether this principle was respected by the recently established permanent swap agreements.

My last point touches on the fact that central banks tend to earn profits when providing an "elastic currency". I believe that this has been the case for the Fed, and it was certainly true of the ECB: whenever it has intervened – whether this was at the turn of the century in the foreign exchange market or during the crisis on covered bonds and peripheral government bonds – it has realised quite hefty capital gains. If you feel that such "commercial" gains are beneath the dignity of a central bank, let me propose two ways to dignify them. First, you can agree with Milton Friedman that interventions which bring profits to the central bank are macroeconomically good. Second, on the assumption that the economy has multiple equilibria, the central bank should receive a financial reward for nudging the economy from a bad to a better point of equilibrium. This paradigm also deals effectively with the question of what penalty rate banks should pay when they receive the elastic currency during a crisis: the applied rate should be higher than the rate that would

prevail under the good equilibrium but lower than the one prevailing during the crisis.

In conclusion, I find the concept of an elastic currency more useful than that of the LOLR, even if I agree with the prescriptions that are traditionally associated with the LOLR.

References

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