Comment on Real and Pseudo-Financial Crises

Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

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by Allan H. Meltzer

Anna Schwartz's paper makes a useful distinction between actual and pseudo financial crises. The distinction in a reaction against the tendency to dilute the language by using extreme terms to refer to ordinary problems. The tendency arises on one side from the understandable desire of the people with the problem to convince the public that the prevention of chaos or disaster depends on special assistance being rendered by government to them and, on the other, by the eagerness with which governments respond to such pleading when it is made by a large, vociferous group. In cases of financial distress, it is in the interest of creditors to palm off the debts of insolvent or illiquid borrowers on the taxpayers by arousing fears of a financial collapse and a return to the depressed conditions of the thirties.

Schwartz attacks this argument with her characteristic vigor, thoroughness and careful scholarship. I will restate her argument in two main propositions, expand the discussion of one, and briefly relate the two propositions to current financial distress. I agree with her conclusions and have no fault to find with her brief, but succinct episodic history of past British and American financial distress. I have a few comments on her discussion of the lender of last resort, so most of my attention is on that.

Two Propositions

Two propositions about crises summarize Schwartz's main conclusions. First, insolvency or illiquidity of a bank is neither a necessary nor a sufficient condition for a financial panic. Second, failure of the central bank to protect the money stock from a sudden, relatively large decline, unanticipated as to timing or magnitude, is a sufficient condition for a crisis. The precipitating cause of the monetary contraction may be a financial failure, but the widespread expectation of a series of failures serves just as well.
The first proposition reminds us that financial panics involve the system not an individual institution. The task of the lender of last resort is to protect the system from mistakes or misfortunes that affect some of its parts. Schwartz emphasizes that the British banking system did not experience any panics after 1866. The reason is not that the world was calmer, more stable or more certain after 1866. Two changes occurred. The Bank of England recognized its responsibility to prevent a panic and always acted promptly when a financial crisis threatened. The public became convinced that the Bank had the power to prevent a crisis; soon after the Bank acted decisively, the panic ended and deposits (or notes) returned to the commercial banks. This is the legacy of Walter Bagehot, whose writings in the Economist and whose book, Lombard Street, show a clearer understanding of the problem than many of today's Cassandras.

Bagehot's book does not criticize the directors of the Bank of England for failing to act. On the contrary, he recounts in lively detail how they responded to the panics of 1824, 1866 and at other times. Bagehot's main criticism, in current terminology, is the lack of credibility and the absence of pre-commitment. According to Bagehot, the Bank acted, at times, as if it intended to protect its gold reserves by contracting loans and advances. Bagehot argued that this policy is mistaken; the way to protect the bank's reserve is to expand, even if this requires temporary suspension of convertibility. Further, Bagehot insisted on the importance of pre-commitment. Panics occur because the public does not know how the Bank will respond. His main recommendation is that the Bank should announce in advance that, although it is privately owned, it accepts the responsibility of a bank of issue to protect the money stock.

Schwartz defines financial distress as a condition in which an individual or firm hold assets with (realizable) current market value below its outstanding liabilities. She shows that there were many ways for banks, non-financial firms or individuals to reach this position. There does not appear to be a uniform pattern or cause of distress that can be identified in advance. Sometimes the problem started abroad, sometimes at home. The initial cause could be a war or some peacetime event. Whatever the cause, when news of the distress spread through the market, Schwartz points out, fear of default by creditors of the firm (or individual) rises. A critical point is reached at which the solvency of secondary or tertiary firms - particularly the banks that are creditors of the insolvent firm and the insolvent firm's creditors - is in question.

In contrast to the diversity of causes, there is one dominant solution. Once the market is assured that the supply of base money will increase sufficiently to prevent the insolvency of otherwise solvent banks and non-financial firms, the demand for currency or specie declines, and a crisis is averted. Schwartz follows Bagehot by emphasizing pre-commitment when she writes (p. 15):
"Knowledge of the availability of the supply was sufficient to allay alarm."

Bagehot's summary brings out the excess burden imposed by uncertainty about policy.

"In common opinion, there is always great uncertainty as to the conduct of the Bank: the Bank has never laid down any clear and sound policy on the subject. ... The public is never sure what policy will be adopted at the most important moment. ... And until we have on this point a clear understanding with the Bank of England, both our liability to crises and our terror at crises will always be greater than they would otherwise be."  

Role Of The Lender Of Last Resort

Schwartz's distinction between real and pseudo financial crises permits her to separate historical experience into periods of distress and panics. She notes that after the Bank of England accepted its responsibility as lender of last resort, in 1866 on her chronology, there were no financial panics or crises in the United Kingdom. Periods of financial distress, at times, required the suspension of specie payments, but distress did not degenerate into financial panic.

In the United States, uncertainty about the lender of last resort function remained high until deposits were insured after 1933. The important institutional change in the United States was not achieved by having the Federal Reserve pre-commit to serve as lender of last resort. Responsibility was divided by the 1930's legislation between the Federal Deposit Insurance Corporation, organized to insure commercial bank deposits up to a pre-set (but periodically adjusted) maximum, the Federal Savings and Loan Insurance Corporation, with comparable responsibilities for thrift institutions, and the Federal Reserve. Later, other institutions were added to provide comparable services for brokerage houses.

None of the institutions that insures deposits has the power to create base money. They can relieve financial distress in two ways. Either they sell some assets and distribute the proceeds to the depositors of the financial institution that is in distress or, by encouraging a merger or consolidation, get solvent financial institutions to accept the deposits and the (discounted) asset portfolio. In the latter case, the insurer assumes the portfolio loss.

If some unforeseen event causes financial distress at several banks or financial institutions simultaneously, deposit insurance is not capable of preventing a financial crisis. The Federal Reserve must act as lender of last resort, supplying currency at a rate equal to the increased demand for currency, thereby preventing a sudden, sharp decline in the means of payment.

3Some suggest that this action is inflationary, but it is not. The action prevents a fall in the price level but, does not require an increase.
It is not difficult currently to imagine the type of event that would exhaust the reserves of the deposit insurance agencies and that could not be resolved by merging financial institutions. Default by one or more of the Latin American governments in Mexico, Brazil and Argentina has the potential to produce severe financial distress. We cannot know whether such distress would be followed by a severe financial panic, by orderly liquidation of some insolvent institutions or by some action intermediate between the two. The reason that we cannot know what the governments' response would be is that central bankers and governments have not chosen to tell us. We are back in the position described by Bagehot, and quoted above, in which uncertainty is greater than it has to be.

Uncertainty could be reduced by a clear statement from the lenders of last resort in each country. The statement should make clear the conditions under which central bank loans will be available and the assets which will be accepted as collateral. Bagehot's two main rules remain applicable.

The first rule determines the quantity of advances. The central bank should lend freely at a penalty rate. This rule makes clear that the only quantitative restriction on the volume of discounts is the penalty rate. When banks, and other financial institutions, can borrow in the market, they will not pay a premium for advances from the central bank. The penalty rate assures us that, in ordinary times, the central bank will not discount. The central bank will be active when (or if) there is a sudden scramble for liquidity – that is a panic.

Bagehot's second rule specifies that the assets on which the central bank lends during a panic should include "everything which in common times is good 'banking security.'"\(^4\) He continued:

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\text{The amount of the advance is the main consideration for the Bank of England, and not the nature of the security on which the advance is made, always assuming the security to be good. An idea prevails (as I believe) at the Bank of England that they ought not to advance during a panic on any kind of security on which they do not commonly advance. But if bankers for the most part do advance on such security in common times, and if that security is indisputably good, the ordinary practice of the Bank of England is immaterial. In ordinary times, the Bank is only one of many lenders, whereas in a panic it is the sole lender...}^{5}
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A third rule is now required to recognize the fact that banking is now international in a way that differs from Bagehot's day. Branches of foreign banks typically do not have the same opportunity as domestic banks to discount at the central bank in the countries in which they are resident. Further, foreign banks have located in so-called "offshore" centers that do not have central banks.

\(^4\)Bagehot, \textit{op. cit.}, p. 100.
Schwartz points out that some economists have recommended the creation of an international lender of last resort. She does not agree with this recommendation, and I believe she is correct.

The unique ability of a lender of last resort is the ability to produce base money on demand. If banks demand dollars, and are willing to pay a penalty rate to obtain them, the Federal Reserve can supply them without limit. (If there is a limit, it must be suspended as it was in Britain during several financial crises.) Only the Bundesbank can supply Deutsche marks, in response to demands of this kind, etc. An international lender of last resort would only have exclusive power to issue unlimited quantities of base money on demand, if it was a world monetary authority and there was a world money stock.

Under the current regime of fluctuating exchange rates, there is no role for a world monetary authority. And there is no role for an international lender of last resort, since the authority to create base money remains with the individual countries.

There should be pre-commitment by the central banks to provide discounts, at a penalty rate, to all holders – foreign and domestic – of "good banking securities" dominated in their currency. A statement of this kind would reduce uncertainty and, as Schwartz demonstrates, prevent a period of financial distress, or pseudo crisis, from becoming a real crisis.

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