

Henry Thornton, Walter Bagehot, and the Modern Central Bank



In the last issue of *Region Focus*, I discussed some of the problems that could result from Federal Reserve support to troubled financial institutions. In particular, I argued that such support, if not done properly, could encourage institutions to take on risks that they otherwise would avoid. This, of course, is the issue of moral hazard, and it should remain in the forefront of the

minds of policymakers as the economy recovers from the current financial upheaval.

But that raises an interesting issue: How can central banks assist distressed financial institutions without inducing undesirable future behavior by those institutions? In short, how can the Fed act effectively as the lender of last resort?

There is no precise answer to those questions. When the Fed intervenes in the market, its actions often have effects that could not have been perfectly forecast. Policymakers rely on economic science to guide their decisions, but policymaking itself is not an exact science. Instead, it is a complicated exercise that often requires people to act on incomplete information, using the best data and theory available to form decisions.

Such theory is often new work done by leading contemporary economists. But not always. There are times when policymakers can learn much from the writings of the classical economists. I think that the current situation is such an instance.

Writing in the 19th century, Henry Thornton and later Walter Bagehot offered thoughtful advice as to how the Bank of England could act effectively as the lender of last resort. As my former colleague Thomas Humphrey has written, the Thornton-Bagehot framework stressed six key points:

- Protecting the aggregate money stock, not individual institutions.
- Letting insolvent institutions fail.
- Accommodating only sound institutions.
- Charging penalty rates.
- Requiring good collateral.
- Preannouncing these conditions well in advance of any crisis so that the market would know what to expect.

This, I believe, is a good place for modern central bankers to start when they think about how to lend to troubled institutions. If the Fed is going to make funds available, it should do so with the primary goal of protecting sound institutions and the financial industry as a whole. It should not attempt to save every institution. The optimal level of failure in any industry is not zero, and that includes the financial industry.

This is often a fine line to walk. There are cases where it is difficult to know in advance how much collateral damage would result if an institution were to fail. But if the rules of the game are spelled out clearly and the market believes the Fed will stick to those rules, then banks will have a strong incentive to avoid putting themselves in situations where they must come to the Fed to borrow at above-market rates. Moreover, banks will seek to protect themselves against a sudden loss of access to liquidity, promoting efficiency and stability in the financial system.

We are going through what is, in many ways, an unprecedented period in American economic and financial history. Economists and policymakers — and I count myself among both groups — do not know exactly why the financial sector has encountered such disruptions recently, although many plausible hypotheses have been proposed. More to the point, however, we do not know exactly how to most effectively help that sector get through this period. The best we can do is to rely on sound theory, data, and judgment to not only restore the health of the financial sector but also to avoid similar upheaval in the future. In this case, I believe that means drawing upon some longstanding principles about central bank policy. They do not provide all the answers, but they do provide a framework that should prove very useful to the Fed and other central banks around the world.

JEFFREY M. LACKER
PRESIDENT
FEDERAL RESERVE BANK OF RICHMOND