MERCATUS CENTER
George Mason University

RESEARCH SUMMARY

Is the Fed Really Operating as the Lender of Last Resort?

Defenders of recent credit-market interventions have argued that the Federal Reserve (Fed) is doing the same thing that central banks such as the Bank of England did 200 years ago. In “Last Resort Lending: Classical Thought vs. Modern Federal Reserve Practice,” Jeffrey M. Lacker rejects this claim. He shows how central banks used to play a far smaller role in credit markets than they do today, in the 21st century.

Unprecedented Intervention by the Fed

In addition to managing the money supply and interest rates, the Federal Reserve and other central banks lend billions of dollars to banks, financial institutions, and other businesses, especially during recessions and financial crises. The scope and scale of the Fed's credit extension grew dramatically in 2008: Fed lending, which had averaged under $250 million a day in the five years prior to August 2007, peaked at more than $400 billion in October 2008.

One justification for the Fed’s crisis credit programs is that they are consistent with a longstanding idea of the central bank acting as the “lender of last resort.”

Following the Bank of England’s Example?

The “lender of last resort” idea traces its origins back to the British monetary system of the late 18th and early 19th centuries. According to the thinking of the day, in the face of a panic the central bank should lend freely and at a high rate of interest to solvent borrowers on good collateral.

The Bank of England’s conduct was well known to the founders of the Federal Reserve in 1913, and it heavily influenced the design and direction of the new agency. But the Fed has strayed since the lender of last resort idea first emerged.

- Bank of England lending was far narrower than current Fed practices and was done only to carry out its monetary policy responsibilities.
- The Fed channels off-budget lending toward disfavored private borrowers such as “Wall Street” banks and favored economic sectors such as housing finance.

The Fed Needs to Focus on Monetary Stability

Over the past two centuries, central bank practice has evolved from lending in the service of monetary stability to lending for its own sake. Such lending is often driven by political considerations. Modern central banks should curtail such lending and focus on managing the supply of money, because their current practice is not at all necessary for conducting monetary policy.

For media or inquiries, call Mercatus at 703-993-4930 or visit mercatus.org/contact.

The ideas presented in this document do not represent official positions of the Mercatus Center or George Mason University.