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International Lending of Last Resort in Historical and Theoretical Perspectives: Introduction

Internationale Kreditvergabe der letzten Instanz in historischen und theoretischen Perspektiven: Einleitung

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Abstract: This paper provides an introduction to the special issue on international lending of last resort. Starting from debates about rescue operations and unconventional policies of major central banks in the contexts of the Global Financial Crisis and the European Debt Crisis, it draws attention to recurring controversies about trade-offs between averting critical contagion in financial markets and avoiding moral hazard. The need for international lending of last resort in strongly interconnected financial systems is more than ever evident, but there is no clear consensus on how to manage it. The contributions to this special issue put relevant issues in historical and theoretical perspectives.

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The 2007/08 Global Financial Crisis and its aftermath in the European Debt Crisis demonstrated drastically the need for international lending of last resort, but also the latter's controversial nature. Between December 2007 and October 2008 the U.S. Federal Reserve introduced reciprocal currency arrangements, also called “dollar swap lines”, with 14 major central banks to avoid severe disruption in global funding and credit markets. In the days of financial market panic, which followed the bankruptcy of Lehman Brothers in September 2008,

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the Fed boosted the supply of dollar liquidity to other central banks by factor ten. Without such swift liquidity assistance, which lasted until February 2010, a larger number of systemically important banks would have collapsed and money markets would have stalled. The adverse consequences for the world economy would have been far greater than the global recession in 2009, which was heavy but relatively short.

When the Global Financial Crisis nevertheless mutated into the European Debt Crisis in late 2009, rescuing systemically important banks turned out to be a particularly tricky issue in the European Monetary Union (EMU). In view of the no-bailout clause in its constitution, the Maastricht Treaty, and the lack of a clear mandate for the European Central Bank (ECB), it was uncertain at the outset to which extent banks could and would be saved by national bailouts or by supranational lending of last resort. Compared to the other major central banks, the ECB acted in a restrained fashion. However, when several EMU member states began to look unable to bear the fiscal burdens of rescuing transnationally operating banks in their jurisdictions and to refinance their debt in international markets, it took a decisive turn towards *unconventional monetary policies*. Quantitative easing and the mere announcement of *Outright Monetary Transactions* – accompanied by Governor Draghi’s famous words: “Whatever it takes...” – stabilized European financial markets in and after 2012.

The ECB’s activities were interpreted as lending of last resort to governments, rather than to the financial sector only, and this was highly controversial. Debates about its role as the lender of last resort were especially heated in Germany, where academic opinion leaders and politicians accused the ECB of violating and overstepping its mandate. Legal action against the supranational central bank was taken, several times over, in the Federal Constitutional Court of Germany. In 2020, this national court issued a judgment that was widely considered as a threat to European Union law and the monetary union. It ruled that, if the ECB did not comply with the court’s demands of accounting for proportionality, its German affiliate, the Bundesbank, would no longer be permitted to participate in ECB programmes that were part of union-wide lending of last resort. The imminent conflict was solved in circumvention of any measures that could be interpreted as submission of the ECB’s policy to German national law.

Even if it is now widely accepted that international lending of last resort is essential for coping with severe crises in a world of transnationally operating banks and financial markets, such legal confrontations indicate that academic and political opinions about its usefulness and designs are deeply divided. The conflicting positions are basically identical with those debated in the controversy between Walter Bagehot and Thomson Hankey (a former governor of the

Bank of England) about 150 years ago. Put in modern terms, one side advocates lending of last resort to contain contagion and other negative externalities of banking crises in order to minimize real effects of financial instability. The other side argues that lending of last resort contributes to generating such crises by encouraging excessive risk-taking, thus creating moral hazard at the expense of the general public.

Then again there are different views among the advocates on how to do lending of last resort. The differences are related to the question, whether the core problem is just temporary illiquidity in the money market, or insolvency of banks that are considered too big to fail. In the *money view*, the central bank should confine itself to *lifting the boats* by providing liquidity in the aggregate. Interbank markets are seen as efficient in re-allocating the injected liquidity to keep solvent banks afloat, while letting insolvent banks sink without putting the system at risk. In the *banking view*, by contrast, it is necessary to bail out individual banks by *lifeboat operations* precisely because their insolvency would put greater parts of the banking system at risk. In this view, interbank markets cannot be trusted to preserve financial stability because combinations of imperfect and asymmetric information create risks of contagion that dwarf the moral hazard risks of bailouts. Adherents of the banking view are less dogmatic about the instruments of crisis management. They are open to combinations of lifeboat operations and aggregate liquidity provision through open market operations or other channels. Circumstances permitting, bailouts can be carried out in arrangements that reduce moral hazard by bailing in shareholders of the troubled banks, or by involving a consortium of private-sector banks, firms and other institutions. To gain in democratic legitimacy, bailouts can be based on support from fiscal authorities. In cases in which the lending capacity of the central bank is limited, a fiscal backstop will be required anyway.

Finding a consensus on lending of last resort in times of crisis is difficult enough at the level of nation states (henceforth: LLR), but matters are further complicated at the international level (henceforth: I-LLR). A central bank's power to act as a lender of last resort is based on its function as provider of ultimate liquidity in the domestic economy. This comes in the shape of currency which is *high powered* by the sovereign. In global financial markets, in which many currencies circulate, it is less clear which, if any, sovereign has the economic power and political determination to let its central bank act as international lender of last resort. The central bank of the nation with the leading currency is an obvious candidate, but to which extent did the Bank of England and the U.S. Federal Reserve take that role in the past? To which extent can and will inter- or supranational institutions, such as the International Monetary Fund or

the European Central Bank, carry out that task? It was a long way to arrive at the acceptance of the Fed as a global and the ECB as a regional lender of last resort. In a multi-currency world, I-LLR requires cooperation between central banks that has to be learnt and practiced to build trust and understanding. Even in single-currency types of monetary unions, such as the euro area, I-LLR must be coordinated with fiscal policies and banking regulation at national levels. The European experience shows that this is not a matter of course.

The special issue at hand provides historical and theoretical perspectives on international lending of last resort. It presents a collection of papers prepared for a conference on I-LLR held at the University of Oldenburg (Germany) in September 2021.¹ The contributions set their focus on selected and partly neglected aspects of central banking in the gold standard era, and they examine different approaches to I-LLR in the history of economic thought from that era until the present.²

Emmanuel Carré and *Laurent Le Maux* open the horizon by a tour through writings about lending of last resort from the mid-19th century to the late 20th century. Standard LLR history begins with Henry Thornton's "Paper Credit of Great Britain" (1802) and Walter Bagehot's "Lombard Street" (1873).³ *Carré* and *Le Maux* take a different angle. They set the focus on endogenous theories of financial crises and their contributions to thought about I-LLR. In this tradition, they examine and compare writings by authors as diverse as Thomas Tooke, Ralph Hawtrey, Hyman Minsky and Charles Kindleberger. They navigate through debates about the management – and mismanagement – of financial crises from the era in which the Bank of England was the London lender of last resort at the centre of the international financial system first, to the era a century later when the Fed became the New York lender of last resort for the international dollar-denominated banking system, and then to the time another half-century later

¹ Due to the Covid-19 pandemic the conference was conducted in a hybrid format, i.e. both on site and online. The author gratefully acknowledges helpful comments made by Charles Goodhart and other participants, as well as financial support by the Deutsche Bundesbank and logistic support by Catharina Schramm and Damian Holschemacher. The usual disclaimer applies.

² For a comprehensive reading of standard historical and recent literature on LLR and I-LLR see *C. Goodhart/G. Illing (Eds.), Financial Crises, Contagion, and the Lender of Last Resort. A Reader*, London 2002; for a post-crisis update on I-LLR see *Bank for International Settlements, Re-thinking the lender of last resort* (BIS Papers No 79, Basle 2014).

³ See, for example, the much-cited article by *T.M. Humphrey/R. Keleher*, *The Lender of Last Resort: A Historical Perspective* (Federal Reserve Bank of Richmond Working Paper No 84-3, Richmond 1984).

when the Fed gradually assumed the role of a global lender of last resort for other central banks and their local banking systems.

Standard history of I-LLR proceeds from the presumption that the Bank of England began to accept the role of a lender of last resort not long after Bagehot's insistence that "it is the proper function of the Bank of England to keep money available at all times to supply the demand of banks which have rendered their assets unavailable."⁴ This view suggests that the Bank of England reoriented its business policy towards fulfilling that "proper function" in the public interest from the 1870s, or at latest from the 1890s, onwards. *Dieter Ziegler* shows in his detailed analysis of the Bank's portfolio and activities from the 1840s until 1914 that its business policy remained, however, that of a private joint-stock bank. He maintains that, even in the last decades before the First World War, the guiding principle for the directors of the Bank of England was to secure stable profits for its shareholders rather than stabilizing the supply of liquidity to the world at all times.

How then could the Bank of England acquire the reputation of an international lender of last in the classical gold standard era? Some clues come from the other end of the world – more precisely: from the other end of the British empire. They come from a monetary union that has not received much attention in the gold standard literature. *Frank Decker* demonstrates by his meticulous study of institutions and operations in the monetary union of Australia, New Zealand and the United Kingdom that the ANZUK union was part of an imperial hub-and-spoke network of banks under a Sterling standard. With London at the centre, Australasia, Ireland and Scotland were distinct satellites, but also interconnected through a carefully managed system of London, intercolonial and inland exchanges. *Decker* emphasizes that the design of the ANZUK union as an international branch system of competing private banks efficiently integrated large and vastly different geographic and economic areas with diverse and unique institutional structures. While the monetary arrangements before the First World War clearly qualify as a monetary union, the ANZUK union became fragmented after the war and broke up in the 1929-31 exchange-rate crisis.

The Latin Monetary Union was quite a different affair, originally set up in 1865 by France, Belgium, Italy and Switzerland as a common coinage system to allow the free circulation of gold and silver coins between the member states. When the bimetallic regime came under pressure in the 1870s, the need for a lender of last resort, or of an alternative arrangement, emerged. The Banque de France took a leading role in the union and acted at times as a sort of clearing-

4 W. Bagehot, *Lombard Street. The Description of the Money Market*, London 1873, p. 83.

house without, however, assuming the role of a lender of last resort. As *Nicolas Barbaroux* points out in his paper, it played instead the role of a *converter of last resort*, accepting coins from other union member states and converting them into gold even at times, when those other states (such as Greece and the Holy See) debased their coins and operated on the brink of sovereign default. In the transition from bimetallism to the gold standard, the first decades of the Latin Monetary Union were full of debates about the advantages and disadvantages of bimetallic and monometallic regimes, respectively. *Barbaroux* examines prominent French positions in these debates by juxtaposing the contributions made by Felix Esquirou de Parieu, the monometallist, and Henri Cernuschi, the bimetalist.

While the Latin Monetary Union was primarily a coinage system, the three central banks in the Scandinavian Monetary Union cooperated over more than four decades through a clearing arrangement that looks like an early modern framework for I-LLR. *Anders Ögren* and *Hans-Michael Trautwein* explain, however, that in the four major banking crises in Scandinavia between 1873 and 1931 (the period in question) I-LLR was practiced only in two cases, plus – for some time and in a contorted fashion – during the First World War. They show that the cooperation through clearing in this polycentric union was indeed fairly advanced, but that a lack of coordination in discount rate policies and banking regulation produced recurrent frictions – both under the gold standard and when it was suspended. The clearing arrangement played, nevertheless, a role in fostering financial integration so as to reduce the need for LLR and I-LLR. In addition to their historical account of Scandinavian banking crises and central bank cooperation, *Ögren* and *Trautwein* survey contemporaneous economists' views on these matters. Of particular interest is Knut Wicksell's prescient praise of the Scandinavian clearing arrangement as an example for frameworks of rational interest-rate policy in fiat money systems. In recent decades, Wicksell's ideas have regained currency in macroeconomic theory and monetary policy.

While the Scandinavian countries can be considered as belonging to the *advanced periphery* of the gold standard world,⁵ countries in Southeastern Europe were in its financially backward quarters. *Nikolay Nenovsky* and *Dominique Torre* set their focus on Bulgaria and Romania, two countries that unsuccessfully tried to join the Latin Monetary Union, adopted the gold standard relatively late and with difficulties, and were linked to the world financial centre in London only indirectly through connections of their banking systems with the German and French language areas. *Nenovsky* and *Torre* provide a detailed compar-

5 See *L.F. Øksendal*, *Monetary Policy Under the Gold Standard - Examining the Case of Norway, 1893-1914* (Norges Bank Working Paper 2008/14, Oslo 2008).

ison of the political responses to the 1931 banking crisis in both countries. Describing the peculiarities of the political sceneries and banking worlds in Bulgaria and Romania before and during the Great Depression, the authors demonstrate fundamental differences in the chosen LLR strategies. Romania took recourse to *lifeboat operations*, rescuing individual banks partly in fashions that were particularly prone to suspicion of moral hazard. Bulgaria, by contrast, resorted to strategies of *lifting all the boats* by generous rediscounting, combined with establishing a sinking fund and other operations to consolidate the banking system.

The 1931 banking crisis did not occur just in Bulgaria and Romania. It had started in the United States, following from the Wall Street crash of stock prices in Autumn 1929, and spread to Germany, Austria and other countries before it reached the Balkans. Many a counterfactual global history of the mid-20th century could be written under the assumption that had the U.S. Federal Reserve acted decisively as a lender of last resort in time, the downward spiral of debt deflation, banking collapse and world trade disruption would thus have been stopped. The opinion that the Fed should have done so prevails among economists and historians in retrospect, regardless of the differences in their views on the causes and nature of the Great Depression. But why did the Fed fail to act as a lender of last resort? *Hugh Rockoff* contributes towards an explanation of this puzzle by drawing attention to the failure of the foremost expert on financial crises to diagnose the Wall Street crash and the ensuing banking panics as such a crisis. The man in question was Oliver M.W. Sprague who had written the authoritative “History of Crises under the National Banking System” for the National Monetary Commission in 1910. *Rockoff* describes how Sprague came to misdiagnose the Great Depression because it did not conform to his set of indicators for crises and because he was sceptical about the effectiveness of expansionary monetary policy once a depression is underway. *Rockoff* also points out that, while Sprague was perhaps the most eminent expert to advise against lending of last resort, he was far from the only one at the time.

Some lessons from the Great Depression had been learnt when the Global Financial Crisis unfolded in 2007/08.⁶ The Fed acted swiftly and resolutely this time, providing liquidity to the international financial markets by organising a network of swap lines between central banks. In the last contribution to this special issue, *Perry Mehrling* takes us full circle back from the past and describes the

⁶ It was probably helpful that Ben Bernanke, the chairman of the Federal Reserve at the time, had made a name for himself by high-profile academic research on financial disruption in the Great Depression.

present system of I-LLR, as it evolved under the leadership of the U.S. Federal Reserve in the course of the Global Financial Crisis and the more recent Corona Crisis. Accounting for far-reaching structural change in the world of finance, *Mehrling* uses the framework of a *money view* in which banking is seen first as a payments system and second as a market-making system. Since finance has increasingly moved from direct bank lending to market-based funding, the need for a lender of last resort has been transformed into the need for a *dealer of last resort*. According to *Mehrling*, the Fed has assumed the role of the global dealer of last resort by operating at the top of a three-tiered system of international liquidity provision. Stylizing this system by moving from the United States to the Global North core and then to the Global South periphery, *Mehrling* draws the dividing lines between quantitative easing in U.S. financial markets, dollar swap lines with major central banks in the North, and specific repo facilities for foreign authorities in North and South. In this way, the system thus provides international liquidity for national or regional LLR at the second and third tiers.

Mehrling emphasizes that the market-based I-LLR system of the present has been developed gradually and pragmatically rather than by conscious design. Various episodes and theories of the past – such as those presented in this special issue – may nevertheless be instructive for thinking about the further evolution of international lending of last resort.

Bionote

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