

Punter Of Last Resort

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Data Archive: <http://econ.jhu.edu/people/ccarroll/opinion/PunterOfLastResort.zip>

The financial meltdown that shifted into high gear last September has flushed into public view many surprising facts. One of the strangest is the existence, in the economics profession, of a bizarre religious cult. This cult adheres to the dogma that the “price of risk” is the Holy of Holies that can properly be set only by the immaculate invisible hand of the financial marketplace; and cult members seem to believe, to paraphrase President Lincoln from a rather different context, that “If the Market wills that the economic crisis continue until every dollar of economic activity created by the taking of risk shall be repaid by another dollar destroyed by a newfound fear of risk, so it still must be said that the judgments of the Market are true and righteous altogether.”

The deep origins of the cult, as always, are obscure; presumably they lie properly in the field of psychoanalysis. But to the extent that overt origins can be traced, the wellspring is the literature that attempts to explain the Mehra and Prescott (1985) ‘equity premium puzzle.’ The ‘puzzle,’ in a nutshell, is that asset prices have not, historically, exhibited a relationship between risk and return that is easy to reconcile with the rational behavior of a representative agent facing perfect markets. Many of the responses to this challenge start with the assumption that asset prices *must* be always and everywhere rational, and then proceed to work out the kind of preferences or environment that can rationalize observed prices. This game brings to mind Joan Robinson’s comment that “utility maximization is a metaphysical concept of impregnable circularity,” and Larry Summers’s remark (quoted by **Robert Waldmann**) that the day when economists first started to think that asset prices should be explained by the characteristics of a representative agent’s utility function was not a particularly good day for economic science. Oddly, even the failure of this literature to produce a widely agreed solution to the ‘puzzle’ does not seem to have weakened participants’ belief in the soundness of the intellectual framework within which asset prices are a puzzle.

Nor does the assumption that asset prices are always and everywhere perfect reflect the actual past practice of economic policymaking during crises.

As DeLong (2008) has recently reminded those of us who are susceptible to the lessons of history (see also Kindleberger (2005)), the “lender of last resort” role of the central bank has always been, during a panic, to short-circuit the catastrophic economic effects of a collapse of financial confidence (in today’s terminology, ‘an increase in the price of risk’).¹

Some economists, of course, view narrative history in the deLong and Kindleberger mode as irrelevant to the practice of their science; they prefer hard numbers to mere narrative. For the numerically inclined, however, Figures 1a and 1b should be persuasive; they show that controlling a market price of risk is something the Federal Reserve has done since it first opened up shop. The top figure depicts a measure of what we are now pleased to call the ‘risk-free’ rate of interest in the United States – essentially, the shortest-term interbank lending rate for which data are available (on a consistent basis) from before and after the founding of the Fed.² Figure 1b shows the month-to-month changes in this interest rate. The only reason this rate is now viewed as ‘risk-free’ is that *the Fed takes away the risk*.³

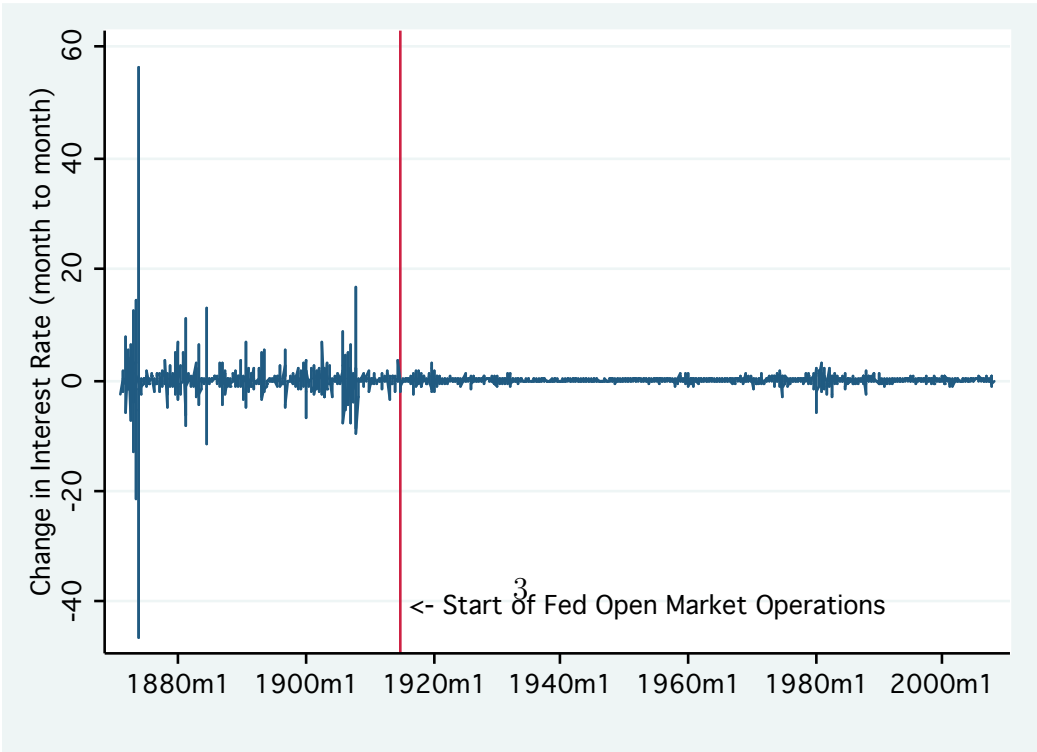
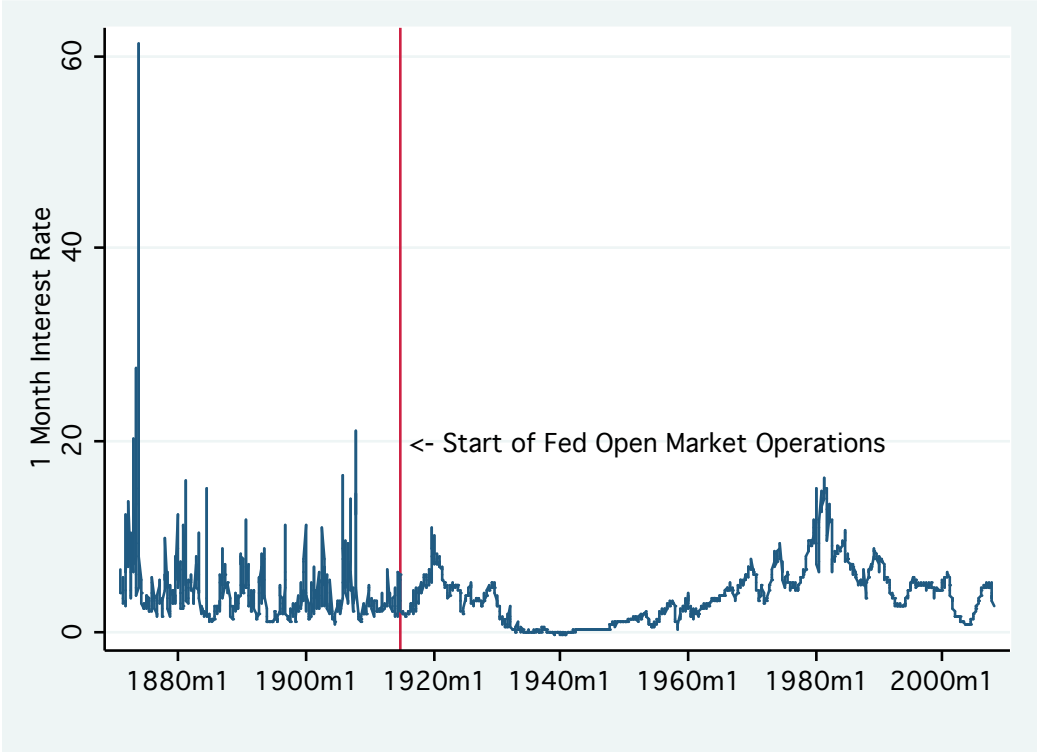
Do the advocates of the risk-is-holy view really believe that we were better off in a *real* free-market era when interbank rates could move from 4 percent to 60 percent from one month to the next (as happened in 1873)? And how long do they think such a system would last? It was, after all, the intolerable stresses caused by financial panics that ultimately led to the founding of the Federal Reserve, in the face of adamant opposition from people holding financial-markets-are-perfect, believe-me-not-your-lying-eyes views that are eerily similar to dogmas that continue to be propounded today. The panic of 1907, in which J.P. Morgan effectively stepped in as a private lender of last resort, constituted the last straw for the unregulated financial system that preceded the managing of risky rates that we have had since the creation of the Fed.

A less extreme version of essentially the same dogma states that while it is acceptable for the central bank to suppress the aggregate risk that would otherwise roil short-term interest rates, the Fed should ignore all other manifestations of financial risk. It is, if anything, harder to construct a coherent economic justification of this point of view than of the strict destructionist view that says the Fed should not exist at all. But there is, at least, a percep-

¹This was first made explicit, for the Bank of England, in 1844 (see DeLong (2008)).

²Data from Macaulay (1938) for before 1926, and from standard sources for subsequent periods. For more information, see the data appendix available at the author’s website.

³For more on this, see the interesting work of Holland and Toma (1991).



tion that this way of operating is hallowed by time and practice: Since the Fed, the story goes, has spent most of its history ignoring risk, it shouldn't change that now.

But even this milder dogma does not match the facts. Recent work by Robert Barbera, Charles Weise, and David Krisch,⁴ shows that over the "Taylor Rule" era of systematic monetary policy (roughly since 1984), the Federal Reserve's choice of the short run interest rate has been powerfully correlated to market-based measures of risk such as the difference between the interest rates on corporate bonds and corresponding maturity Treasuries. When risk has been high, the Fed has felt the need to stimulate the economy by cutting short-term rates, and vice-versa.

Given the Fed's pattern of past responses to risk and economic conditions (as embodied in risk-augmented Taylor rules), the implied value of the short term interest rate right now should be somewhere below negative 3.3 percent (actually even lower, since these projections do not reflect the dire recent news). Since interest rates cannot go below zero, the Fed must do something else to boost the economy. The obvious answer is to do everything possible to rekindle the appetite for risk – even if that means taking some of that risk onto the Fed's balance sheet. This could be accomplished under some interpretations of the still-evolving *Term Asset Lending Facility* and has already happened in the case of some other, bolder, Fed actions that have been properly viewed as necessary to prevent financial collapse (Bear Stearns; the takeover of the commercial paper market). How much to buy, and which assets to buy, and how to minimize the political risks, are all difficult questions. But the danger of doing too little is far greater, at present, than the danger of doing too much.

The voices that say the Fed should do nothing at all, or nothing beyond perhaps some purchases of longer-dated Treasury securities, are not the voices of reason; they represent a howling dogma that was discredited in 1844 (when the Bank of England received its first implicit authority to intervene during panics; see DeLong (2008)), was discredited again in the panic of 1907, and again during the Great Depression (by being adopted in an extreme form), and is in the process of being discredited yet again today. (In fairness, during ordinary times it is probably wise for the authorities to avoid attempting systematic manipulation of the price of risk, for all the reasons Kindleberger (2005) and Robert Peel (1844) articulated. But this is no ordinary time).

⁴See Barbera and Weise (2008), Weise and Krisch (2009) for details.

Let's put it this way: Simple calculations show that the current price of risk as measured by corporate bond spreads amounts to a forecast that about 40 percent of corporate America will be in bond default in the near future.⁵ The only circumstance under which this is remotely plausible is if government officials turn these dire forecasts into a self-fulfilling prophecy by failing to intervene forcefully in a way that quells the existential terror currently afflicting the markets. While I realize that some economists (and some politicians) might be willing even to undergo another Great Depression as the steep price of clinging to their faith, those of us who do not share that faith should not have to suffer such appalling consequences.

As the *Economist* magazine might put it, the problem is that the 'punters' (investors) who normally populate the financial marketplace and risk their fortunes for the prospect of return, have fled from the field in terror. Back when the financial system was almost entirely based on banks, the solution to such a problem was that the Federal Reserve would act as the 'lender of last resort' to quell the panic. In the new financial system where banks are a much smaller share of the financial marketplace than they once were, the Fed's appropriate new role seems clear: It needs to intervene more broadly than before, in public markets (as has already been done for the commercial paper market) as well as for banks; it needs, in other words, to step up to the plate and become the punter of last resort.

⁵The BAA-Treasury 10 year spread is about 6 percent. If you assume that all defaults will take place at once and the recovery rate is 1/3 then the approximate odds of default, p , satisfies $p = [1 - (1/3)] * 0.06 * 10$ or 40 percent.

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