THE LENDER OF LAST RESORT AND A MONEY SUPPLY RULE

David I. Meiselman

The Humphrey–Keleher paper provides an interesting and illuminating survey of some of the important literature in the history of economic doctrine and in monetary theory.[1] I have little to quarrel with or to add to their historical analysis. Instead, my comments are related to the fact that I believe the paper is incomplete when the authors shift their attention to the current scene. My comments are primarily directed to suggesting some updating of their excellent analysis.

Most of the discussion of the lender of last resort (LLR) concept has been rather vague since Bagehot, as the Humphrey–Keleher paper indicates. The role of an LLR has been framed primarily in terms of worse case, scare scenarios. It would be useful to subject the LLR concept to a rigorous and systematic analysis, including, for example, the appropriate goals, targets, and indicators for an LLR. Such an analysis would produce a body of tested knowledge about what to do (and what not to do) before a crisis.

The term "lender of last resort" may itself be a source of much mischief and confusion. One reason is that the term confounds money and credit, and similarly confounds the problems of credit markets and those resulting from sharp changes in the quantity of money, especially a monetary collapse. The Humphrey–Keleher analysis points this out very clearly, and I have nothing to add to their analysis on this issue.

Cato Journal, Vol. 4, No. 1 (Spring/Summer 1984).

The author is Professor of Economics and Director of the Graduate Economics Program in Northern Virginia, Virginia Polytechnic Institute and State University, Falls Church, Va.

[1]Thomas M. Humphrey and Robert E. Keleher, "The Lender of Last Resort: A Historical Perspective," *Cato Journal* 4 (Spring/Summer 1984): 275–318.

It is useful to evaluate alternative monetary regimes, as the authors have done to some degree, and in the process, to examine the stabilization properties of alternative regimes, even under various "scare" scenarios. For example, consider a regime characterized by fractional reserve banking and a money supply rule that fixes the growth rate of money. Assuming a financial panic, can there really be a "liquidity" crisis?[2] In my judgment, it would be most unlikely, perhaps close to impossible.

If the monetary authority abides by the money supply rule, it is hard to see any role for an LLR. Under a money supply rule, it seems to me that we would have a situation similar to the one that Bagehot described, where the monetary authority would make "funds" freely available to maintain the desired money stock. This would be the credit aspect of not permitting the money supply to collapse when there is an increase in the currency-deposit ratio or the reserve-deposit ratio which, for a given stock of reserves, would lower the money multiplier and contract the money supply. Alternatively, with a monetary base rule, some deviation from a base target may be desirable when there are significant changes in the currency-deposit ratio or in the reserve-deposit ratio, as may occur during a panic.

Most of the discussion of a money supply rule has emphasized its desirable price and output stabilization properties. Perhaps we should also add the desirable credit stabilization or LLR qualities to a money supply rule, as well.

With respect to institutions and phenomena peculiar to the United States, I am especially curious about the role and connection between the Federal Deposit Insurance Corporation (FDIC) and the LLR function of the monetary authority, especially given the unique role of the FDIC in the U.S. banking system. I believe this merits extensive and serious treatment.

Although I appreciate the interesting and useful survey of the history of doctrine regarding the LLR, I believe it would help the discussion if we considered the question: What would have happened in the past decade if the Federal Reserve had engaged in *no* micro bailouts, and instead, had tried to maintain whatever money stock was indicated by their own targets? For example, what if, under Arthur Burns, the Fed had not taken special steps to bail out Franklin National Bank, or, under Paul Volcker's chairmanship, what would have happened if the Fed had achieved its money targets but there

[2]The term "liquidity" remains quite vague, and I continue to search for a good, workable definition.

had been no central bank intervention in the silver crisis, or when the Mexican debt problem surfaced in August 1982?

Incidentally, I take issue with the notion advanced in some quarters that the turn in monetary policy in mid-1982 can be attributed to the Fed's response to the Mexican debt problem. The Mexican debt problem came to a head in late August 1982, which was *after* interest rates had fallen sharply and *after* the Federal Reserve had changed monetary policy in June 1982, when it shifted from an overly tight monetary policy (with essentially no money growth for six months) to an overly easy monetary policy (with M1 growing at 15 percent per annum). Thus, even if the Fed had intervened to help Mexico or Mexico's bankers, or if the Fed were to intervene to supply credit to an improvident foreign government, I do not see the connection between that step—whether merited or not—and the necessity to move from zero money growth to a 15 percent growth path for M1.

I believe the alternative explanation of Fed monetary behavior in mid-1982 was that the economy was in very poor condition, that the forecast for economic recovery had not been realized, and that the Fed, and especially the administration, panicked in the face of upcoming congressional elections.

Finally, the Humphrey–Keleher paper discusses Robert Mundell's recent proposal for an international LLR with powers to create world reserves. This proposal is simply another request for still another printing press, run by still another group of international bureaucrats, with the result being still another engine of inflation. We and other countries have more than enough problems with our own central banks without adding another. However weak the constraints happen to be on the central banks of individual countries, these constraints are even weaker when international civil servants are in charge.

THE IMPOVERISHING EFFECTS OF FOREIGN AID

Manuel F. Ayau

Introduction

The way the current debt crisis of some countries is frequently being analyzed is reminiscent of prior occasions when the solution was considered to be subsidized bail-outs of debtor nations by the governments of lending nations or by international financial agencies. These attempted solutions, however, have in most cases aggravated the problem. And those debtor nations that have achieved some economic success have achieved it in spite of, not because of, foreign aid.

In his book, *Will Dollars Save the World?* (1947, p. 29), Henry Hazlitt recalled the doubts that John Maynard Keynes raised about U.S. lending to Europe in 1919:

> "The chief objections to all the varieties of this species of project are, I suppose, the following. The United States is disinclined to entangle herself further (after recent experiences) in the affairs of Europe. . . . There is no guarantee that Europe will put financial assistance to proper use, or that she will not squander it and be in just as bad a case two or three years hence as she is now. . . . In short, America would have postponed her own capital development and raised her own cost of living in order that Europe might continue for another year or two the practices, the policy, and the men of the past nine months. . . .
>
> ". . . If I had the influence at the United States Treasury, I would not lend a penny to a single one of the present Governments of Europe."[1]

Cato Journal, Vol. 4, No. 1 (Spring/Summer 1984).

The author is President of the Universidad Francisco Marroquin in Guatemala City, and founder of the Centro de Estudios Economico Sociales. He is a former member of the Legislative Assembly of Guatemala.

[1]Quoted from Keynes (1920, pp. 283–84). Even though Keynes had reservations about foreign aid to Europe, he did not oppose such aid. However, he would attach strict conditions to the loans, which would have to be "repaid in full" (Keynes 1920, pp. 286–87; and see Hazlitt 1947, p. 30).