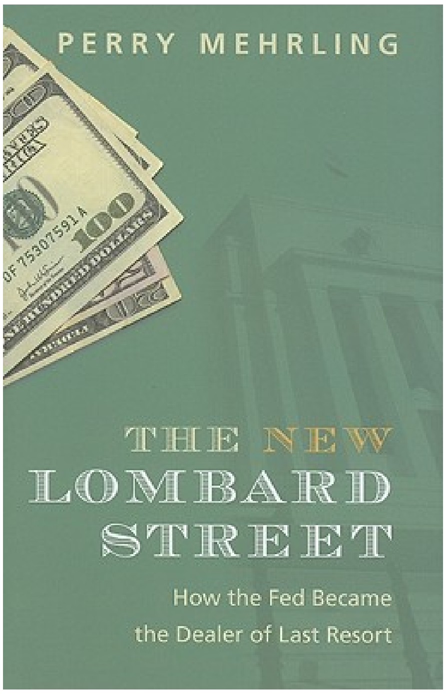

The New Lombard Street: How the Fed Became the Dealer of Last Resort

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Walter Bagehot's *Lombard Street*, published in 1873 in the wake of a devastating London bank collapse, explained in clear and straightforward terms why central banks must serve as the lender of last resort to ensure liquidity in a faltering credit system. Bagehot's book set down the principles that helped define the role of modern central banks, particularly in times of crisis--but the recent global financial meltdown has posed unforeseen challenges. *The New Lombard Street* lays out the innovative principles needed to address the instability of today's markets and to rebuild our financial system.

Revealing how we arrived at the current crisis, Perry Mehrling traces the evolution of ideas and institutions in the American banking system since the establishment of the Federal Reserve in 1913. He explains how the Fed took classic central banking wisdom from Britain and Europe and adapted it to America's unique and considerably more volatile financial conditions. Mehrling demonstrates how the Fed increasingly found itself serving as the dealer of last resort to ensure the liquidity of securities markets--most dramatically amid the recent financial crisis. Now, as fallout from the crisis forces the Fed to adapt in unprecedented ways, new principles are needed to guide it. In *The New Lombard Street*, Mehrling persuasively argues for a return to the classic central bankers' "money view," which looks to the money market to assess risk and restore faith in our financial system.

The New Lombard Street: How the Fed Became the Dealer of Last Resort Details

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From Reader Review The New Lombard Street: How the Fed Became the Dealer of Last Resort for online ebook

Chi Pham says

Brilliant. The book offers clear and interesting explanations about boring economic theories since the start of central banking practice.

Nancy says

A perfectly reasonable discourse on how the global monetary system functions, highlights on its weaknesses and historical failure points, and only briefly on the possible remedy against future systemic collapse. This book is dense, pithy, non-sensationalist, and skirts academic ideology. It requires a re-read, maybe a re-watching of the Coursera course, and is a definite must read for the oligarchy. For everyone else, it may be interesting to know that the syntax of the system has changed since the dawn of central banking, that powers have shifted from one to another, and the system always works until it doesn't.

Richard Shelton says

You've heard of Credit Default Swaps, Currency Swaps, Interest Swaps, Collateralized Debt Obligations etc.. but don't understand how they're financed and want to then I think this is a good book to read.

Tari says

Great history of the Fed and intro to the new era of central banking

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Matthew says

I read this book in conjunction with taking the author's Coursera class on the economics of money and banking (superb) so my review is colored by having that course in the back of my mind. The book ties together the big ideas while the course provides some of the technical plumbing behind these ideas, so they fit quite well; the book also likely stands alone quite well as a work of financial and intellectual history. It is relatively short; the first few chapters discuss the history of central banking (tracing it from the Bank of England and Walter Bagehot's principle of lending freely at a high rate during times of crisis, as expressed in the original Lombard Street), as well as the evolution of ideas of monetary economics which fed into how central banking was conducted; the last two chapters retrace the more recent history of the financial crisis and look at -- in the light of the foregoing monetary ideas -- how the Fed's actions fit into this framework.

The central idea is the American financial system, since the early 20th C, is unique for the link between money markets and capital markets (due to the banks holding of long term bonds for capital investment, as opposed to the short term commercial bills dominant in England) -- and thus that it is key to watch not only funding liquidity but also market liquidity in the monitoring of the credit cycle. This connection is made even stronger with the growth of shadow banking, which Mehrling defines broadly as money market funding of capital market lending (e.g. ABS backed by repo). This structure means that during a liquidity crisis, the Fed cannot only backstop banks funding liquidity (which seemed to work at first because the shadow banking system collapsed onto the formal banking system, as the parent banks were contractually obliged to take the securities back onto own balance sheet when the SIV repo funding dried up) but must also support market liquidity, by expanding its own balance sheet. Mehrling traces central bank history to show these actions are not unique to our day but were previously used in different contexts.

In that respect it is excellent, the most lucid analysis of the crisis and of the Fed's response I have yet seen, and set into a clear intellectual framework. However, the limitation -- and the reason it is a four and not five star -- is that its conclusion isn't far reaching enough. The books ends with the suggestion that the Fed, having successfully used emergency tools to support market liquidity, learn its lesson and change its framework and mission to formalize the goal of not only maintaining price stability but also managing system liquidity, and not only by targetting short end rates but by committing to backstop market liquidity when necessary. However the suggestion ends there without delving further into questions that immediately come to mind. For example: Is the implication is that the Fed was right to expand its balance sheet, and that it should also be relatively easy to reverse that process and sell back the securities to the market -- should we not be at all worried then? What does Mehrling have to say about the current state of monetary looseness -- granted the actions were right during crisis, but is policy now too loose for too long, and does that matter (book published 2011 so perhaps this is not a fair criticism)? Since the Fed could do what it needed with emergency innovation, why is there a need to change its framework and mandate? Finally, if Fed is asked to support market liquidity, does this run into the question of what extent of price collapse should it be expected to step in, how do you measure fair value of distressed assets (surely the job of market participants rather than the central bank; though Mehrling makes the subtle point that it can be structured that the Fed takes liquidity risk and the Treasury takes the credit risk) and how much moral hazard does this introduce?

Frank Stein says

Like most of Perry Mehrling's books, this one demonstrates deep scholarship and original thinking, and although there's much to disagree with as always, there's even more that provokes thought and reflection.

This book basically synthesizes Mehrling's other two works (one on the institutionalist monetary thought of the 1910s through 1950s, and the other on Fischer Black's work on the Capital Asset Pricing Model) and uses them to analyze the recent financial crisis. Trying to place himself between the "fiscal" and the "financial" view of the business cycle, Mehrling argues for the "money" view, where it is the loss of liquidity of financial and other assets that leads to crises and disruptions. He makes a compelling case that beginning with economist (and Brookings Institution head) Harold Moulton's work in 1918, the federal government and especially the Federal Reserve worked to make all financial assets "shiftable" at all times, and thus provide a ready source of liquidity to any market in danger. While not technically a "bailout" the promise to temporarily buy and sell all financial assets, whether they were for short or long terms, obvious or opaque, lead the financial and intellectual worlds to believe that "liquidity" was a free good that didn't have to be modeled (such as in the economic work of James Tobin or Arrow and Debreu) or accounted for in business, and that therefore the amount of cold hard cash ready at hand for businesses was not a concern.

The explosion of currency swaps, and then interest rate swaps and then credit default swaps (the latter two the direct result of capital asset pricing model theories by people like Black), which acted like loans but did not have the same banking networks and regulations, lead to increasingly illiquid and opaque financial markets. All of the producers of these assets acted as if only risk, and not liquidity (or the ability to time inflows and outflows of cash), as the only problem that needed to be solved or insured against. When the liquidity in these markets dry up, however, chaos broke out.

Mehrling thus celebrates the efforts of the Federal REserve to be the dealer for all potential assets in the system during this time of crisis (similar to Walter Bagehot's "Lender of Last Resort" role for the Bank of England in his 1870s "Lombard Street" book). From the 2007 creation of a Term Auction Facility, to a host of other facilities to calm money market mutual funds, commercial paper markets, and mortgage markets, the Fed provided the liquidity that the market needed, both by borrowing and lending, on both sides of the market, as a "dealer." Yet Mehrling still worries that the excessive and free provision of liquidity by the government can cause regular asset bubbles that need to be popped early.

After reading the book I'm still not sure how Mehrling defines "ease" or "discipline" at the Fed, except for more money coming in or out, or how he plans to identify and pop asset bubbles early, or how to balance "dealer of last resort" with the prevention of bubbles, but the book can't help but get you to think about these issues. For an original interpretation of the crisis and its ties to past economic thought and practice, this is a great place to go.

Anthony P Badali says

Insightful

Provides great insight into the Feds behavior and motives. Both of which are so often misrepresented by mainstream media and politicians.

Liam says

"The economics view and the finance view meet in the present, where cash flows emerging from past real investments meet cash commitments entered into in anticipation of an imagined future. This present is the natural sphere of the money view. But both economics and finance abstract from money; for both of them, money is just the plumbing behind the walls, taken for granted." (4)

"The point is that, in a really severe crisis, market liquidity is no longer a matter of the funding liquidity of private dealers but rather of shiftability to the Fed. If an asset is not shiftable to the Fed, it may not be shiftable at all, or only at an unacceptably large price discount. The Fed in a crisis is not so much the lender of last resort (funding liquidity) as it is the dealer of last resort (market liquidity)." (107)

Iworld1991 says

It is an inspiring book. The conventional role assigned to the Fed since its establishment was the Lender of the Last Resort, the idea behind which dated back to 19th century. But the author in this book argued that Fed was no longer only in a position to extend discount loans to financial institutions in liquidity crisis by a punishment rate as proposed by the Bagehot rule, but also has got deeply involved in the money market and capital market by holding and selling securities and other assets, as the so called the Last Dealer of Resort. Unlike what's believed in the past, the Federal funds rate, the only tool controlled by the central bank, can not be smoothly translated into the money market and asset market. Liquidity is not actually a free good. But the institutions in the current system take for granted the fact that as long as the liabilities and risks can be shifted to other institutions, they are in a safe position. It turned out they are wrong.

Maximus says

Perry walks through the history of the Fed focusing mostly on the evolution of policy. He breaks down the recent 2008 crisis, the Fed’s actions, and the ‘plumbing’ of the financial system. The Fed has transitioned from lender of last resort to dealer of last resort. Market liquidity being the main focus in the transition.

!Tæmbu?u says

KOBOBOOKS
