Don’t Blame the Central Banks -- Thank Them

by Jeremy Siegel, Ph.D.

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The stock market's electrifying response to the dramatic 50 basis point reduction in the Fed Funds rate engineered by Ben Bernanke at the September 18 FOMC meeting amply demonstrates the power of modern central banks.

And the Fed is not the only central bank taking action. The European Central Bank (ECB) was the first to intervene in the market last August when the sub-prime crisis caused the cost of European bank reserves to soar.

More recently the Bank of England (BOE) has de facto guaranteed the deposits of Northern Rock, a British mortgage lending bank and has reportedly lent the bank over 3 billion pounds. Central banks are stopping financial panics dead in their tracks, stabilizing credit costs, and mitigating the impact of this crisis on the real economy.

Don't get me wrong. I am not saying that central banks can completely prevent the boom and bust cycles that have plagued market economies from time immemorial.

There was very little that the Fed could do to prevent the 1990 recession caused by the real estate bust and soaring oil prices triggered by Saddam Hussein's invasion of Kuwait. Nor could the central bank prevent the 2000 recession caused by the popping of the technology bubble and 9/11. But central banks have reduced the severity of recessions by preventing a financial panic from developing into a full-blown economic collapse.

What's the Magic?

Why can central banks stop financial crises? Because they have a monopoly on the supply of the ultimate source of liquidity: the currency that forms the base of our monetary systems. "Liquidity" refers to an asset that can easily be transformed into purchasing power. And no asset that is better suited to that function than central bank money.

This is how central banks calmed the crisis. The first signs of disrupted markets appeared in August when the European Central Bank saw the interest rate at which banks were borrowing reserves from each other on the overnight market soar far above the rate that they had targeted in their monetary operations. This meant that the banks' demand for reserves had jumped beyond the supply that was available. The ECB then immediately bought securities, paying for them by crediting reserves to the banks. This increase in the supply of reserves pushed the rate back down to the ECB's target.

Where do the central banks get such reserves? They create them "at will" by either buying bonds, paying with newly-created reserves or loaning banks reserves against the banks' assets. Modern central banks do not require gold or silver to back the money they create; government securities, or just collateral from banks are all that is required.

The day after the ECB acted, the Federal Reserve performed the same actions in the Fed funds market, the U.S. market for bank reserves. In fact, the Fed decided to create more reserves than were needed to keep the rate at the then-targeted 5.25% level. The Fed's actions pushed the rate below the target and offset some of the increased risk premiums that were being demanded by the lending banks.

The Bank of England confronted a different problem. Lacking the same comprehensive deposit insurance scheme that prevails in the U.S., depositors in Northern Rock, a large saving bank that lent in the sub-prime market, feared for the safety of their deposits and rushed to convert their deposits into hard currency.

Unfortunately, banks have only so much currency on hand and to raise more they would have had to sell assets, or worse yet, call in their loans. This is what starts a financial panic, as those borrowers who have their loans called in turn try to raise cash by selling assets or borrowing from some other institution. This cascading effect can start a panic if more liquidity is not provided.

Fortunately, the Bank of England announced that it would back Northern Rock's deposits by lending against the institution's assets. This is called exercising the "Lender of Last Resort" function of the central bank. The BOE effectively provided Northern Rock all the currency it needed to satisfy depositors' withdrawals. Once depositors saw that the money was there, the panic subsided and the rush towards liquidity eased.

Avoiding a 1930s Disaster

It is very important to understand how significant this Lender of Last Resort function is. In 1929 a stock market crash turned into a liquidity crisis when depositors worried about the loans banks made against the stock market. But the Federal Reserve and other central banks did not lend money to the banks that were besieged by depositors. The Fed had claimed at that time that the banks that made bad loans should fail and should not be bailed out.

We hear the same objections today. Critics claim that the Fed is "bailing out" the sub-prime lenders and encouraging risky lending. But these fears are misguided. In no way do the central bank's actions "bail out" the sub-prime lenders. Those that bought these securities through the capital markets will suffer the full impact of their imprudent actions, as central banks offered no reserves to lenders outside the banking system. And those banks who made bad loans will also suffer impairment of their capital base.

The Fed made the right move at the right time and Bernanke's ability to secure a unanimous policy directive from the Federal Open Market Committee is impressive. The Fed stanched a contagion that threatened to turn a problem isolated to the real estate sector into a full blown liquidity crisis and recession.

The world's other central banks have also acted accordingly by supplying all the liquidity needed to keep credit costs under control and assure the stability of their banking systems. Thanks to their concerted actions, the sub-prime crisis should not turn into a recession.