Perry Mehrling, *The New Lombard Street: How the Fed Became the Dealer of Last Resort*

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Lombard Street is at the heart the City of London, connecting Bank junction with the Bank of England on Threadneedle Street, and until WW1, was considered to be the centre of the financial world. The Bank of England was one of the oldest Central Banks and was known for its financial innovations to control the money market and to manage liquidities. *Lombard Street: A description of the Money Market* is the title of the famous book by Bagehot (1873), which described these innovations and—70 years after Thornton’s *Enquiry into the Nature and Effects of the Paper Credit of Great Britain*—discussed the monetary initiatives available to a Central Bank to counteract a credit crunch. *The New Lombard Street* by Perry Mehrling, one of the last living scholars whose far-reaching talents enable him to write technical papers for the *Journal of Mathematical Economics*, important articles for *The American Economic Review*, to publish less orthodox essays in the *Journal of Economic Issues*, to offer “A Tale of two Cities” in *History of Political Economy*, will interest historians but also overall stimulate macroeconomists. The book is not an update of the Bank of England policies but a stimulating essay on the Federal Reserve System practices from its beginnings until last years.

Perry Mehrling reminds us that the Federal Reserve—a fairly young Central Bank—has learned a great deal more from the Bank of England’s techniques than generally is acknowledged, but also has applied them extensively without any apparent limits. Not only has the “Fed” rigorously applied Bagehot’s principle of “Lend freely but at a high rate”, over the years it has developed ways to facilitate this free lending activity, but also after the 2008 collapse, “the Fed did even more, shifting much of the wholesale money market onto its own balance sheet”. Beyond its “lender of last resort” function, the Fed became a “dealer of last resort”.

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In Mehrling’s view, this shift is extremely significant, and one of the clearest signs of a change in the Central Banks’ policy. From its beginnings—and until the subprime crisis—the Fed extended the “lender of last resort principle”, from application initially in periods of crisis, to permanent active interventions on the money market. By using the “Bank Rate” to control liquidities, the Federal Reserve provided the US economy with the Federal Reserve Act described as an “elastic currency”, i.e. it increased or contracted liquidities discretionarily, in response to the needs of economic activity. This widespread practice, for Mehrling, exemplifies the “money view” prevalent in the first half of the last century. From the 1960s, this view began to be overtaken by the “view of economics”, encouraging policymakers to “look through the veil of money to see how the prospects for the present generation depend on investments… made by generations past” (4). This notion was then complemented by the “view of finance”, which prioritizes the value of current assets, a value that reflects the value of future cash flows and, ultimately, prefigures the value of our future wealth.

Mehrling describes how the economic and finance views modified the practices of the Fed, until the monetary authority acquired the habit to “treat liquidity as a free good”. This accommodationist attitude, which provides liquidity without excessive restriction to the banking system, is a consequence of one of the more acknowledged analytical results of modern microeconomics, which shows that relaxing the cash constraint is welfare enhancing since it makes the decisions of agents dependent only on intertemporal budget constraints. The consequence is that all possible ways to transform long term assets into short term liquidities become legitimate—particularly the use of repurchase agreements. Although Mehrling does not emphasize it, this does not apply exclusively to the Fed: other Central Banks, such as the European Central Bank, have also increased their use of such techniques over the years. Then, “in the crisis, the system broke down. As assets valuations came into question, haircuts for secured borrowing rose sharply, even for Treasury but especially for non-Treasury securities and the result was forced deleveraging and disordered markets” (27). Mehrling’s conclusion is that “just because the Fed can evade the reserve constraint that others must obey does not mean that it should” (29).

The New Lombard Street defends the above thesis using analytical arguments and the historical stages in the changing practices of the Fed from its beginnings in 1913 up to the present. In easy-to-read chapters, where events, debates, academics and practitioners are interconnected in a quite deterministic way, Mehrling highlights the important dates, figures and changes of practices. The views of Wicksell, Fisher, Hawtrey, Hicks, Friedman, Gurley and Shaw, Tobin and Minsky interact in chapters 3 and 4. The contribution of Benjamin
Strong and Alan Sproul, two bank governors who, during the 1920s and the 1950s respectively, made the Federal Reserve Bank of New York the most innovative and advanced component in the Federal Reserve System (chap. 2 and 3). Some chapters are historical or analytical, others are more technical (chap. 4 and 5) and explain in a limpid way how financial innovations contributed to this change in the role of the Fed on the money market. From the use of swaps to the modern CDO, CDS and other securitization devices, the Fed developed and extended its role of “dealer of last resort” during its management of the subprime crisis.

This latest book by Perry Mehrling not only explains modern monetary regulations, it also urges us to change the way we conceive monetary regulations. Is a return to the “money view” possible or must we find some new ideas that will allow an escape from the excesses of the existing economic and financial views? Anyway, if Merhling’s analysis is correct, the future theory of monetary policy will render accommodationism as well as monetary orthodoxy irrelevant principles to manage money markets and liquidity.