

Plumbing Matters

A Review of

Perry Mehrling's *The New Lombard Street: How the Fed Became the Dealer of Last Resort*. Princeton & Oxford: Princeton University Press, 2011;
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by

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Perry Mehrling's bold claim to the mantle of Walter Bagehot, 19th century economic and political commentator and editor of *The Economist*, cries out for a detailed comparison with the most famous book ever written on the money market. Thus, I reread the old *Lombard Street* as preparation for a second reading of the *New Lombard Street*. The parallels turn out to be both deep and real, though there are also differences that are not traceable to the 140 years of institutional change in the money markets.

Both *Lombard Streets* are addressed at wide audiences. Both are lively, readable, and non-technical; although both occasionally suppose more knowledge of institutional details than the modal reader is likely to have. Both address the problems faced by central banks forced to play an unaccustomed or uncomfortable role in response to financial innovation. The Bank of England in the middle of the 19th century faced the development of joint-stock banking and the increasing role of the City of London, whose financial district centered on the eponymous street of the titles, as the center of world

finance. The pound sterling and, particularly, the sterling deposits of commercial banks at the Bank of England became the *de facto* reserve currency for the United Kingdom and the international financial system. The Bank, which was legally not even a central bank but a private, for-profit commercial bank with special privileges, found itself – very much against its self-conception and its desires – to be the lender of last resort for the world. The charter of the Federal Reserve charges it with maintaining an elastic currency – effectively a lender of last resort, but properly only for its commercial member banks. A quarter century of financial innovation, including the demise of the Glass-Steagall Act, which had built a wall between commercial banks and other financial institutions, rendered the Fed’s original scope too narrow to cope with the crisis of 2008-9 under the old assumptions. In effect, the Fed became the lender of last resort for the entire financial system.

Both *Lombard Streets* start with the premise that the financial plumbing matters. Mehrling is more explicit than Bagehot in arguing that the structure of monetary institutions is a more vital consideration to monetary policy than any abstract principles of economic theory. And both make the case that there is no going back: intellectual analysis has no alternative but to catch up with institutional change. Catch-up is uncomfortable. The Bank of England resisted acknowledging or planning for its role as the reserve base of the financial system, while in the end embracing that role in crises. The Fed has, perhaps, shown less resistance to its changing role, though it has been widely criticized by politicians on the left and the right for effectively insuring financial institutions against their own failings. The policy conclusions of each author can be summarized in a slogan. Every student of central banking knows Bagehot’s rule for

crisis management: *discount freely but at a high rate of interest*. The rule is meant to guarantee that liquidity is widely available, yet to provide an incentive for banks to develop sources of liquidity other than the central bank. Mehrling’s modern version runs: *insure freely at a high premium*. The rule is meant to guarantee that financial institutions will not face a cascading collapse of collateral, yet to provide an incentive for them to stabilize their own affairs and reconstruct private insurance arrangements.

Mehrling sometimes exaggerates his novelty relative to Bagehot. Bagehot’s discussion of the House of Rothschild anticipates Mehrling’s discussion of the shadow bank of today – indeed, the two institutions are deeply similar. And just as Mehrling endorses the Fed’s policy of intervention in a wide array of financial assets, Bagehot argued that the Bank of England should consider purchases of railway bonds and other assets outside the usual discount mechanism that was restricted to purchasing “self-liquidating” commercial bills.

One difference between the two *Lombard Streets* is that Mehrling, far more than Bagehot, is sensitive to the history of economics. He is particularly insightful with respect to the changing conceptions of liquidity in the work of early 20th century financial economists. On the earlier conception, an asset is liquid if it can be quickly turned into cash without capital loss. The newer conception, according to Mehrling, focused on *shiftability*: was it easy to move an asset as part of portfolio rebalancing. Shiftable assets are not necessarily capital secure, but they can be reliably traded in thick markets. The barrier to liquidity, according to the old notion was the lack of reserves: enter the central bank as the lender of last resort. The barrier to shiftability is the lack of collateral, hence the development of insurance instruments such as credit default swaps, which Mehrling

discusses in detail. The Fed’s role in the crisis was to backstop shiftability, to be the insurer or dealer of last resort.

Mehrling traces the development of modern monetary economics and finance to the rise of the shiftability point of view. In the work of James Tobin and other “monetary Walrasians,” money is not special – or rather, as with children in a modern American kindergarten, all assets are special in their own way. Modern finance – e.g., the expectations theory of the term structure or no-arbitrage pricing – treats all assets as substitutes. Risk matters, of course, but if risk is perfectly priced, then substitution becomes seamless and all assets become shiftable. Monetary policy in the monetary Walrasian approach typically operated through control of short-term interest rates transmitted smoothly along the yield curve. This approach to policy, however, still has one foot in the old money-is-unique view. What Mehrling points out is that that foot was systematically lamed by financial innovation that provided channels through which banks could loosen the liquidity constraints on which the policy depended.

Mehrling concentrates on the crisis, and, unfortunately, does not provide a well-developed alternative foundation for the normal conduct of monetary policy. He writes as if the mainstream analysis of the operation of monetary policy was simply irrelevant. For example, long-standing debates over the channels of monetary transmission are treated as beside the point. Instead, what we really need to focus on is the plumbing – how dealers, traders, and other money market players act. Here Mehrling may go too far. In focusing on the crisis – on the overflowing toilet, as it were – he overlooks the fact that the day-to-day user need only know to push down the handle and can usually depend on its smooth operation. To change the metaphor, when a Klingon attack has breached the

hull of the starship *Enterprise*, Mr. Scott, the doughty engineer comes into his own; but when all is well, he is a minor character and it is to Captain Kirk that the crew looks for leadership and efficient operation. Mehrling rightly reminds us that when things go wrong we cannot ignore plumbing or institutions. Yet, policy must address the mission of the well functioning machine, as well as the crisis when it breaks down. If Mehrling’s focus is unbalanced, it is in no small measure the result of the fact of the recent crisis and the equally unbalanced approach of modern monetary economics that provides a manual for fair-weather sailing with hardly an acknowledgment that it takes a lot of carefully maintained machinery to keep the ship afloat. Mehrling’s splendidly written and important book redresses that imbalance.