Central Banks' Distribution, Revisited

Author : Anna Gelpern

Date : November 16, 2020

Nadav Orian Peer, *Negotiating the Lender of Last Resort: The 1913 Federal Reserve Act as a Debate over Credit Distribution*, 15 **N.Y.U. J.L. & BUS.** 367 (2019).

Fifteen years ago, U.S. legal scholarship treated central banks like the neglected stepchildren of bank regulation and administrative law: hardly anyone wrote about them, and no one who did not work for them seemed to care. The financial crisis that began in 2007 put the Federal Reserve, the Bank of England, and the European Central Bank in the middle of national and global crisis response strategies, and instantly made central banks the center of attention in a rich and fast-growing legal literature that continues to attract exciting new scholars.

Nonetheless, ceding central banks to economists for so long turned out to be costly: lawyers have spent much of the last decade fleshing out the underlying assumptions and basic terms of the debate, and deciding whether and how to assimilate economists' theories of central banking into their own. The foundational question of distribution—how central banks' monetary policy and financial stability activities distribute resources and allocate losses from crises among constituents—has lingered especially awkwardly over this area.

The slightly-stylized standard view associates distribution with fiscal policy, politics and legislatures. In this view, monetary and financial stability policies of the sort conducted by central banks do not distribute: they are for everyone at once, no one in particular, and best left to independent technocrats. This standard view is increasingly at odds with public perceptions of central banks as purveyors of bailouts for the few and peanuts for the rest. The disjunction can become a big political problem, freshly salient in the face of the multi-trillion-dollar response to the COVID-19 pandemic. The pandemic response again put central banks at the center, and took me back to Nadav Orian Peer's pre-pandemic article situating the Federal Reserve at the intersection of political battles over corporate concentration, regional and sectoral development and, of course, money.

Orian Peer's claim is that the Federal Reserve's Lender of Last Resort (LOLR) function, which has been analyzed almost exclusively in financial stability terms—preventing and stopping contagious bank runs—represents a political settlement over credit allocation at the start of the 20th century.

In conventional textbook accounts, the LOLR stands ready to lend to solvent but illiquid banks in the face of panic withdrawals by depositors. It solves a coordination problem. In theory, the LOLR does not take credit risk because the solvent bank puts up good collateral for the emergency loan. In practice, central bank collateral eligibility can become a pitched political battle, because an asset that can be pledged to the central bank in exchange for cash when markets freeze up is way more liquid—and therefore way more valuable—than one that cannot be exchanged for cash. This in turn invites questions about capture, which dominate progressive accounts of LOLR.

Orian Peer's article challenges conventional accounts in a way that is considerably more granular and interesting than a capture story. He focuses on three sets of constituents: large corporations, newly arrived on the scene in the mid-19th century, small businesses in East Coast urban areas, championed by Democrats, and Midwestern farmers. The three groups had very different credit needs, and used different instruments to access credit against the background of massive reserve concentration in New York City, which had become entrenched under the National Banking Acts in the aftermath of the Civil War.

Rapidly growing corporations primarily sought long-term funding for capital investments, mergers, and acquisitions. They issued stock and longer-term debt in the securities markets, which in turn relied on speculators' willingness to buy these securities on credit. Speculators primarily financed themselves with very short term, secured, and therefore relatively cheap "call loans" from banks, which preferred call loans to other assets for their cash-like liquidity. Orian Peer cites contemporary sources that put call loans at nearly 10 percent of all bank deposits in the system shortly before the Federal Reserve Act was passed. Call loans were notoriously volatile—when banks needed cash, they called the loans—deepening and amplifying the link between commercial banks and the stock market.

Banks' demand for cash was heavily seasonal. Farmers in the Midwest borrowed during planting season, often with no ability to repay until harvest time. Agrarian interests sought to distribute reserves more evenly across the United States (dethroning New York), boost the supply of long-term credit for farm economies in the West, and stabilize seasonal fluctuations in credit supply. They pressed for the new central bank to accept "accommodation loans" of nine months or longer as collateral for its liquidity support. In contrast, small businesses in urban areas focused on short-term "commercial paper," working capital financing from the securities markets, with maturity of up to 90 days—for instance, to tide a merchant over between the purchase and sale of their inventory.

Abstracting from the details of the historical account, debates over collateral eligibility for call loans, commercial paper, and accommodation paper[1]—as over Greek government securities, U.S. municipal bonds, car loans, home mortgages, and small business loans a century later—are not just about stopping bank runs. They are at least as much about who controls the supply of credit, about whether large corporations get to grow bigger and industries more concentrated, about the value of farmland and the prospect of stability in neglected regions and sectors of the economy. The article makes the connection between financial stability and credit allocation feel intuitive, and helps frame more fruitful lines of inquiry into the distributive work of central banks.

1. The final compromise extended eligibility to commercial paper, excluded call loans, and partially accommodated farm interests by extending eligible instrument maturity to six months.

Cite as: Anna Gelpern, *Central Banks' Distribution, Revisited*, JOTWELL (November 16, 2020) (reviewing Nadav Orian Peer, *Negotiating the Lender of Last Resort: The 1913 Federal Reserve Act as a Debate over Credit Distribution*, 15 **N.Y.U. J.L. & BUS.** 367 (2019)), https://corp.jotwell.com/central-banks-distribution-revisited/.