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**The Constitutionality of the
Federal Reserve's Role as
Lender of Last Resort**

Lender of Last Resort (LLR)

An often poorly understood and miscommunicated term:

1. Economists primarily are concerned with the *quantity* of monetary injection by the LLR (usually new reserves when done by the central bank).
2. Lawyers and most politically attuned laymen primarily are concerned with the *structure of and legal authority for* LLR operations.
3. Both concerns matter, and it is a mistake for each side to ignore the concerns of the other.

The Fed's main argument for its LLR authority

- 1. Section 13(3) authorizes the Board of Governors, by a supermajority vote, to declare a financial emergency (“unusual and exigent circumstances”) in which**
 - (a) Federal Reserve banks may make loans on any satisfactory security or collateral**
 - (b) to “individuals, partnerships, and corporations.”**
- 2. This section was added to the Federal Reserve Act in 1932, before it was clear how responsibilities between the Fed and the Reconstruction Finance Corporation (RFC) would be divided.**

- 3. Section 13(3) was used only rarely in the 1930s and not at all after 1936. It does not contain the term “lender of last resort.”**
- 4. Section 13(3) was amended in 1991 to remove prior collateral restrictions (collateral previously had to be of the types “eligible for discount,” essentially, Treasury securities and real bills).**
- 5. The last amendment of Section 13(3) was in Title XI of the Dodd-Frank Act of 2010.**
 - (a) Procedural limitations were added that essentially require the Treasury, in consultation with the President, to agree to the declaration of financial emergency.**
 - (b) Section 13(3) no longer can be used to assist specific firms but must be part of a lending program of broad-based applicability (e.g., “all bank holding companies,” or “all automobile companies”).**

- 6. During the 2008 financial crisis, the Fed always cited Section 13(3) as the legal authority for whatever it was doing. A rarely used emergency statute was transformed into the daily operating procedure of the Fed's monetary operations.**
- (a) Normal FRBNY purchase and sale of government securities in the repurchase agreement market (repos for purchases, reverse repos for sales) ceased by January 2009.**
 - (b) Until the beginning of QE1, virtually the entirety of the Fed's monetary policy activity was emergency lending, plus foreign exchange liquidity swaps with foreign central banks.**
 - (c) At its peak in December 2008, the amount of central bank swap drawings was \$600 billion. The second peak was just over \$100 billion in December 2011-February 2012, as economic disturbances emerged in the Euro Zone.**

7. Current outstandings under the ECB's swap line are \$35 million, for one bank (unidentified). The swap lines are rolled over weekly. [As of July 11, 2017, it is 2 banks and \$55 million.]

Walter Bagehot and the Constitution

1. Walter Bagehot's *Lombard Street* (1873) usually is cited as the source of economists' beliefs about operations of the LLR.
2. Bagehot was British, writing nearly 100 years after American independence, and theoretically cannot be cited as "legal authority" in U.S. courts (his is "expert opinion," but so is Ed Kane's, and so is mine).
3. Conti-Brown (2015) quite properly challenges those purporting to quote Bagehot to quote all of the relevant passages, not just the frequently manipulated paraphrases of Bagehot.
4. A fair rendering of the paraphrase is, "In an emergency, the LLR must lend (discount) freely on any collateral reasonably presumed good, but only at a penalty rate." In practice, the Fed often distorts one or more elements of this paraphrase.

The U.S. Constitution, of all things

- 1. Willem Buiter (2009) challenged the Fed's procedures under Section 13(3) on the basis of U.S. Constitution, Article I, Section 9, clause 7:**

No money shall be drawn from the treasury, but in consequence of appropriations made by law; and a regular statement and account of receipts and expenditures of all public money shall be published from time to time.

- 2. The argument is that the Fed's liabilities may be withdrawn as currency notes, and those notes have the Full Faith and Credit of the United States.**
- 3. Therefore, emergency advances are a back-door way of drawing money from the Treasury without appropriations.**

- 4. Otherwise, the Constitution is silent on central banking, let alone emergency advances.**
- 5. Are the Fed's emergency advances authorized expenditures? To date, they have been subject neither to appropriations nor to limits by authorization.**
- 6. What do Madison's notes on the Constitutional Convention say about the matter? The most relevant passage is from September 14, 1787. Madison's notes are not binding legal authority, but they amount to expert opinion. (See next slides.)**

Docr. FRANKLIN moved [\[FN15\]](#) to add after the words "post roads" Art I. Sect. 8. "a power to provide for cutting canals where deemed necessary"

Mr. WILSON 2ded. the motion

Mr. SHERMAN objected. The expence in such cases will fall on the U. States, and the benefit accrue to the places where the canals may be cut.

Mr. WILSON. Instead of being an expence to the U.S. they may be made a source of revenue.

Mr. MADISON suggested an enlargement of the motion into a power "to grant charters of incorporation where the interest of the U.S. might require & the legislative provisions of individual States may be incompetent." His primary object was however to secure an easy communication between the States which the free intercourse now to be opened, seemed to call for. The political obstacles being removed, a removal of the natural ones as far as possible ought to follow.

Mr. RANDOLPH 2ded. the proposition

Mr. KING thought the power unnecessary.

Mr. WILSON. It is necessary to prevent a State from obstructing the general welfare.

Mr. KING. The States will be prejudiced and divided into parties by it. In Philada. & New York, It will be referred to the establishment of a Bank, which has been a subject of contention in those Cities. In other places it will be referred to mercantile monopolies.

Mr. WILSON mentioned the importance of facilitating by canals, the communication with the Western Settlements. As to Banks he did not think with Mr. King that the power in that point of view would excite the prejudices & parties apprehended. As to mercantile monopolies they are already included in the power to regulate trade.

Col: MASON was for limiting the power to the single case of Canals. He was afraid of monopolies of every sort, which he did not think were by any means already implied by the Constitution as supposed by Mr. Wilson.

The motion being so modified as to admit a distinct question specifying & limited to the case of canals,

N. H. no. Mas. no. Ct. no. N. J. no. Pa. ay. Del. no. Md. no. Va. ay. N. C. no. S. C no. Geo. ay. [\[FN16\]](#)

The other part fell of course, as including the power rejected.¹

Translation: The power of Congress to charter a corporation (necessarily including a bank) was considered explicitly and was voted down, 8-3, the states voting as units.

The “power rejected” refers to the power to charter corporations (like central banks).

Conclusion: LLR activity through the central bank is a bad idea under the U.S. Constitution

- 1. Congress fairly clearly has the power to be a LLR or to charter an agency to do that activity as its agent, *fully subject to appropriations, oversight (audit), and review*. The RFC (1930s) was such an entity; the Fed was not and is not.**
- 2. The Fed resists appropriations, audit, and review.**
- 3. The Fed's LLR activities after 2008 later were audited, over the Fed's vehement objections. There is no permanent authority for such audits, but the Dodd-Frank Act does provide for lagged, quasi-contemporaneous reporting to Congress and full retrospective reports. (Todd, 2016)**

- 4. Economists need to be more aware of the legal, structural, and even constitutional issues regarding LLR activity.**
- 5. Lawyers and members of Congress and their staffs need to be more aware of the quantitative and monetary policy implications of LLR activity and to intervene when appropriate (lawsuits, audits, reviews, oversight, etc.).**

Questions?

Helicopter Money (Illustration, Mankiw, *Macroeconomics*, ch. 16)



Emergency Lending

<https://www.clevelandfed.org/en/our-research/indicators-and-data/credit-easing.aspx>

ⁱ Madison (1842). Madison's notes on the constitutional convention were kept secret until around 1828. In fact, under the rules of the convention, it is arguable that he was not supposed to keep notes; the members were sworn to secrecy. Before his death in 1836, he told his wife Dolly that publishing his notes might bring her money later on. They were published in 1842. I am indebted to John Vile, Dean of the Honors College at Middle Tennessee State University for this story.

