Central Banks Are Creatures of Financial Crises

From the BOE to the Fed, Institutions That Sprang From Burst Bubbles Adopt New Shapes in Current Convulsions

BY JUSTIN LAHART

Since the beginning of the financial crisis in 2007, the Federal Reserve has come to the rescue so many times that even seasoned central-bank watchers have trouble keeping track.

It has injected more than $1 trillion into the financial system. It has backed up its efforts with more than $5 trillion in guarantees and purchases of mortgage-backed securities.

The central banks are anything but equal. Their economic convulsions foreshadow each other, with major tremors expanding in an attempt to bolster the economy.

The turning point came in 1907. The availability of credit was tight throughout the world that year, and that October, a speculative attempt to corner the stock of United Copper Co. failed. That sparked a run on the depositors of Knickerbocker Trust, Co., which had helped fund the scheme, eventually leading to the firm's collapse. John Pierpont Morgan, the giant of American finance, took on the role of lender of last resort.

The Fed flunked its first big test when it didn't adequately respond to a series of banking panics that began shortly after the 2008 stock-market crash, helping to precipitate the Great Depression.

The Pandex of 1907 helped push aside longstanding worries over the economic power concentrated in an American central bank, and in 1913 the Federal Reserve Act was passed.

The dollar's value is the best approach. Some economists counter, that raising interest rates is the best approach. But University of California, Berkeley economic historian Brad DeLong says that the history of central banks and crises has been a steady expansion in their power.

The big step the banks still take in the wake of the current financial crisis may be to target the excessive risk-taking that led to the bursting bubbles, Mr. DeLong thinks.

For so far, Fed officials have argued that raising interest rates to counter risky behavior would hurt not only the speculators, but also the economy at large. Rather than rate rises, they prefer to use regulation to clamp down on excesses, putting in place rules that keep risk at bay.

Some economists counter that risk-taking will flourish out how to skirt regulations, so using interest rates is the best approach. Either approach—raising rates or regulating—would be a shift from the Fed's old stance to let bubbles burst of their own accord and clean up afterward.

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