

# Monetary Policy and Financial Stability

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A couple of days ago I thought my role at this conference would be to introduce my old friend and now former colleague Bill Poole. Bill was unable to be here and David Kotok asked me a couple of days ago if I could modify my introduction slightly to discuss monetary policy and the turmoil in the credit markets. I suggested that it would have to be a little more than a slight modification and it would be difficult to fill Bill's shoes, but that I would do the best I could on short notice.

Before I go any further, I should mention that the usual disclaimer applies. My remarks reflect my views and are not necessarily those of the Federal Reserve System or of my colleagues on the FOMC.

As I mentioned, I have been asked to discuss monetary policy's response to the turmoil in financial markets. To begin I would like to make a distinction between a central bank's responsibility for monetary policy and its responsibility for financial stability. I view these responsibilities as related but different, and I think it is important and useful to think about them in that manner.

The role of monetary policy is to ensure the stability of the purchasing power of the nation's currency so that markets are not distorted by inflation. In the U.S. we also are charged with supporting sustainable economic growth. I believe, along with many other economists, that maintaining price stability is one of the most important contributions a central bank can make to promoting sustainable growth. To promote financial stability,

central banks seek to ensure the smooth functioning of the payment system and the orderly functioning of the financial markets.

These two responsibilities, monetary policy and financial stability, are related but different and sometimes call for central banks to use different tools depending on their objectives. They are related because in some circumstances financial instability can have consequences for the broader economy and, by like token, macroeconomic conditions can sometimes have consequences for financial stability.

On the monetary policy front, the problems that developed in the housing sector and the subprime mortgage market in 2007, along with further increases in the price of oil, led to successive downward revisions in the outlook for the economy. As the outlook for the economy deteriorated, the Federal Reserve reduced the target for the federal funds rate in a series of steps by 300 basis points — from 5.25 percent in early September to its current level of 2.25 percent. Taking expected inflation into account, the level of the federal funds rate in real terms — what economists call the real rate of interest — is now negative. The last time the level of real interest rates was this low was in 2003-2004. But that was a different time with a different concern — deflation — and monetary policy was intentionally seeking to prevent prices from falling. Recently, we have had reason to be worried about rising inflation, not declining prices. Thus, comparing the nominal funds rate today with the stance of policy in 2003–2004 is like comparing apples and oranges.

We must keep in mind that monetary policy works with a lag. The full impact of changes in monetary policy on output and employment may not materialize for several quarters at the earliest. This lagged response means that monetary policy decisions depend critically on the outlook for the economy over the intermediate term. In times of economic turbulence and uncertainty, forecasting becomes more difficult. That does not mean that you can stop forecasting, but it does mean that the uncertainty surrounding any forecast will be unusually large.

This weakening in economic fundamentals began with a decline in the demand for housing after a number of years of rapid expansion and rising prices. This, in and of itself, need not have been anything extraordinary. What to my mind changed the picture was the confounding impact of the increasing defaults, primarily in the subprime mortgage market. House prices actually began their deceleration in 2005. In 2007, the concerns about the nature of the mortgage contracts in the subprime arena became apparent as default rates on these mortgages began to rise more than expected, further exacerbating the decline in house prices.

The rise in defaults began to reveal serious flaws in the pricing and risk assessments of a variety of structured instruments in the financial market which had been built around the growing market for subprime lending. Market participants began to have serious doubts about the value of these instruments and products. The assumed default rates that determined their original rating and valuation seemed to fly out the window, and no one knew what the new price or valuation should be. Moreover, the securitization process resulted in the repackaging of these loans into securities of various risk classes, which were then sold to different investors. The result was a lack of transparency regarding who held how much of what were now suspect securities. Thus, market participants faced a very complex two-part problem: how to value the underlying securities and who held them.

Problems in the subprime mortgage market spilled over to other markets and resulted in more widespread impairment of the funding markets for many types of firms — both financial and nonfinancial — thereby disrupting the effective functioning of financial markets. Some interest rate spreads remain high, and financial capital has taken serious hits at a number of institutions. The current turmoil in financial markets has led to a tightening of credit that has affected the broader economy and has the potential to continue to restrain economic growth going forward. The risk that the financial turmoil could become more severe and further adversely affect the functioning of financial markets suggests to some that short-term interest rates need to be lower than they would

be otherwise in order to provide a form of insurance. However, determining the appropriate extent of such extra accommodation is difficult to quantify.

In any case, the bottom line is that, on the monetary policy front, the Fed's response to the deterioration of the economic outlook and the turmoil in financial markets has resulted in an accommodative level of real interest rates that should support the market forces that will bring economic growth back toward its long-term trend.

Nevertheless, the turmoil in the financial markets and the liquidity problems that arose in certain markets raised concerns from the perspective of the Federal Reserve's responsibility for financial stability.

On the financial stability front, the Federal Reserve applied a different set of tools to provide additional liquidity to financial markets to try to improve their ability to function smoothly. These steps included lowering the discount rate, narrowing its spread to the target fed funds rate, and extending the term of discount window loans. In addition, the Fed established three new types of lending facilities:

- the Term Auction Facility (TAF): to auction longer-term loans to banks;
- the Term Securities Lending Facility (TSLF): to auction loans of our own holdings of Treasury securities in exchange for various types of non-Treasury securities that we then hold as collateral;
- and the Primary Dealer Credit Facility (PDCF): to make collateralized loans directly to primary securities dealers.

Finally, the Fed took special steps so that the collapse of Bear Stearns would not cause serious disruptions to other financial institutions and their customers. All of these actions fall under the central bank's responsibility for ensuring financial stability and reflect the Fed's role as lender of last resort. It is important to recognize that these actions are not what I would call monetary policy, in the sense that they are not designed to alter the FOMC's target for the fed funds rate. They are intended to support the liquidity and smooth functioning of the short-term funding markets. Indeed, in each case, to the extent

that additional reserves were added to the banking system, they were sterilized through open market operations. That is, they did not add new reserves independent of the decisions made regarding the fed funds rate target.

However, the recent financial turmoil has also surfaced problems regarding subprime mortgages and certain other financial practices that have also raised issues about the ability of existing financial regulations to protect consumers. Consequently, on the financial regulation front, the Fed has proposed new rules (under the Home Owners Equity Protection Act, or HOEPA) to strengthen oversight and prevent abusive lending practices in order to help consumers in the future. Significantly, these rules will apply to the entire mortgage industry, not just those institutions directly regulated by the Federal Reserve. The Federal Reserve Board also continues to work toward more effective consumer disclosure rules and will be doing extensive consumer testing to ensure that proposed new disclosures are comprehensible to borrowers. Changes to the Truth in Lending Act are being proposed that will require earlier disclosures by lenders and address concerns about misleading mortgage loan advertisements.

In addition to proposing changes in regulations to help consumers in the future, the Fed has also been concerned about helping consumers today who are at risk of losing their homes to foreclosure. Consequently, on the foreclosure front, the Federal Reserve, along with the other federal financial regulators, has worked to guide federally supervised institutions as they deal with mortgage defaults and delinquencies. The federal regulatory agencies, along with the Conference of State Bank Supervisors, have encouraged lenders to work proactively with borrowers who may be facing delinquency or foreclosure. We have also encouraged servicers of securitized residential mortgages to determine what they can do to restructure failing loans and to pursue appropriate strategies for mitigating losses on such loans.

In February the Philadelphia Fed's Community Affairs Department hosted a meeting for 180 housing counselors from the Third District and seven of the top 10 national subprime loan servicers. The purpose was to open the lines of communication between housing

counselors and mortgage loan servicers so they could find ways to modify or refinance delinquent loans to avoid having people's homes go into foreclosure.

Finally, on the economic and financial education front, a number of Fed officials, including me, have stressed the importance of enhancing financial literacy so that consumers have more information and are able to make better decisions regarding their own financial well-being. In my view, the current economic environment and recent financial turmoil underscore the need for improved economic and financial literacy. I am not the first, nor will I be the last, to make this plea. But our current economic and financial situation has reinforced my sense of urgency in this regard.

In sum, the Federal Reserve has been acting on several fronts to address the recent turmoil in financial markets. Some of those actions are intended to stem the immediate problems. Others are intended to have longer-term benefits in helping to prevent future financial problems. But let me also add some words of caution about expecting more from the Fed than it has the ability to deliver.

I think it is particularly important, for example, to recognize that monetary policy cannot solve all the problems the economy and financial system now face. It cannot solve the bad debt problems in the mortgage market. It cannot re-price the risks of securities backed by subprime loans. It cannot solve the problems faced by those financial firms at risk of being given lower ratings by rating agencies because some of their assets are now worth much less than previously thought. The markets will have to solve these problems, as indeed they will. But it will take some time.

Unfortunately, the public perception of what monetary policy is capable of achieving seems to have risen considerably over the years. Indeed, there seems to be a view that monetary policy is the solution to most, if not all, economic ills. Not only is this not true, it is a dangerous misconception and runs the risk of setting up expectations that monetary policy can achieve objectives it cannot attain. To ensure the credibility of monetary policy, we should *never ask monetary policy to do more than it can do*.

The same could be said of the Fed's lender of last resort function. All of the special lending facilities I described can be interpreted as part of that responsibility.

Traditionally, in times of financial crisis, a central bank is supposed to lend freely at a penalty rate against good collateral. The experience of the past nine months suggests to me that we need to better understand how to apply this lender of last resort maxim in the context of today's financial environment. Walter Bagehot's words from the 1870s were applicable to a banking and financial system that did not have today's complexity.

Clearly, our objective today is the same as it was in Bagehot's day — to stem systemic risk. But how to implement that principle in today's world needs to be given some serious thought. But such rethinking is best done not in the heat of a crisis, but after things have cooled down and we have had time to reflect on what we have learned from the crisis.

The Federal Reserve has responded to the turmoil in financial markets on several fronts with tools designed to address specific problems. But the challenges we have faced raise a myriad of questions that we must address going forward. The answers are neither easy nor obvious, and we must be careful in our approach to solutions to avoid creating more problems than we solve. A critical element of any solution rests in the ability to communicate effectively the underlying objectives of policy choices and the means by which we will achieve them. No easy task to be sure, but I am confident that we can meet this challenge to promote an efficient and effective environment for continued prosperity.