

Some Thoughts on the Economy and Financial Regulatory Reform

Presented to The Economics Club of Pittsburgh

Pittsburgh, PA

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The views expressed today are my own and not necessarily
those of the Federal Reserve System or the FOMC.

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Introduction

Today I want to discuss two general topics that relate directly to our current financial situation. One is the outlook for the economy and inflation. The other is financial regulatory reform. In particular, I will focus on several issues that relate to the Federal Reserve's roles in supervision, regulation, and financial stability.

Let me begin with the economic outlook.

The Economic Outlook and Inflation

Recent data — including the monthly data on housing, auto sales, consumer spending, and industrial production — have all pointed to a significant weakening of the economy. The latest report on real GDP growth indicated the economy contracted slightly in the third quarter. In addition, the increased stress in financial markets, leading to the seizing up of credit in September and early October, has continued to disrupt the ability of businesses and households to borrow.

What's more, the stress in financial markets has now become global, weakening the prospects for growth among many of our trading partners. Since our economy has benefited substantially from strong exports over the past two years, the prospect of a global slowdown further contributes to a weaker outlook for the U.S. economy going forward.

After a slight contraction in real GDP in the third quarter, I anticipate a somewhat sharper decline in the fourth quarter. This forecast will put real GDP growth for 2008 in the neighborhood of one-half of 1 percent (0.5 percent) (measured on a fourth-quarter-to-fourth-quarter basis). Growth in the first half of 2009 is also likely to be weak, but I expect improvement in the second half of the year. Even so, overall growth for 2009 (fourth-quarter-to-fourth-quarter) is likely to be below 2 percent. With relatively weak performance over the next several quarters, I expect the unemployment rate to rise above 7 percent in 2009 before it begins a gradual decline in the latter half of the year.

As the housing sector finally bottoms out and the financial crisis abates during 2009, I expect we

will see the economy start to pick up. In 2010 and 2011, I expect real GDP growth will be close to its trend of 2.7 percent. With a return to more solid economic growth, the unemployment rate will decline over time and return to near 5 percent.

As you know, this recent deterioration in the economic outlook led the FOMC to reduce its federal funds rate target to 1 percent on October 29. Another factor in that decision was a lessening of the risk that inflation expectations would become unanchored. The decline in energy and commodity prices in recent months has reduced my own concern about rising inflation expectations — at least in the near term. This is good news, but it does not mean we should be complacent or ignore our responsibility to maintain price stability. Our current policy is injecting large amounts of liquidity into the economy. Unless we withdraw that liquidity in a timely fashion, it could fuel renewed inflationary pressures down the road.

Let me be clear that the economy still faces significant financial stress and the outlook remains highly uncertain. While the actions by central banks and governments in a number of countries have helped alleviate some of the financial pressures, it will still take some time before financial markets return to some sense of normalcy.

The consequences of the financial turmoil of the past year will be many. We are already seeing the financial industry restructure itself as major investment banks become bank holding companies, weaker financial institutions consolidate into healthier ones, and various types of nonbank financial firms, once thought to be powerful engines for profit and growth, find they must either substantially revise their business models or throw them out entirely.

Another consequence of the crisis is that the regulatory structure of the future is likely to look different from the one we have today. That raises the question of what future role the Fed will play in supervision, regulation, and financial stability, which brings me to my next topic.

General Principles for the Fed's Role in Supervision, Regulation, and Financial Stability

History tells us that financial crises invariably lead governments to adopt regulatory reforms intended to prevent similar crises in the future. In general, I would argue against making major policy reforms in the “heat of battle” because doing so risks adopting policies that have unintended consequences. Such “quick fixes” may inadvertently hamper market competition or innovation and create conditions that may provide the foundation of the next crisis. Moreover, without careful analysis of the crisis, hasty reform may fail to address the problem and could impose unneeded and burdensome regulation.

The role of the central bank in a new regulatory environment will be an important issue in the deliberations. Some proposals envision the Federal Reserve becoming the supervisor and regulator of a broad array of financial firms in order to ensure financial stability. I have a number of concerns about such proposals, especially those that go beyond the limits of what a central bank can and should do.

In general, we should avoid giving the Fed overly broad mandates, missions, or goals that

conflict with the one goal that is uniquely the responsibility of a central bank — price stability. Instability in the general level of prices — whether inflation or deflation — is itself a significant source of financial instability. Consequently, we must make sure that in trying to cure one source of financial instability, we do not sow the seeds of another.

Both theory and evidence suggest that sound monetary policy should be guided by four basic principles. First, policy should have clear and explicit objectives. These objectives must be realistic and feasible, not just what might be desirable. For example, I have argued on several occasions that the expectations about monetary policy's ability to manage the economy often exceed what can actually be accomplished. So we must be careful to ask only for what can be delivered.

Second, policy must be conducted in a systematic way toward achieving the stated objectives. Moreover, to avoid unnecessary volatility, policymakers must be committed to this systematic approach over time, even when it seems expedient to abandon it. Third, policymakers should be clear and transparent in communicating their policy and actions to the public. Fourth, central banks should remain independent of short-term political pressures. Experience tells us that independent central banks are more effective in achieving their objective of price stability.

I believe that these four principles — clearly stated and feasible objectives; a commitment to conduct policy in a systematic fashion; transparency; and independence — should apply broadly to other central bank roles, including our role in promoting financial stability and in exercising prudential supervision.

As we think more explicitly about regulatory reform, I believe that we should focus not just on more regulation but on better regulation. For example, we should think about ways to strengthen market discipline and market infrastructures to make our financial system more resilient to shocks. In doing so, we must ensure that regulation does not inhibit innovation. For example, despite much of the turmoil and problems with subprime mortgages, the majority of homeowners who financed their homes with these new instruments are meeting their obligations. Indeed, these new types of mortgage products have given many families an opportunity they might never have had before — to live in their own home. Thus, the subprime mortgage has been a valuable innovation for many consumers. We must be careful that heavy-handed regulation does not discourage innovations that make such progress possible.

With these guiding principles in mind, I want to touch on three areas I believe will be crucial elements of regulatory reform and the future role of the Fed. These include resolution mechanisms for failing financial firms; the regulation of payment and settlement systems; and the scope and scale of the Fed's role as lender of last resort.

Resolution Mechanisms for Failing Financial Firms

The rationale for banking regulation stems, in large part, from the dangers posed by systemic risk. Systemic risk generally refers to the risk that problems at one financial institution will spill over to a broad set of otherwise healthy institutions, thereby posing a threat to the integrity of the financial system as a whole. This can occur because of linkages among financial institutions

through counterparty borrowing and lending arrangements or through payment and settlement systems. Lack of transparency, imperfect or asymmetric information, and uncertainty about exposures can all give rise to such financial contagion.

One of the lessons from the current financial crisis is that, for policymakers, bankruptcy is not an attractive option for a failing institution that poses systemic risk. In fact, the underlying rationale of bankruptcy law is maximizing the payoffs to creditors. Although state insurance regulators do have special procedures for the orderly liquidation of regulated insurance companies that fail, their focus is on paying off policyholders and claimants. Their procedures are not intended to address systemic risk.

Since systemic risk involves an externality not easily represented in normal bankruptcy proceedings, we have long had a specialized regimen for dealing with bank failures. The FDIC may consider systemic concerns in a failing bank's resolution and has the authority to act as a receiver for a failed commercial bank and run a bridge bank for up to five years. However, there is no similar mechanism for the orderly liquidation of most nonbank financial firms that pose systemic risk. Policymakers are thus left with one of two outcomes: (1) very costly failures; or (2) very costly interventions to avoid the failure. Since there is no clear commitment to, or mechanism for, a systematic approach to such failing financial firms, substantial uncertainty arises, leaving market participants guessing about how policymakers will respond.

Indeed, the financial problems at Bear Stearns, AIG, and Lehman elicited different responses. When serious funding problems led to the prospect that Bear Stearns might go bankrupt and potentially bring down many other financial firms and disrupt important pieces of the payment system, the Federal Reserve, in consultation with the Treasury, invoked its emergency powers as lender of last resort to allow for a more orderly resolution of the firm's problems. A private-sector buyer (JPMorganChase), with Fed assistance, then purchased Bear Stearns. When AIG and Lehman faced severe funding problems, the Fed and the Treasury again attempted to find private-sector solutions to avoid the imminent failure of these firms. None was forthcoming. The judgment was made that given the nature of AIG's financial obligations; its disorderly collapse would severely threaten financial stability. So the Federal Reserve provided an emergency credit line to facilitate an orderly resolution. In the case of Lehman, the Fed and Treasury declined to commit public funds, because the judgment was that its failure posed less systemic risk, since Lehman's problems had been known to the market for some time.

In hindsight, some have criticized these decisions. But at the time, it was a reasonable judgment based on systemic risk. I also believe that the failure of Lehman was a symptom and not the cause of the resurgence of financial market stress we saw in late September and early October. These actions did lead to uncertainty about how nonbank financial failures would be handled, and arguably, this uncertainty contributed to the stress in the markets. To help alleviate such uncertainty, we should seriously consider establishing alternative resolution mechanisms that would be more predictable and systematic in their approach, as suggested by the principles I have previously outlined.

Since my first principle is to set clear and feasible policy objectives, let me at least be clear about

what I have in mind for such resolution mechanisms. In my view, the objective is not to prevent the failure of an individual firm, but to reduce the systemic risks that such a failure may create while minimizing any losses to the taxpayer.

One alternative resolution mechanism might follow the one used by the FDIC. That is, extend some type of “bridge-bank” authority to regulators of nonbank financial firms that pose systemic risk. It is not clear to me whether centralizing that type of bridge authority in one regulatory body — whether it is the FDIC, the OCC, the Fed, or the SEC — would be optimal. Certainly that is an issue for further study.

We can look to banking for other examples of systematic policy approaches. For instance, the prompt corrective action provisions of the FDIC Improvement Act (FDICIA) provide an example of a systematic approach that is required when a bank gets into trouble and is at risk of failing. Trigger points are specified for when bank regulators must take action to deal with the bank’s problems. Because Congress embodied these prompt corrective action provisions in legislation, the regulators are insulated from near-term political pressures and constrained to behave in ways that are more systematic. This offers the regulators a degree of political independence and the markets more clarity.

Regulation of the Payment System & Clearing and Settlement Systems

Another issue that policymakers and legislators will need to address is the Fed’s role in regulating the payment system and in promoting effective and robust clearing and settlement systems. This financial crisis has demonstrated that innovative financial products can create new risks in the payments system. Sometimes those risks are not well understood — at least not until something breaks.

Due to the increased complexity and inter-relationships among various innovative financial instruments and the markets in which they are traded, we have found that the failure of a major counterparty has the potential to disrupt many other financial institutions, their customers, and other markets. The lack of transparency in some of these instruments and markets makes it more difficult for market participants to identify who is at risk and to what degree. The consequence of the lack of transparency and potential asymmetric information is to increase the systemic risks of such failures.

The New York Fed, for example, recognized emerging problems in the clearing and settlement of over-the-counter credit default swaps even before the financial crisis began. These difficulties included a lack of standards, automation, or even basic information about the trades.

Chairman Bernanke has suggested that the Fed have a formal mandate to regulate systemically important payments and settlement systems. Determining which systems are systemically important, whether to regulate them, and by whom will require careful consideration. In doing so, we must avoid giving the Fed a mandate for financial or systemic stability that is too vague or too sweeping or that lacks clearly defined principles. We must set objectives that are feasible. Otherwise, over-promising puts at risk the credibility of the central bank.

In some cases, it is feasible and desirable to promote private-sector solutions, market mechanisms, or infrastructures that help strengthen the resiliency of the payments system without heavy-handed regulation. One such approach is for industry participants themselves to set up a central counterparty, such as a formal exchange or clearinghouse. A regulator, whether the Fed or another agency, might then be responsible for ensuring the appropriate functioning of the central clearinghouse rather than being involved in overseeing multiple bilateral trading arrangements. The clearinghouse would help facilitate transparency and the use of more standardized products. Such an initiative is currently under consideration for the over-the-counter derivatives market.

The Scope and Scale of the Fed's Role as Lender of Last Resort

Let me now turn to my last issue. As policymakers and legislators consider regulatory reform, they will need to address the scope and scale of the Fed's role as lender of last resort.

By any measure, we have expanded the role of the Fed as lender of last resort to historic proportions to deal with the current financial crisis. Starting last year, the Fed expanded its existing discount window operations and created a series of new lending facilities to help funding markets function more effectively. Some of these actions required the Fed to invoke section 13(3) of the Federal Reserve Act so that it could lend temporarily to nondepository institutions in "unusual and exigent circumstances."

This panoply of lending facilities bears little resemblance to the classic textbook image of the Fed's discount window in normal times. It doesn't even look similar to lending activities during other financial crises since the Great Depression.

Consider how much has changed: Prior to this crisis, the Fed lent only to depository financial institutions — banks, savings and loans, savings banks, and credit unions — and such lending was typically overnight. During the past 16 months, we have made loans to primary securities dealers, investment banks, a global insurer, and most recently to issuers of commercial paper, including financial and nonfinancial companies. These lending arrangements have been for terms as long as 84 days for the Term Auction Facility, 90 days for the primary credit "discount window," and even as long as 10 years for the financing provided in the Bear Stearns merger.

Prior to this financial crisis, Fed lending typically amounted to less than 1 percent of the total assets on the Fed's balance sheet. By the first week in November, it had risen to about 44 percent.

This expansion of the scope and scale of Fed lending may not have been so large had we had better resolution mechanisms to deal with such failing firms as Bear Stearns and AIG. And perhaps our lending would not have become so wide-ranging had there been better regulation or more resiliency in the payment and settlement systems, including more transparency about the markets for mortgage-backed securities and credit default swaps.

Eventually we will have to face the issue of the appropriate scope and scale of the Fed's lending facilities once this financial crisis passes. We must consider how to wind down some of these

facilities and how we should operate the discount window in “normal” times. We must also consider how we should proceed the next time a crisis arises.

Difficult questions will arise about if and when firms without access to the discount window in normal times should be given *ad hoc* access to the Fed’s lending facilities in a future crisis, and under what terms and conditions. Intervening too often or expanding too broadly the set of institutions that have access to the central bank’s credit facilities can create moral hazard, distort the market mechanism for allocating credit, and thereby increase the probability and severity of a future financial crisis. So it would be useful to explore whether we can develop systematic approaches to making decisions about the existence of “unusual and exigent circumstances” that might help contain such moral hazard.

Clarifying the Fed’s lending policy and the criteria that will be used in taking actions, as well as the criteria that will be used to determine when to close any special lending facility no longer needed, will all help lower the costs of uncertainty during a financial crisis.

To lay a foundation for those decisions, we should follow the general principles I cited earlier. The central bank should clearly state objectives and set boundaries for its lending that it can credibly commit to follow. We should take a systematic approach to clarify the criteria on which the central bank will intervene in markets or extend its credit facilities to banks — and to nonbank financial firms. We should be prepared to stay the course once our policy is set and clearly communicate the lending policy and the actions we take in our capacity as lender of last resort.

As we revisit our central bank lending policies, we must not overlook one other important principle: central bank independence. Just as we know that independence leads to more effective monetary policy, free from fiscal and political influence, I believe independence is vital to a more effective lending policy.

To protect that independence, the central bank’s lending policies should avoid straying into the realm of allocating credit across firms or sectors of the economy, which I believe is appropriately the purview of the market. The perception that the Federal Reserve is in the business of allocating credit is sure to generate public pressures on the Fed from all sorts of interest groups. In my view, if government must intervene in allocating credit, doing so should be the responsibility of the fiscal authority rather than the central bank.

By setting objectives and pursuing a systematic approach to its lending policies that avoids credit allocation, the Fed can operate independently from these types of pressures, resist them when they arise, and better ensure its ability and credibility to maintain price stability and sustainable long-term growth.

Conclusion

Let me conclude with a few final observations. Today I have highlighted some of the important issues that regulators and legislators will need to address as they consider the Fed’s role in

financial stability and regulatory reform.

The current financial crisis and the actions by the Fed and Treasury to address it are leading to a restructuring of the financial services industry. As I said before, history tells us that financial crises invariably lead to regulatory reforms. Indeed, when some semblance of normality returns to the financial markets, I expect some type of regulatory reform will be warranted. Yet, there are risks in rushing into these regulatory issues without establishing in advance the guiding principles and objectives for such regulations.

Some may think access to the Fed's lending facilities should be permanently expanded to include a wide range of financial institutions. I believe such expanded access to central bank credit would raise significant issues of moral hazard that would need to be addressed. And I have urged that we must continue to avoid compromising the Fed's independence — one of the great strengths of central banks.

Some people might think that expanding the Federal Reserve's regulatory and supervisory authority and giving it a sweeping mandate for financial stability would prevent the types of financial crises we have been experiencing this year. That is unrealistic.

I have raised several concerns about adopting overly broad regulatory reforms that give the Federal Reserve a role that goes beyond the limits of what a central bank can and should do. We should avoid giving the Fed new missions or goals that conflict with the one goal that is uniquely the responsibility of a central bank — price stability. This is one objective that cannot be delegated to an agency other than the central bank. No other institution can be charged with this objective, since no institution other than the central bank is capable of delivering it.

Going forward our focus should be on better regulation, not necessarily more regulation. We need to focus on ways to strengthen our financial markets to make market discipline more effective at mitigating systemic risk. We should think about which financial markets are critical to the efficient functioning of the payment system rather than focusing on individual firms. Ideally, we need to determine which aspects of the financial system are critical and then make sure we have the market mechanisms, regulations, and supervision to ensure those sectors are resilient.

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