

BROOKINGS

QUALITY. INDEPENDENCE. IMPACT.

Responding to the Breakdown of the Financial System

The Federal Reserve in the Crisis of 2007-2009

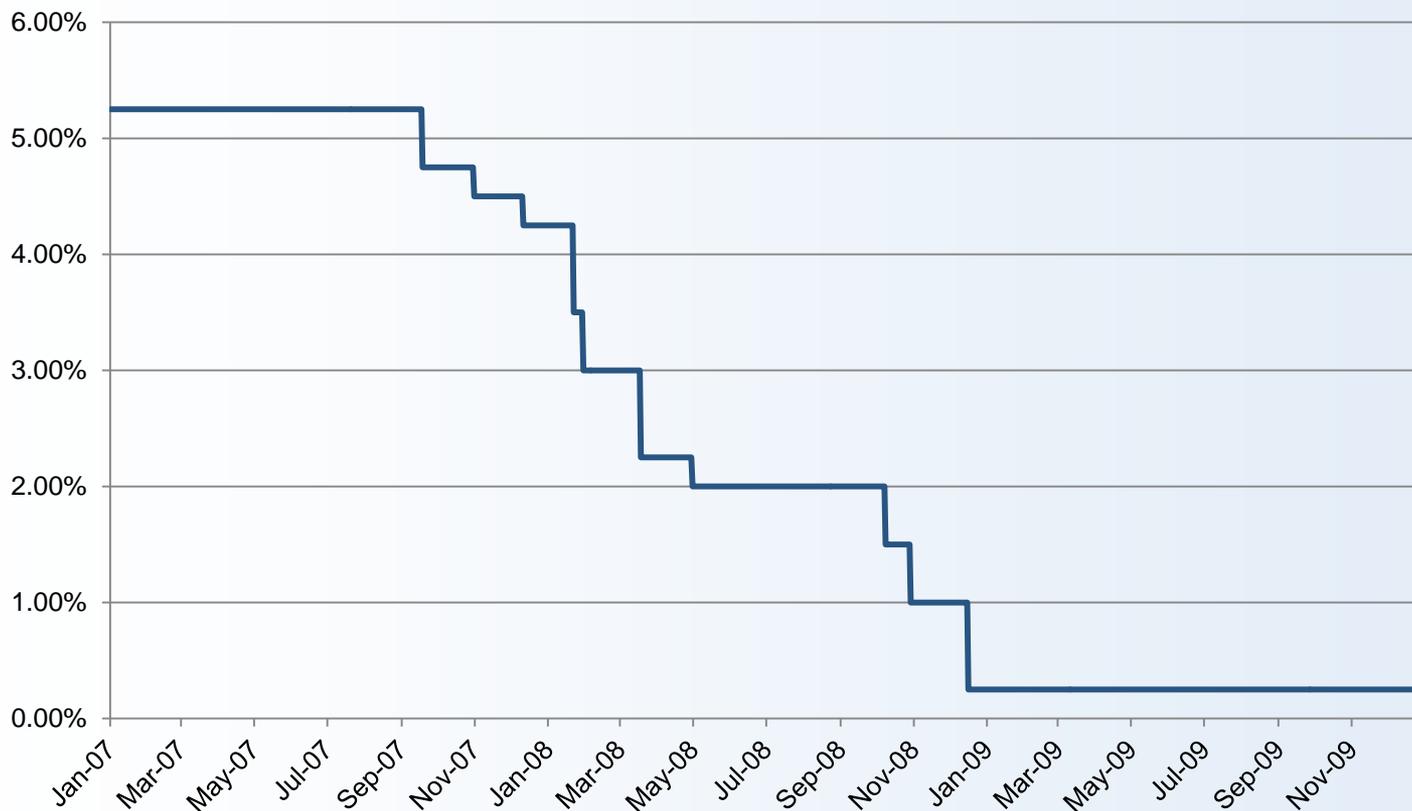
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Background

- Policymaking under true Knightian uncertainty
 - » But react with force: “whatever it takes”
- Required unprecedented response
 - » But deeply rooted in central bank history and practice

Open Market Operations

Federal Funds Target Rate



Open Market Operations

Federal Reserve Securities Portfolio



Open Market Operations

- Issues – Large Scale Asset Purchases
 - » Transmission
 - » Credit Allocation
 - » Calibration
 - » Exit

Open Market Operations

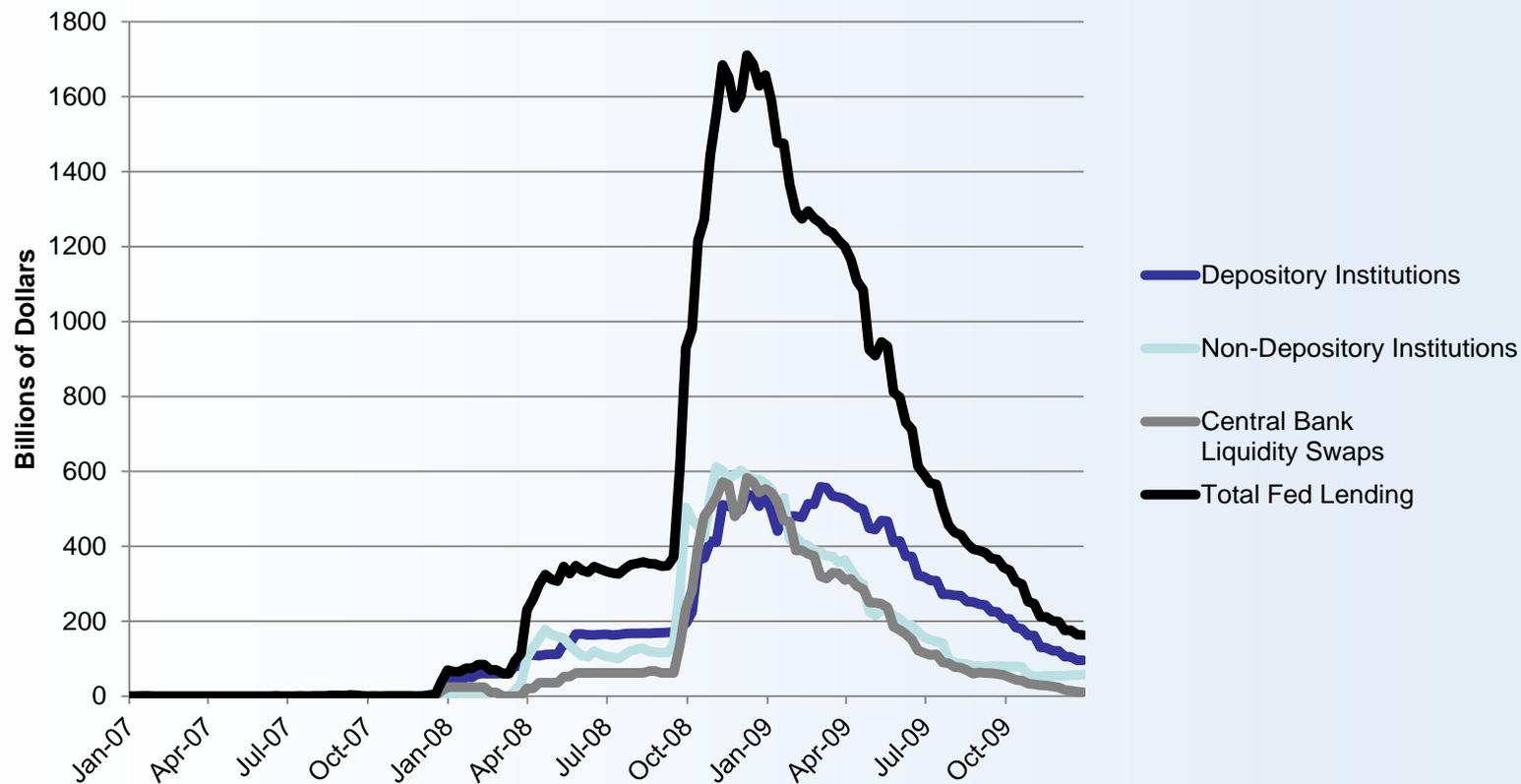
- Forward Guidance
 - » December 16, 2008:
 - “... the Committee anticipates that weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate **for some time...**”
 - » March 18, 2009
 - “...the Committee...anticipates that economic conditions are likely to warrant exceptionally low levels of the federal funds rate **for an extended period...**”

Discount Window Operations

- “The holders of the cash reserve must be ready not only to keep it for their own liabilities, but to advance it most freely for the liabilities of others. They must lend to merchants, to minor bankers, to ‘this man and that man,’ whenever the security is good.”
 - Walter Bagehot, Lombard Street: A Description of the Money Market

Discount Window Operations

Lending by the Federal Reserve



Discount Window Operations

- The Setting
 - » Buildup of risk
 - Overbuilding and overpricing of houses
 - Increase in leverage, maturity transformation, and opaque connections in financial sector, often related to mortgages
 - » Declines in house prices lead to uncertainty about the size and incidence of counterparty losses, disrupting
 - Interbank markets
 - Secured funding markets
 - Short-term credit generally
 - Securitization markets
 - » Result
 - Runs
 - Fire Sales
 - Lack of credit for households and businesses

Discount Window Operations

- Central bank playbook for a panic:
 - » **Lend Freely**
 - » **To solvent institutions**
 - » **At a penalty rate**
 - » **Against sound collateral**

Discount Window Operations

- Federal Reserve response
 - » Ease bank borrowing
 - Reduce penalty
 - Auction credit
 - » Extend to nonbanks
 - Primary dealers
 - Money market funds (indirectly)
 - Corporate CP borrowers
 - Securitization buyers

Discount Window Operations

- Relative to the playbook
 - » **Lend Freely**
 - Moral Hazard
 - » **To solvent institutions**
 - Liquidity vs. Solvency
 - » **At a penalty rate**
 - To normal market functioning
 - » **Against sound collateral**
 - Scope
 - Valuation
 - Nonrecourse loans and tail risk

Discount Window Operations

- Relative to the founders
 - » Robert Owen
 - The Federal Reserve Act “gives assurance to the businessmen of the country that they never fear a currency famine. It assures them absolutely against the danger of a panic.”
 - » The Federal Reserve limited the panic but didn't prevent it. Why?

Discount Window Operations

(1) Stigma

- » Perceptions by counterparties
- » Public/media reaction
- » Progress on this issue?
 - Auctions help
 - But political reaction (“bailout”) and transparency requirements go in the other direction

Discount Window Operations

(2) Restrictions on assistance to nonbanks (Section 13-3)

- » Requires crisis already underway
 - “unusual and exigent”
 - “unable to secure credit from other banking institutions”
- » Progress on this issue?
 - Added speed bumps for 13-3
 - Piecemeal regulation of shadow banks
- » Required: Comprehensive approach
 - Plans for deploying 13-3
 - Systematic regulation of eligible nonbank entities and markets