Lessons Learned from the Financial Crisis for Federal Reserve Policy

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Marvin Goodfriend[1]

Friends of Allan Meltzer Professor of Economics

Tepper School of Business

Carnegie Mellon University

and

Research Associate

National Bureau of Economic Reserach

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[1] Former Senior Vice President and Policy Advisor, Federal Reserve Bank of Richmond, 1993-2005.

I am pleased to be invited to testify before the House Committee on Financial Services on "Re-examining the Federal Reserve's Many Mandates on Its 100-Year Anniversary." My testimony, "Lessons Learned from the Financial Crisis for Federal Reserve Policy," will reconsider the Fed's performance in meeting its mandates in the 2008-9 financial crisis and resulting Great Recession. For the most part, inflation was reasonably stable prior to the crisis and remained so. Hence, I will assess the success or failure of Fed policy with regard to its other two major mandates—financial stability and employment stability. I will emphasize the following six points in my testimony:

1) Fed credit policy (financed with monetary policy) worked well to stabilize short-term credit markets after the full-blown financial crisis erupted in fall and winter 2008-9.
2) However, the ambiguous boundary of expansive Fed credit policy itself triggered the crisis on September 16th when the $85 billion Fed loan to AIG drew criticism from prominent members of Congress as a questionable commitment of taxpayer funds.
3) The public became frightened that neither the Fed nor Congress would offer further effective support for the financial system.
4) The personal saving rate rose sharply by 5 percentage points, collapsed spending, pushed unemployment to 10%; the mild contraction begun in Dec. '07 became the Great Recession.
5) The enormous growth of shadow banking that financed the unstable credit cycle was facilitated, in the first place, by ineffective regulation of banking and money market finance divided between the Fed and the SEC.
6) To better serve the Fed's employment and financial stability mandates I recommend: i) that the boundary of the Fed's credit policy reach be narrowed and clarified and, ii) that the Fed be given authority to make sure that money market rules and regulations preserve monetary stability.

How Fed Credit Policy Differs from Monetary Policy

Briefly, monetary policy refers to the expansion or contraction of currency or bank reserves via Fed purchases or sales of Treasury securities. We think of these operations as monetary policy because—were the Fed to adhere to a Treasuries-only asset acquisition policy as it did prior to the crisis—then when consolidated with the Treasury's balance sheet, the Fed balance sheet would contribute only currency and bank reserves. With short interest rates reduced nearly to zero in fall 2008, monetary policy was employed then only to help finance credit policy.

Fed credit policy involves lending to financial institutions (or the purchase of non-Treasury securities) financed by selling Treasury securities or with the creation of bank reserves. When consolidated with the Treasury's balance sheet, Fed credit policy would contribute loans and purchases of non-Treasury securities as well as reserves, if any, created to fund credit policy. Unlike monetary policy, Fed credit policy involves fiscal policy—lending to particular borrowers—whether financed by sales of Treasuries against future taxes or the creation of reserve (money).

Why Fed Credit Policy Worked in the Financial Crisis

When the full-blown financial crisis erupted in September 2008 for reasons that will be discussed below, Fed credit policy worked successfully on a massive scale to re-intermediate banking and money markets by selling Treasuries to entities no-longer willing to lend in money markets (including in interbank markets) and lending the proceeds to depositories no-longer able to borrow at reasonable rates in money markets, in part, so depositories could refinance their money market clients. By April 2009, the Fed had grown its balance sheet from around $900 billion to over $2 trillion, lending to depositories, to foreign central banks, to a variety of money market credit facilities, and to special purpose entities formed to rescue specific firms such as Bear Stearns and AIG. These Fed credit policy initiatives were financed with around $250 billion sales of Treasury securities, around $300 billion of funds deposited in the Federal Reserve banks by the Treasury Department, and about $800 billion of bank reserves created by the Fed. Amazingly, prior to the crisis the Fed had supplied only $10 to $20 billion of aggregate reserves to the banking system.

The combination of Fed credit and monetary powers were well-suited to addressing the financial crisis in fall 2008. The Fed made the most of its independence to employ credit and monetary policies on an unimaginable scale. By spring 2009 financial markets were stabilized and the Fed balance sheet was stabilized as well. Unfortunately, there is another side of this story: the Fed's very independence, the ambiguous boundary of expansive Fed credit policy itself, would help trigger the great financial crisis in September 2008 that would produce the Great Recession.

Expansive Fed Credit Policy Helped Trigger the Great Recession

In March 2008 the Fed created and funded a special purpose entity, Maiden Lane LLC, for the purpose of acquiring risky mortgage obligations, derivatives, and hedging products from Bear Stearns to facilitate the acquisition of Bear by JPMC. Maiden Lane was funded by a $29 billion Fed loan and a $1 billion first-loss loan by JPMC. In effect, the Fed purchased the assets in Maiden Lane, with funds from the sale of Treasuries from the Fed portfolio. Since the Fed would have returned to the Treasury interest on the Treasuries it held, the Fed's credit policy support of Maiden Lane amounted to a "debt-financed fiscal policy purchase of pool of risky private financial assets." The Fed acknowledged the loan as fiscal policy by June 2008. Maiden Lane was brought on to the Fed's balance sheet, and the Treasury accepted responsibility for any loss.

Meanwhile, in an April speech to the Economics Club of New York Paul Volcker described the Fed as acting at the "very edge of its lawful and implied powers." In retrospect, Volcker's remarks can be seen as a "life preserver" to help the Fed persuade Congress to make resources available, if need be, to stabilize the financial markets. Instead the fiscal authorities were not then so involved. And the Fed remained exposed to having its balance sheet utilized as an “off budget” arm of fiscal policy without formal authorization from Congress.

Occasional Fed lending to solvent, supervised depositories on short term, against good collateral is protected against ex post loss and ex ante distortion. Such circumscribed lending deserves a degree of operational independence. However, Fed credit policy cannot be the front line of fiscal support for the financial system. A Fed credit policy decision that <u>commits</u> substantial taxpayer resources in support of the financial system or one that <u>denies</u> taxpayer resources is inherently a highly-charged, political, fiscal policy matter. Initiatives that extend the Fed’s credit reach in scale, maturity, and eligible collateral to unsupervised or potentially insolvent institutions inevitably carry credit risk, excite questions of fairness, and potentially threaten conflict between the Fed and the fiscal authorities—with the potential to destabilize financial markets and employment. Worse, an ambiguous boundary of expansive Fed credit policy creates expectations of Fed accommodation in financial crises, which blunt the incentive of private entities to take preventive measures beforehand to shrink their counterparty risk and reliance on short-term finance, and build up financial capital. Events surrounding the Fed’s rescue of AIG in fall 2008 illustrate the problem.

On September 7th the GSEs failed and were taken into conservatorship by the U.S. government. On September 15th Lehman failed. On September 16th the Fed chose to lend $85 billion on equity collateral to rescue AIG; this, in order to make AIG’s counterparties whole rather than risk world-wide financial collapse. At that point the Fed had no good options left. The politics were such that even prominent members of Congress criticized the Fed’s credit policy overreach as a questionable commitment of taxpayer funds. Chairman Bernanke replied on September 17th that the Fed was stretched to the limit and could do no more, and that the time had come for Congress to appropriate financial resources to stabilize the financial system or risk a severe contraction if not another Great Depression. The U.S. government appeared paralyzed. A run on money market funds on September 17th abated only after the U.S. Treasury made an extraordinary offer on September 19th to guarantee money market mutual fund assets for a year, apparently with backing from the Exchange Stabilization Fund which did not need a Congressional appropriation. The run on money market funds was contained. Congress rejected TARP on September 29th and the DOW dropped 7%. The $700 billion TARP was passed and became law on October 3rd. Equity markets were down over 30% in month to October 10th. Most telling, high-yield spreads over Treasuries jumped to 16 percentage points and remained elevated for months well above the prior 6 percentage-point spread peak reached since the turmoil began in mid-2007.

The public was frightened by the tumult in financial markets, and by the political recriminations, government paralysis, the extraordinary rescue or demise of a variety of financial institutions, and talk of another Great Recession. Out of an understandable degree of prudence, households saved more than otherwise. Unfortunately, the aggregate consequences were devastating for employment. The household saving rate jumped sharply by around 5 percentage points in the ensuing months. Since consumption accounts for over two-thirds of aggregate spending, the collapse in aggregate demand pushed the unemployment rate up sharply to around 10 %. The chaos transformed a relatively mild recession that began in December 2007 into The Great Recession.

Unalloyed flexibility of Fed credit policy, unconstrained by rules or boundaries, proved counterproductive for the stabilization of financial markets and employment in fall 2008. Congress in its oversight role should clarify the boundary of the Fed's responsibilities for taking expansive credit actions and correspondingly restrict its independence in doing so.

The 2010 Dodd-Frank Act recognizes the problem and requires Fed lending extended beyond depositories to be approved by the Treasury Secretary and to be part of a broad program not directed to any particular borrower. The Dodd-Frank requirements do not address the problem adequately, however, because the Administration is no more authorized to commit taxpayer resources than the independent central bank—only Congress can do so. And the Treasury is as likely as the Fed to favor expansive credit policy in a financial crisis rather than risk immediate financial collapse.

The Fed's Regulatory Authority Should Extend to Money Markets

Financial markets have long had an incentive to employ low interest deposits and money market instruments to finance higher-yielding, less liquid, long term cash flows. Investors will supply loanable funds via deposits and money market instruments at low interest in return for a monetary services (implicit liquidity, convenience) yield. Usually, deposit and money market finance offer a stable aggregate source of long-term finance even as individual deposits and money market instruments change hands frequently. But monetary services everywhere are susceptible to doubt about the quality of assets backing deposits and money market instruments anywhere. Deposits or money market instruments are held at low interest for their monetary services only if the public regards them as perfectly safe without question.

As in the recent credit cycle, money market finance can fuel extreme asset price appreciation, a breakdown in market discipline, and an eventual collapse of asset prices, banks, and money markets. Monetary financing of long-term cash flows is inherently fragile in both theory and practice. The great financial crisis of 1907 that eventually led to the establishment of the Federal Reserve System was precipitated by "trust companies" outside the jurisdiction of the private New York Clearinghouse (which acted before the 1913 advent of the Fed as a private regulator of the commercial banking system). The trust companies of 1907 were the shadow banks of their day. Likewise, the financial crisis of 2007-9 was precipitated by shadow bank finance in money markets outside the jurisdiction of the Federal Reserve.

The problem today is that U.S. regulators play “zone defense” with regard to the regulation of monetary services provided by bank deposits and money markets. The Federal Reserve regulates depositories. The Securities and Exchange Commission (SEC) regulates money markets. The financial services industry takes advantage of “zone regulations” much as a football team adapts its offense to take advantage of a zone defense.

For instance, money market mutual funds have grown enormously since the 1980s in part because securitization and structured finance produced a growing supply of instruments for financing in money markets; but also because regulators allowed depository institutions to guarantee asset backed commercial paper purchased by money funds without requiring that sufficient regulatory capital be set aside against these guarantees. Most importantly, the SEC granted money funds an exemption from mark-to-market accounting, which ordinarily is required for mutual funds operating under the Investment Company Act (ICA) of 1940.

Money funds sought to market themselves as close substitutes for bank deposits, so they could offer a stable net asset value like a bank deposit, but without the regulatory burdens of direct regulatory oversight of the Federal Reserve. Thus did money markets take advantage of “zone regulations” to attract short-term funding of long-term securities by 2007 that rivaled depository intermediation in volume—but without the regulatory oversight, insurance, or central bank backstop lending available to depositories. Despite the runs on money market funds during the crisis, little has been done to address the problem adequately in the Dodd-Frank legislation, by the SEC, or by the Financial Services Oversight Council.

The Federal Reserve’s financial stability mandate dictates, above all, that it protect the payments system and those parts of the commercial banking system supporting the payments system. However, in light of the evident power of money markets to fuel excessive investment and asset price appreciation, and to require Fed credit-policy crisis intervention, and to destabilize depository institutions—the Fed should be given the authority to make sure that money market rules and regulations preserve monetary stability. Among other things, this would mean giving the Fed the power to insist that money market mutual funds mark their shares to market so that investors know immediately the true value of the securities held on their behalf. More generally it would mean ending the ability of financial markets to exploit "zone regulations" to their advantage at the expense of monetary stability.

The macro-economy has proven robust to extreme fluctuations in investment and asset prices <u>not</u> fueled by excessive short-term credit, as during the "1997-2000 dot-com bubble." Hence, the Fed would serve its financial stability mandate well by focusing narrowly on the stabilization of short-term bank credit and money market finance, and the Fed should be given the regulatory authority to do so comprehensively.

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