

**Comments on the paper:
“Unprecedented Actions: The
Federal Reserve’s Response to the
Global Financial Crisis in Historical
Perspective”**

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Disclaimer

This presentation represents my own views and not necessarily those of the Federal Reserve Board of Governors or its staff.

Comfort Zones, Shmumfort Zones

The Paper's Contribution

- Addresses the interplay between the use of monetary policy for macro stabilization and financial stability.
- Brings a new perspective to this analysis
 - By assessing the Federal Reserve's actions since the global financial crisis against Bagehot's rule.
 - By comparing these actions to those taken by selected central banks since the mid-19th century.
- The analytic issues and historical narratives addressed by the paper are very provocative and informative.

The Paper's Central Conclusion

- Temporary, discretionary deviations from monetary policy rules may be necessary to address financial crises, but ...
- ...measures must be taken in rein in any resulting moral hazard.

Summary of the paper

Summary of the paper (1)

- Three key premises:
 - Price stability requires that monetary policy be conducted according to clear and transparent rules, with minimal discretion.
 - Potential tension between the objectives of price stability and financial stability.
 - Addressing financial crises may require liquidity provision that exceeds limits of the price stability rule.
 - Bagehot's rule is a way to ensure that financial stability actions are consistent with the price stability rule.
 - The rule: Lend freely to solvent firms, against good collateral, and at high interest rates.
 - Limits moral hazard, excessive liquidity creation.

Summary of the paper (2)

- Starting from these premises, the paper argues:
 - The Federal Reserve undertook a wide range of unprecedented actions during the global financial crisis. In many cases, these actions went beyond the limits prescribed by Bagehot's rule.
 - But it turns out these actions were not quite so unprecedented.
 - Review of historical record since the late 19th century uncovers numerous instances where central banks forcefully intervened to rescue ailing institutions or provided for their orderly liquidation.
 - So Fed's recent experience only latest example of how a central bank can violate Bagehot's rule and quell financial crisis without sacrificing price stability, as long as it quickly reverts to its rule.

Summary of the paper (3)

■ But:

- In the past, care was taken to limit moral hazard by ensuring stakeholders took losses, rescues were temporary/limited.
- More recently, central banks have taken actions that promote moral hazard
 - Continental Illinois,
 - LTCM
 - “Greenspan put” -- persistent loosening of monetary policy after LTCM.
- So the critical challenge is to design strategies for addressing financial crises that control moral hazard.

Comments on the paper

Comments on the paper (1)

Key premise: “Under fixed and flexible exchange rates regimes, price stability requires a rule that can be easily monitored so that central banks, and the political authorities who delegate responsibility to them, will be induced to follow credible, time-consistent policies.”

- Historically, many central banks did follow relatively non-discretionary rules like the gold standard.
- Rules limited monetary emission, helped peg exchange rates.
- But not clear were needed historically to achieve price stability, and certainly not needed now.
- An earlier Mishkin argued: under inflation targeting central banks are accountable for macroeconomic outcomes but there are no set rules required to achieve those outcomes.

Bernanke and Mishkin (1997)

“First, at a technical level, inflation targeting does not qualify as a policy rule in that it does not provide simple and mechanical operation instructions to the central bank...

Second, and more importantly, inflation targeting as it is actually practiced contains a considerable degree of what most economists would define as policy discretion...central bankers have in practice left themselves considerable scope to respond to current unemployment conditions, exchange rates and other short-run developments.”

Comments on the paper (2)

The paper argues that there is a tension between the price stability objective and the measures needed to address financial instability.

- The rules faced by the Bank of England in 1867, or when the gold standard impeded the flexibility of monetary policy, may have limited the provision of liquidity.
- But with modern monetary policy, no conflict between liquidity creation and price stability, as long as central bank is credible.
 - Demand for credible currency actually rises during financial crisis.
- In fact, with central bank credibility, financial stability and price stability objectives mutually reinforcing.
 - Actions to rescue financial system during GFC also warded off deflation.

Comments on the paper (3)

The paper argues that the Fed's actions during GFC materially violated Bagehot's rule. Paper lists:

1. Unusual monetary easing
2. Non-Bagehot liquidity facilities
3. International central bank cooperation
4. Non-conventional monetary policy
5. Rescue/orderly liquidation of financial institutions
6. Direct Treasury collaboration/intervention/aid
7. Supervisory actions

Comments on the paper (3, continued)

Some of these have little relevance to central bank implementation of Bagehot's rule:

1. Unusual monetary easing
 2. International central bank cooperation
 3. Non-conventional monetary policy
 4. Direct Treasury collaboration/intervention/aid
 5. Supervisory actions
- Clearly, monetary policy loosening was not a violation of the price-stability rule: helped prevent deflation.

Comments on the paper (3, continued)

Not clear how many of the new liquidity facilities were non-Bagehot.

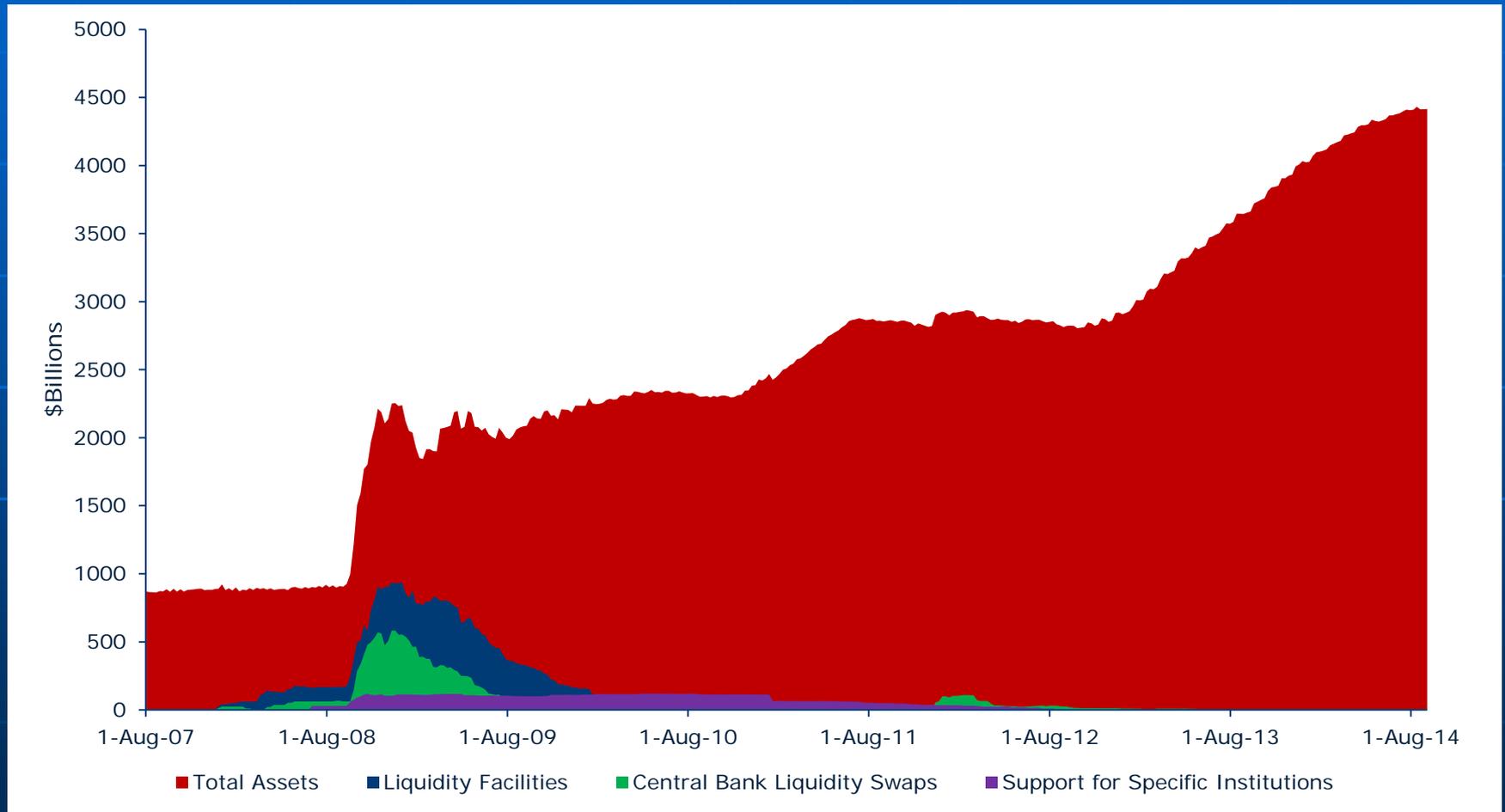
- Involved lending freely for good collateral to solvent institutions and markets, to avert collapse of intermediation and financial system.
- Lending not always at penalty rate, but that was to offset stigma of borrowing from Fed – didn't contribute to moral hazard.
- By some interpretations, Bagehot rule not intended to apply exclusively to banks. In new age, banking not the only channel of intermediation.
- Brian Madigan, "Bagehot's Dictum in Practice: Formulating and Implementing Policies to Combat the Financial Crisis" Aug. 21, 2009

Comments on the paper (3, continued)

Rescue/orderly liquidation of financial institutions.

- Funding for troubled institutions collateralized by marked-to-market assets, with haircuts.
- Fed didn't lose a dime on Bear Stearns, AIG.
- Scale of this funding very small compared with overall expansion of Fed's balance sheet.

Selected Assets of the Federal Reserve



Comments on the paper (4)

The paper argues that a number of actions in recent decades ratcheted up moral hazard and contributed to the eruption of the global financial crisis: Continental Illinois; LTCM; Greenspan put.

- Skeptical of these developments' importance; many causes of GFC; what about European banks?
- Paper mute on the moral hazard implications of Fed's response to GFC.
- Much of the post-GFC action around the world Dodd-Frank Act can be viewed as an attempt to rein in moral hazard.
 - US: Stress tests/Dodd-Frank Act/Orderly Liquidation Authority.
 - Europe: Bail-in rules
 - Everywhere: Basel rules on bank capital, liquidity

Comments on the paper (5)

Preemptive, shmreemptive

“Bagehot’s rule is a reactive policy, unlike the ‘unprecedented’ actions that may be considered to be preemptive policies.”

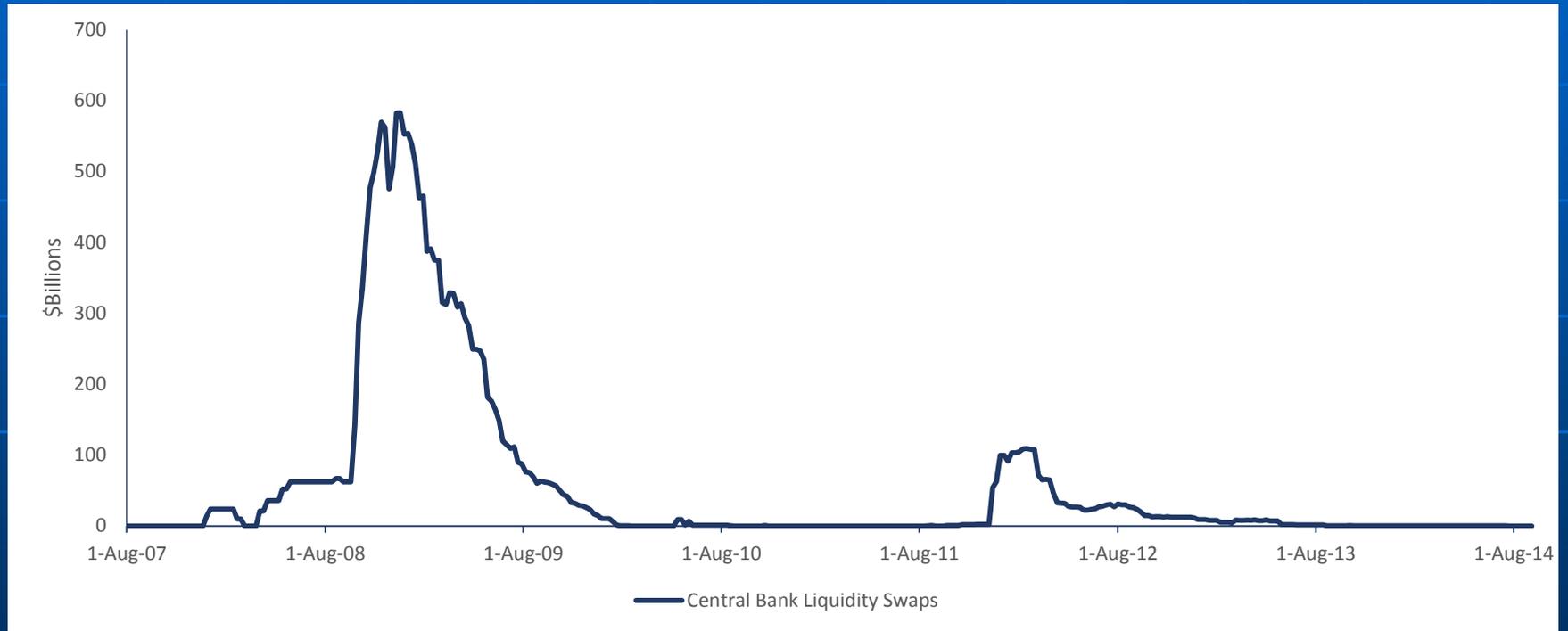
- Is distinction between preemptive and reactive central bank policy helpful?
- Hard to argue that central bank responses to GFC purely preemptive.

Additional thoughts

Additional thoughts (1)

- Not much reference to the Federal Reserve's recent actions in the global economy, aside from some references to the swap lines.
- Swap lines come off well, partly because they align well with Bagehot's rule.
 - Between central banks with strong balance sheets.
 - Strongly backed by exchanges of each other's currencies.
 - Prices at a premium over market interest rates in normal times.
 - Helped avert collapse in global dollar funding markets in stressed times, ran off endogenously as conditions normalized.

Central Bank Liquidity Swaps



Additional thoughts (2)

- Bagehot's rule intended to address moral hazard and encourage risk management for solvency.
- Besides the penalty rate, does it encourage or discourage risk management for liquidity?
- Liquidity stress tests, LCR, NSFR, etc.

Additional thoughts (3)

- Is the most important issue facing monetary policy makers today the scope to respond to financial crises without engendering moral hazard?
- Or, is it how to calibrate monetary and macroprudential policies to address macro objectives without encouraging future financial imbalances?

Conclusion

- Interesting, informative, provocative paper!
- Not sure about all the premises.
- Certainly agree with conclusion that financial crises require extraordinary responses, but measures must be taken to control moral hazard.



Thank you