Unprecedented Actions: The Federal Reserve’s Response to the Global Financial Crisis in Historical Perspective

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“The Federal Reserve System’s Role in the Global Economy: An Historical Perspective”
Federal Reserve Bank of Dallas
September 18-19, 2014
Unprecedented Actions?

• Great Inflation led to recognition of time-inconsistency problem of discretionary monetary policy → consensus for rule-like commitments by central banks

• Fed’s discretionary actions during global financial crisis seem “unprecedented”

• After Bear Stearns’ demise, Volcker comments that Fed’s actions: “extend to the very edge of its lawful and implied powers.”

• Historical perspective on unprecedented actions provides a framework for understanding when they may be justified.
Rules for Price and Financial Stability Mandates

• **For Price Stability (PS):** Gold Standard. Inflation Targeting. Solve the time-inconsistency problem arising from discretionary interventions by announcing a rule and building credibility, strictly avoiding violations of the rule.

• **For Financial Stability (FS):** “Bagehot-rule”. Lend freely at a high rate on good (in normal times) collateral, no pre-emptive interventions to save banks, no bailouts, announce the rule and adhere to it; solves the problem of moral hazard caused by discretionary interventions that may produce the next crisis.
Rules Versus Contingent Rules?

• Central bank is an agent delegated by legislature to provide PS and FS. Follows rules to avoid time-inconsistency problems.
• Problem of writing a rule that covers all contingencies, so allow discretion in extraordinary circumstances. Works, if there is a commitment to return to the rule.
• Example for PS: Gold Standard (Bordo & Kydland, 1995); paper pound 1797-1821
• Example for PS: Bernanke & Mishkin (1997) Inflation targeting as “constrained discretion”
• Example for FS: Issue of “chancellor’s Letter” to permit Bank of England to violate Act of 1844
• Examples for FS: Section 13(3) of the Federal Reserve Act
• How did this evolve?
The Fed’s Unprecedented Actions

1. Unusually Easy Monetary Policy
2. New Non-Bagehot Liquidity Facilities
3. International Central Bank Cooperation
4. Non-Conventional Monetary Policy
5. Rescues of Financial Institutions/ Provision for Orderly Liquidation
6. Treasury Collaboration/Intervention/Aid
7. Supervisory Actions
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The Historical Record

• Unprecedented, discretionary interventions in financial crises are the norm, not the exception; and they were often successful at both crisis containment and moral hazard containment

• What about Bagehot’s advice? (Lombard Street, 1873) It reflected the contemporary financial system: no “SIFIs” and no globalized world financial system

• Central bank policy for financial crises continued to evolve after 1873 as the financial system evolved

• Bank of England, Banque de France and the Fed---all try to follow Bagehot’s rule, but….evolve towards contingent rules
Bank of England (BoE)

• After 1844 crisis (low rates, discounts rationed, crisis amplified) BoE follows Bagehot rule.

• **1866 Crisis:**
  – *Overend-Gurney (OG)* fails, no bailout & Bagehot rule with a chancellor’s letter to suspend gold reserve rule. Sharp contraction

• **1890 Crisis:**
  – *Barings Brothers (BB)* bigger than OG & in globalized financial world. (Rothschild: BB worse than OG, a SIFI)
  – BoE with Treasury backstop organizes a lifeboat (lasting 1895) to liquidate BB. BB partners make up most of losses. Bagehot-rule lending for others.
  – Currency crisis as gold reserves fall, BoE fears raising discount rate would be misinterpreted, arranges for “swaps” (bonds for gold) with BdF and Russia.
Banque de France (BdF)

• **1882 Crisis:**
  – **Union Generale** & other banks fail, stock market settlement crisis (defaulting counterparties in forward market), lifeboat only for Paris Bourse on Bagehot’s terms for Bourse and rest of market, profound recession.

• **1889 Crisis:**
  – **Comptoir d’Escompte** (2nd largest = SIFI) insolvent (guarantees on forward copper contracts),
  – BoF organizes a lifeboat, lends against collateral of all the bank’s assets but with a syndicate of banks to absorb losses. BoF winds down its portfolio. Treasury support. Management and directors cover most of losses. CdE recapitalized.
  – Additional lending to others a la Bagehot. Modest recession.
The Fed and the Great Depression

• **Stock Market Crash of 1929:**
  – FRBNY lends freely to banks so they will lend freely to brokers
  – Success with credit spreads declining and recognized by similar response to 1987 crash
  – But breech rules set for open market operations and FR Board in 1929 censures the FRBNY.
The Fed and the Great Depression

• **Banking panics of 1930-1933:**
  – Fed adheres strictly to Bagehot like rule. If banks need liquidity discount window is open, few come, no expansionary policy conducted.
  – Disaster
  – Congress prods the Fed unsuccessfully until March 1933: off gold standard, bank holiday ("stress test"), banks open recapitalized by RFC
  – **Result:** **1935 Act: Section 13(3)** provides Fed with authority for unprecedented, discretionary actions in “unusual and exigent circumstances”
Four Later Interventions

• **Penn Central 1970:**
  - Fed provides non-Bagehot liquidity facilities for banks (like France, 1882) to ensure that firms have access to short-term funds to replace CP market when PC fails.
  - Prevents severe financial shock
  - Limits moral hazard by not lending to firms in CP markets; Instead uses banks as delegated monitors.

• **Continental Illinois 1984:**
  - Fearing panic, Fed supplies liquidity and FDIC capital, with 100% insurance of *all* creditors
  - Begins TBTF that promotes moral hazard and later banking crises
Four Later Interventions

• **Stock Market Crash of 1987:**
  – Providing liquidity to banks to provide brokers with funds prevents larger financial shock (like US 1929)
  – No severe recession
  – Liquidity provision temporary

• **LTCM 1998:**
  – Fed induces formation of lifeboat to prevent large shock from LTCM failure (like UK, 1890).
  – Fed lowers rates to counteract interest rate and swap spreads
  – Not reversed, leading to “Greenspan Put” that promotes moral hazard (unlike UK, 1890).
Conclusions: Lessons

• “Unprecedented” actions of Fed during the global financial crisis (GFC) in line with central bank actions since 19th century

• Temporary deviations from Bagehot and price stability rules were frequently successful, while strict adherence led to disasters as in 1930-33.
  - Provides rationale for “unprecedented” Fed actions during GFC

• Deviations from Bagehot rule can promote financial instability if steps are taken to mitigate moral hazard: Continental Illinois and LTCM.
Conclusions: Bottom Line

• Designing central bank mandate should not focus on strictly following rules: instead should focus on contingent rules that limit moral hazard

• Federal Reserve’s “unprecedented” actions during GFC should be judged not on whether they were discretionary, but rather on whether they were accompanied by adequate measures to constrain moral hazard.