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

Frederic S. Mishkin, Columbia University & NBER
and
Eugene N. White, Rutgers University & NBER

"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

	Unusual Mon, Easing	Non-Bagehot Liquidity Facilities	Internat Central Bank Coop	Non-Conven Monetary Policy	Rescue/ Liquidation of FI	Treasury Intervention/ Aid	Supervsn
	1	2	3	4	5	6	7
U.S. 2008	X	X	X	X	X	X	X
U.K. 1866						X	
France 1889					X	X	
U.K. 1890			X		X	X	
U.S. 1907		X	X			X	
U.S. 1929		X					
U.S. 1930-1933				X	X	X	X
Penn Central 1970		X					
Continental Illinois 1984					X		
Crash of 1987		X					
LTCM 1998	X				X		

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** (2^{nd} 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.