For release on delivery
7:00 p.m. EDT
October 5, 2007

Financial Stability and the Federal Reserve

Remarks by

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at the

New York State Economics Association
60th Annual Conference

Siena College
Loudonville, New York

October 5, 2007

Thank you to the New York State Economics Association and our hosts here at Siena College for inviting me to participate in the conference. They say you can never go home again. Well, I am testing that theory and am pleased to be back in upstate New York for the second time in as many weeks. In my remarks at the School of Business at the University at Albany, I argued that the conditions causing the turmoil in the financial markets were long in the making and that these causes should not be conflated with the particular troubles in the mortgage markets. I also posited that the financial market conditions may have proven to be overly ebullient, masking troubles that may have sown the seeds of financial distress.[1] This evening, I will underscore the responsibility of the Federal Reserve during periods of financial market turmoil and offer some perspective on the current state of financial markets.

The Gathering Storm

Several months ago, many large, global commercial and investment banks appeared on pace to post another record year of corporate profits. Underwriting and M&A activities were robust. Sales and trading revenues were bolstered by the acceleration of financial innovation. Principal investing appeared to be an increasingly accepted industry practice alongside traditional advisory business. Private pools of capital were growing strikingly. Public and private pension funds were reportedly increasing capital allocations to alternative investments. And, thanks in part to accommodative credit markets, the golden age of private equity appeared upon us.

Note. The views expressed herein are my own and do not necessarily reflect the views of other members of the Board of Governors or of the Federal Open Market Committee. I thank Board staff members James Clouse and Roberto Perli for their valuable contributions to these remarks.

[1] Warsh, Kevin (2007), "Financial Market Developments," speech delivered at the University at Albany, State University of New York, School of Business, Albany, NY, September 21, www.federalreserve.gov/newsevents.

Finance companies and other nondepository financial institutions were increasingly able to thrive, proving to be formidable competitors for traditional banks and thrifts. In sum, market functioning appeared robust, and risks underlying various assets were seemingly dispersed among a range of sovereignties, financial intermediaries, and investors.

During this period of seemingly benign economic conditions, most market participants appeared more focused on the dynamics of the new financial architecture than on the policy judgments of central bankers. Surely, market participants did not presume that the Federal Reserve was a mere spectator to market developments. Nonetheless, discussions of the Fed and financial stability may have seemed somehow anachronistic with the new paradigm sweeping financial markets.

How quickly times change. As you well know, by mid-August, volatility spiked in many markets. Risk premiums widened significantly. Term premiums reappeared with force. Signs of illiquidity were evident in a number of important markets. And clarion calls for the Fed to bring stability to financial markets were loud. Almost overnight, the role of the Federal Reserve and other central banks in fostering financial stability found its way to the front pages of major media. So, let me discuss the responsibilities of the Federal Reserve in promoting stable financial conditions. Although our policy tools are powerful, and our judgments are informed, our pronouncements are not made in isolation. The roles and responsibilities of other public agents, domestic and abroad, and private market participants are particularly critical during times of financial turmoil. We are, after all, central bankers, not central planners.

Responsibilities of the Federal Reserve

So what is the role of a central bank like the Federal Reserve in fostering financial stability?[2] Historically, episodes of financial instability and the sharp economic downturns that sometimes ensued were a driving force in the creation of the Federal Reserve itself. After earlier, sporadic, and ultimately less-than-successful attempts to create a central bank of the United States, the U.S. financial system found itself lacking an effective means to address the periodic financial crises that occurred in the second half of the nineteenth and in the early twentieth century.[3] Against this backdrop, the Congress authored the Federal Reserve Act in 1913, creating the Federal Reserve System. It is worth emphasizing that the Federal Reserve's concern with financial stability stems largely from the adverse implications of financial instability for overall economic performance.[4] The Fed's interest in promoting financial stability is thus intimately connected with its macroeconomic objectives: maximum sustainable employment and price stability.

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[2] The Federal Reserve is by no means the only institution in the United States that is concerned with the stability and functioning of the financial system. Indeed, the Federal Reserve works closely with a number of other U.S. government agencies on both a bilateral basis and jointly through the President's Working Group on Financial Markets to enhance the integrity, efficiency, orderliness, and competitiveness of financial markets and to maintain investor confidence. In addition, the Federal Reserve participates in a number of important international groups, such as the Financial Stability Forum, the Basel Committee on Banking Supervision, the Committee on the Global Financial System, and the Committee on Payments and Settlement Systems, to name just a few. Indeed, in today's tightly integrated international financial markets, fostering financial stability requires a global perspective.

[3] The First Bank of the United States was created in 1791 and lasted until 1811. The Second Bank of the United States operated from 1816 to 1836.

[4] Originally, the preamble to the Federal Reserve Act of 1913 stated that the Federal Reserve System was created "[T]o furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes." Macroeconomic objectives were explicitly introduced later, with the 1977 amendment of the Federal Reserve Act, which stated, "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."

From the founding of the Federal Reserve to the present, a key question confronts policymakers and market participants alike: What is financial stability? Perhaps it is better to address what it is not. In my view, financial stability does not demand a state of lessened financial market movements, a state of muted volatility. More often than not, financial markets process new information efficiently: If some unexpected news arrives, markets adjust, sometimes even sharply, and they should. These types of movements are healthy, even necessary. They serve to quickly bring prices in line with underlying fundamentals. And markets that move quickly and adroitly do not necessarily produce unstable financial conditions. Nor should those who take up the cause of ensuring financial stability protect individual investors or financial institutions from substantial losses or insolvency. To the contrary, a healthy and well-functioning financial system will tend to reward well-managed risk-taking and punish imprudence.

I am inclined to interpret the Federal Reserve's interest in promoting financial stability as a desire to foster conditions that favor sustainable growth and stable prices. In this sense, financial stability concerns may rightly shape policymakers' views about the modal outlook for the economy as well as the risks surrounding this outlook. Financial instability may thus be characterized as a situation in which the financial system becomes incapable of efficiently allocating resources at market-clearing prices across the economy.[5] If financial markets become dysfunctional, financial intermediaries' flexibility may be impaired, and investors may become uncertain about their prospects. And if this situation were to persist, overall macroeconomic performance could be

[5] We should also recognize that financial instability is symmetric and could arise equally when credit flows too freely or at prices that are too low.

threatened. In an earlier period of financial turmoil, this phenomenon was termed "fear-induced disengagement."[6]

Assessing Financial Stability

The Federal Reserve is well positioned to monitor developments in financial markets and assess the quality of market functioning. We have access to a wide range of financial and economic data and extensive contacts with market participants. Particularly in times of financial distress, we must draw on a full range of market indicators. We also glean important information by virtue of our responsibilities as a banking regulator and payment system operator. And although such a dashboard of key information is exceedingly useful, it should not be confused with a crystal ball. For even if our understanding of the financial markets was somehow perfect, the transmission mechanism between financial markets and the real economy is only partially understood. Like private market participants, the Federal Reserve is in the business of making policy judgments amid uncertainty and must assess the prospects for the real economy with considerable humility.

What indicators might help us assess the economic and financial situation? We look to prices at which investors are willing to provide capital by reviewing risk premiums across a range of asset markets. As an example, we monitor corporate credit spreads from bond, loan, and credit derivative markets, and we follow closely the evolution of pricing in mortgage markets. We also look to the terms by which market participants are willing to lock up funds over various time horizons by reviewing term

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[6] Those were the words used by then-Chairman Alan Greenspan in his comments on the 1998 financial crisis. Alan Greenspan (2000), "Technology and Financial Services," speech delivered before the Journal of Financial Services Research and the American Enterprise Institute Conference, in Honor of Anna Schwartz, Washington, DC, April 14, www.federalreserve.gov/newsevents.htm.

premiums embedded in financial market prices. And we constantly revisit investors' willingness to conduct business with financial intermediaries to assess counterparty credit risk. In this respect, market-based indicators are certainly informative, as are measures of current exposures of financial institutions obtained through the supervisory process. No central bank financial market dashboard is complete, however, if it does not give considerable weight to measures of price stability. As a result, we constantly review inflation expectations, as measured by spot and forward TIPS spreads, surveys, commodity prices, and foreign exchange values.

Volume indicators are often particularly useful in assessing market functioning in times of market turmoil. Volume indicators impart knowledge about the depth and extent of trading and the willingness of financial intermediaries to serve as market makers. By reviewing the sizes of issuance of various financial instruments as well as trade volumes in a number of markets, we try to assess the relative strength and resilience of markets. And we try to assess the reliability of prices by reviewing information on bid-ask spreads and quote sizes where available. Of course, these various price and volume indicators are not easy to disentangle, necessitating that our judgments on the state of market functioning customarily be provisional.

Throughout the turbulence of the past few months, we have followed a number of indicators that pointed to strains in several markets. For example, we saw spreads on subprime residential mortgage-backed securities soar and securitization volumes slow to a trickle as market participants became concerned about their ability to value those products amid mounting delinquency rates and defaults in the sector. Investors' lack of confidence in valuations was also apparent in other securitized products, as evidenced by higher spreads and lower issuance in markets for collateralized debt obligations and collateralized loan obligations. The asset-backed and the lower-grade unsecured commercial paper markets also came under pressure; difficulties spread to other money markets, and term spreads in interbank funding markets climbed much above historical levels.

It is also true, however, that some financial indicators provided some reassurance during this period. Important parts of the financial system continued to function well, especially in markets where less-complex financial products are traded and where investors are less reliant on the role of the rating agencies. For example, although equity markets were quite volatile at times, trading was generally not impaired, and investors were able to buy and sell stocks at market-prevailing prices, even at the times of greatest turbulence. The markets for longer-term Treasury securities and investment-grade corporate bonds generally continued to function well, albeit at new market-clearing prices. It is notable that the level of fails-to-deliver in Treasury trades did not spike amid the market turmoil despite very intense safe-haven demands for Treasury securities at times. Of great importance, clearing and settlement systems proved to be extremely resilient throughout the episode, even if most post-trade infrastructure providers experienced record transaction volumes. To be sure, mortgage lenders came under severe stress, and several large commercial and investment banks were subjected to strains brought about by higher contingent liabilities and various other commitments. Still, at least by number, most financial institutions remained "open for business," willing to lend, albeit at tighter terms. And although many hedge funds posted meaningful losses, on balance, they appear to have performed a useful function during this period of considerable tumult.

Although these positive signs are acknowledged, financial conditions were clearly stressed in recent months. When markets do not clear and some large financial institutions withdraw from risk-taking, it is prudent for a central bank to take account of the impaired nature of market functioning. The specter of financial instability is heightened, and the prospect of harm to the overall economy is difficult to dismiss. The Federal Reserve responded to these developments by providing reserves to the banking system; it announced a cut in the discount rate of 50 basis points and adjustments to discount window practices to facilitate the provision of term funding. In the current episode, the disruptions in the structured finance, mortgage, leveraged loan, commercial paper, and interbank term funding markets made credit considerably less available for many households and businesses and thus, ultimately, represented a risk to the performance of our macroeconomy. As a result, the Federal Reserve took action to help forestall this risk, including the 50 basis points cut in the target federal funds rate on September 18.

Recent Financial Market Developments

It is premature to judge the ultimate effects of our policy actions on financial conditions, let alone on macroeconomic performance. Our dashboard of financial indicators, however, points to some encouraging signs, suggesting that financial conditions might be normalizing somewhat. In particular, I am encouraged by the price differentiation in certain markets based upon company-specific and asset-specific assessments of fundamental value. Although prices in several markets were no doubt affected by distortions around the quarter-end, some term spreads in the interbank market appear to have reversed a portion of their earlier increases, as have spreads in some parts of the commercial paper market. On the basis of our most recent data, it seems that the runoff in outstanding commercial paper may be slowing. Similarly, there are some signs of stabilization in the leveraged loan market. Banks have been able to sell substantial parts of large deals to investors in recent weeks, and some collateralized loan obligations are coming to market. Issuance of speculative-grade bonds resumed somewhat of late. Still, the functioning of several markets continues to be strained, a condition which I would expect to continue for awhile. Consequently, my colleagues and I on the FOMC will continue to assess the effects that these and other developments could have on the prospects for the economy. We will rely not only upon economic modeling, but also real-time, forward-looking indicators to help inform our policy judgments.