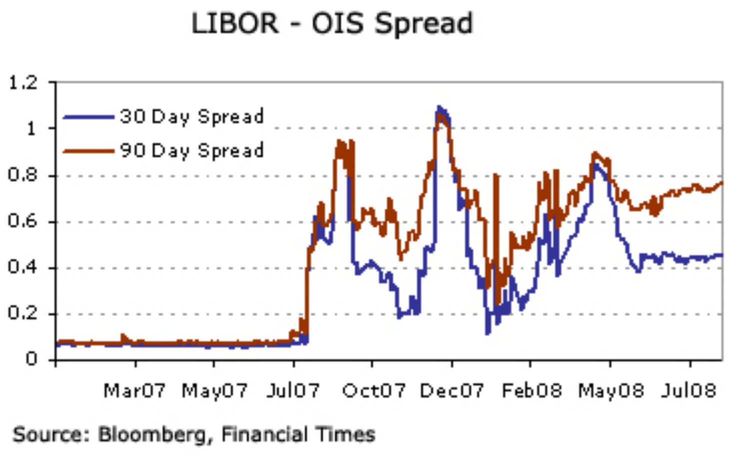
August 14, 2008

What the Fed did during macroblog's vacation

To state the very obvious, it has been quite an eventful twelve months since I last committed fingers to laptop. I might well have titled this post "Four Fed programs that did not exist one year ago." Over the four months from December to March, the Federal Reserve Board of Governors and the Federal Open Market Committee, or FOMC, introduced an alphabet soup of new lending programs to address acute stress in financial markets, some of which required the invocation of emergency powers based on "unusual and exigent circumstances."

I know that in some quarters—maybe the one where you reside—all this activity had a certain frenetic, whack-a-mole feel to it. But I think it appropriate to view the Fed's actions over this period as what I believe them to be: A measured and logical sequence of steps to address very specific liquidity distress in financial markets.

If I had to choose one picture to describe the crux of the "liquidity" problems to which I am referring it would be this one:



In effect, the OIS (overnight index swap) yield is a measure of the rate that banks charge one another for overnight loans and the LIBOR (London Inter Bank Offered Rate) yields represent the rate charged for *slightly* longer-term (30- and 90-day) lending. The explosion in this spread in August 2007 was the marker for the emergence of a severe disruption in the means by which lending institutions typically finance their ongoing operations.

A brief chronology, then:

August 17, 2007: The Board of Governors cuts the primary credit rate (or discount rate), the interest rate Federal Reserve Banks charge on direct loans made to banks.

September 18, 2007: The FOMC cuts its target for the federal funds rate, the first in a string of seven consecutive rate reductions.

December 12, 2007: The Board of Governors introduces the Term Auction Facility (or TAF), initially a mechanism for providing loans to banks for a period of 28 days (as opposed to the typical overnight maturity associated with standard primary credit loans). Last week, the Board announced the program would be extended to make loans available for a term of 84 days.

March 7, 2007: The FOMC authorizes the New York Fed to conduct open market operations using Term Repurchase Agreements. Like the TAF, the term repo program allowed the Fed the flexibility to conduct operations over periods of about a month rather than the overnight basis that is typical in more normal environments.

March 11, 2008: The FOMC approves the creation of the Term Security Lending Facility (TSLF), which authorized swapping Treasury Securities (over a period of 28 days) for "other securities, including federal agency debt, federal agency residential-mortgage-backed securities (MBS), and non-agency AAA/Aaa-rated private-label residential MBS."

March 16: The Board of Governors creates the Primary Dealer Credit Facility (PDCF), authorizing direct loans to broker dealers who are authorized to engage in securities transactions with the Federal Reserve.

What do I want you to see? As I noted above, I see a progression of logically consistent steps that neither lurched to extreme solutions nor ignored the imperatives of the problem at hand:

- The first step was to invoke the usual tools of monetary policy (in the form of discount window lending and federal funds rate adjustments).

- Then it became obvious that injecting liquidity into overnight markets alone was not solving the problem of funding being unavailable for periods of time even as short as one to three months. The next step, then, was to lengthen the maturity of loans and asset exchanges in policy operations (in the form of the TAF and Term Repurchase Agreements). (An additional salutary effect of the TAF was apparently the lack of "stigma" that is thought to be attached to borrowing from the discount window.)
- From there, it became clear that Treasury securities were rapidly emerging as the only widely accepted form of collateral to support short-term borrowing and lending, a function that securities backed by real estate assets were simply unable to perform. Some relief to this problem was already inherent in the form of the broader-than-Treasuries collateral options in the TAF. Further relief was provided by the TSLF, which in effect implemented a swap of in-demand Treasury securities from the Federal Reserve's balance sheet for less liquid mortgage-backed assets.
- Finally, the potential systemic consequences of acute stress in the primary dealer network led us to the PDCF, in effect broadening the class of institutions to which the central bank would stand ready to infuse short-term liquidity.

Once again, in my view there is a methodical progression to the whole process that is too commonly overlooked: Start with the standard tools (the discount rate and federal funds rate), move on to a lengthening of the maturity in the term of those standard tools (TAF and Term Repurchase Agreements), on to a broadening of the collateral used to support monetary policy operations (TSLF), and finally expanding the class of institutions to which the Federal Reserve will lend (PDCF).

It is not entirely obvious that the new long-run level of the OIS-Libor spreads pictured above will once again converge to the values that prevailed prior to August 2007, but I would argue that the still-elevated levels of these spreads implies we have a ways to go before financial markets are again fully functional. Though the lending programs put in place in the past year have not been, and could not be, a magic elixir for solving all financial market woes, I would take the bet that they are least providing enough stability for the market to continue the painful process of healing itself. Getting to this point has not always been pretty in real time, and there is plenty of room for debate about the long-run costs and benefits of each step along the way. But given a little time for perspective I believe we will find a certain beauty to it all.

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