FEDERAL RESERVE BANK of CHICAGO

Last Updated: 11/30/09

Nontraditional Monetary Policy

Executives' Club of Chicago
Chicago, IL

Introduction

Good morning and thank you, Diane for that kind introduction. And thanks to Kaarina of the Executives' Club of Chicago for inviting me to speak today. I'm delighted to be here to share my thoughts on non–traditional monetary policies.

Following the worst financial crisis of the past 70 years, we are currently experiencing a recession that will likely match or surpass those of the 1970s and 1980s in depth and severity. These exceptional circumstances have posed great challenges for policymakers. For us at the Fed, the response has been to pursue a variety of aggressive and innovative approaches that differ significantly from the standard policies of the past. The programs we have put in place are designed specifically for these exceptional circumstances. As such, they will have to be unwound as our financial system returns to normal and the economy is more clearly headed toward sustainable growth and price stability. This morning I would like to discuss the precepts that underlie these nontraditional policies and some tactical issues we must address in unwinding them. I should note that these are my own views and not necessarily those of my colleagues in the Federal Reserve System.

Nontraditional policies

In the current crisis, traditional monetary policy has reached its limits in two ways. One obvious way is that the federal funds target rate, which had been the Fed's traditional policy instrument, has been lowered to essentially zero. This target cannot be reduced below zero even when further accommodation is warranted. The second limit of traditional policy has to do with the functioning of financial markets. Under normal circumstances, participants seeking profit opportunities tend to align risk-adjusted returns across all markets. This allows a change in the Federal funds rate to flow through to other interest rates across the entire range of maturity and risk structures. But during the crisis, disparities in rates across markets have indicated that arbitrage was not taking place as usual. Thus, even before our target was constrained by zero, we found that we could not affect the interest rates that matter to consumers and businesses to stimulate aggregate demand as much as was necessary.

Because of these limitations, the Fed has turned to nontraditional policies. These can be broadly categorized in three groups. The first group expands on something that has always been a part of our policy toolkit, namely discount window lending through which the Federal Reserve Banks make short-term loans to depository institutions against adequate collateral. Since August 2007, the Fed has taken steps to encourage the use of the discount window as a source of liquidity, including reducing the discount rate and lengthening the terms of the loans. The second group of policies consists of opening new lending facilities to a wide array of participants in financial markets. One can think of it as a sort of discount window for financial actors who are not depository institutions. The third group of policies consists of large-scale purchases of GSE notes. This can be seen as an extension of traditional open-market operations: the Fed still exchanges reserves for bonds, but on a vastly different scale.

Within these groups, there are a number of particular programs or facilities, each with its own terms and conditions. Taken as a whole, our nontraditional policies might look like a vast array of acronyms—the famous "alphabet soup" (TSLF, PDCF, etc.). But there is a method to the madness, and I will highlight three precepts that guide our thinking. The first is insurance: Don't put all your eggs in one acronym. The second is innovation: This is not your grandfather's Fed. And the third is size: In an environment of great uncertainty, as we like to say in Chicago, "make no little plans." I will discuss each of these precepts in turn, before concluding with some thoughts about the return to traditional policies.

Insurance

To understand the first precept, we have to remember the diversity of risks that emerged in the past two years and the speed at which they emerged. Each risk was a challenge to our mandate of fostering a sound financial system, stable growth, and price stability; and diagnosing each risk raised difficult questions. We saw failures in parts of the financial system. How serious were they, and how would they affect the rest of the economy? We also saw economic activity begin to deteriorate significantly, with month–to–month job losses and sales declines as steep as any in recent memory. Finally, prices declined for the first time in decades. Were we about to slide into an extended period of deflation?

The diagnosis was surrounded with much uncertainty and included some dire scenarios. But the remedies that we considered brought their own measure of uncertainty as well. By definition, we had little experience with these new policies. Which treatment was appropriate and could be implemented in a timely fashion, particularly given the practical and legal constraints

we were facing? Under what circumstances and for how long should it be applied? How should the treatment be scaled back as conditions improve?

The Fed decided to adopt an approach that would be robust to these multiple dimensions of uncertainty. Rather than rely on any single tool lest it prove inadequate, we have put in place a number of different remedies in quick succession, in the hope that we may learn which ones work best without losing valuable time.

Innovation

I won't retrace the complete list of new programs, as these have been covered extensively in other speeches. But I will discuss one program because it demonstrates our second precept, which is the need to innovate as quickly as circumstances change. Let us look at the Term Asset–Backed Securities Loan Facility, or TALF.

The market for asset–backed securities has long played a vital role in funding loans to consumers and small businesses. This market effectively shut down in October 2008 after the failure of Lehman Brothers. In response the Fed announced the formation of TALF in November 2008. With backing from the Treasury, TALF provides loans to investors to finance their purchases of certain highly–rated asset–backed securities, with the securities themselves as collateral for the loans.

As conditions evolved we modified the facility along multiple dimensions, even before it began its operations at the beginning of April. The first markets targeted by the facility were those for securities backed by relatively simple assets. These securities were familiar to market participants and their pricing was relatively straightforward. Then we moved on to more complex and long–lived instruments.

Initially the only eligible securities were those backed by newly and recently originated auto, credit card, and student loans, and small business loans guaranteed by the Small Business Administration. In April, other securities were made eligible, namely, loans backed by mortgage servicing advances, leases of business equipment or vehicle fleets, and dealer inventories. This month, eligibility was broadened to commercial mortgage–backed securities.

We changed the acceptable origination date as well. Initially, securities were eligible for TALF only if they were backed by new or recently issued loans. The intent was to bring the asset–backed market back to life by directly financing investors willing to purchase the securities, and therefore indirectly funding the loans that backed them. In March 2009, the Fed signaled that TALF could be extended to legacy assets, with the intention of stimulating the extension of new credit generally by easing balance sheet pressures on potential lenders.

Finally, the maximum maturity of TALF loans has been extended from three years to five, and in February the maximum size of the operation was increased from $200 billion to $1 trillion to match the growing list of eligible securities.

Admittedly TALF has generated two opposite concerns: one is that our credit requirements are too conservative and unlikely to fund large volumes; the other is that the central bank is taking too much credit risk on its balance sheet. I think we have struck a good balance between these concerns. We have taken appropriate action to limit our exposure to credit risk through stringent credit quality requirements on the assets, substantial haircuts, and the direct support of the Treasury. Importantly, TALF is not intended to substitute for the ABS markets as they existed before the crisis, nor is it intended to revive them to their former level of activity solely on the back of the Federal Reserve System. The goal rather is to jump–start these markets back to life by mitigating some of the stresses they are experiencing. In turn, this should allow them to reach their appropriate size in a less disruptive fashion. At this point we see evidence that TALF is working as intended. Spreads on asset–backed securities have come down. And while much of the recent ABS issuance has been supported by TALF loans, some institutional investors are re–entering these markets without that support.

Rightsizing

The third precept relates to size. Until recently, monetary policy tended to change in small steps, a behavior that some have labeled "policy gradualism." Our response to the present crisis has moved beyond gradualism. Our rapid January 2008 cuts in the Fed funds rate were one indication, and the size of our nontraditional policies is another.

Last March, as the Fed gave notice that TALF would be expanded, we also announced a considerable increase in the size of another program, our large–scale asset purchases in which we buy agency debt, agency-guaranteed mortgage–backed securities, and Treasury securities. These actions, taken together, represented a substantial escalation of our nontraditional policies, and they will probably maintain or increase the size of our balance sheet well above what it was until a year ago.

I think this aggressive move was appropriate considering the many risks we were facing, the direness of some forecasts, and the uncertainty surrounding our new tools. Future developments will help us determine if our actions to date have been too much, too little, or just right.

We moved swiftly to launch nontraditional policies, but some of them have taken time to implement because their proper design required great care. And just as traditional policy is well known to act with long lags, nontraditional policies also take time to affect economic activity. So I expect to see further deterioration in some areas, notably job market conditions, before

our policies gain full traction. Weak economic news by itself would not imply that we have misjudged the size of our latest actions. In my view, it would take a significant deterioration relative to our outlook for me to view our current policies as inadequate.

Over time the degree of success of specific programs will let us reconsider the size of our actions. If we find that a given program is not proving as useful as we anticipated, we would be faced with a choice between making its terms more attractive (and taking on more risk) or letting it lapse. We will then need to keep in mind that the same level of aggressiveness may not be warranted by the circumstances of the day. Indeed, the possibility that the economy is close to a turning point is stronger now than just two months ago. Financial market spreads have improved even as long Treasury and mortgage rates have increased. And disinflationary pressures have been weaker than we had feared. Part of rightsizing will be to decide where boldness ends.

Back to normal

Over time, as the economy moves toward sustainable growth and stable prices, the Fed will progressively return to its traditional policies—that is, setting the Fed funds rate—and will reduce its balance sheet in an orderly way.

How will it do so? Partly on its own. Many of our liquidity programs provide short–term loans, so as these programs come to an end, the loans will mature fairly quickly and our balance sheet will shrink. Also, the pricing of our programs is designed to be unattractive in normal times, and attractive only to those who really need them in these unusual times. As they cease to be useful, they will cease to be used. Indeed, some programs are already being used less and we should see that trend continue as conditions in financial markets improve further.

Nonetheless, a significant portion of our balance sheet may not shrink on its own or at the appropriate rate. We need tools to reduce it actively so that monetary policy can be easily recalibrated. In this respect, we can be as creative on the way out as we were on the way in; or, put another way, we can be creative with our liabilities the way we have been creative with our assets.

One way to manage our balance sheet is to sell the assets. They can be sold outright, or they can be leased through reverse repurchase transactions. Another tool is the payment of interest on reserves, which we began last fall. Without interest on reserves, rates are raised only by restraining the quantity of reserves available to the market, and reaching our target could require sharp reductions in our balance sheet. With interest on reserves, we can raise the interest paid on reserves in tandem with our target rate. This will raise the opportunity cost of banks' lending and keep the Fed funds rate near the target. Finally, as we announced in March, we are seeking with the help of the Treasury additional tools through legislative action. An example of such tools would be the authority to issue interest–bearing debt in exchange for reserves or an expansion of the Supplementary Financing Program.

What circumstances might require us to use the tools we have, and those we may have in the future, to reduce our balance sheet aggressively? One clear concern is price stability. Our balance sheet grew very fast in a matter of weeks last fall, and remains large. There are historical precedents for large increases in central bank balance sheets to result in broader credit expansion and to be subsequently associated with inflation. But I want to emphasize the middle link in this chain: inflationary pressures will not arise without broader credit expansion, and there is no evidence for that at present. Nevertheless, these precedents explain why there is concern on this point and why we look after our ability to reverse the growth in our balance sheet.

Forecasting inflation is never easy, but these are particularly difficult times for this exercise. All one has to do is look at the remarkable lack of consensus among professional forecasters. The spread between the lowest and the highest inflation forecast for 2010 reported by Blue Chip Economic Indicators is more than twice what it was a year ago for inflation in 2009. Two conflicting forces could come into play to explain such a wide range of opinions. A high unemployment rate and low rates of capacity usage, such as we now have, normally place strong downward pressure on costs and tend to lower inflation. Indeed, some statistical models have pointed to possible deflation risks in the quarters ahead. But inflation has not fallen to the extent we might have feared; and there is another factor that could come into play, namely consumers' and businesses' expectations of future inflation. So far, expectations as measured by surveys have remained relatively stable, which is a bit of a surprise considering the severity of the downturn. But as economic conditions improve consumers and businesses might expect upward pressure on inflation; and experience shows that a rise in inflation expectations, once solidified, becomes embedded in many economic decisions and makes inflation harder to control.

Currently, with core inflation near 2 percent, I see inflation at a level that would be acceptable under normal circumstances. But these two potentially strong forces work in opposite directions, and the Fed must be in a position to respond, whichever force dominates.

Conclusions

These have been challenging times, and the Fed has met the challenge with an array of innovative programs that depart from traditional policy. We have pursued this approach in a manner that is both commensurate to the size and robust to the variety of risks we faced. The multiplicity of programs should not obscure the fact that, although the means are many, the ends remain

unchanged. Both traditional and nontraditional policies are aimed at fostering a stable financial system, sustainable growth, and price stability. As economic conditions improve and we lay the groundwork for an orderly reduction in our balance sheet, these ends remain uppermost in our minds.

Note: Opinions expressed in this article are those of Charles L. Evans and do not necessarily reflect the views of the Federal Reserve Bank of Chicago or the Federal Reserve System.