Current Events in the Economy and Financial Markets

Additional Information

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R.I.S.E. Global Student Investment Forum

University of Dayton

March 27, 2008

Introduction

As you all know, financial markets have been undergoing a great deal of stress these past several months. It has indeed been a challenging and interesting time to be a policymaker, and I welcome this opportunity to share my perspectives on what has been happening in financial markets.

The Federal Reserve System was created in 1913, not long after a severe banking crisis, to address our country's need for financial stability. The Federal Reserve has the authority — and I might add — the responsibility — to provide the banking system with a ready source of funds in times of market stress.

Today, I will provide some context for the current financial market turmoil, describe its progression, and then explain why and how the Federal Reserve has been responding to the situation.

The views I express today are mine alone and do not necessarily reflect the views of my colleagues in the Federal Reserve System.

I. A Context for the Current Financial Turmoil

To appreciate the unique nature of the current financial market turmoil and policy responses, I would like to begin by setting the context behind it. I will describe three key contributing elements — the housing boom and bust, changes in the structure of mortgage markets, and the role of highly leveraged financial institutions.

The first element, of course, is the unwinding of the recent housing boom. Housing booms and busts are not all that unusual at a local or even regional level. For example, we saw these boom-bust patterns in Texas in the mid-1980s and in Massachusetts and California in the early 1990s. Foreclosure rates in those regions rose and remained high for years as housing prices fell. What is unusual about the current situation is how broad-based and persistent housing price declines have been. Only a few regions of the country have been spared, and unfortunately, Ohio is not one of them.

A second key element relates to changes in the structure of mortgage markets. Years ago, people purchased homes by borrowing from local banks and thrift institutions, which kept the loans on their books. Banks and thrifts bore the risk of loss if a loan went bad, so they had a clear incentive to apply high standards for approving mortgage loans.

But mortgage lending has changed dramatically over the past decade or so with the increasing move to an "originate to distribute" model of lending. In this model, mortgage brokers originate the loans, but do not own them. Other financial companies, such as investment banks, buy these loans, pool them, and repackage them for sale as mortgage-backed securities. These securities are sold to investors around the world.

Mortgage brokers and investment bankers earn fees for their roles, and they have strong incentives to generate large volumes of business. Indeed, huge sums of money have flowed into the U.S. housing market. At the end of 1995, investors owned $194 billion worth of home mortgages packaged as mortgage-backed securities. Ten years later, that number had skyrocketed by about tenfold, to $1.6 trillion.

To satisfy investors' appetite for ever-higher yields, investment banks offered their customers pools that contained mortgage-backed securities along with securities backed by other kinds of loans, such as student, auto, and commercial real estate loans. Many of these new financial instruments were complex blends of securities, each with varying degrees of risk. Often, there was a lack of transparency about exactly what assets were in the pools.

The third key element to the story involves the growing role of highly leveraged financial institutions, such as hedge funds and investment banks. Take hedge funds, for instance. Hedge funds pool large sums of money from very wealthy individual and institutional investors, such as pension funds, and use the money to buy a variety of assets, including complex asset-backed securities. Because they are not legally required to hold any cushion against losses in their portfolios, hedge funds can earn more for their investors by taking on additional risk. One way they do this is to rely heavily on borrowed funds.

The basic strategy is to borrow for the short term at a relatively low, fixed rate of interest and use the funds to purchase relatively longer-term and high-yielding assets. This strategy enables the hedge fund to boost the rate of return for its investors. The use of borrowed money in this way is called leverage. Although highly leveraged investments can increase the investors' returns, they also increase their risk. The risk is that they will not be able to continue to attract lenders and will have to sell off their assets to pay back the loans. Hedge fund investors and their lenders can lose confidence in periods of financial stress — behaving much like depositors did at banks before the advent of deposit insurance. In the terminology of the new financial environment, we call this bank-run-like behavior a "liquidity squeeze."

These three elements — the housing market correction, changes in the structure of mortgage markets, and the role of highly leveraged financial institutions — all set the stage for the financial turmoil we have seen over the past few months.

II. The Turmoil Unfolds

With that background in mind, let me describe the progression of the financial turmoil. Rising interest rates had been driving up monthly mortgage payments for some borrowers. Home prices had begun to weaken, and an increasing number of homeowners found they had negative equity — that is, their outstanding mortgages exceeded the value of their homes. These and other circumstances led many homeowners to default on their mortgage loans and caused many properties to go into foreclosure. Higher mortgage default rates and foreclosures translated into lower returns on mortgage-backed assets and the portfolios holding them.

The first signs of a liquidity squeeze emerged last August, when lenders to highly leveraged financial institutions became fearful of the potential losses. To satisfy their lenders, these highly leveraged institutions were forced to sell some of their assets. When a large number of assets came on the market for sale, there were few buyers. Prices for these risky assets fell further, and lenders became reluctant to finance their traditional customers. The financial system that had worked so well when asset values were appreciating was now struggling. People who had been willing to hold complex financial assets now wanted safe U.S. Treasury securities or cash.

As the nation's central bank, the Federal Reserve has the ability to create an asset that every other participant in the financial system always accepts at face value. We provide cash to the banking system electronically, in one of two basic ways. Banks can borrow short-term funds directly from Reserve Banks at the discount window, and we require them to post collateral for the term of the loan. We lend at a rate called the discount rate on primary credit. We also provide cash to the banking system by buying U.S. Treasury securities on the open market and paying for them by crediting the bank account of the primary securities dealer who sells them to us. We call these transactions open market operations.

In normal times, the Federal Reserve relies overwhelmingly on open market operations to supply money to the financial system. Lending at the discount window comes into play occasionally to help individual banks with very short-term liquidity needs.

Between August and November, we used the traditional tools of monetary policy and discount window lending, and they appeared to be working. Indicators of risk seemed to stabilize. But markets remained fragile, and they reacted strongly to news about the health of various financial companies. By mid-December, the situation entered a new, more disconcerting phase. The housing downturn appeared to be spilling over into other sectors of the economy, as consumer spending and business investment slowed. Some of the large companies that stood at the crossroads of the financial markets were still having liquidity problems. And, perhaps more important, many creditworthy borrowers who were far removed from the mortgage markets could not find credit.

III. Unusual Circumstances Call for Creative Policy Responses

Let me describe how the Federal Reserve has responded to these unusual circumstances. As liquidity pressures intensified in December, it became clear that the Federal Reserve would need to take additional steps to address these problems.

One shortcoming of using discount window lending, especially in periods when markets are strained, is that many financial institutions and market participants infer that a bank that borrows from the discount window may be in trouble. This stigma, which exists regardless of the actual reasons for borrowing or the soundness of the borrower, often makes banks reluctant to take a discount window loan, especially in times of market stress. Thus, even though the Federal Reserve announced its willingness to lend at the discount window, creditworthy banks were reluctant to take up the offer.

To address the stigma problem, in December the Federal Reserve created the Term Auction Facility, or TAF, as it is called. This new supplementary tool addresses liquidity demands by providing an opportunity for healthy banks to bid in an auction for discount window loans with a 28-day maturity and to use a broad array of instruments for collateral.

Despite the success of the TAF, financial conditions worsened in early 2008. Liquidity became scarce again when a highly leveraged hedge fund defaulted on a loan, making creditors even more cautious. Another problem emerged, as a shortage of Treasury securities in the marketplace threatened to interfere with the process of reducing leverage. In more tranquil times, both U.S. Treasury securities and triple-A rated private mortgage-backed securities serve as collateral in private borrowing arrangements. Not so in today's environment. Many lenders will now accept only Treasury securities as collateral, and shun the triple-A rated mortgage-backed securities. Some creditworthy borrowers are shut off because they do not have Treasury securities.

On March 11, the Federal Reserve created a new tool to address this problem.

Specifically, to alleviate the Treasury securities shortage, the Federal Reserve introduced the Term Securities Lending Facility, or TSLF. This facility allows primary securities dealers to use highly rated private securities as collateral for the Treasuries they borrow from us.

On March 16, the Federal Reserve announced another facility. In perhaps its most aggressive action, the Board of Governors authorized the Primary Dealer Credit Facility, or PDCF. This innovation gives the Federal Reserve Bank of New York authority to lend directly to primary dealers to provide financing to participants in securitization markets.

Collectively, these innovations provide for much longer terms of lending, broader types of collateral, a wider class of counterparties, and a tighter spread between the primary credit rate and the target federal funds rate. All of these innovations are designed to bolster market liquidity and promote orderly market functioning. Liquid, well-functioning markets are essential for promoting financial stability and economic growth.

Conclusion

These are challenging times for our economy and financial markets. We know from studying economic history that booms are often followed by busts, and this pattern has repeated itself in our housing markets lately. However, we also know that these stressful periods will abate and that our economy will improve over time.

The Federal Reserve was created to support long-term economic growth by promoting low and stable inflation and by providing financial stability. I hope that my remarks today help you better understand the forces that have shaped our current financial situation and how the Federal Reserve has been responding with timely actions.