



The Credit Crisis and the Role of the Federal Reserve

Introduction

The last time I spoke at this forum was back in the spring of 2004, just about a year after I was named president and CEO of the Federal Reserve Bank of Cleveland. At that time, I shared some of my views on the state of the regional economy during a period of relative prosperity at the national level. Since then, we have seen dramatic changes in our credit markets that have affected not just our regional and national economy, but economies across the world. Indeed, these are historic and unprecedented times.

The Federal Reserve has certainly been getting its share of press coverage. We have also seen numerous stories about “Wall Street” versus “Main Street,” as if there were a giant wall dividing the two. In reality, the two work together— these are the nuts and bolts of finance and commerce that touch our everyday lives.

In my remarks today, I will talk about Wall Street and Main Street. I will describe the turmoil in financial markets, as well as the Federal Reserve’s actions to address the situation. I will make some comments about the economy. And then I will address the question I get asked most often: “When will financial markets return to normal?”

Of course, the views I express today are my own and do not necessarily reflect the views of my colleagues in the Federal Reserve System.

History

Let me begin by walking you through a bit of history behind Wall Street and Main Street. I would like to take you all the way back to the early years of the twentieth century, before the Federal Reserve came into existence¹.

The story starts in 1906 - a time when the U.S. economy had been expanding for most of the previous 50 years. But that boom ended following the massive earthquake in San Francisco, and over the course of the first quarter of 1907, the Dow Jones Industrial Average fell nearly 25 percent.

In October of 1907, the turmoil grew. A number of leading trust companies had supported an attempt by speculators to manipulate the stock price of a copper mining company. Depositors began to suspect that some trust companies were insolvent, and they feared that their savings were at risk. Once the trust companies lost the public’s confidence, depositors demanded to withdraw their funds immediately before they lost everything.

Additional Information

Sandra Pianalto

*President and CEO,
Federal Reserve Bank of Cleveland*

The City Club of Cleveland

Cleveland, Ohio

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Panic quickly broke out. A brokerage firm declared bankruptcy, and a number of established banks were in turmoil. [Sound familiar?] But 100 years ago, there was no official mechanism to absorb the shocks to the system—there was no Federal Reserve.

Riding to the rescue was someone who is still legendary in financial circles: J.P. Morgan. He functioned as a de facto central banker for the U.S. economy - and he played a vital role in ending the panic. With New York City teetering on the verge of bankruptcy, and the original trust companies facing a run on their deposits, he brought together the presidents of dozens of trust companies at his home library. He told them to cobble together a loan totaling \$25 million, or else, and I quote, “the walls of their own edifices might come crumbling about their ears.” He left them to work out the details, and locked the door from the outside, so they couldn’t leave until they had an agreement.

His tactics worked. The financiers put aside what they perceived as their individual interests and joined together to support the entire financial system. Thus began the restoration of confidence, and market recovery. But the episode highlighted our nation’s dependence on the willingness of private interests to safeguard our financial markets. And many viewed this state of affairs as placing Main Street at the mercy of Wall Street.

Our nation was ready to create a new institution to underpin its financial infrastructure, and President Woodrow Wilson signed into law the Federal Reserve Act in December 1913.

Background on the Federal Reserve

The profile of the U.S. economy has changed dramatically since 1913, and so has America’s financial sector. The Federal Reserve has evolved as well over the past 95 years, although one key feature of the original legislation has stood the test of time: a decentralized structure aimed at ensuring that the Federal Reserve is accountable to the whole country, and not just the financial centers.

That is why there is a Board of Governors in Washington as well as 12 Federal Reserve banks, which are focused on ensuring that the economic needs and interests of every region - including this one - are well represented in the policy-making process. Figuratively speaking, I am your seat at the table. The existence of Reserve Banks, branch offices, and their directors guarantees a truly nationwide Main Street perspective that influences the formulation of Federal Reserve policy.

For close to a century, that structure has provided a framework for the Federal Reserve to pursue its mandate of keeping prices stable and maximizing economic growth. The Federal Reserve has faced its share of challenges since its founding, but we are in the midst of one of our biggest challenges ever. Today’s financial situation is historic, and many of our actions are without precedent.

Explaining the Turmoil

As we all know, global financial markets have been subjected to extreme stress for a little more than a year now². We are seeing this stress in the equity markets, where the Dow Jones Industrial Average has had dramatic daily swings. We are also seeing credit markets seize up. Some borrowers simply cannot get loans.

So how did this all happen? It is certainly a complex story, and we don’t have enough time today to explore every chapter. But I will comment on three in particular. First, the entire housing industry boomed as a result of lax underwriting standards, soaring housing

prices, and an endless supply of investors looking for attractive returns. When rising delinquency rates made it clear that hundreds of billions of dollars of mortgage loans were based on dubious assumptions, lenders shut off the supply of new money, people tried to sell off the questionable investments that they were holding, and housing prices plunged.

Second, technology and financial engineering had revolutionized the marketplace. Loans that were once held on the books of well-capitalized banks were now pooled together, and portions of the pools were sold off to investors as individual securities. In cases where credit quality was low, the sponsor of the securities could achieve a high rating for them from a rating agency by purchasing a credit guarantee. When housing prices fell, the values of these complex securities fell as well, in some cases quite steeply.

In hindsight, everyone relied too heavily on models that were based on historical assumptions. Complicating matters further, loans backed by different kinds of income streams, such as student loans, credit card loans, and automobile loans, were also pooled together and securitized. When the housing bust set in, investors lost confidence in all kinds of financial assets and headed for the exits.

Finally, many lenders were highly leveraged, meaning that they were financing their activity with very little of their own capital at risk. Instead, they were relying on borrowed money. Not surprisingly, the creditors who were at risk wanted their money back, and to pay them the lenders had to sell their assets at distressed prices, meaning that they had to take large losses. With little capital to protect them against these losses, people began to question the solvency of nearly all firms involved in these markets.

A recent article in The Wall Street Journal nicely illustrated how this fear manifests itself. Here's what the author wrote:

Imagine that you are playing poker with 10 people and that you learn that a minority of them is broke and would not pay you if they lose. You don't know, however, who the ones are who won't pay. In this environment, the risk of losing would be too high even if you know that most of the players are perfectly sound financially and would pay up if they lose.

In this environment, any rational card player would stop making bets until the true solvency position of each player is revealed and the bankrupt ones are expelled from the game.

Having insolvent players sitting at the table spoils the game³.

Likewise, in today's global financial system, the commercial banks, investment banks, securities dealers, credit rating agencies, insurance companies, and mutual funds all deal closely with one another. So it isn't surprising that the threat that any one of them might be insolvent jeopardizes confidence in the entire system.

Remember that the foundation of every financial system is confidence. In order for money to circulate through an economy, in the form of credit, there must be confidence that funds that are loaned will be paid back. Similarly, there must be confidence that the infrastructure supporting the financial system will support the system in times of turmoil. Remove this confidence and you're left with financial markets in a state of paralysis.

Responding to the Recent Volatility

Just as J.P. Morgan took bold action in 1907 to help restore financial stability and confidence, so has the Federal Reserve a century later. Over the past year, the Federal Reserve has been playing a pivotal role in helping to restore stability to the financial system while we

navigate through the many economic cross-currents. Indeed, our role as provider of liquidity and lender of last resort has never been more important.

We have taken actions on a number of different fronts. I'll mention a few.

First, in response to the early turbulence in the summer of 2007, we began reducing our federal funds rate target. Our efforts have been aggressive—we have lowered that rate by 425 basis points as the economic outlook has progressively weakened.

But we have done more than cut interest rates. To address liquidity issues in the commercial banking sector, the Federal Reserve has used its traditional lending authority in creative ways. We have extended credit to banks in significant amounts and for longer periods than is typical. Currently we have roughly \$500 billion outstanding in these loans, versus about \$300 million a year ago.

Normally, we lend only to commercial banks. As the financial turmoil spread, it became clear that we would have to broaden our scope. In the spring of this year, we began to use our emergency powers to deal with problems at systemically important non-banks such as Bear Stearns and AIG. In addition, the Federal Reserve has been lending to a group of primary securities dealers who are critically important to the functioning of credit markets.

Unfortunately, the financial turmoil has not been limited to the United States. It has become a global problem, and the demand for dollar liquidity extends well beyond our borders. Consequently, the Federal Reserve has been providing substantial amounts of dollar liquidity to other central banks.

We are also paying close attention to the performance of some particular financial instruments, such as commercial paper, which are critical to financing daily business functions such as meeting payroll. We have taken a number of actions to support trading in these instruments.

These various activities illustrate how forcefully we are using our authority to help financial markets regain their health. In total, our various lending facilities have provided more than a trillion dollars of added liquidity to the financial system.

While the Federal Reserve has undertaken historic and unprecedented actions, the severity of the situation has required the executive and legislative branches of government to also step in.

As you are aware, the Treasury has allocated \$700 billion to its Troubled Asset Relief Program, also known as TARP. While there have been well-publicized changes to the direction of this program in just the past few days, the mission of the TARP remains clear—to get private credit flowing again.

I can understand why some people find it difficult to keep track of the many initiatives I have been describing, and even why some critics describe them as a “bailout” of Wall Street firms. In my view, the critics are missing the point. Without the normal functioning of credit markets, Main Street cannot function either.

The broader point, about the range of actions taken by federal authorities, is that actions took place only when it became clear there were grave threats to the overall stability of the financial system and to the outlook for economic growth.

The actions of the Federal Reserve, the U.S. Treasury, international central banks, and other government entities have together helped

to mitigate much of the potential damage to the global economy. Still, the turmoil has taken its toll, and today the economic outlook is decidedly negative.

At the Federal Reserve Bank of Cleveland, we look at a lot of economic data and at the results of complex forecasting models. We also talk with a lot of people. In recent weeks we have stepped up our contacts with business, banking, and civic leaders. We are hearing that the credit crunch is affecting many sectors of the regional and national economy. We are also seeing a ripple effect play out across the real economy.

Recession and Recovery

Collectively, the information I have been looking at tells me that the economy is now in a recession, although the National Bureau of Economic Research, the referee in such matters, has yet to call one. Nationally, employment has been declining all year, and in last week's employment report we saw the characteristic monthly employment losses that are associated with a recession. Manufacturing output has been following a similar course. And you won't be surprised to learn that retailers are posting dismal sales figures--some of the lowest seen in decades. In fact, just this morning, the Commerce Department reported the worst retail sales figures in 40 years.

I had been expecting the pace of economic activity to slow down for more than a year now, although I had not been expecting a recession. Economic forecasting is never an exact science, and these exceptionally volatile credit market conditions make forecasts all the more uncertain. The worsening of financial market conditions during the year, and especially since September, has profoundly affected my outlook for the economy. The financial stress is raising the cost of credit, restricting the availability of credit, and inducing cautious behavior by borrowers and lenders. All of this is reducing spending by both businesses and consumers. State and local government finances are being affected as well.

At the moment, the signs point to a recession beyond just a "garden variety" downturn. The length and severity of the recession will depend on how quickly credit markets return to normal. And there is evidence in some financial markets, such as inter-bank lending and commercial paper, that progress is being made. But how will we know when the financial markets are back on solid ground? Here are some signs of "normal" that I am looking for:

First, banks have to begin lending to one another and credit markets have to operate without extraordinary involvement from the Federal Reserve and the Treasury. While the Federal Reserve's involvement has been consistent with our role as the lender of last resort, the private sector's ability to stand on its own two feet will be pivotal to an eventual recovery of financial markets.

Second, home prices must stabilize. The downturn in the housing market, of course, was the catalyst in driving the volatility in the broader economy and in freezing up the credit markets. I am looking for housing prices to reach a bottom, and I don't think we are quite there yet.

Third, today's extremely low trading volumes in the private markets for mortgages, student loans, and auto loans must pick up. I believe this process will accelerate as confidence in the pricing of these assets is slowly restored.

Finally, just from my personal perspective, I'll consider us to be back to normal when the Federal Reserve returns to the back pages of the

paper's business section.

But we are not there quite yet. And even when markets return to what is typically thought of as "normal," changes will still be needed for the long term. We need to focus on the factors I cited as causes of the turmoil—lax underwriting standards, complex financial products, and excessive leverage. The next Congress and the incoming Administration are sure to seek stricter regulation and more government oversight. The private sector is already taking action on its own. Financial institutions have started to rein in risky practices, and many of the problematic financial products of the past have disappeared. The Federal Reserve has tightened up regulations that apply to mortgage loan products and underwriting standards. Government and private actions, I'm convinced, will make strong efforts at having our financial markets become more transparent and less complex.

As we work toward that future, let's not forget what resources we have to work with. And when I talk about resources, I am not referring to all of the funds advanced by the Federal Reserve and the Treasury. I am referring to the true resources of our country: our people, our business enterprises, and our ingenuity. These are the resources we can all have confidence in. Money provides a means of exchange, but it is not the true source of our wealth. As we struggle to repair our financial system, we should not lose confidence in the forces that have worked to our advantage throughout our history. They are intact, and they will endure.

One of our founding fathers, James Madison, understood this. In a speech he gave to the Virginia Convention in 1788, he said, "The circulation of confidence is better than the circulation of money."

Just as confidence was paramount then, so it is today as well. We all know that our economy is taking some very hard knocks, but in fact it is our underlying resourcefulness as a nation that gives me great confidence in our ability to bounce back. And that's worth remembering whether you are on Wall Street, Main Street, or right here on East Ninth Street.

[1] The following is primarily drawn from Robert Bruner and Sean Carr, *The Panic of 1907: Lessons Learned from the Market's Perfect Storm*, 2007.

[2] Using August 9, 2007 as a start date of the extreme volatility.

[3] *Wall Street Journal*, Oct. 9, 2008 — http://online.wsj.com/article/SB122351071819917433.html?mod=todays_us_opinion