

# The Financial Tsunami and the Federal Reserve

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William E. Simon Graduate School of Business

University of Rochester

30th Annual Economic Outlook Seminar

December 2, 2008

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The views expressed today are my own and not necessarily  
those of the Federal Reserve System or the FOMC.

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## **Introduction**

Good afternoon. I am very pleased to see so many familiar faces and old friends here in Rochester and to participate in the 30<sup>th</sup> Annual Economic Outlook Seminar. I left Rochester just over two years ago in the summer of 2006. While at that time the housing market had begun to slow, no one imagined the economic turmoil that has since ensued.

There was no one cause of that turmoil. Rather, we need to look to several factors — conditions akin to a “perfect storm” — which led to the financial tsunami we’ve experienced for more than a year. The tidal wave that has roiled the economy began with a sustained decline in housing after a decade-long boom. Yet, more than a reversal in housing was needed to cause our current problems.

The innovations in lending that made subprime mortgages possible in the 1990s succeeded in expanding homeownership to millions of families. These products proved both successful and profitable through 2006. This success, however, led to lending terms that were highly dependent on rising house prices. Many lenders began to offer products with little or no down payment to even the riskiest borrowers and, at times, at very low teaser rates. Many borrowers were speculators, who expected to ride the wave of higher home values until they resold. Others expected to refinance their mortgages when teaser rates expired. Yet, as the housing market declined, many homeowners and investors found themselves unable or unwilling to meet their mortgage payments.

The economy and financial system may well have been able to absorb the downturn in housing, if not for other contributing factors. Mortgage originators often sold off or securitized these risky loans as mortgage-backed securities and then resold them to other investors. What’s more, investors in these securities bought insurance against their default with another innovative product — credit default swaps — which has turned out to be riskier than expected.

These new products, however, were very complex and lacked transparency. They also resulted in even more interconnections among financial institutions, allowing the problems in the U.S. housing market to spread to a wide array of financial institutions. As house prices began to fall and mortgage delinquencies and defaults rose, market

participants grew uncertain about how to value the various complex financial instruments and which firms faced losses and to what degree. As a result, they became very risk-averse and reduced their exposure by curtailing their lending. This has led to higher credit spreads or risk premiums on the securities of financial firms that may be at risk. It has also led to rating agency downgrades and sharp declines in stock values, which ultimately disrupted financial markets and created a widening credit crisis. Now nonfinancial firms are finding it difficult to obtain short-term credit to meet continuing operational needs and capital investments.

Today, in the wake of this financial tsunami, I would like to offer my outlook for the economy in the coming quarters and make some observations about the Fed's actions and about financial regulatory reform.

Let me begin with the economic outlook.

### **Economic Outlook**

The financial turmoil of the past year has taken its toll and the economy has slowed significantly since the early summer. Housing starts and permits continued to fall in October, and other recent monthly data — on auto sales, consumer spending, and industrial production — have all pointed to a significant weakening of the economy. This month the Philadelphia Fed's Business Outlook Survey of manufacturing activity recorded the lowest numbers in 18 years. Neither consumers nor businesses have much confidence in the prospects for the economy in the near term.

Even exports are no longer the bright spot they had been over the past two years. The stress in financial markets has now become global, undermining economic growth among our trading partners. Consequently, the prospect of a global slowdown further contributes to a weaker outlook here in the U.S.

The latest report on real GDP growth indicated a moderate contraction in the third quarter. I anticipate a sharper decline in real GDP in the fourth quarter. This will likely put real GDP growth for 2008 below one-half of 1 percent (0.5 percent) measured on a fourth-quarter-to-fourth-quarter basis. Growth in the first half of 2009 is also likely to be weak, with improvement in the second half of the year. Even so, overall growth for 2009 (fourth-quarter-to-fourth-quarter) is likely to be below 2 percent.

With relatively weak performance over the next several quarters, I expect the unemployment rate to rise above 7 percent in 2009 before it begins a gradual decline later in the year.

During 2009 the housing sector should finally bottom and the actions taken by the Federal Reserve and the Treasury will gradually help financial markets return to some semblance of normalcy. So I expect the economy will start to pick up in the second half of next year with a gradual return to growth close to its trend of 2.7 percent in 2010 and 2011. I should caution that many forecasters, including me, have anticipated an

improvement in housing for some time and were proven wrong. What's more, financial disruptions continue to flare up unexpectedly. So more than the usual amount of uncertainty surrounds this forecast. We all must keep in mind that forecasting can be a humbling exercise in the best of climates.

As for inflation, the decline in energy and commodity prices in recent months has reduced my own concern about rising inflation expectations — at least in the near term. This is good news, but it does not mean the Fed should be complacent about its responsibility to maintain price stability. The current monetary policy and the Fed's extraordinary lending facilities created to address the crisis have injected large amounts of liquidity into the economy. We will need to begin withdrawing that liquidity when financial markets begin to stabilize or else risk fueling renewed inflationary pressures down the road.

At a time of great concern about financial turmoil, we should keep in mind that instability in the general level of prices — whether inflation or deflation — is itself a significant source of financial instability. Federal Reserve officials, myself included, have spoken of the importance of keeping inflation expectations well anchored. When the public's inflation expectations begin to rise, that can contribute to higher actual inflation. It is therefore important for the Fed to maintain its credibility to keep inflation low and stable when large relative price movements in energy and food commodities led to large increases in the consumer price index.

It is just as important that inflation expectations remain well anchored in the face of falling energy prices. Significant declines in gasoline and fuel oil prices, for instance, have recently led to declines in the consumer price index. This has prompted some commentators to suggest that the U.S. is facing a threat of sustained deflation, as we did in the Great Depression or as Japan faced for a decade. I do not believe this is a serious threat. Although the recent dramatic declines in energy prices have led to declines in the monthly headline CPI, it still increased 3.7 percent over the last 12 months while core CPI increased 2.3 percent. So we are not close to a sustained deflation. The recent declines are simply the mirror image of the increases we saw earlier in the year. As long as inflation expectations remain well anchored, these declines in energy prices are unlikely to lead to sustained deflation any more than their previous increases were likely to lead to sustained inflation.

To help anchor expectations, the Fed must credibly commit to preventing sustained deflation from becoming widely anticipated, just as it must prevent sustained inflation from becoming widely anticipated. I have long argued that monetary policy would benefit from establishing a clear and explicit inflation target as a way of signaling a commitment to keep inflation low and stable. Such an inflation target would be just as valuable in preventing expectations of deflation from materializing.

## **Federal Reserve Actions**

To address the financial crisis and its impact on the economy, the Fed has acted on multiple fronts. Since September 2007 we have reduced the federal funds target rate by 425 basis points in response to a steady deterioration in the economic outlook. As I have already indicated, this added significant liquidity to the economy.

While lowering the fed funds target seems like a fairly standard monetary policy response, the Fed also took historic actions to promote financial stability by expanding its role as lender of last resort. Starting last year, the Fed expanded its existing discount window operations and created an alphabet soup of new lending facilities to help the funding markets function more effectively. Some of these actions required the Fed to invoke a special provision of the Federal Reserve Act — referred to as Section 13(3) — which gives the Fed the authority to lend to any individual, partnership, or corporation in “unusual and exigent circumstances.”

Prior to this crisis, the Fed lent only to depository financial institutions — that is, banks, savings and loans, savings banks, and credit unions — and such lending was typically overnight. During the last eight months, we have made loans to primary securities dealers, investment banks, a global insurance company, and most recently to industrial and financial companies that issue commercial paper. These lending arrangements have been for terms ranging from 90 days to as long as 10 years in the case of the financing provided in the Bear Stearns acquisition.

Prior to this crisis, Fed lending typically amounted to less than 1 percent of total Fed assets. According to the latest data, lending has risen to nearly 50 percent.

The most dramatic decisions were made jointly by the Federal Reserve and the Treasury. In particular, the decisions to provide funding to facilitate the acquisition of Bear Stearns by JPMorgan Chase, to lend to AIG, and to not commit funds to Lehman Brothers have raised fundamental questions about the role of the Fed in promoting financial stability. More generally, the necessity of taking these actions suggests the need for a new regulatory structure to match the reality of our complex financial markets.

## **Principles of Sound Central Banking**

The current financial crisis and the actions by the Fed and Treasury to address it are leading to a restructuring of the financial services industry. We are already seeing major investment banks become bank holding companies, weaker financial institutions consolidate into healthier ones, and various types of nonbank financial firms substantially revise their business models.

The financial turmoil and the resulting restructuring in the marketplace have prompted calls for the Fed to assume expanded responsibilities. Some envision the Fed’s becoming the supervisor and regulator of a broad array of financial firms in order to ensure

financial stability. Some want to expand the Fed's authority or give it a sweeping mandate to prevent systemic risk. Some want the Fed to lend to a wider range of financial institutions. Yet, before we seek to dramatically expand the Fed's responsibilities, I believe it is important to recognize the limits of what a central bank can and should do.

In general, we should avoid giving the Fed overly broad mandates, missions, or goals that conflict with the one goal that is uniquely the responsibility of a central bank: price stability. As I noted earlier, instability in the general level of prices — whether inflation or deflation — is itself a significant source of financial instability. Consequently, we must make sure that in trying to cure one source of financial instability, we do not sow the seeds of another.

Over the past two decades, economists have learned to conduct monetary policy more effectively by following four general principles:

- First, Clarity. Policymakers should set clear and explicit objectives. These objectives must be realistic and feasible and not just what might be desirable.
- Second, Commitment. Policymakers must commit to conducting policy in a systematic way over time, even when it seems expedient to abandon it.
- Third, Transparency. Policymakers must be as transparent as possible in communicating their policies and actions to the public.
- Fourth, Independence. Experience has shown that monetary policy yields better outcomes when it operates independently of fiscal and political influence.

I believe these four principles also apply broadly to other central bank roles, including our role in promoting financial stability. Indeed, we can think about how each of these principles applies to the challenges we face as a lender of last resort.

#### *Clear and Explicit Objectives*

Fortunately the Fed has had to act as a lender of last resort very infrequently. The traditional goal of central bank lending has been to protect against systemic risk in the banking system. So central banks traditionally fulfill their role as lender of last resort by lending to solvent banks with liquidity problems to prevent problems in one bank from spilling over and causing failures in otherwise sound institutions.

However, financial instruments and the markets in which they are traded have become very complex and interconnected. We have found that the failure of a major counterparty — even a nonbank — has the potential to severely disrupt many other financial institutions, their customers, and other markets. The lack of transparency in some of the instruments and markets makes it more difficult for market participants to identify who is at risk and to what degree, increasing the systemic risk posed by such failures.

In today's financial system, we must devise new and clearer objectives for central bank lending. If the goal is to protect the financial system against systemic risk, then we must clearly define such risk and articulate in advance the circumstances and terms under which we will lend and to whom.

I believe we should concentrate on financial markets that are critical to the efficient functioning of the payments system, rather than focusing on individual firms. Indeed, it would be desirable to be in an environment where no firm was too big, or too interconnected, to fail.

Even so, we must be realistic and set objectives that are feasible. Central bank lending cannot prevent all types of financial instability. Indeed, the economy benefits from financial institutions' and markets' taking on and managing risk. That means inevitably some firms will fail. As my friend the economist Allan Meltzer has said, "Capitalism without failure is like religion without sin. It doesn't work."\* Our goal should not be to try to prevent every failure. Instead, our goal should be to lower the probability of a financial crisis and the costs imposed from any troubled financial institution.

#### *Commitment to a Systematic Approach*

According to the second principle, policy should be systematic. This means that policymakers should avoid unnecessary volatility by committing to a mostly predictable response to events — even when it seems expedient to do otherwise. Uncertainty breeds volatility. I liken this to declaring the rules of the game in advance. If the rules are constantly changing during the game, players don't know what to do next, outcomes become highly uncertain, and resources will be unnecessarily wasted in the process.

During the past year, the Fed has taken steps to limit the systemic risks caused by the potential failure of several large financial institutions. The decisions were always made based on the risks to the financial markets, not the desire to preserve individual institutions. Yet, the old "rules of the game" were out of date. The ability to deal with the potential failure of systemically important nonbank financial firms was limited. We had to improvise. As a consequence we had no choice but to generate some uncertainty. We must correct that going forward.

#### *Transparency*

The third principle simply stresses that policymakers should be clear and transparent in communicating their policy and actions to the public. This is an important part of reducing the uncertainty and making the "rules of the game" clear.

Clarifying the Fed's lending policy and the criteria that will be used in taking actions, as well as the criteria that will be used to determine when to close any special lending

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\* Allan Meltzer, "Asian Problems and the IMF," *Cato Journal*, 17:3 (Winter 1998), pp. 267-74.

facility no longer needed, will all help lower the costs of uncertainty during a financial crisis.

### *Independence*

Finally, as we revisit our central bank lending policies, we must not overlook the importance of central bank independence. The record shows that central bank independence leads to more effective monetary policy. That principle is vital to our lending policy as well.

To protect that independence, central bank lending policies should avoid straying into the realm of allocating credit across firms or sectors of the economy, which is best left to the marketplace. The perception that the Federal Reserve is in the business of allocating credit is sure to generate public pressures on the Fed from all sorts of interest groups. In my view, if the government must intervene in allocating credit, it should be the responsibility of the fiscal authority rather than the central bank. This division of labor, so to speak, will better ensure the Fed's ability and credibility to maintain price stability and promote economic growth.

### **Conclusion**

To sum up, the past year has been a challenging time for the U.S. economy and for policymakers. The Fed responded to the deteriorating economic outlook and ongoing stresses in financial markets with monetary policy and extraordinary actions to ensure financial stability. I expect economic growth will continue to be weak over the next several quarters before improving in the latter part of 2009 and then returning to near-trend growth in 2010 and 2011.

Because of the financial crisis and the response by the Treasury and the Fed, the financial services industry is restructuring. When some normality returns to the markets — which eventually it surely will — some type of regulatory reform will be needed.

Some people may think that expanding the Federal Reserve's regulatory and supervisory authority would prevent the types of financial crises we have been experiencing this year. Yet, I believe it is important to be realistic about recognizing the limits of what a central bank can and should do. A modern financial system will never be immune to all financial stress. Setting up expectations that the Fed will surely be unable to fulfill would undermine our ability to achieve our primary monetary policy and financial stability objectives.

The exact outcome of this regulatory reform is unknown at this point. However, as we work on this reform, I believe we must strive to develop sound policies that obey the four principles I have discussed today — clear and feasible objectives; a commitment to systematic policies; transparency; and a healthy respect for the independence of the central bank.