

The US Financial Crisis and the Policy Response of the Federal Reserve

Keynote remarks at *"The Global Financial Crisis - Central Bank responses in the Western Hemisphere"*

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Monday, March 16, 2009, Lima - Peru

The current conjuncture in the United States ...



Building an understanding in five parts:

1. Origin of the downturn
2. Magnification through markets and policy missteps
3. Onset of an adverse dynamic
4. Path for policy and the outlook
5. Risks to the outlook



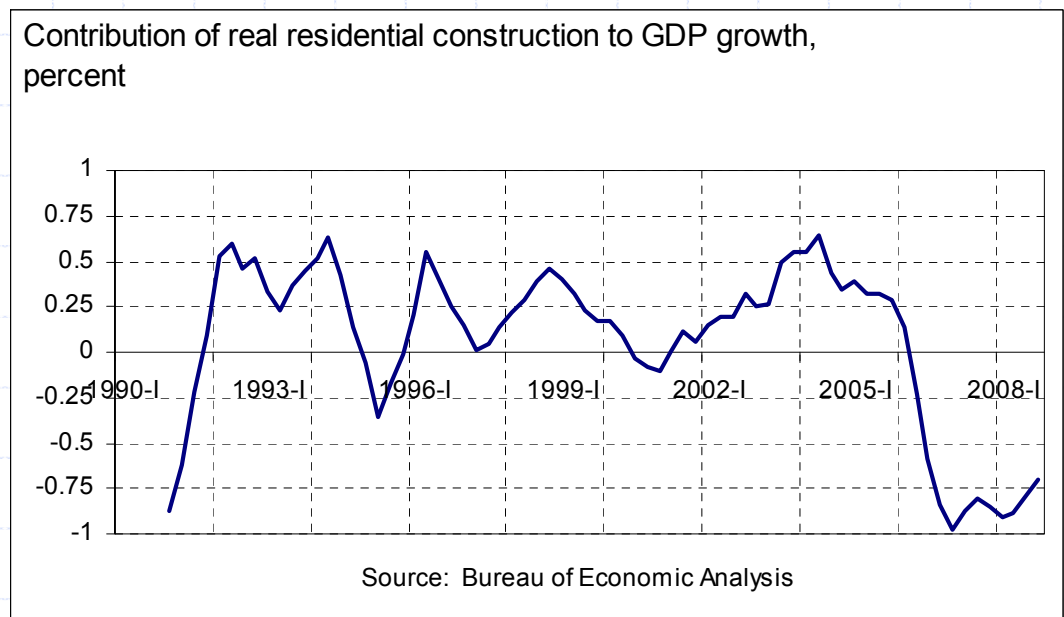
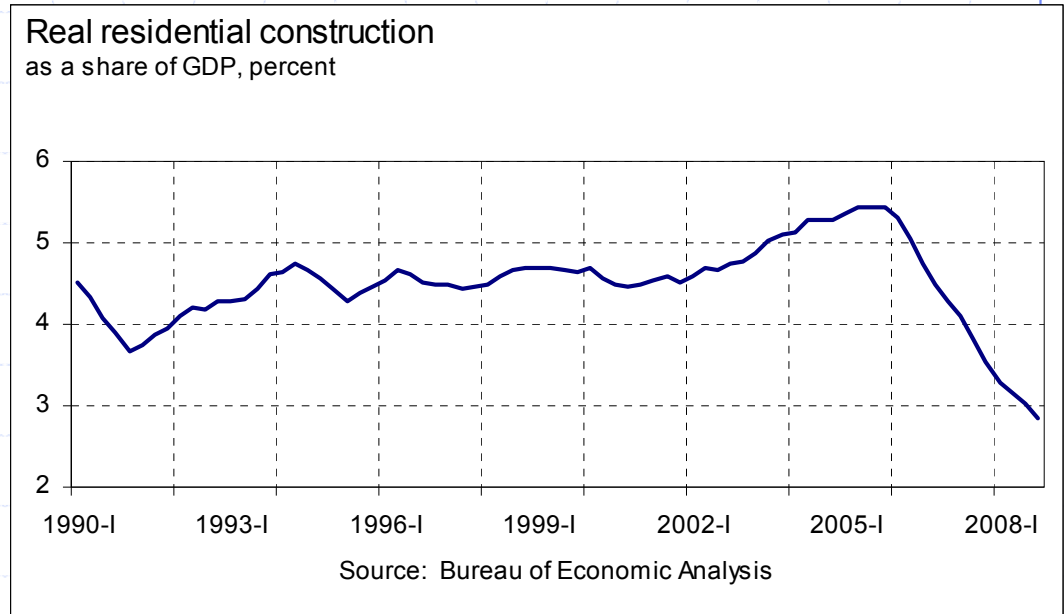
1. Origin of the downturn ...

is that too many houses were built in the United States.

The correction of that excess is posing **three drags** on the U.S. economy.

The first drag: housing construction

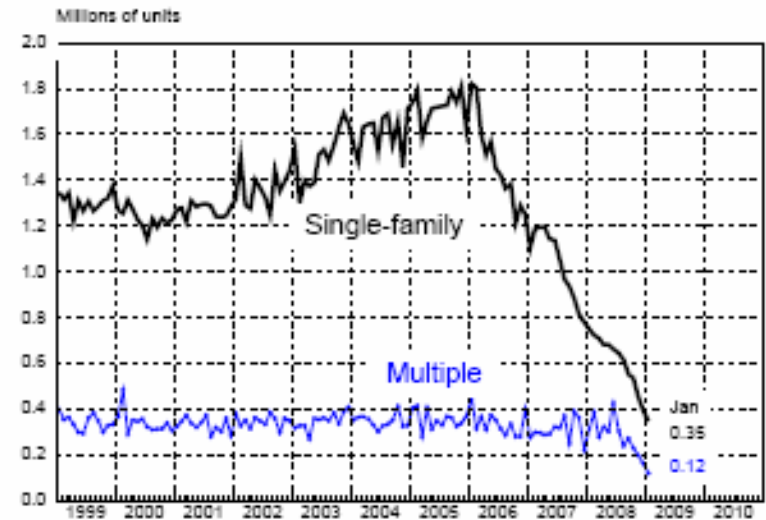
- ◆ Added 1-3/4 percentage points to the level of GDP from 1992 to 2005
 - as fundamentals supported home purchases
- ◆ But when fundamentals softened
 - Terms and standards on lending were eased aggressively
- ◆ Correcting prior excesses requires cutting construction to work down excess inventories
 - Residential construction has been a drag on spending for three years



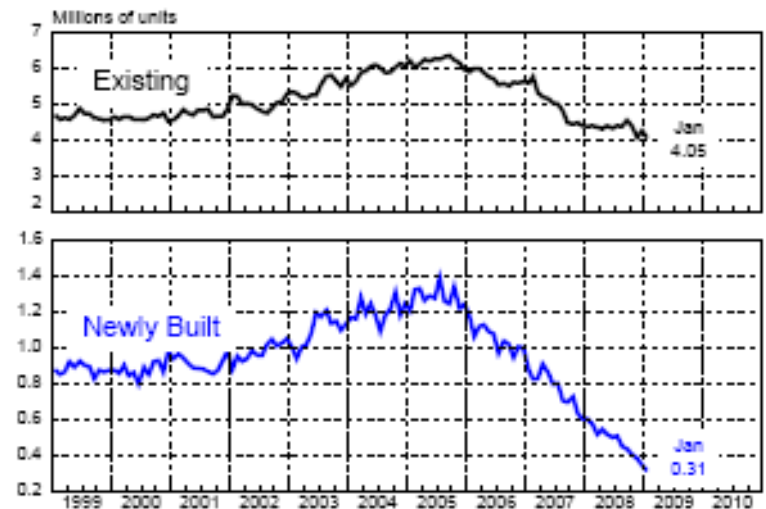
The problem is ...

- ◆ Cutbacks in construction have been chasing declines in sales
- ◆ The unresolved excesses:
 - have produced declines in home prices
 - exposed the weaknesses in underwriting standards

HOUSING STARTS
Seasonally Adjusted Annual Rate



SINGLE FAMILY HOME SALES
Seasonally Adjusted Annual Rate

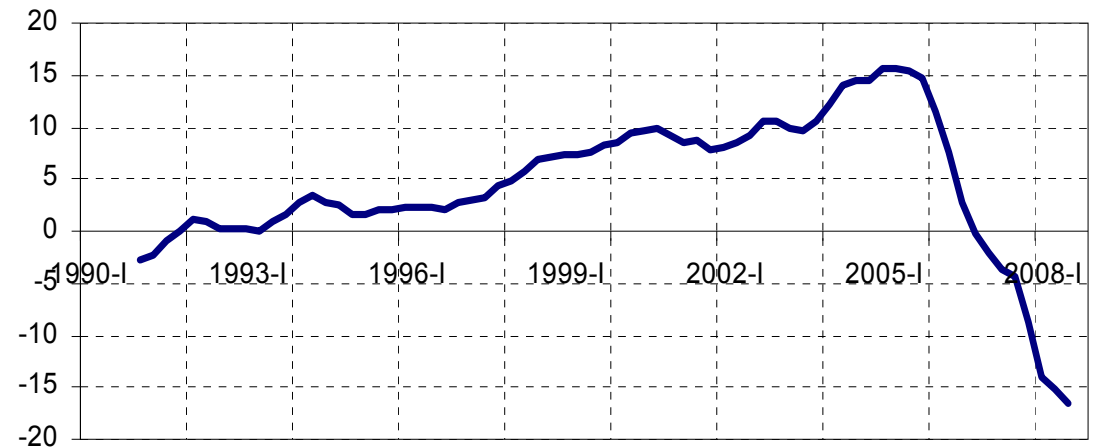


The second drag: wealth losses

House prices have slid,
reducing household
wealth ...

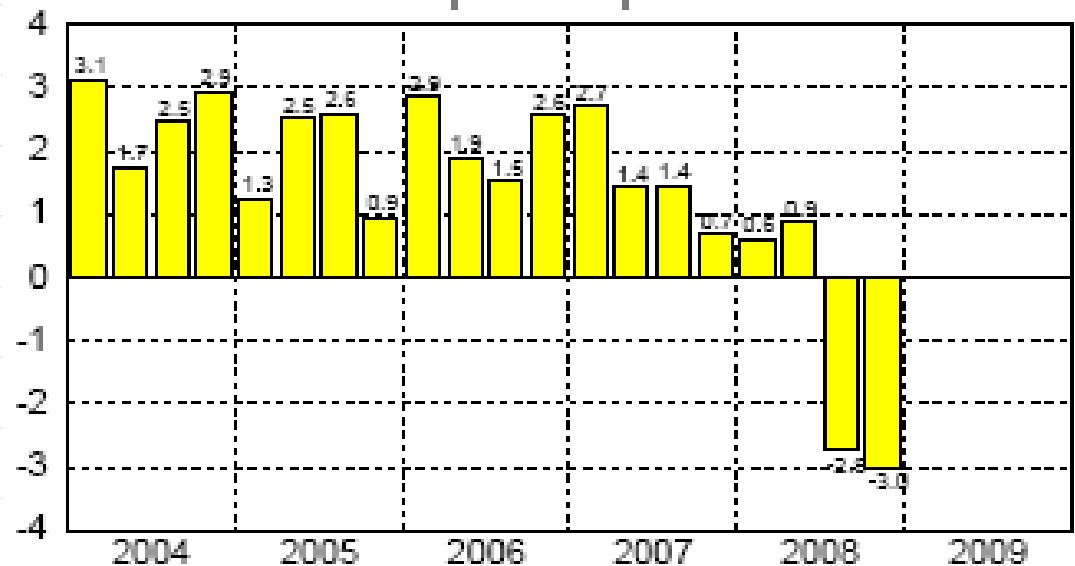
Case-Shiller national home price index

Four-quarter change, percent



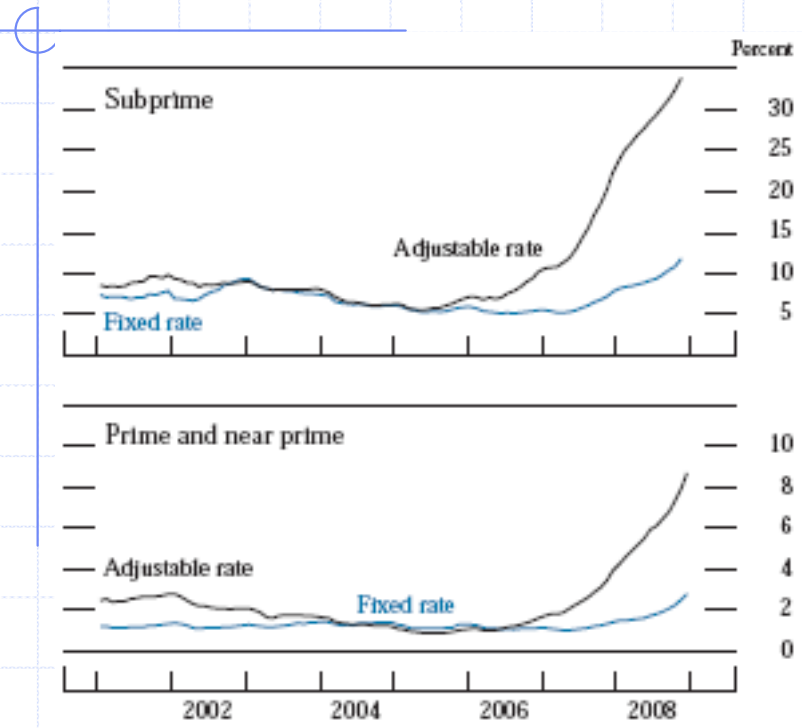
Source: Case-Shiller S&P

Personal Consumption Expenditures

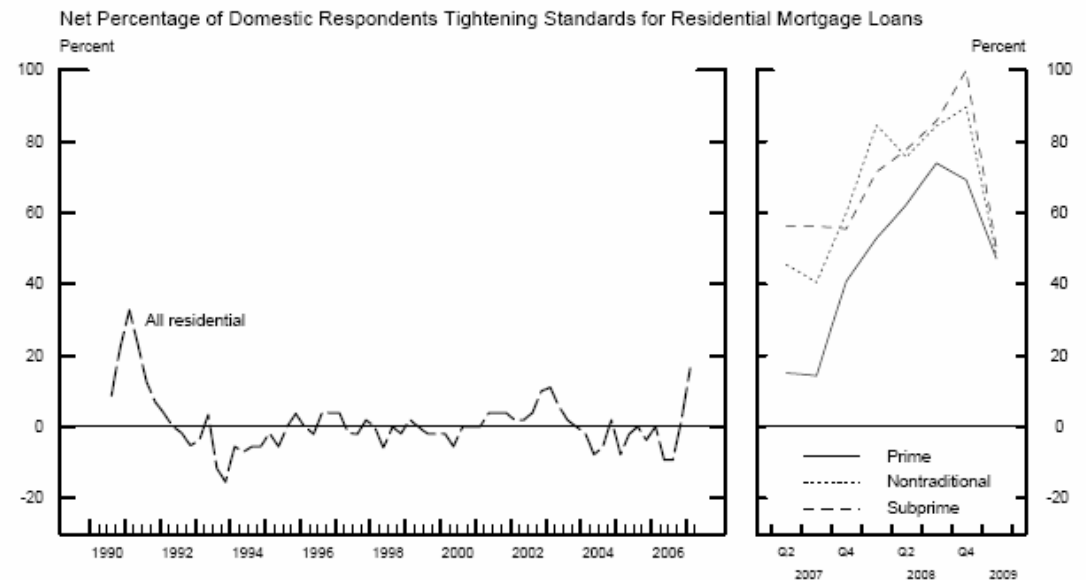


... and consumption

The third drag: mortgage delinquencies have mounted



Leading financial institutions to toughen terms and standards on mortgage lending





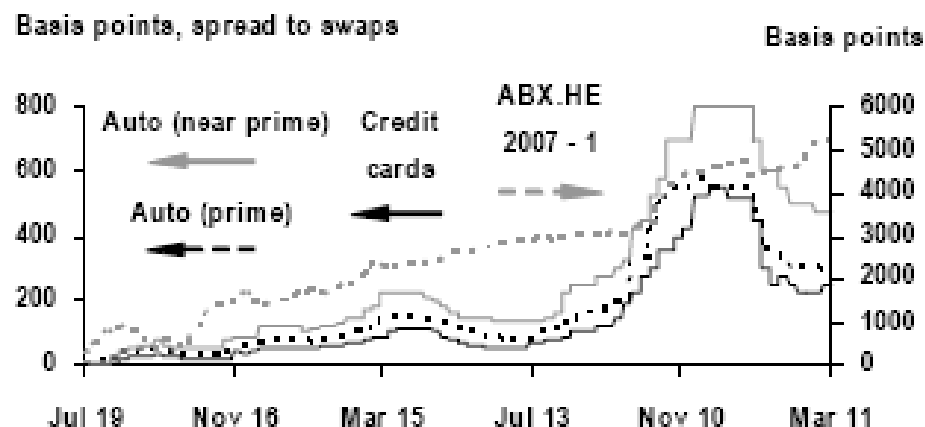
2. Magnification through markets and policy missteps ...

because of the complexity of asset-backed securities and the use of leverage as well as bad policy making

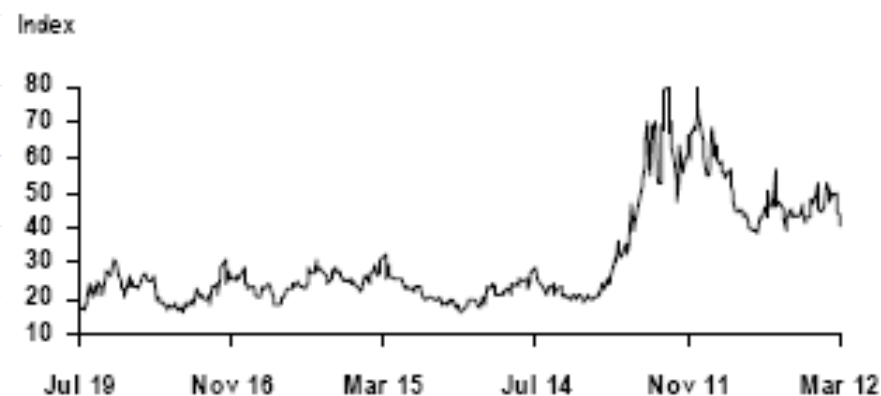
Financial markets face ...

- ❖ *Riddle:* What are securities backed by mortgage collateral worth?
- ❖ *Mystery:* Who holds those securities?
- ❖ *Enigma:* How levered are those holdings?

AAA-rated, 2-year ABS consumer loan products and ABX spread



VIX volatility index

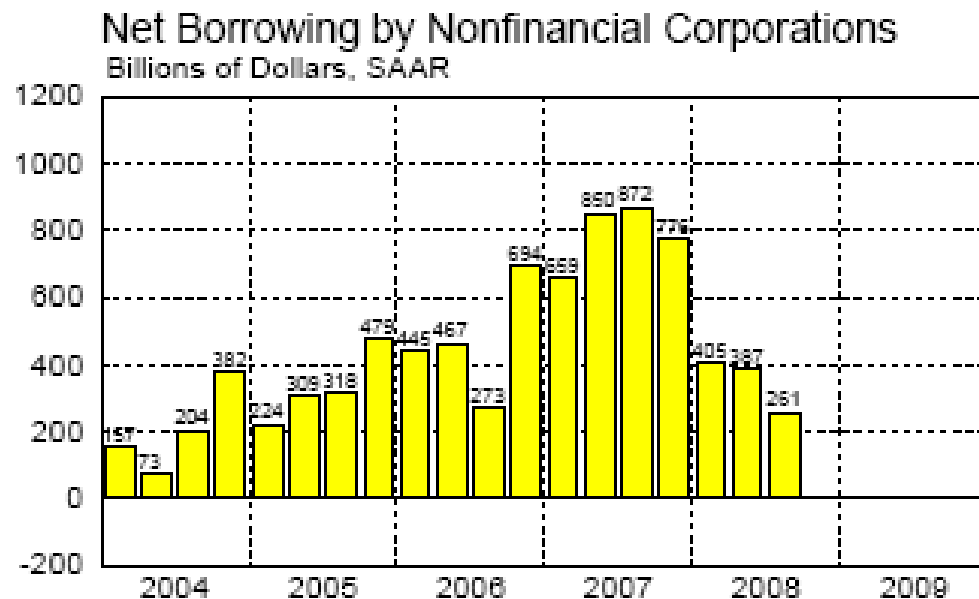
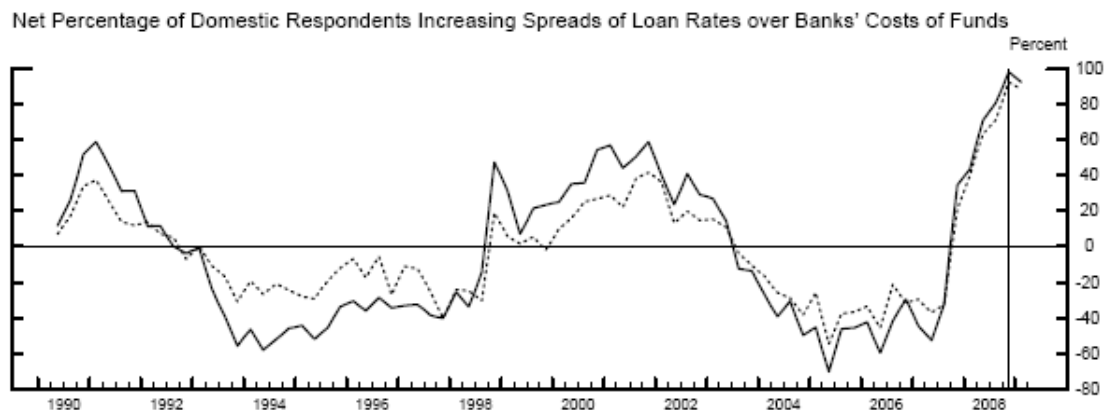


In the resulting withdrawal from risk-taking . . .

- ◆ Financial institutions seek to conserve their capital given
 - Their losses
 - Uncertainty about their own positions
 - Doubts about their counterparties

- ◆ Credit become harder to get.

- ◆ And firm's individual efforts to repair balance sheets worsen the aggregate situation



Four rules of bail-outs

1. Don't do them.
2. If you break rule one, be consistent.
3. If you break rule two, be prepared to spend a lot.
4. Whatever you do, don't add to uncertainty and worsen confidence.

Policy has shaped the contours of this crisis ...

- ◆ Policy interventions by the Federal Reserve and the Treasury,
 - were ambiguous as to the scale and scope of the protection offered.

- ◆ This created incentives
 1. For firms with capital deficiencies to postpone adjustment
 2. For creditors and short sellers to test the limits of intervention
 3. For investors to delay capital investments

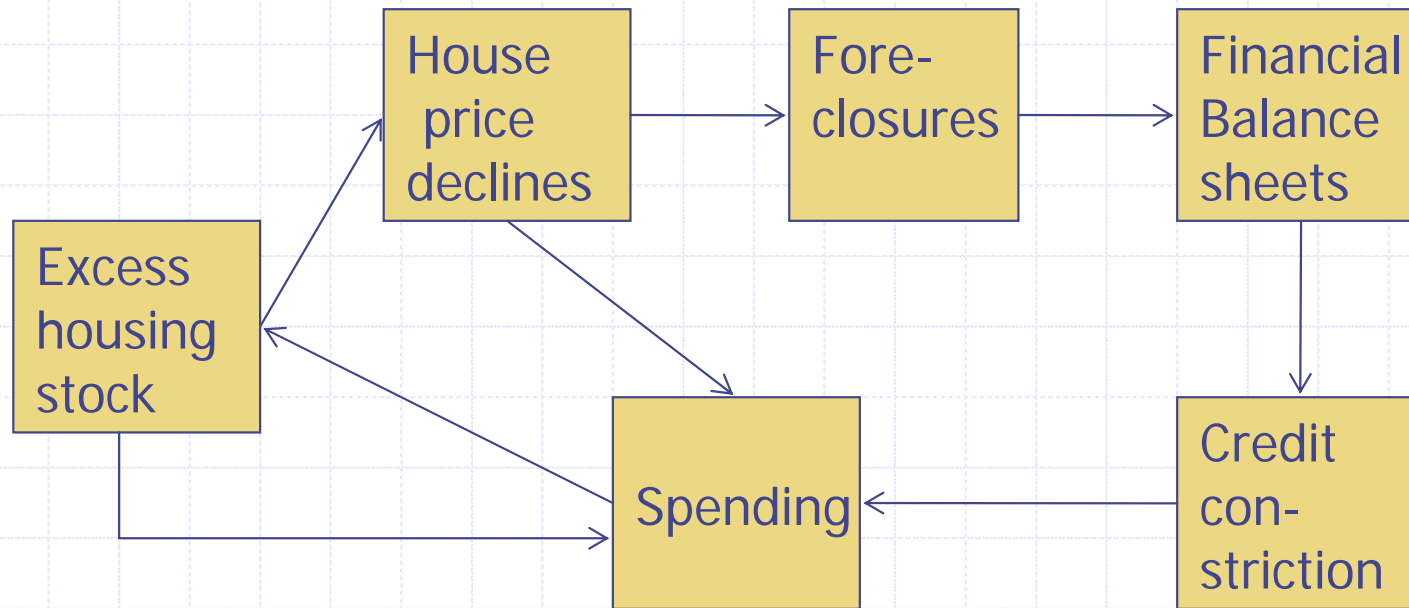
- ◆ Policy has been explained poorly and often with inflammatory rhetoric.



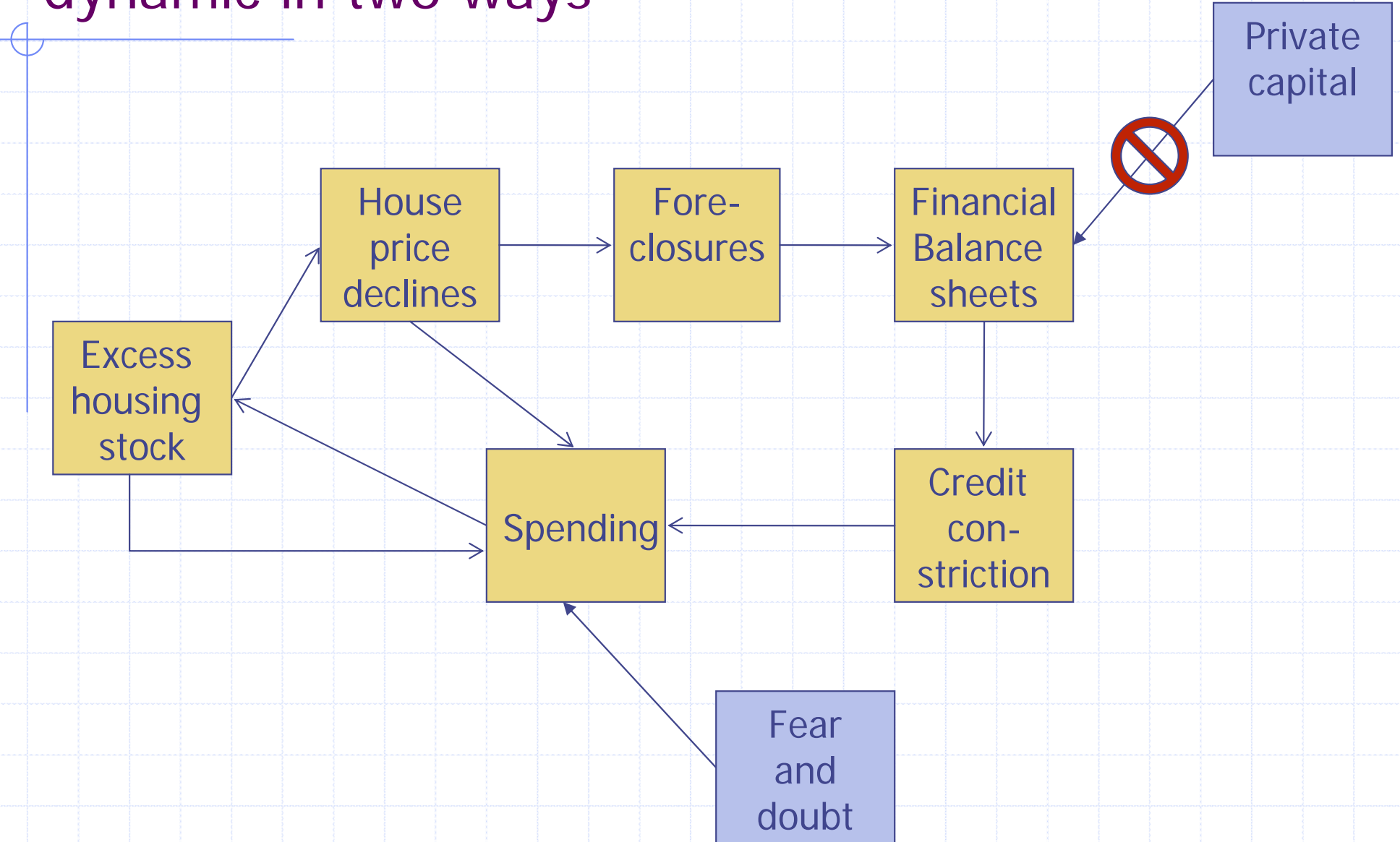
3. An adverse dynamic has set in ...

worsening the economic contraction.

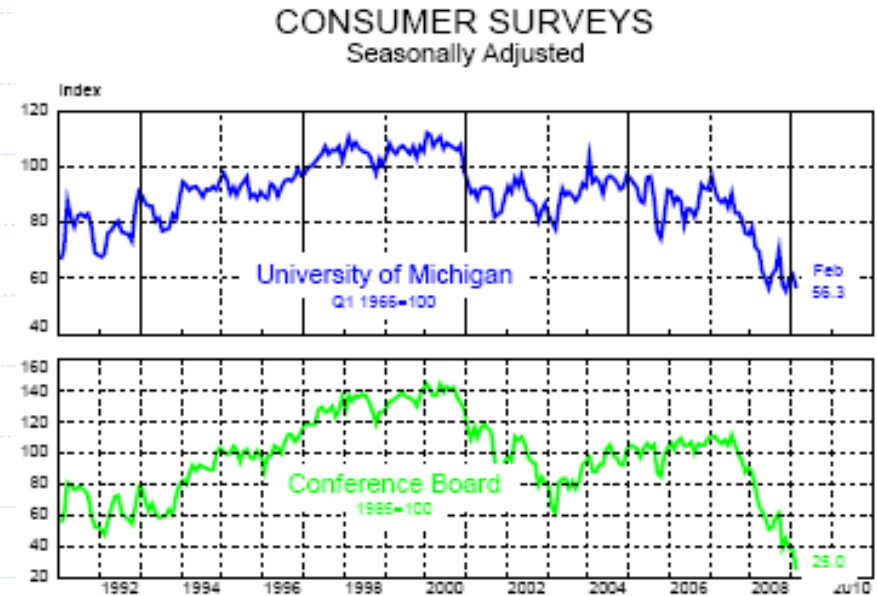
The story thus far: an adverse dynamic has taken hold reinforcing the three drags on spending



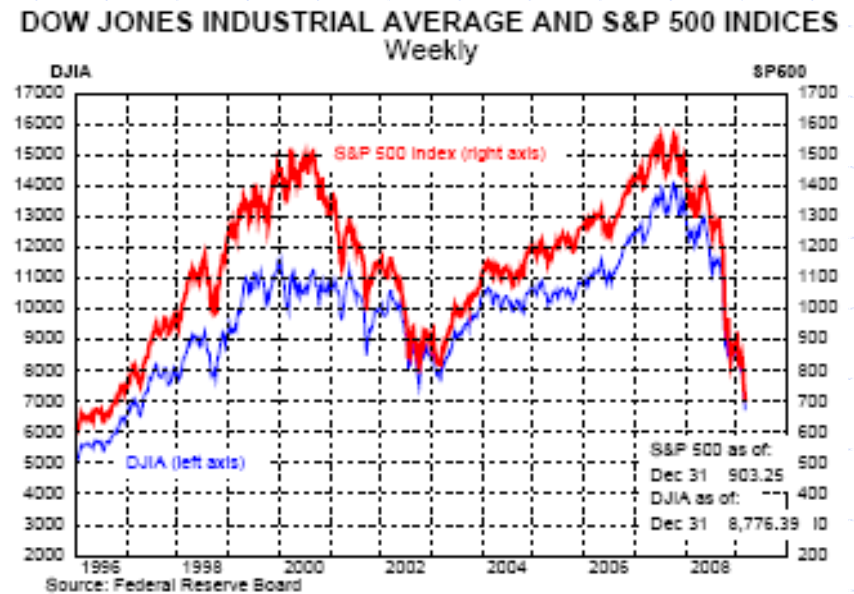
Policy missteps have worsened this adverse dynamic in two ways



Both households and firms are scaling back ...



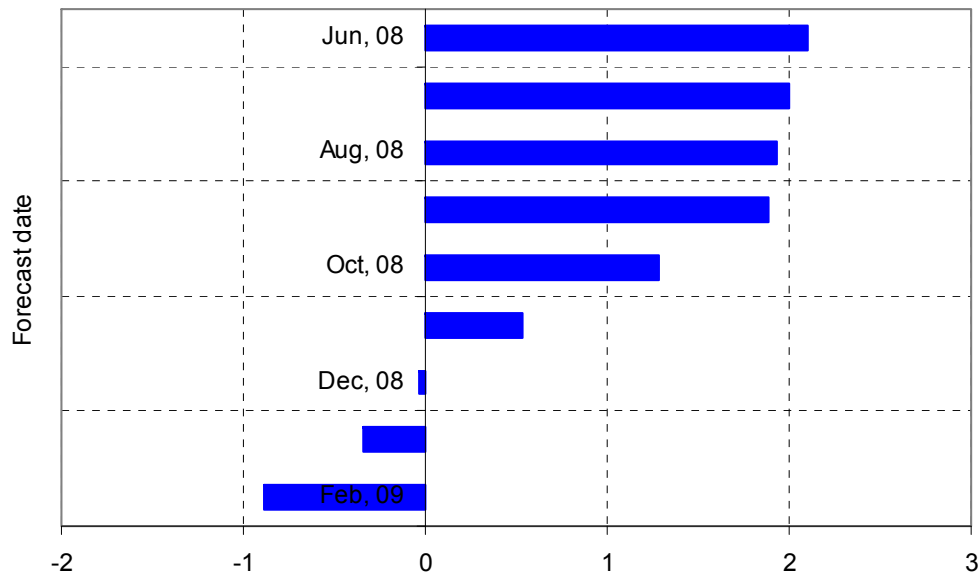
and investors continue to withdraw from risk-taking



As a result, the U.S. economic outlook is deteriorating

Real GDP growth for 2009

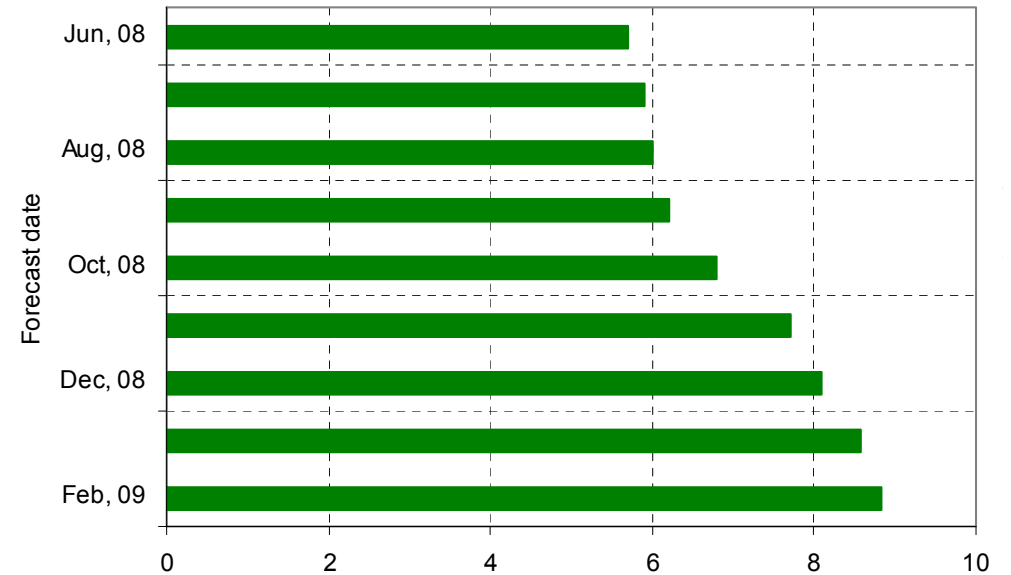
Survey average, percent



Source: WSJ Survey of economists

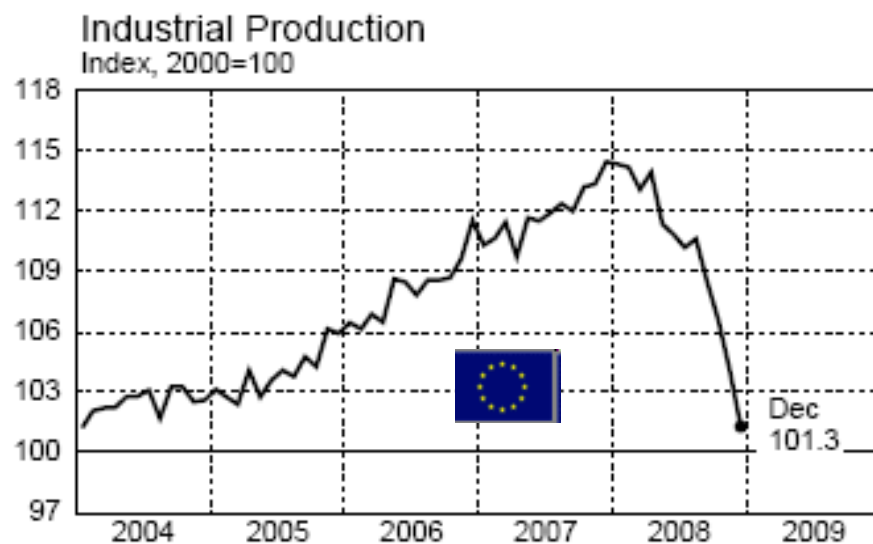
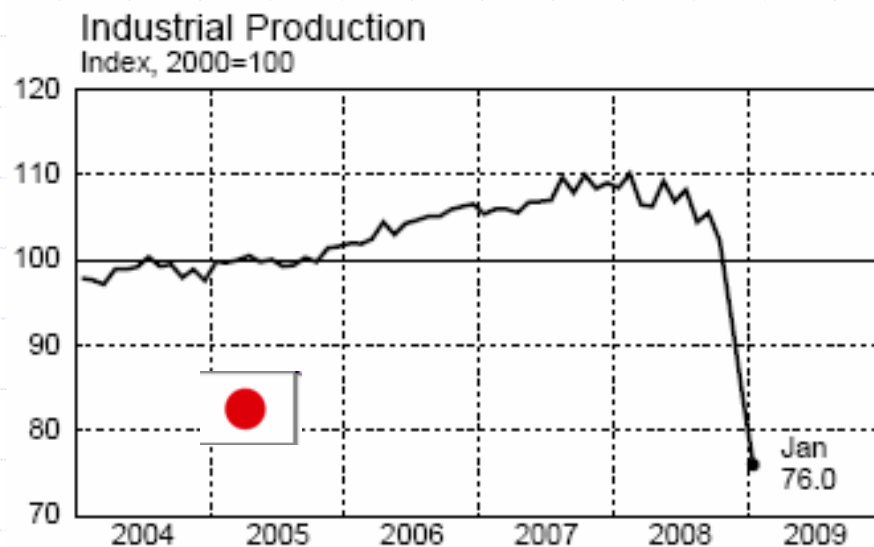
Unemployment rate at year-end 2009

Survey average, percent

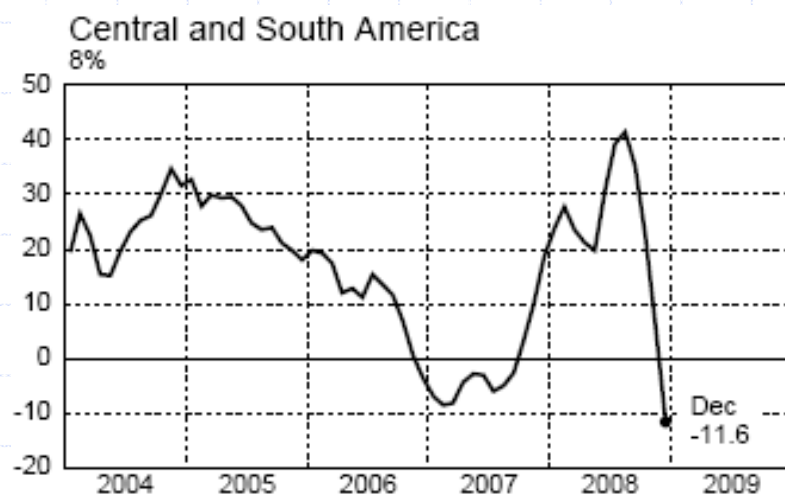
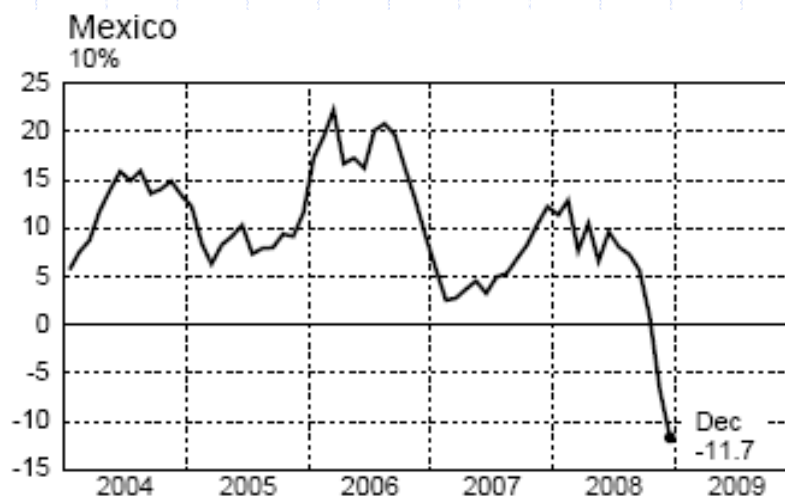
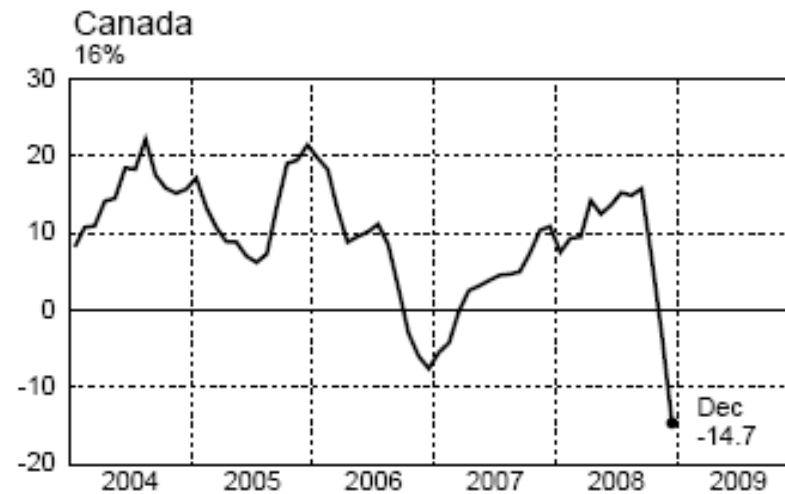
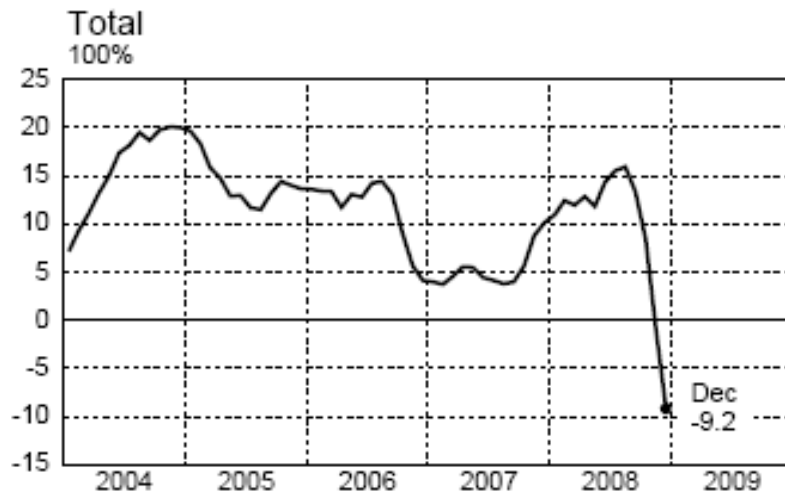


Source: WSJ Survey of economists

And economic weakness is spreading ...



The weakness is spreading through a deterioration in financial markets, a drying up of lending, and contraction in trade





4. The path for policy and the outlook ...

depends on how effectively the new Administration uses the tools at its disposal.

The new Administration ...

◆ is going to have to solve four serious economic problems simultaneously

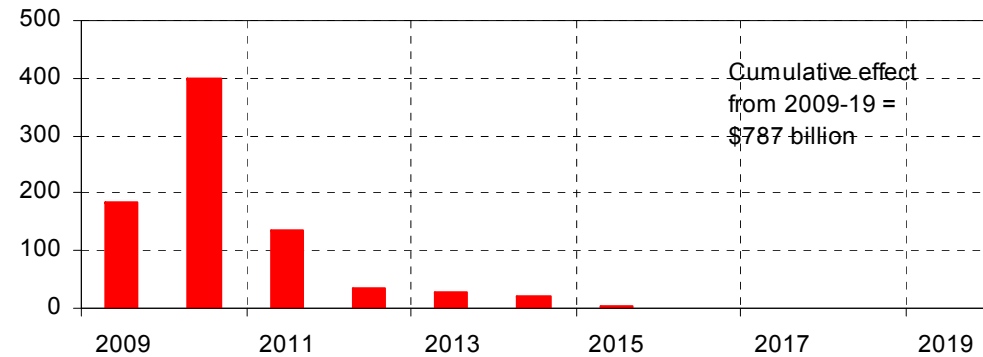
- Financial market repair
- Fiscal stimulus
- Housing market relief
- Sectoral aid (auto companies)

Going forward,

◆ U.S. officials have the tools at their disposal to solve the problem

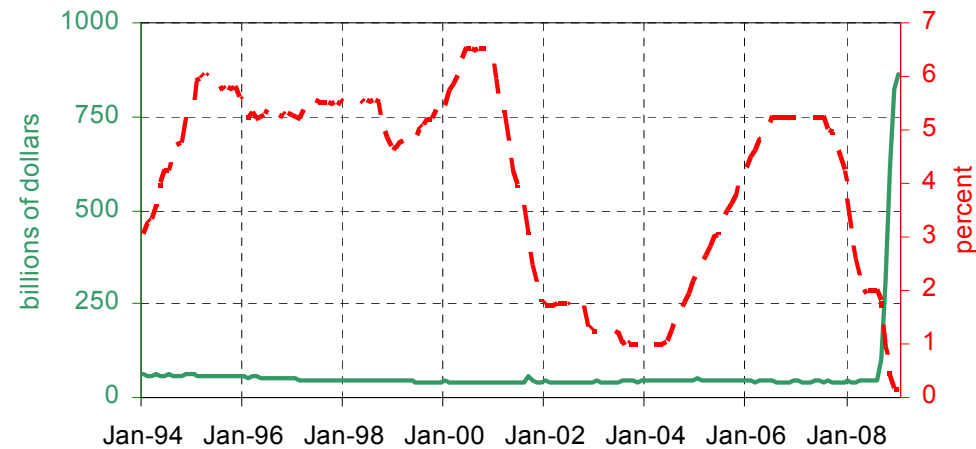
◆ For the Federal Reserve, this implies easing quantitatively

Effect of the stimulus plan on the federal budget deficit
billions of dollars



Source: Congressional Budget Office

Total reserves and the federal funds rate



Source: Federal Reserve

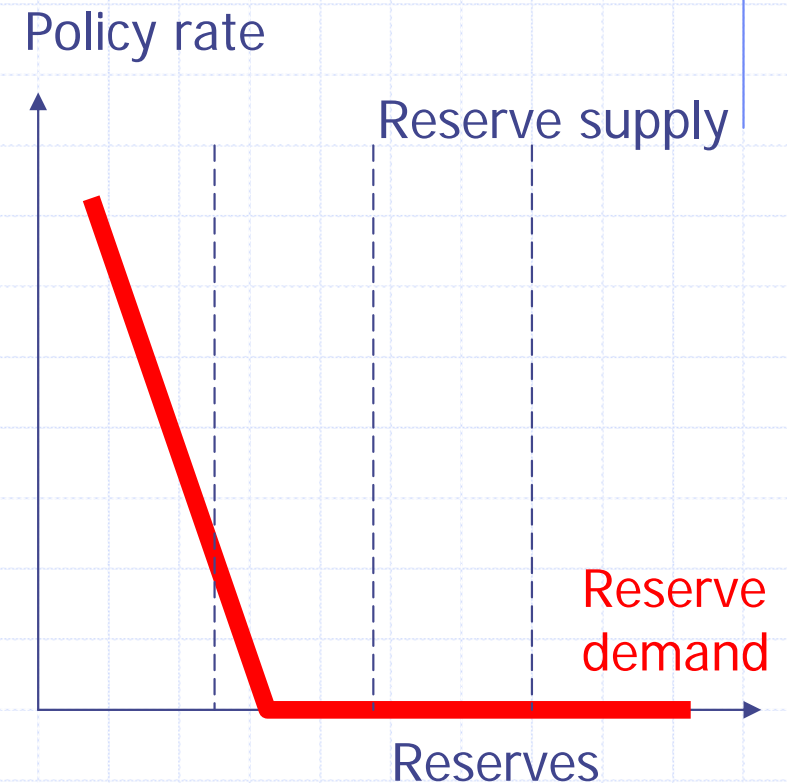
QE: the composition and size of a central bank's balance sheet can influence financial markets and the economy

◆ Asset accumulation

- Supports the prices of certain assets
- May generate revenue that provides "fiscal space"

◆ Reserve creation

- Directly encourages the expansion of the balance sheets of commercial banks
- Commits to keeping the policy rate low for a long time





5. The risks to the outlook ...

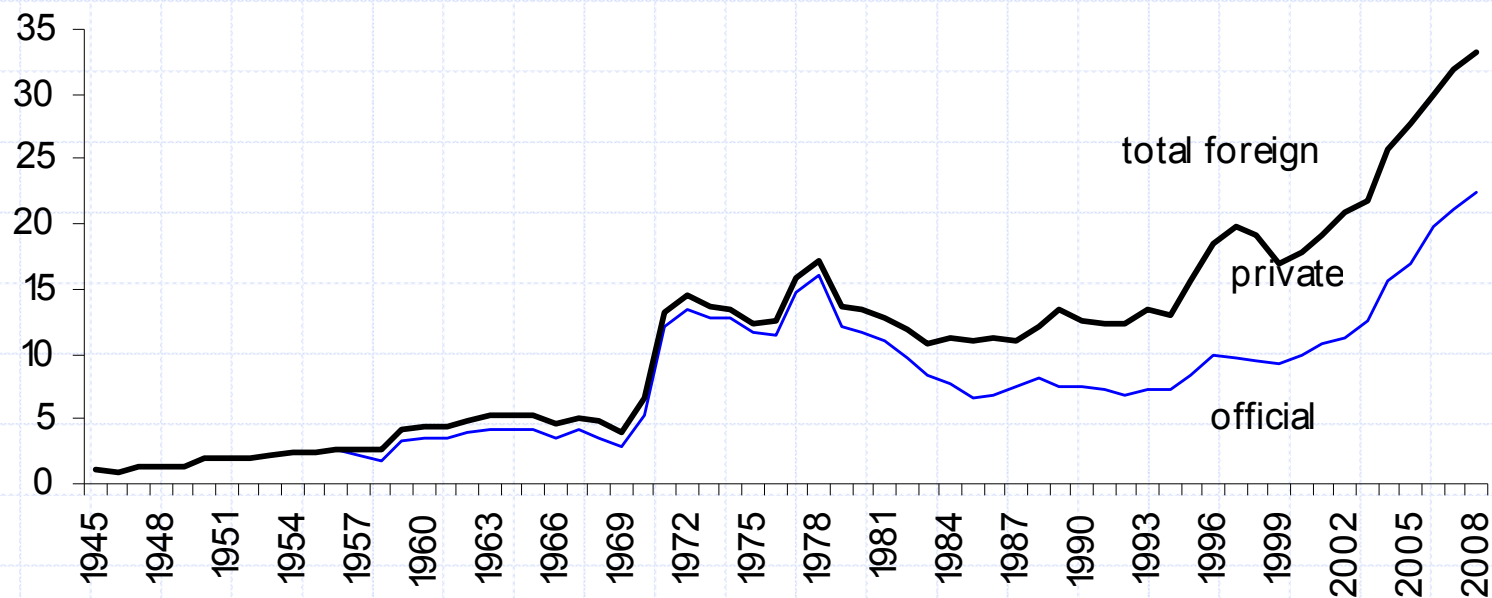
are considerable.

RRRs: The U.S. government will have to

- ◆ Reconcile domestic and international interests in resolving sectoral problems
 - in the financial sector
 - in the auto and parts industry
- ◆ Resist protectionist sentiment
 - As domestic unemployment mounts
- ◆ Revamp financial regulation
- ◆ Satisfy the public's desire to punish wrongdoing
 - without deterring private capital

Foreign investors will have to remain willing to add to their holdings of U.S. government securities.

Foreign ownership of U.S. government securities
share of total, percent

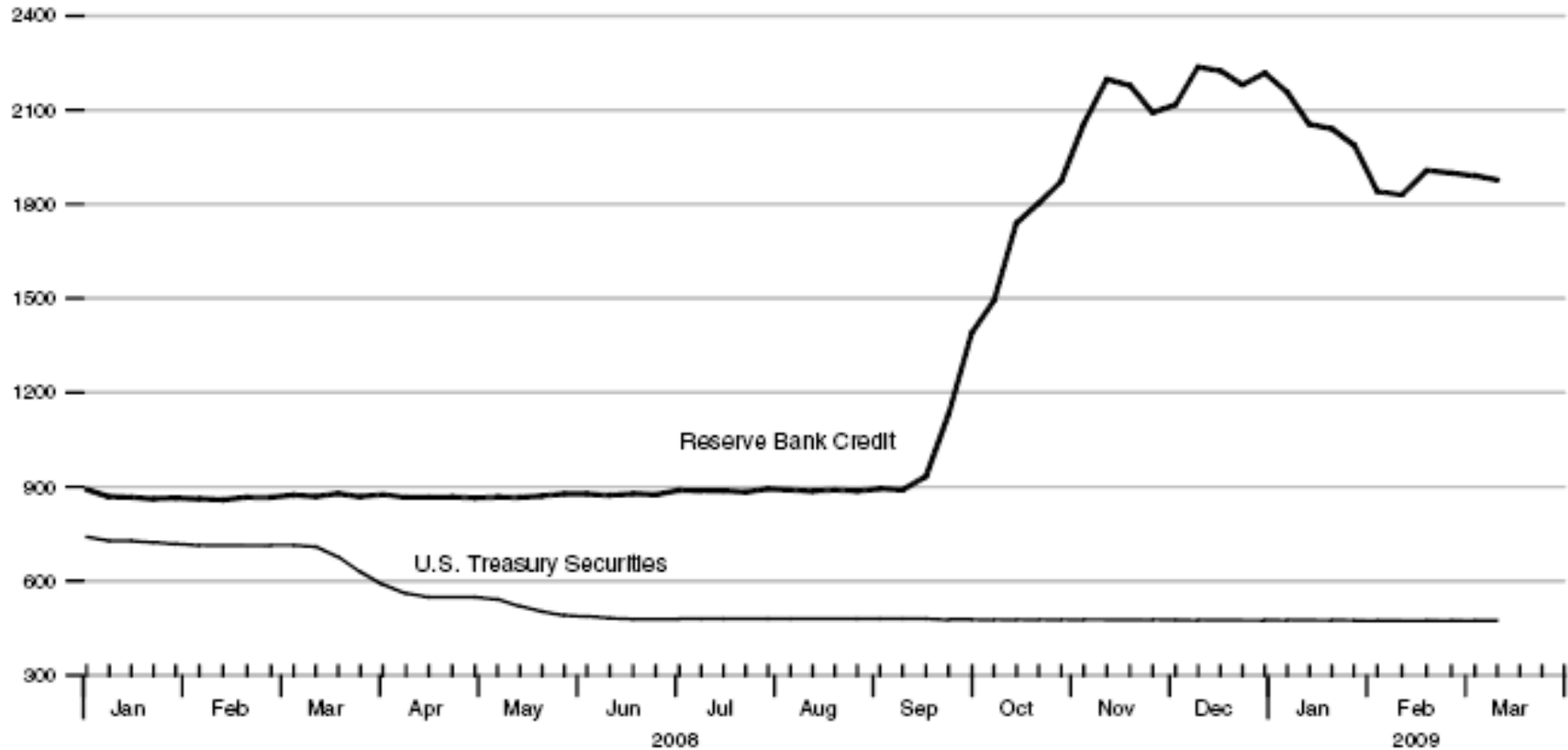


The Federal Reserve must continue to expand its balance sheet

Reserve Bank Credit and Federal Reserve Holdings of U.S. Treasury Securities

Averages of Daily Figures

Billions of dollars



Potential pitfalls with QE

❖ Communication

- Channels are hard to quantify

❖ Governance

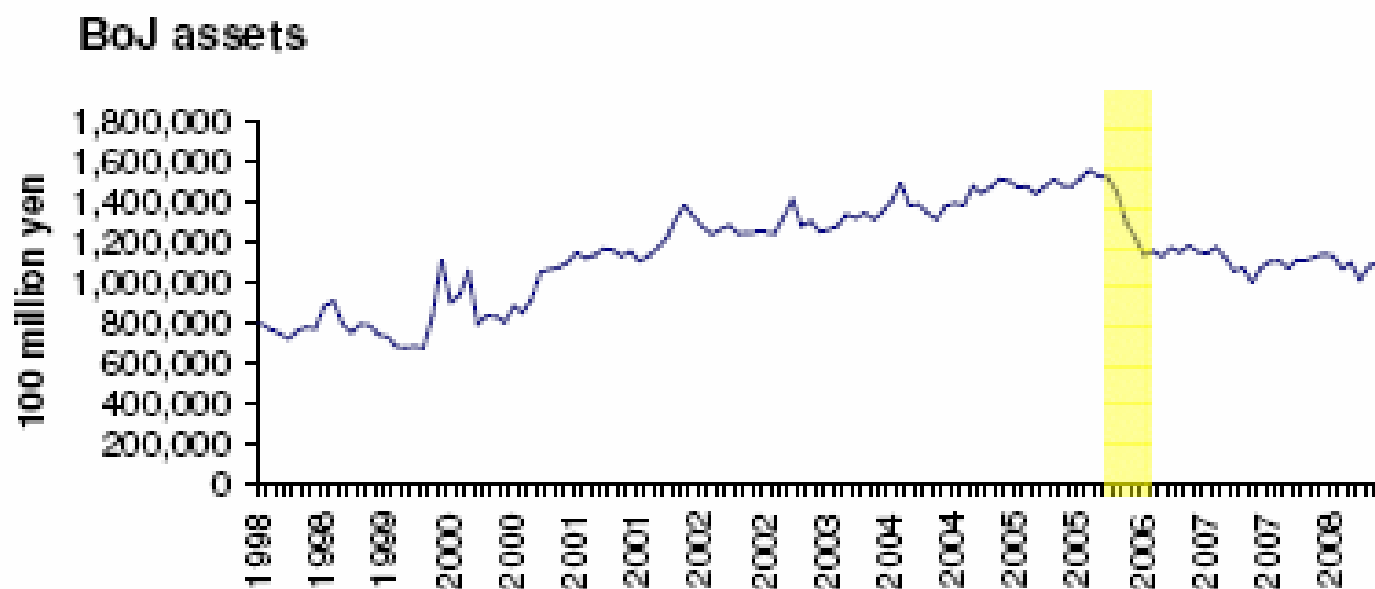
- Board vs. FOMC
 - ◆ Started QE in October '08
 - ◆ Embraced QE for macro reasons in December '08

❖ Risk of political interference

❖ Difficulties in unwinding

About the unwind . . .

- ◆ The BoJ did it, sort of



	2005.12	2006.05	Change yen	percent
Total assets	1,556,071	1,227,935	-328,136	-21
of which:				
Bills purchased	440,899	279,140	-161,759	-37
Government securities	989,175	840,124	-149,051	-15

About the unwind . . .

- ◆ Will the Federal Reserve be able?
 - Some long-lived assets might no longer have markets
 - Political pressures might be intense
- ◆ The Federal Reserve might ask for the authority to issue debt

- Why would the swap matter?
- What are the political risks?

Assets	Liabilities
Assets	- Δ Reserves
	+ Δ Debt

My preferred solution,

- ❖ Don't let the possibility that the Fed will not do the right thing in the future prevent it from doing the right thing now
- ❖ Put mechanisms in place that force good behavior in the future
 - Inflation goal
 - Harder floor on deposit rates
 - Term limit on holding private credit risk funded with reserves

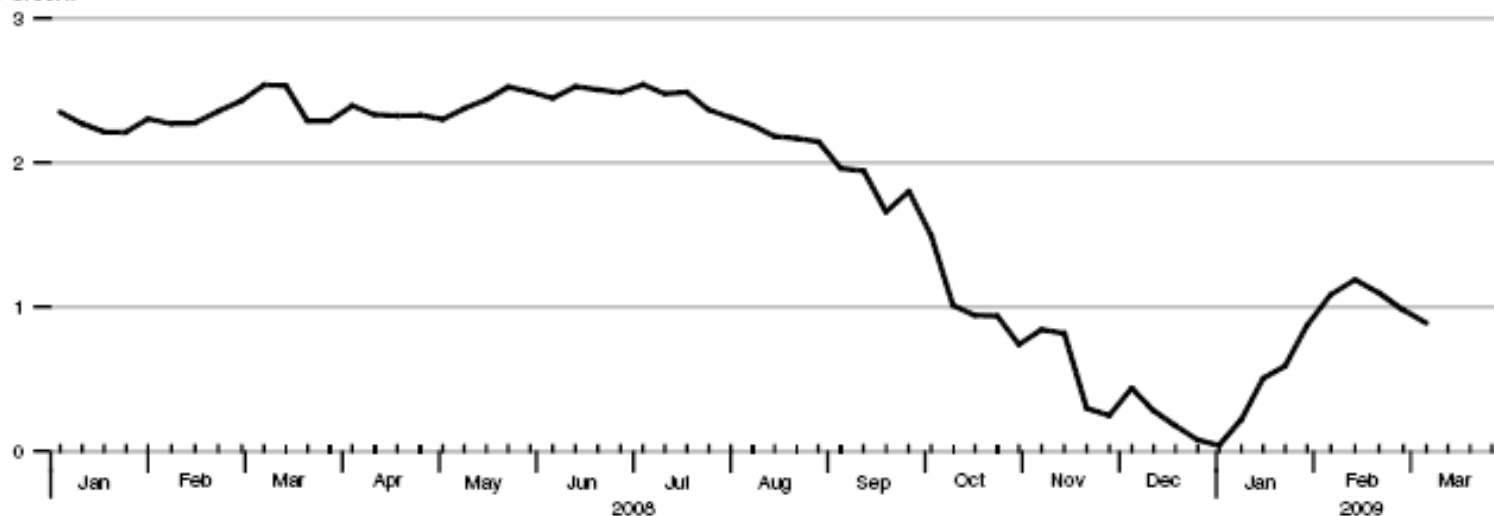
My fear, after heightened government intervention

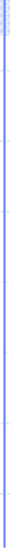
- ◆ More and burdensome regulation is a certainty
 - which may make the job of restoring confidence harder
- ◆ Capital once infused will be slow to exit
- ◆ The Federal Reserve will be overburdened
 - ◆ potentially subject to political pressures that will call its inflation resolve into question

10-Year Inflation-Indexed Treasury Yield Spread

Averages of Daily Figures

Percent





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