

**Panel Comments for the
Bank of Korea International Conference 2010**

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The views expressed today are my own and not necessarily
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In the United States, the Federal Reserve is charged with promoting financial conditions that provide for maximum employment and price stability. During normal times, when small to moderate adjustments in policy are appropriate, our primary policy tool has been a market interest rate, the federal funds rate. Indeed, to address just about all of the deviations of employment and inflation from their goal values, a policy of adjusting the short-term market rate—though sometimes by hundreds of basis points—has been sufficient. Of course, in the nearly three years that I have been Chicago Fed president, economic and financial fluctuations have been far from typical. Today, I would like to comment on monetary policy strategies for responding to unusually large risk-events.

Central banks must always be on guard against risks that are relatively rare, but have potentially large and disruptive effects. Or, to put it another way: Central banks must always monitor economic conditions for potentially large disruptions in the economic infrastructure. Such disruptions might lead to structural impediments to previously

sustainable growth rates, long periods of disinflation, or stagflationary conditions, to name just a few possible negative outcomes. In my discussion, I will take it for granted that inflation scares and loss of central bank credibility must be included on this list of infrastructure disruptions.¹

One major disruption occurred in the 1970s when the Federal Reserve arguably did not appreciate the persistence of the productivity slowdown and monetary policy unintentionally generated destructive inflationary pressures.²

Other disruptions have been associated with financial crises. I think of the problem posed by these in the following way. At some point in time, circumstances arise that create large real losses for investors, businesses, and households. These losses are *real* in the sense that now the current and future production possibility set is smaller or consumption possibilities are more limited. Just to be completely clear, production possibilities may be smaller if everyone's previous assessments are shown to be exaggerated. And lower expected consumption follows naturally from any decline in permanent income and wealth. For a central bank, with no ability to eliminate these underlying real losses, the challenges in assessing the situation are threefold:

1. Will these real losses increase further? How much of the losses are already in train and when will they end?

¹ See Marvin Goodfriend, 1993, "Interest rate policy and the inflation scare problem: 1979–1992," *Economic Quarterly*, Federal Reserve Bank of Richmond, Vol. 79, No. 1, Winter, pp. 1–23.

² See Athanasios Orphanides, 2002, "Monetary policy rules and the Great Inflation," *American Economic Review*, Vol. 92, No. 2, May, pp. 115–120.

2. Will leverage and zero-sum hedging activities result in concentrations of distress that disrupt systemically important financial intermediation?
3. Will these losses and collateral financial consequences negatively impair the economy's infrastructure, capital stock, and labor force in ways that amplify the effects?

I think it is safe to say that we have yet to develop realistic macroeconomic models incorporating a rich enough array of financial markets and frictions to provide definitive policy analysis.³ But the history of central banking and most monetary analyses suggest to me the following policy directions to address these three challenges. First, when an economy has accumulated real losses that limit production and consumption possibilities, a central bank cannot eliminate those primary losses with its access to the printing press, even if it is a twenty-first-century printing press.⁴ Second, however, well-designed lending facilities may be able to mitigate amplification and knock-on effects associated with wholesale increases in the risk aversion of private liquidity-providers. In this way, these programs may limit the effects of these losses on unaware agents and collateral economic sectors. Third, limiting the effects of increased perceptions of liquidity risks may avoid additional destruction of economic infrastructure. However, an

³ See Charles L. Evans, 2008, "Challenges that the recent financial market turmoil places on our macroeconomic toolkit," speech by Federal Reserve Bank of Chicago President and Chief Executive Officer at the Swiss National Bank Research Conference, Zurich, Switzerland, September 19.

⁴ Here I have in mind innovative approaches that channel liquidity to markets for newer financial products. The Term Asset-Backed Securities Loan Facility (TALF) is one example, which directed liquidity to the market for asset-backed securities. That being said, in another way there is little "new" about this avenue for money creation—liquidity injected through programs like the TALF will still show up on the liability side of the central bank's balance sheet as an increase in high-powered money.

important caveat is that central bank actions must strike a balance between reasonable repair and unreasonable liquidity expansions that misdirect activities into unproductive areas, create larger incentive problems, or ultimately fuel inflation scares.

It is easy to describe this balancing act, but difficult to draw bright lines. Nevertheless, in my judgment, there can be substantial scope for central bank action in the face of a financial crisis. Here are a few examples.

In the U.S. in the early 1930s, there was a string of bank failures that the Fed failed to contain. These hobbled the real economy in a period when firms were heavily dependent on bank lending. Moreover, the effective destruction of bank expertise in underwriting loans and originating credit increased the real cost of credit intermediation, adding to the length and severity of the depression.⁵ During the recent episode, we also saw something akin to a series of runs—liquidity runs—that multiplied the impact of the initial losses. This time the liquidity runs were not on standard commercial banks. Instead they were on institutions in the “shadow” banking system, especially those that support securitization. This was of great concern because in the U.S., securitization plays a critical role in the ultimate provision of credit to households and nonfinancial businesses.

This time, the Fed responded aggressively. We eased access to our ordinary discount window. In a departure from normal practice, the Fed made loans available to financial

⁵ See Ben S. Bernanke, 1983, “Nonmonetary effects of the financial crisis in the propagation of the Great Depression,” *American Economic Review*, Vol. 73, No. 3, June, pp. 257–276.

institutions other than commercial banks. Our programs also supported money market funds and the commercial paper market. And in an effort to revive lending that had been dependent on securitization, we cooperated with the Treasury to lend to purchasers of asset-backed securities.

In 2008, the Federal Reserve also cooperated with many foreign central banks to help address liquidity strains. Institutions in other countries also had financed asset purchases—many of them U.S. based—with short-term dollar-denominated borrowing. Some of the same spillovers that had affected U.S. credit markets also pressured these foreign financial firms and put further demands on dollar liquidity in U.S. markets, with possible negative consequences for our economy. Accordingly, the Fed set up dollar-swap facilities with foreign central banks.

The Federal Reserve recently reopened these swap lines. This step seems prudent as the dramatic repricing of the sovereign credit risk of some peripheral European countries has the potential to create dollar funding pressures in world markets. As we did earlier, the Federal Reserve today offers dollars in exchange for foreign currency collateral—at a *fixed exchange rate* and a penalty rate. In this way foreign central banks can extend dollar liquidity support to creditworthy financial institutions facing temporary liquidity strains in foreign credit markets.

With respect to many of our lending programs, some have described our actions as taking the place of the private sector while the private sector was incapacitated. In fact, it was a *partial and incomplete* step in that direction. The central bank's difficult job is to provide liquidity, without taking on undue credit risk. So, we never went as far as offering funding on the same terms that private institutions previously did in credit markets. *Believe me, I heard that often and repeatedly from some of my financial sector contacts!* We lent only against higher-quality assets and priced our loans and haircut collateral at what in normal circumstances would have been hefty penalty rates. The exceptions to this were the special assistance offered to specific institutions during the Bear Sterns demise and AIG assistance. In these cases, taking on some credit risk was a necessary cost of preventing further intensification of the financial crisis.

My time is running short, but I would like to make just some quick comments on quantitative easing. While the liquidity support we provided the economy was very helpful, it was clearly not enough. Given the huge resource gaps, and low and declining inflation, more monetary accommodation was appropriate. Under any version of the Taylor Rule, the funds rate should have been quite negative during the darkest period of the recession. But policy was constrained by the zero-bound on interest rates. So we increased accommodation by turning to large-scale purchases of long-term assets. We ultimately purchased \$1.7 trillion of GSE debt, MBS, and long-term Treasuries. The idea was that significant purchases of these assets would lower term risk premia through a portfolio balance effect. In addition, in the case of MBS, our purchases likely lowered liquidity premia.

I think the jury is still out on exactly how much additional monetary accommodation these purchases have provided. By some empirical estimates, these purchases decreased term premia on long-term assets somewhere in the 30 to 100 basis point range.⁶ Although even the smallest effect would be helpful to the economy, I suspect the larger beneficial effects were nonlinear. Back in March 2009, every business contact I spoke with was extremely concerned that the downward spiral might turn into a complete financial meltdown. It may be easy to dismiss that concern today—*ex post*, sort of like surviving a cancer scare or a sharp pain in your chest—but it was a very real risk at that time. And I think that by announcing unprecedented monetary policy actions during this time, in conjunction with substantial fiscal stimulus, that everyone understood today's twenty-first-century public policymakers were committed to doing everything in their power to avoid the worst-case events that befell the U.S. economy in the 1930s.

My time has undoubtedly expired. So I'll save any further commentary on exit strategies to the general panel discussion.

⁶ See Joseph Gagnon, Matthew Raskin, Julie Remache, and Brian Sack, 2010, "Large-scale asset purchases by the Federal Reserve: Did they work?," Federal Reserve Bank of New York, staff report, No. 441, March. Gagnon et al. (2010) conclude, "The overall size of the reduction in 10-year term premium appears to be between 30 and 100 basis points, with most estimates in the lower and middle third of this range."