9.11

- The event
  - Terrorists hijack four planes, crashing two into and destroying NY World Trade Center, and one into the Pentagon
  - U.S. financial markets closed for four trading days and reopen on 9/17/01

Overview

- Fundamental Question: Who will be the First Responder in the next financial crisis?
- What will the First Responder be empowered to do? Constrained to NOT DO?
- History doesn’t exactly repeat, but it does rhyme. Will TBTF be at the heart and center of the next crisis?

Overview (cont.)

- Rapid resolution of financial institution failures could improve the likelihood that monetary policy could work in a timely manner
  - reducing the depth and length of a recession
  - thereby mitigating the possibility of reaching the zero lower bound
- Unfortunately, it may take a crisis
  - to improve political focus
  - achieve agreement on how to handle TBTF
  - By then, it's too late.

Classic Policy Errors During the 2008-09 Financial Crisis

- Willful blindness/denial
- Lack of preparation to serve as first responder
- *Ad hoc*/unpredictable policy behaviors
- Poor communication, allowing others to fill the vacuum
- Little penalty for failure to perform basic duties and functions
- Possible “capture” by the regulated institutions.
- Avoiding a “repeat” of these classical errors requires the **triumph of hope over experience**.

In the 2008-09 Financial Crisis

- The Fed re-arranged its molecules, and transformed its DNA, by becoming:
  - **First responder**
  - Doing **whatever it takes at whatever speed** required
  - **Fourth branch of government**
  - Exposing the alchemy of central banking—the Fed could create money from nothing
- Clearly **not the same Fed** we observe **in 2015**

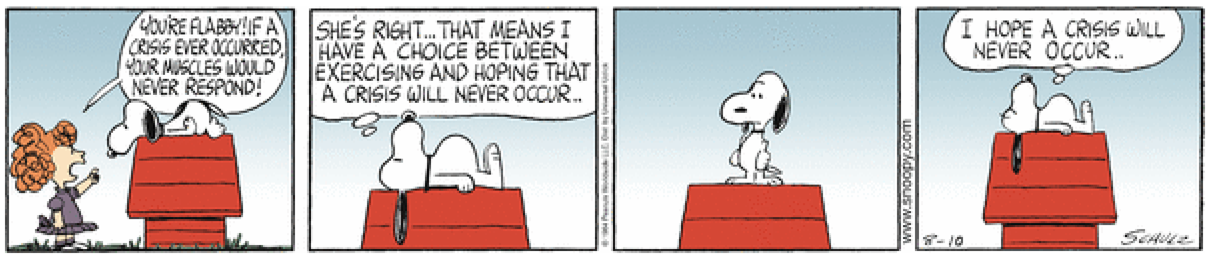
In the 2008-09 Financial Crisis (cont.)

- The Fed was forced to play Superman because
  - Colossal failure of the imagination
  - In times of crisis, it is a necessity to **get both the policy substance and the theater** (communications) **right**
  - The Fed muffed the theater because communications had never been part of its DNA
  - The rest of government seemed helpless and powerless
- In 2015, that same **government now resents its dependency upon unelected Fed officials** , wishing to curtail the Fed's power to act in the future.

A Recent Quote

- "The combined policies of the Federal Reserve and the government helped reduce the effects of the Great Recession, but it was also their policies that helped create the conditions for the collapse. **Applauding the Federal Reserve is a little bit like cheering for the arsonist who helps put out the fire**."

John Mauldin, ***Thoughts from the Frontline***, Sept. 12, 2015


YOU'RE FLABBY! IF A CRISIS EVER OCCURRED, YOUR MUSCLES WOULD NEVER RESPOND!
SHE'S RIGHT... THAT MEANS I HAVE A CHOICE BETWEEN EXERCISING AND HOPING THAT A CRISIS WILL NEVER OCCUR..
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8-10
SCHULZ

Should This Be Our Motto?

"I hope a crisis will never occur."

Snoopy

Some Views from Capitol Hill

Senators Warren and Vitter: "Bailout Prevention Act of 2015"

- **Future interventions by the Fed are limited to**:
  - Assisting **<u>solvent</u>** banks
  - At a **<u>penalty rate</u>** (**<u>500 basis points above comparable US Treasury rates</u>**)
  - Any emergency lending program must be approved by Congress within 30 days, and be clearly broad-based; that is, eligible for participation by at least 5 companies.
- End commodity trading exemption for Goldman Sachs and Morgan Stanley
- Simon Johnson's comment: "retains sufficient flexibility and fire-fighting capacity for the Fed, along with more democratic accountability."
- **Ben Bernanke's comment: "their approach is roughly equivalent to shutting down the fire department to encourage fire safety**; more relevant to today's context, eliminating deposit insurance so banks will be more careful. Rather than eliminating the fire department, it's better to toughen the fire code."

S. 1206 – Too Big to Fail, Too Big to Exist Act: Senator Bernard Sanders

- FSOC shall **compile a list of entities deemed Too Big to Fail** (i.e., Systemically Important banks) to the Secretary of the Treasury
- **Within one year, the Secretary shall break up entities included on the Too Big to Fail List**, so that their failure would no longer cause a catastrophic effect on the US or global economy without a taxpayer bailout.
- **Those institutions included on the TBTF List may not use or access advances from any Federal Reserve credit facility or discount window** (including asset purchases, bridge loans, or capital injections).

Current Legislation - Key Proposals

- **FORM Act – Series of reforms to Fed practices**
  - H.R. 3189, Rep. Bill Huizenga (R-MI)
  - S. 1484 Sen. Richard Shelby (R-AL)

- Centennial Monetary Commission Act – *Establishes **commission to review role and power of Fed***
  - S. 1789, Sen. John Cornyn (R-TX)
  - H.R. 2912, Rep. Kevin Brady (R-TX)

- Federal Reserve Transparency Act - "***Audit the Fed***"
  - S. 264, Sen. Rand Paul (R-KY)
  - H.R. 24, Rep. Thomas Massie (R-KY)

- FFOCUS Act – *Repeals Dual Mandate*
  - S. 1848, Sen. Mike Lee (R-UT)
  - H.R. 1154, Rep. Marlin Stutzman (R-IN)

Common Themes

Transparency	Increased Congressional Oversight	Economic Impact Analysis
• **Articulated Rules for Monetary Policy** • Changes to Transcript Release Timeline and Blackout Rules	• Reports to Congress • Senate Approval of Various Positions • GAO Reports	• **Cost-Benefit Analysis Requirement for New Regulations** • Alterations to Dodd-Frank Supervisory

Word on the Hill

"The Fed must provide more complete explanations of its actions in order for the financial system and the U.S. economy to function effectively. "

Sen. Richard Shelby (R-AL), Chairman, Senate Banking Committee

"Our economy would be healthier if the Federal Reserve were more predictable …and more transparent … Today we're merely left with so-called 'forward guidance,' which unfortunately remains amorphous, opaque and improvisational, and leaves hardworking taxpayers uncertain as they attempt to plan their economic futures"

Rep. Jeb Hensarling (R-TX), Chairman, House Financial Services Committee

"The Federal Reserve was created by Congress and is supposed to be overseen by Congress. The Fed is now in every nook and cranny of banking with unprecedented regulatory powers and no Congressional oversight. I believe **the Fed should be audited and the regulatory power should be placed back under the control of Congress."**

Sen. Rand Paul (R-KY), Republican Presidential

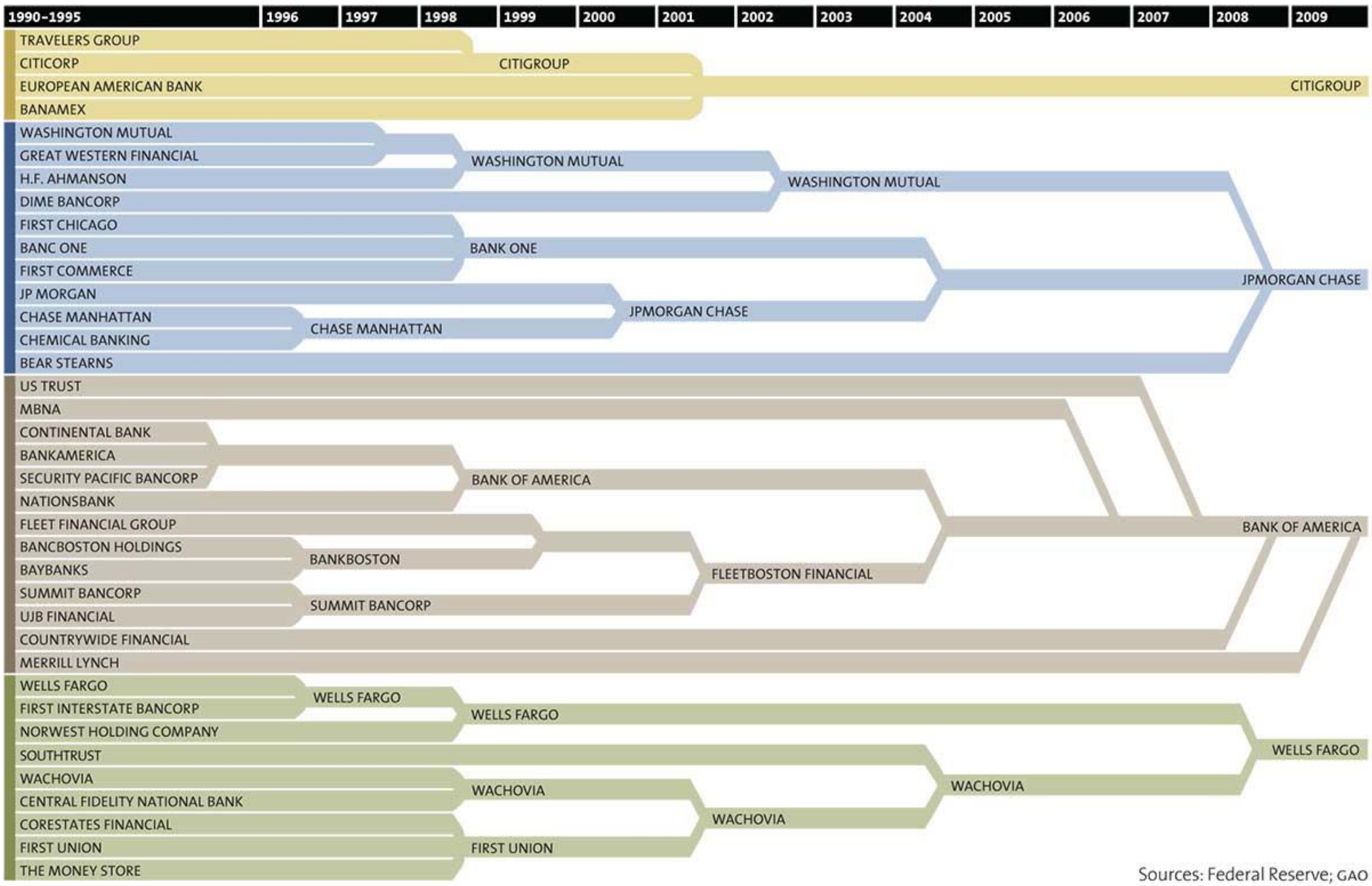
The Fed's recent high degree of discretion and its lack of transparency in how it conducts monetary policy demonstrate that not only are reforms needed, but more importantly that reforms are necessary. We need to modernize the Federal Reserve and bring it into the 21st Century."

Rep. Bill Huizenga (R-MI), Chairman, House Subcommittee on

Essence of Legislative Proposals

- Reduce the Fed's "Independence" and ability to respond in the next financial crisis.
- Validates Snoopy's line: "I hope a crisis will never occur."
- Possibly ignores the risks inherent in today's banking and financial system.

If Rip Van Winkle Went to Sleep in 1995, and Woke Up Now, He'd Be Shocked!!



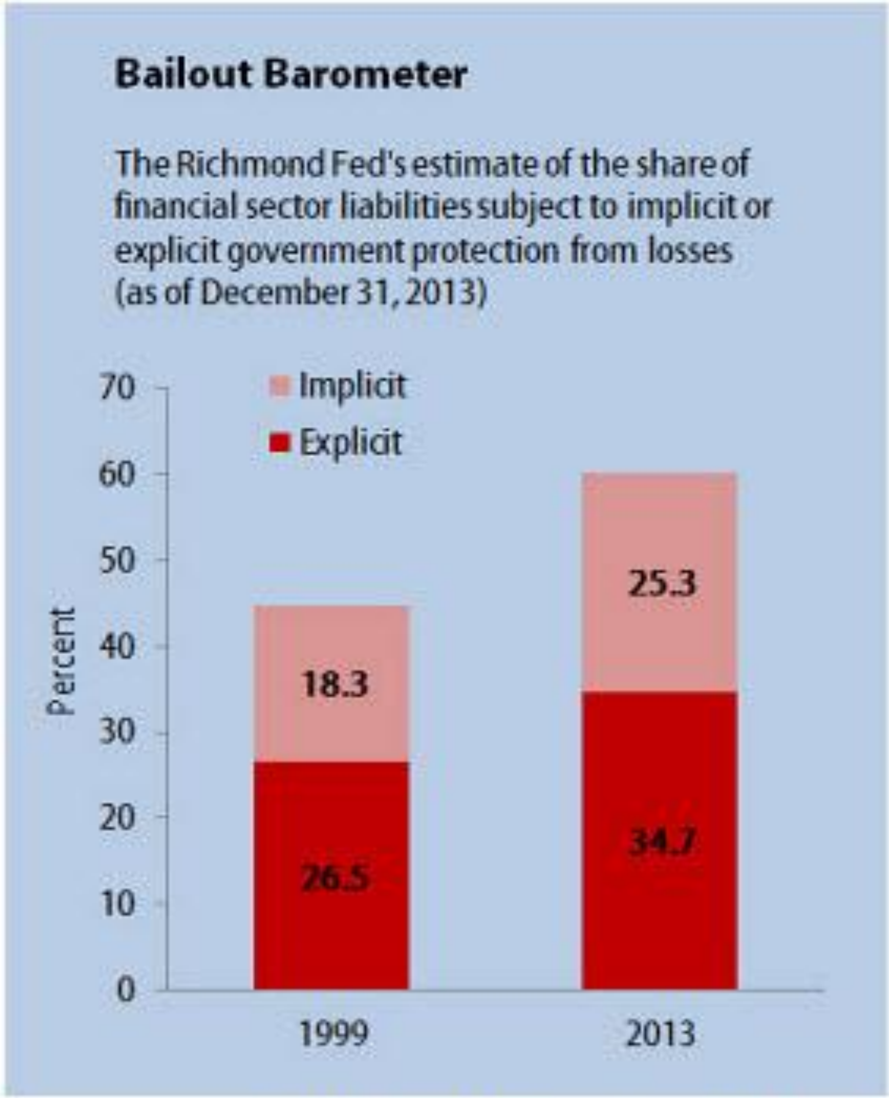
Sources: Federal Reserve; GAO

Mr. Winkle Takes a Five-Year Nap, and Wakes Up in 2020: a **Hypothetical Horror Story**

- And finds the MorganAmericanGroup BHC ("MAG") as the largest bank in the world with assets of over $8 trillion;
- MAG pays -1.2% for deposits, and charges a monthly "account maintenance fee" of $25
- The Fed limits cash withdrawals to four per month, each not to exceed $ 300;
- This, of course, is **Science Fiction**.

Can We Rely on Dodd-Frank?

- **“Simplify and codify quickly.”**
  - Harvey Rosenblum, Dallas Fed’s *2011 Annual Report*
- **Cannot enforce if rules only 60% written**
- **As of mid-2015, rules on capital and liquidity becoming clearer, but OLA (Orderly Liquidation Authority) and other important rules as baffling as ever.**
- **DFA progress is glacial, its sense of urgency captured by the word mañana!**



Source: Federal Reserve Bank of Richmond

Turning to Monetary Policy

Ten Reasons to Raise by One-Eighth Point

- With Fed funds so close to zero, 12 basis points is a meaningful change in the rate
- **Some movement is better than no movement at all; stuck at ZLB for almost seven years**
- One-eighth consistent with Fed's promise to move rates gradually and incrementally
- When you are at Price Stability, the entire structure of interest rates is very low, not just the overnight fed funds rate; in this context, 25 basis points is a large move; smaller incremental changes make more sense
- The Fed can test the financial market's reaction to small movement off the ZLB; see if the world crashes and burns
- The fed is stuck in a corner by its own painting: It's possibly inappropriate benchmark for an inflation target of 2%, which may be very difficult to achieve; and a near-zero fed funds rate, which is not consistent with an economy approaching "full employment.

Ten Reasons to Raise by One-Eighth Point (cont.)

- One-eighth may be the perfect compromise between those on the FOMC who wish to move, and those on the Committee who seem frozen into no movement.
- **"It's a desperate situation when you're at the zero bound"**
- If the Fed needs to respond in the next recession, it would be better to reduce rates via conventional monetary policy; to do so requires getting off the ZLB before that time comes. QE has very little impact and takes many years to begin to work.
- Just as there is a need for **Price Discovery** in the fed funds market, there is need for gaining experience in normalizing rates via the Interest on Reserves, which has never been adjusted since its implementation in 2008. The Fed staff has NO hands-on experience with this tool, and should gain experience with small increments.

Extraordinary Times…

…call for extraordinary policies:

- ✓ **Special credit and liquidity facilities**
- ✓ **Extended safety net beyond commercial banking**
- ✓ **ZIRP(s)**
- ✓ **QE(s)**
- ✓ **Operation Twist**

A Stylized Timeline of the Financial Crisis

Financial & Economic Events

'07–'08	'08–'09		'09–'10	'10–'12
Nonbank SIFIs get in trouble →	Big banks suffer significant losses →	Economy in trouble →	Small and medium banks struggle →	Sluggish recovery

Can ZIRP Be Avoided?

Monetary Policy Responses

'07–'08	'08–'09		'09–'10	'10–'12
Special facilities	ZIRP 1	QE 1	QE 2	ZIRP 2 + MEP; ZIRP 3

"If your only tool is a hammer, every problem looks like a nail"

Problems Abound at the Zero Lower Bound

- The real rate of interest cannot be lowered
- If deflation occurs, real interest rates increase, making monetary policy inadvertently tighter
- Aggregate demand curve becomes “kinked,” with upward sloping portion; lower interest rates **reduce** aggregate demand
- **To summarize**, **conventional monetary policy is virtually impotent at the zero bound**

Source: Mishkin, *Macroeconomics,* 2nd edition, 2015.

Limited Impact of QE

- QE2 added in late 2010
  - 0.13 percentage point to GDP
  - 0.03 percentage point to inflation
- Much of this very limited impact depended on commitment to ZIRP for an extended period
- **Impact comparable to a rounding error**

Source: Curdia and Ferrero, "How Stimulatory Are Large-Scale Asset Purchases?" FRBSF Economic Letter, Aug. 12, 2013.

Extremely Long Impact Lags of Unconventional Monetary Policy

- The FOMC's unconventional policy actions provided no material additional monetary policy stimulus in the first two years following the financial crisis, probably reflecting…the inherent lags in the transmission of monetary policy;
- The economy is only now (early 2015) approaching the full unemployment effect, while the peak inflation effect …is not anticipated until early 2016; i.e., **full impact takes 7-8 years**.

Source: Eric Engen, Thomas T. Laubach, and David Reifschneider (2015). "The Macroeconomic Effects of the Federal Reserve's Unconventional Monetary Policies," Finance and Economic Discussion Series 2015-005. Board of Governors of the Federal Reserve System, p. 26.

Unconventional Monetary Policy Exacerbates Regional Dispersion of Economic Activity

- **QE1 worked least well in those regions of the US where stimulative policy impacts were most needed**, i.e., those regions with low relative income and depressed collateral values
- QE1 was ineffective in stimulating aggregate demand

Source: Martin Buraja et.al., "Regional Heterogeneity and Monetary Policy," *Liberty Street Blog*, Federal Reserve Bank of New York, June 2015.

The BLOB That Ate Monetary Policy

THE WALL STREET JOURNAL.

OPINION September 27, 2009, 7:38 p.m. ET

The Blob That Ate Monetary Policy

Banks that are 'too big to fail' have prevented low interest rates from doing their job.

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By RICHARD W. FISHER AND HARVEY ROSENBLUM

Fans of campy science fiction films know all too well that outsized monsters can wreak havoc on an otherwise peaceful and orderly society.

But what B-movie writer could have conjured up this scary scenario—Too Big To Fail (TBTF) banks as the Blob that ate monetary policy and crippled the global economy? That's just about what we've seen in the financial crisis that began in 2007.

While the list of competitive advantages TBTF institutions have over their smaller rivals is long, it is also well-known. We focus instead on an unrecognized macroeconomic threat: The very existence of these banks has blocked, or seriously undermined, the mechanisms through which monetary policy influences the economy.

Monetary policy is undermined by TBTF banks

Time Is Critical

- Resolution procedures for failing financial institutions
  - Must be known in advance
  - Requires prior political and public consent and understanding
  - Must be carried out quickly
- The **First Responder’s First Duty is Economic Damage Control**
  - Requires at least tacit consent of the nation’s political leadership
  - Debates on the First Responder’s legitimacy creates a leadership vacuum and guarantees policy ineffectiveness
  - Stable financial system creates an environment where monetary policy may have intended impact

Conventional Monetary Policy Trumps Unconventional Monetary Policy

- More impact, more quickly
- **Critical to have room to lower interest rates when a crisis occurs**
- Monetary policy works by inducing future spending to take place sooner
- Now that the US economy is close to full employment, the Fed needs to think about normalizing rates to **allow more room to respond to a possible future financial crisis**, especially given the limited benefits of current unconventional monetary policy.

A “To-Do List” for the Fed

- Devote half the semi-annual testimony on monetary policy to an honest assessment of the health of the banking and financial system;
- Use plain English; No Fedspeak; have a communication team and plan in place long before a crisis;
- Just as it requires for SIFIs, demonstrate its own ability and resiliency to pass a First Responder Stress Test;
- Convince its stakeholders to provide the legal and financial wherewithal to accomplish innovative first responder duties, including responses to TBTF situations;
- Requires somewhat different vision, leadership and skill sets from those developed in the past. They don’t teach this at Yale or MIT!

Conclusions

- The ambiguity surrounding the resolution of failing financial institutions must be addressed now, not during the next crisis
- In a crisis, there's no time for debate
- Need a stable and resilient financial system ASAP
- Only then can monetary policy mitigate the impact of the next recession
- **"It's a desperate situation, when you're at the zero bound."**