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The Fed and the 2008 Financial Crisis: What the FOMC Transcripts Reveal

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Background

- The US government announced it was placing housing finance GSEs (Government-Sponsored Enterprises) Fannie Mae and Freddie Mac in conservatorship on September 6, 2008, under legislative authority obtained on July 30, 2008 under the Housing and Economic Recovery Act of 2008;
- Lehman Brothers filed for Chapter 11 bankruptcy in the early hours of Monday, September 15, 2008;
- The FOMC (Federal Open Market Committee) met on Tuesday September 16 and by unanimous vote kept the federal funds target rate at 2%. Here is the full FOMC statement (emphasis mine):

"The Federal Open Market Committee decided today to keep its target for the federal funds rate at 2 percent.

Strains in financial markets have increased significantly and labor markets have weakened further. Economic growth appears to have slowed recently, partly reflecting a softening of household spending. Tight credit conditions, the ongoing housing contraction, and some slowing in export growth are likely to weigh on economic growth over the next few quarters. Over time, <u>the substantial easing of monetary policy, combined with ongoing measures to foster market liquidity, should help to promote moderate economic growth</u>.

<u>Inflation has been high</u>, spurred by the earlier increases in the prices of energy and some other commodities. <u>The Committee expects inflation to moderate</u> later this year and next year, but the inflation outlook remains highly uncertain.

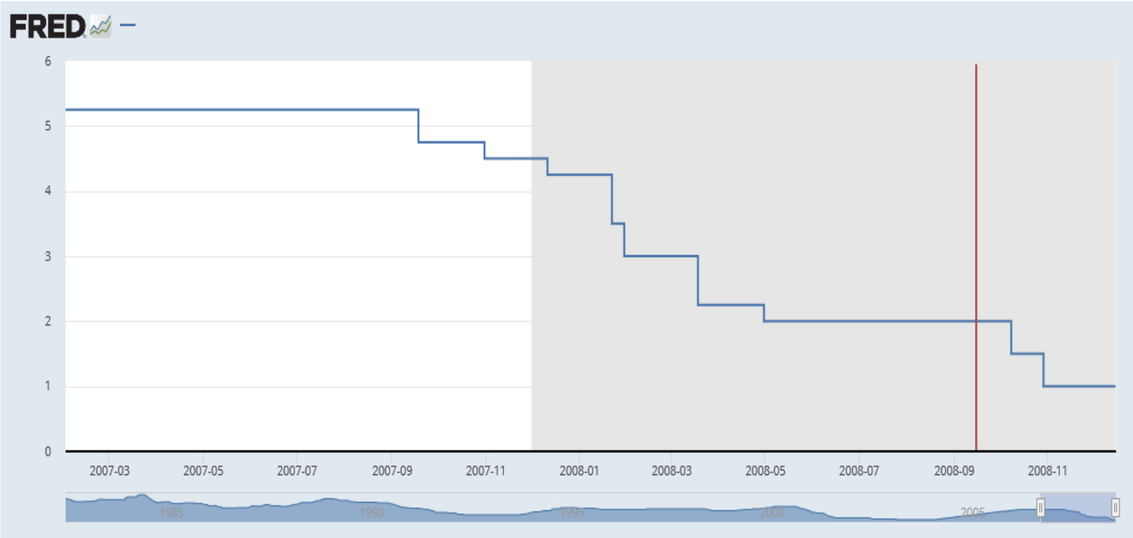
<u>The downside risks to growth and the upside risks to inflation are both of significant concern to the Committee</u>. The Committee will monitor economic and

financial developments carefully and will act as needed to promote sustainable economic growth and price stability."

- Core PCE inflation was 2.2% y-o-y in Q2 2008 and bottomed at 0.9% y-o-y in Q3 2009; real GDP growth (seasonally adjusted annualized rate) was 2.1% in Q2 2008 and was -8.4% by Q4 2008;
- The events unfolding in the first half of September 2008 were the equivalent of the US and the global financial system suffering a near-fatal cardiac arrest, which in turn triggered the worst collapse of global aggregate demand since the Great Depression of the 1930s;
- As funding markets froze and economic activity fell sharply, the Federal Reserve announced a series of lender-of-last-resort/"credit easing" schemes and, starting on October 8, cut the federal funds target rate (its monetary policy operating variable) in three steps from 2% to a target range of 0-0.25% by December 15-16, 2008;
- At this FOMC meeting, the Fed announced, in somewhat veiled language, that henceforth it would be using the size and composition of its balance sheet (QE) as its main monetary policy tool. Here is the key part of the FOMC statement (my emphasis):

"The focus of the Committee's policy going forward will be to support the functioning of financial markets and stimulate the economy through open market operations and other measures that sustain the size of the Federal Reserve's balance sheet at a high level. As previously announced, over the next few quarters the Federal Reserve will purchase large quantities of agency debt and mortgage-backed securities to provide support to the mortgage and housing markets, and it stands ready to expand its purchases of agency debt and mortgage-backed securities as conditions warrant. The Committee is also evaluating the potential benefits of purchasing longer-term Treasury securities. Early next year, the Federal Reserve will also implement the Term Asset-Backed Securities Loan Facility to facilitate the extension of credit to households and small businesses. The Federal Reserve will continue to consider ways of using its balance sheet to further support credit markets and economic activity."

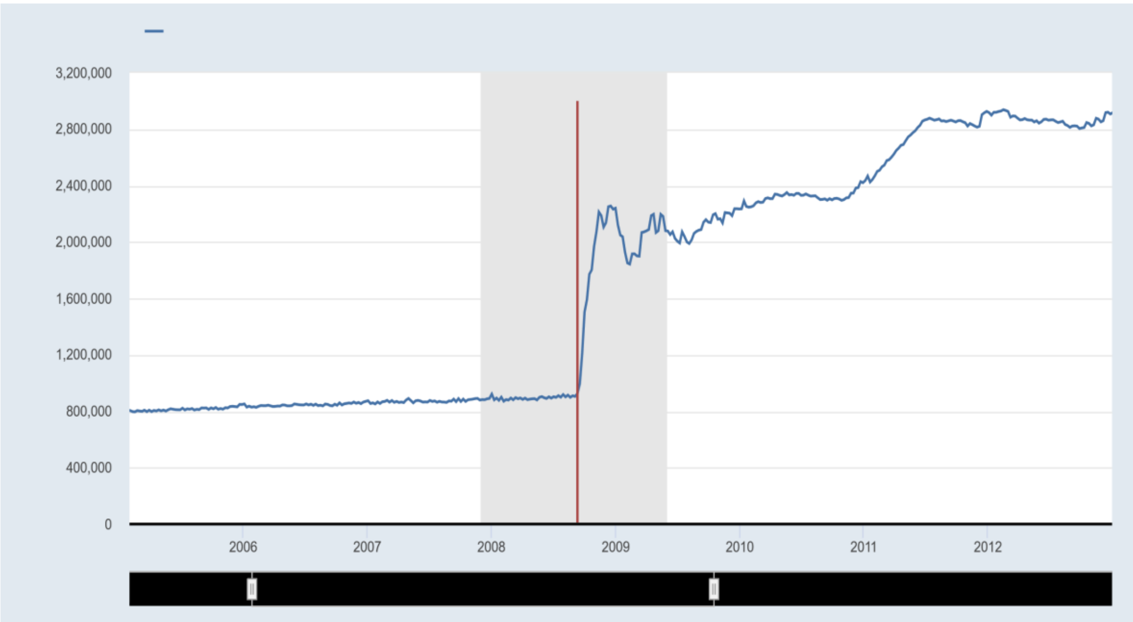
Federal funds target rate, January 2007 to December 2008 (%)



Note: Shaded area is recession; vertical line denotes date of Lehman Brothers failure; series ends on December 15, 2008, after which the Federal Reserve began to set a target range for the federal funds rate of 0-0.25%, which it continued to do until December 16, 2015.

Source: St Louis Federal Reserve FRED Economic Data

Size of Federal Reserve balance sheet, 2006-2012 ($ million)



Note: Shaded area is recession; vertical line denotes date of Lehman Brothers failure.

Source: St Louis Federal Reserve FRED Economic Data

Key changes in Fed balance sheet between failure of Lehman Brothers and announcement of policy to focus on size of balance sheet ($ billion)

Asset component	September 11, 2008	December 11, 2008	Change
U.S. Treasury securities	479.8	476.2	-3.5
Federal agency securities	0.0	15.8	15.8
Term auction credit	150.0	448.0	298.0
Other loans	23.6	233.1	209.6
Commercial Paper Funding Facility	0.0	312.4	312.4
Maiden Lane (Bear Stearns)	29.3	26.9	-2.4
Maiden Lane III (AIG)	0.0	19.6	19.6
Other assets (including central bank liquidity swaps)	96.5	632.2	535.7
Total assets	924.5	2262.3	1337.8

Source: Federal Reserve H.4.1 Statistical Release (weekly)

2008 FOMC transcripts

- With a five-year lag, the Fed publishes close to verbatim transcripts of FOMC meetings and conference calls and associated materials. The Fed released all such materials on February 21, 2014. I read all of the 2008 transcripts after the Lehman Brothers failure and many of the earlier ones, and summarized my key take-aways in the attached ("Step Into The Boardroom" article, which includes substantial quotes from the transcripts;
- Here are my key take-aways:
    - The quality of the debate was high and was informed by strong economic research and academic thinking, as FOMC participants grappled with the theory and application of monetary policy easing at the zero interest rate bound. That said, differences in understanding, reflecting different implicit or explicit economic models, were on display;
    - The Fed learned from and applied lessons, not only from the Great Depression, but also from Japan's experience with deflation and

monetary policy at the zero bound (quantitative easing or QE);

- At times, the FOMC paid extraordinary attention to its choice of words, in keeping with the importance accorded communication in the modern theory and practice of monetary policy and keenly aware that even minor nuances of language could influence the understanding of and reaction by market participants and therefore the transmission of monetary policy;
- The Fed's policy response brought to the surface long-forgotten nuances of the governance of monetary policy within the Fed and the division of labor between the Board of Governors of the Federal Reserve System and the FOMC, the FOMC having responsibility for formulating and communicating monetary policy but the Board of Governors being the decision-making body for lender-of-last-resort operations and obtaining (in the October 2008 Troubled Assets Relief Program legislation) the authority to pay interest on reserves;
- The transcripts cast light on what is and will remain the most contentious question surrounding the Fed's actions in the financial crisis: should the Fed have used its Section 13(3) "unusual and exigent circumstances" authority under the Federal Reserve Act to prevent Lehman Brothers from going bankrupt (along the lines of the action it took in March 2008 to facilitate the "rescue" of Bear Stearns by JP Morgan)? Here is the text of Section 13(3) as it existed at the time of the financial crisis (see Appendix for how Section 13(3) was amended by the so-called Dodd-Frank legislation):

Federal Reserve Act, Section 13(3), as of time of financial crisis:

"In <u>unusual and exigent circumstances</u>, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal reserve bank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 357 of this title, to <u>discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange</u> when such notes, drafts, and bills of exchange are indorsed or otherwise <u>secured to the satisfaction of the Federal reserve bank</u>:

Provided, that before discounting any such note, draft, or bill of exchange for an individual or a partnership or corporation the Federal reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe."

- Chairman Bernanke claimed that the Fed did not have the legal authority, under Section 13(3), to rescue the financial system from Lehman's failure, but I am skeptical;
  - The premise of Section 13(3) is that circumstances are "unusual and exigent" ("exigent" being defined by the Merriam-Webster Dictionary as "demanding immediate aid or action"), that the borrower in question cannot obtain adequate finance elsewhere, and that the lending must be "secured" to the Fed's "satisfaction". The Fed has interpreted this last part as requiring its Section 13(3) lending to be "adequately secured," which it seems to interpret as "fully secured," but seems to be inconsistent with the whole premise of when such lending would be needed. There is no bright line between a "liquidity" problem and a "solvency" problem in a dire financial crisis, as the central bank's actions themselves can determine whether ex post a liquidity problem turns into a solvency one;
  - There is also a Catch-22: Chairman Bernanke and US Treasury Secretary Hank Paulson claimed that one difference with the Bear Stearns case was that there was no buyer for Lehman Brothers, but one reason for that presumably was that the Fed was not prepared to provide Section 13(3) support.

- In keeping with the established independence of the Fed and the importance of financial markets in "transmitting" monetary policy, the transcripts reveal an FOMC very focused on financial markets, but little occupied with how Congress would respond to its actions or with broader political considerations;

- Chairman Ben Bernanke emerges from the transcripts looking good, coming across as being: thoughtful, modest, deft, firm, decisive, collegial, calm, and innovative;
- The transcripts reveal just how hard it is even for highly qualified, experienced and resourced forecasters to foresee what lies around the corner. It seems that economic forecasting is found most wanting when it is most needed.

Appendix: Amendments made to Section 13(3) by Dodd-Frank legislation

i. As soon as is practicable after the date of enactment of this subparagraph, the Board shall establish, by regulation, in consultation with the Secretary of the Treasury, the policies and procedures governing emergency lending under this paragraph. Such policies and procedures shall be designed to ensure that <u>any emergency lending program or facility is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company</u>, and that the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion. The policies and procedures established by the Board shall require that a Federal reserve bank assign, consistent with sound risk management practices and to ensure protection for the taxpayer, a lendable value to all collateral for a loan executed by a Federal reserve bank under this paragraph in determining whether the loan is secured satisfactorily for purposes of this paragraph.

ii. The Board shall establish procedures to <u>prohibit borrowing from programs and facilities by borrowers that are insolvent</u>. Such procedures may include a certification from the chief executive officer (or other authorized officer) of the borrower, at the time the borrower initially borrows under the program or facility (with a duty by the borrower to update the certification if the information in the certification materially changes), that the borrower is not insolvent. A borrower shall be considered insolvent for purposes of this subparagraph, if the borrower is in bankruptcy, resolution under title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, or any other Federal or State insolvency proceeding.

iii. A program or facility that is structured to remove assets from the balance sheet of a single and specific company, or that is established for the purpose of assisting a single and specific company avoid bankruptcy, resolution under title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, or any other Federal or State insolvency proceeding, shall not be considered a program or facility with broad-based eligibility.

iv. The Board may not establish any program or facility under this paragraph without the prior approval of the Secretary of the Treasury.

Further reading/references

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