Market Stability and the Fed’s New Credit Facilities

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Financial Crises and Learning

Financial Crises are times in which learning occurs.

1907—role of trusts; need for elastic currency
  ▪ Lessons proved themselves in 1914

1932—need for deposit insurance
  ▪ Again, a useful lesson

1987—destabilizing role of dynamic hedging strategies

1998—need for moderation of leverage, liquidity impairment, contrarian traders

2007-8—need for better discount window mechanism in face of aggregate shock, instability of secured funding markets, increased role of investment banks, problems with excessive reliance on ratings agencies, opaqueness and complexity of structured credit products, …
1. Discount window in light of aggregate liquidity demand

The current crisis has many, many lessons to teach.

Unilateral method of approaching discount window to borrow at a premium to the target rate has little to recommend it in light of an aggregate liquidity demand.
Data: Derived from the Fedwire Transactions journal

Eurodollar, Fed Funds Activity

- Orange: Fed Funds
- Blue: Eurodollar

$ Billions

1/1/07 4/1/07 7/1/07 10/1/07 1/1/08 4/1/08
Differences among U.S. dollar overnight rates

Difference between Overnight Interbank Borrowing Rates and Target Rate

Sources: BBA, FRBNY
Plot of the spread of overnight Libor to the effective fed funds rate

Overnight LIBOR-Effective Fed Funds Spread

Sources: Bloomberg, FRBNY Markets Group
Why the lack of integration?

1. No reserve requirements.
   The demand and supply of funds in the London Eurodollar market are highly inelastic.

2. Time-zone mismatch.
   The greater integration between NY Eurodollar and fed funds, and Euribor and the Euro policy rate both suggest that time-zone is an important friction.

3. Different intermediaries.

TAF and FX Swaps with ECB and SNB are directed to addressing the increased aggregate demand, caused in part by less integration in European and US money markets.
2. Lack of liquidation facilities in secured finance market

The instability of the secured finance market is surprising—but less so when one considers that there is no coordination in the liquidation of the assets that had been used as collateral.

In the event of default, the “fire-sale” of collateral can impose severe losses on lenders. As a result, the ex ante incentives can be quite unstable, and lead to a refusal to roll-over, initiating a crisis.

Similarly, for investment banks there is no resolution procedure similar to what exists for banks under the FDI Act.
The central bank can’t solve all problems. For example, Chairman Bernanke said on July 8, 2008, that “Because the resolution of a failing securities firm might have fiscal implications, it would be appropriate for the Treasury to take a leading role in any such process, in consultation with the firm's regulator and other authorities.”

http://www.federalreserve.gov/newsevents/speech/bernanke20080708a.htm
Lessons

The current crisis has taught us much (with more teaching likely to be administered). We better understand the role of investment banks, the vulnerabilities of secured financing, the role of the discount window, and much more about housing finance and securitization.

We also likely realize that the role of the lender of last resort is a powerful and important financial role in a modern economy.

It may be that in a dynamic financial system, the lender of last resort is more important than in a static system in which no new lessons need be learned.