

What Has the Fed Gotten Itself Into?

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Outline

- Background
 - Financial crises and the lender of last resort
- The Fed's expansion of the LOLR function
 - What has it done? Is it working?
- Credit risk and its implications
 - Seigniorage?
 - Loss of independence?

Background

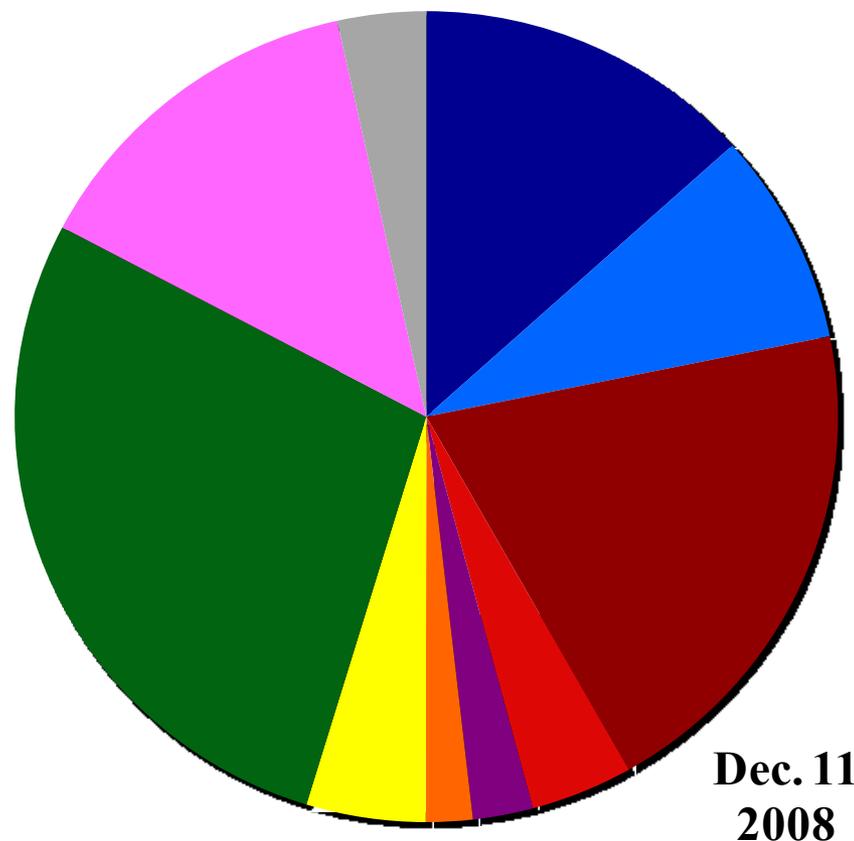
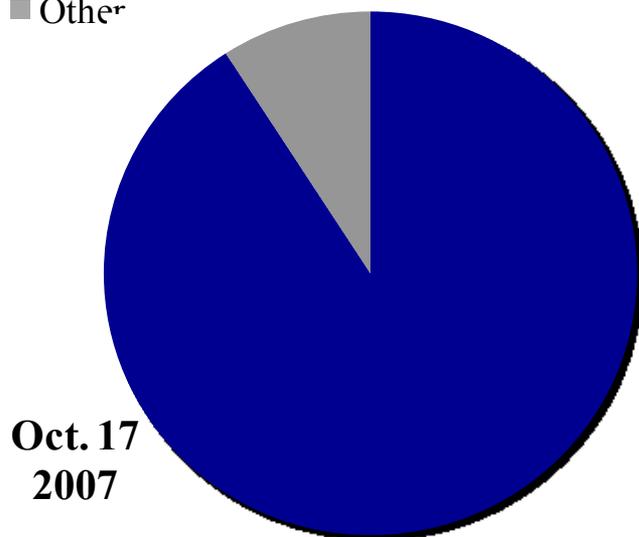
- Subprime lending.
- Minsky/Kindleberger: displacement, credit expansion, overtrading...
 - “When the rest of the world are mad, we must imitate them in some measure.”
 - “There is nothing so disturbing to one’s well-being and judgment as to see a friend get rich.”
- Hesitation, revulsion, panic. Liquidity stampede.

The Lender of Last Resort (LOLR)

- A long history...
 - Bahehot: lend at a penalty rate on good collateral.
- Why the Fed got involved...
 - ...the scale and scope are unprecedented.

Fed balance sheet, then and now

- Securities, excluding TSLF
- Term Securities Lending Facility (TSLF)
- Term auction facility (TAF)
- Discount window
- Primary Dealer Credit Facility (PDCF)
- ABCP + MMIFF
- Direct Lending (AIG, Bear)
- Swap lines
- CP Funding Facility (CPFF)
- Other



Areas represent approximate balance sheet sizes.

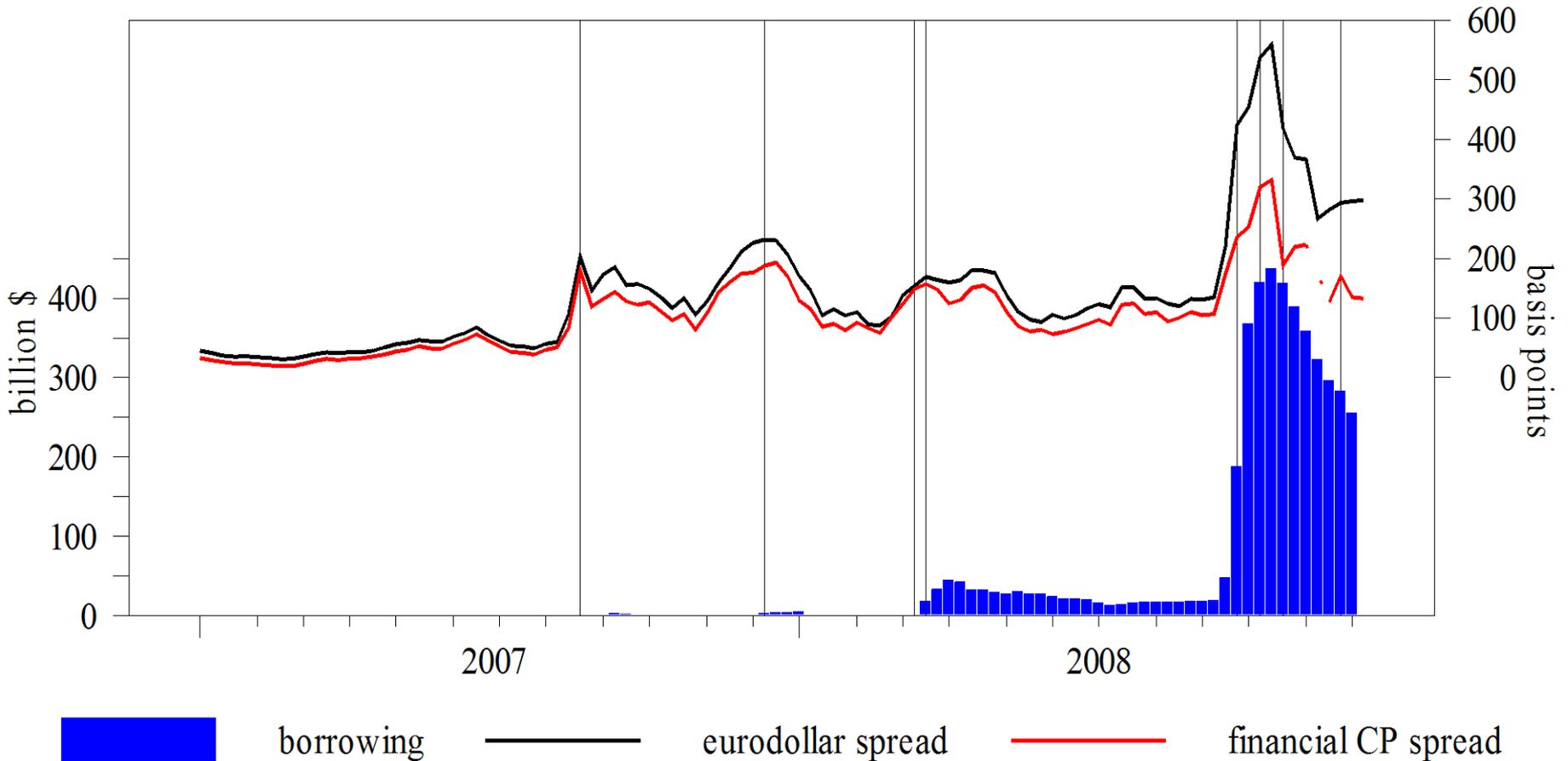
The escalation

- March: purchase of Bear Stearns' assets, Primary Dealer Credit Facility.
- September: credit line to AIG.
- October: purchases of commercial paper.
- November:
 - Purchases of asset-backed securities, GSE debt
 - Citigroup credit risk protection
- Next: General Motors?

Has it worked? Three criteria

- Collapse prevention.
- Resuscitation of money markets.

Spreads and borrowing



Has it worked? Three criteria

- Collapse prevention.
- Resuscitation of money markets.
- Macroeconomic stimulus.
 - How effective *is* quantitative easing if banks are capital constrained?

Problems for the Fed

- Operational: maintaining control of the Fed funds rate.
- Moral hazard.
- Credit risk.

How much credit risk?

- Nobody knows.
- Low for some facilities (term auction facility)
- Higher for others (purchase of Bear Stearns assets)
- Explicit credit protection for Citigroup

Economic implications

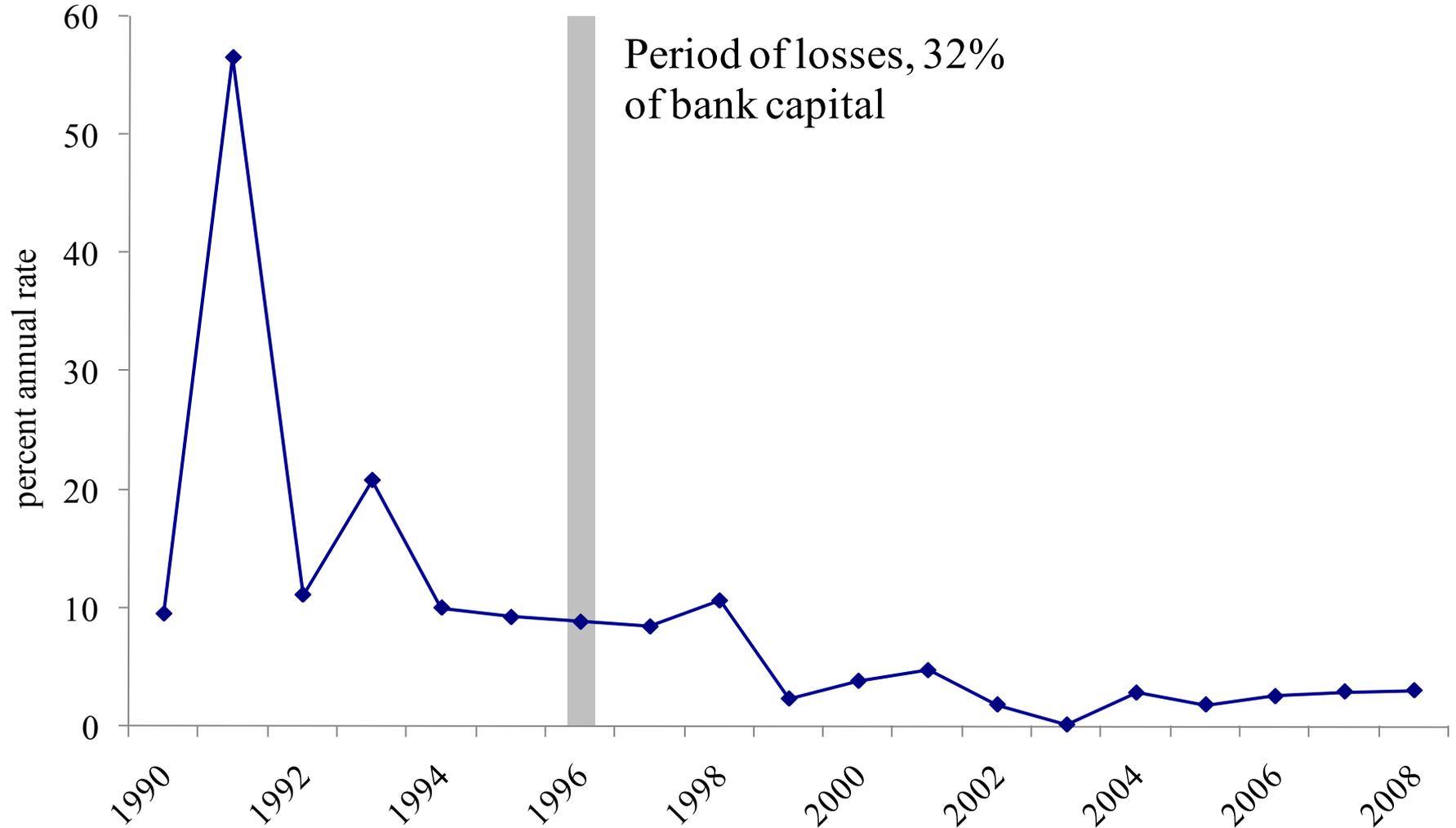
- Loan losses have to be financed...
 - Taxes, or seigniorage?
 - What does recapitalization do?
- Independence could be compromised...
 - Loss of income
 - Perception of subservience to the Treasury
 - Bailouts without accountability
 - Incompetence

Other central banks' experiences

- Major losses are not uncommon.
- Some banks were recapitalized, others were not.
- If not recapitalized, does inflation rise following losses?
- Does autonomy matter?

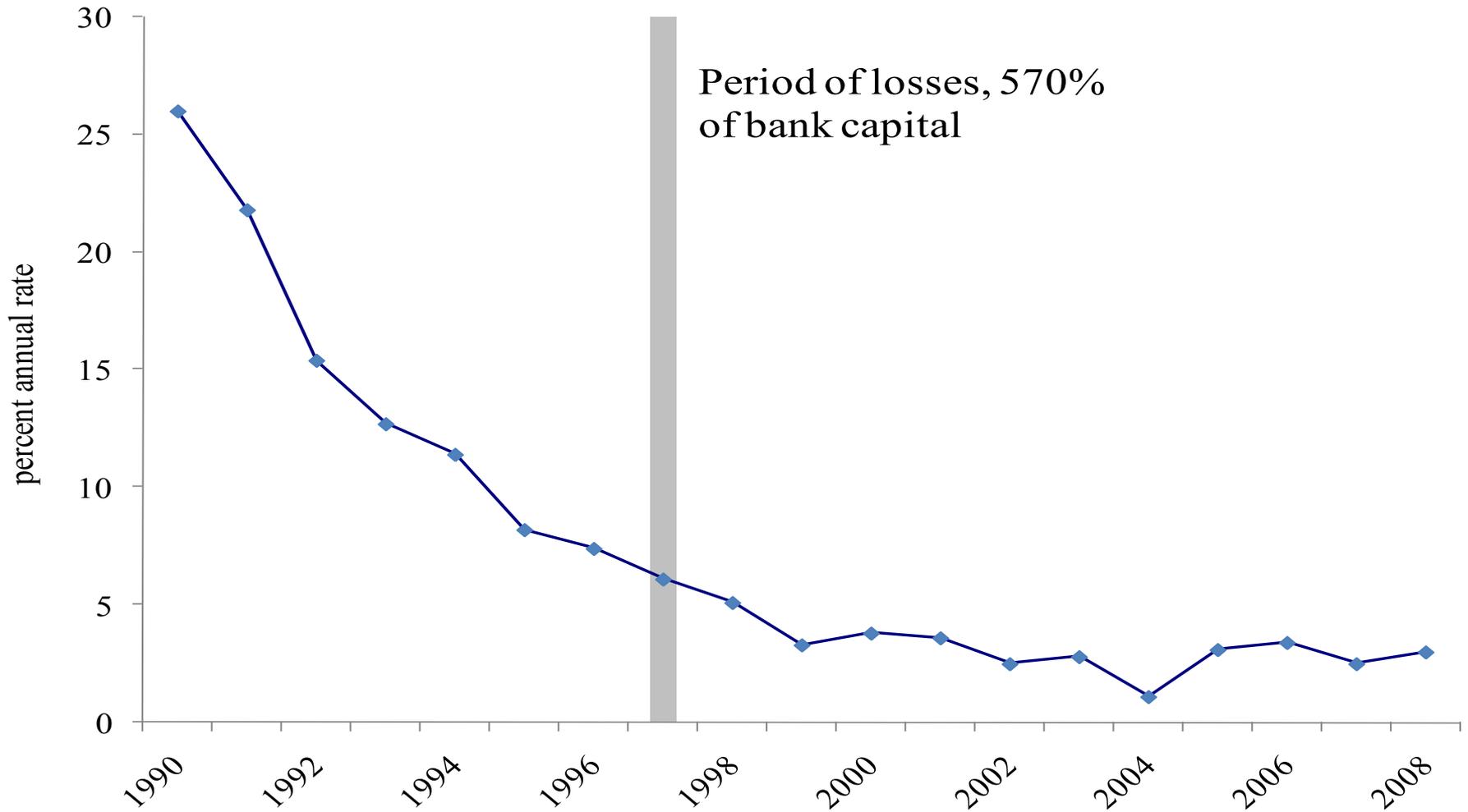
Czech Republic

not recapitalized



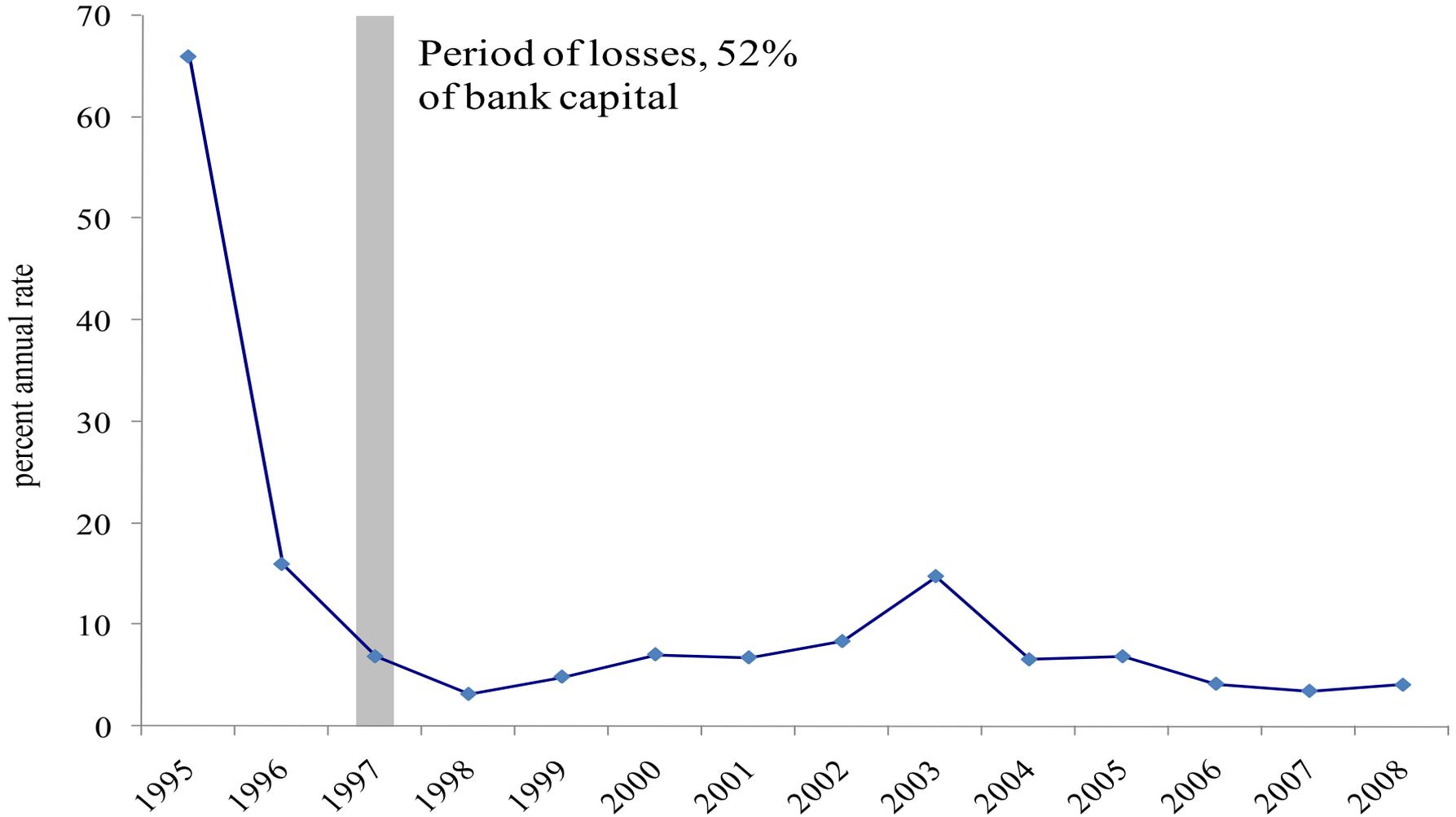
Chile

not recapitalized



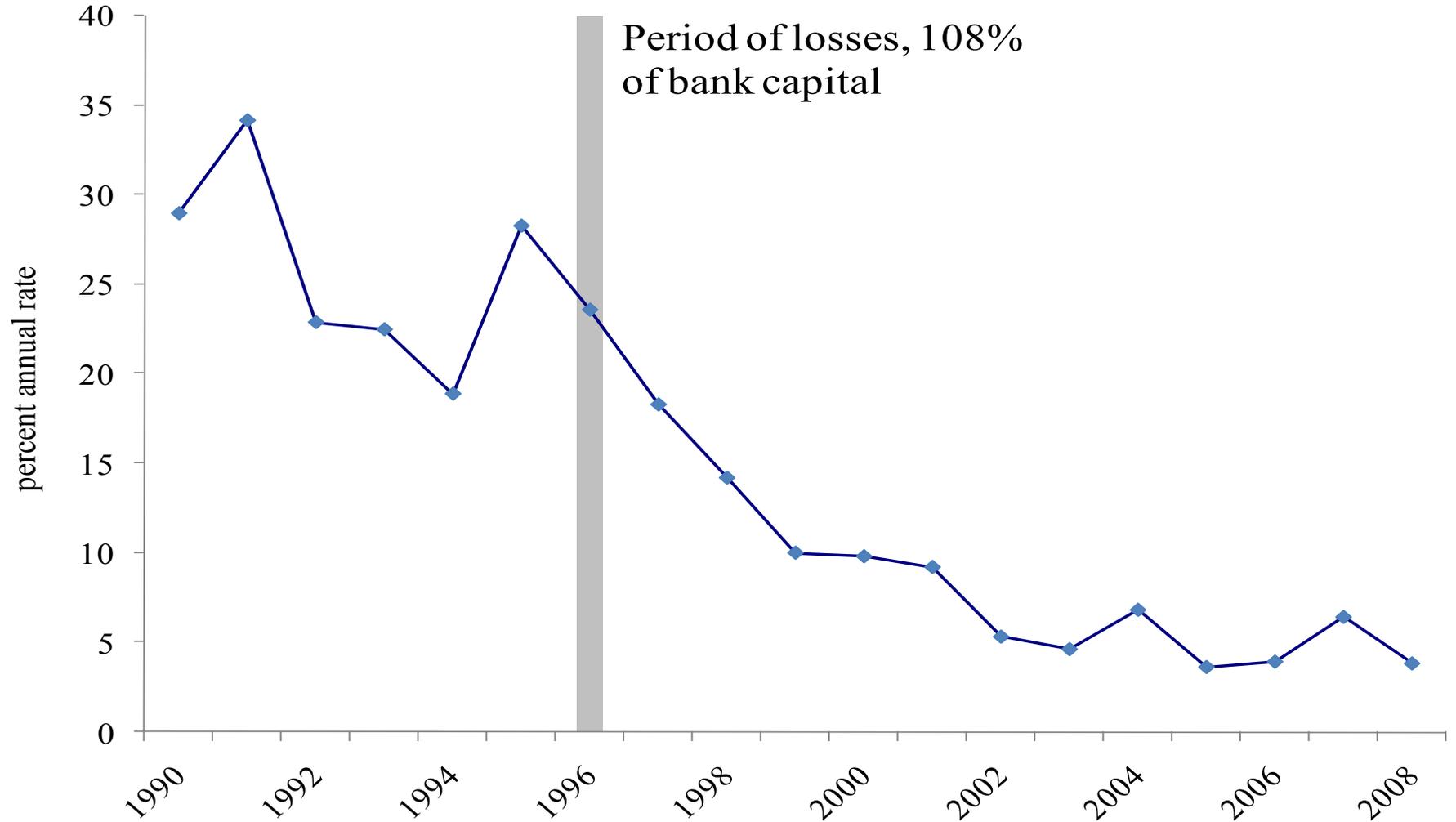
Brazil

recapitalized



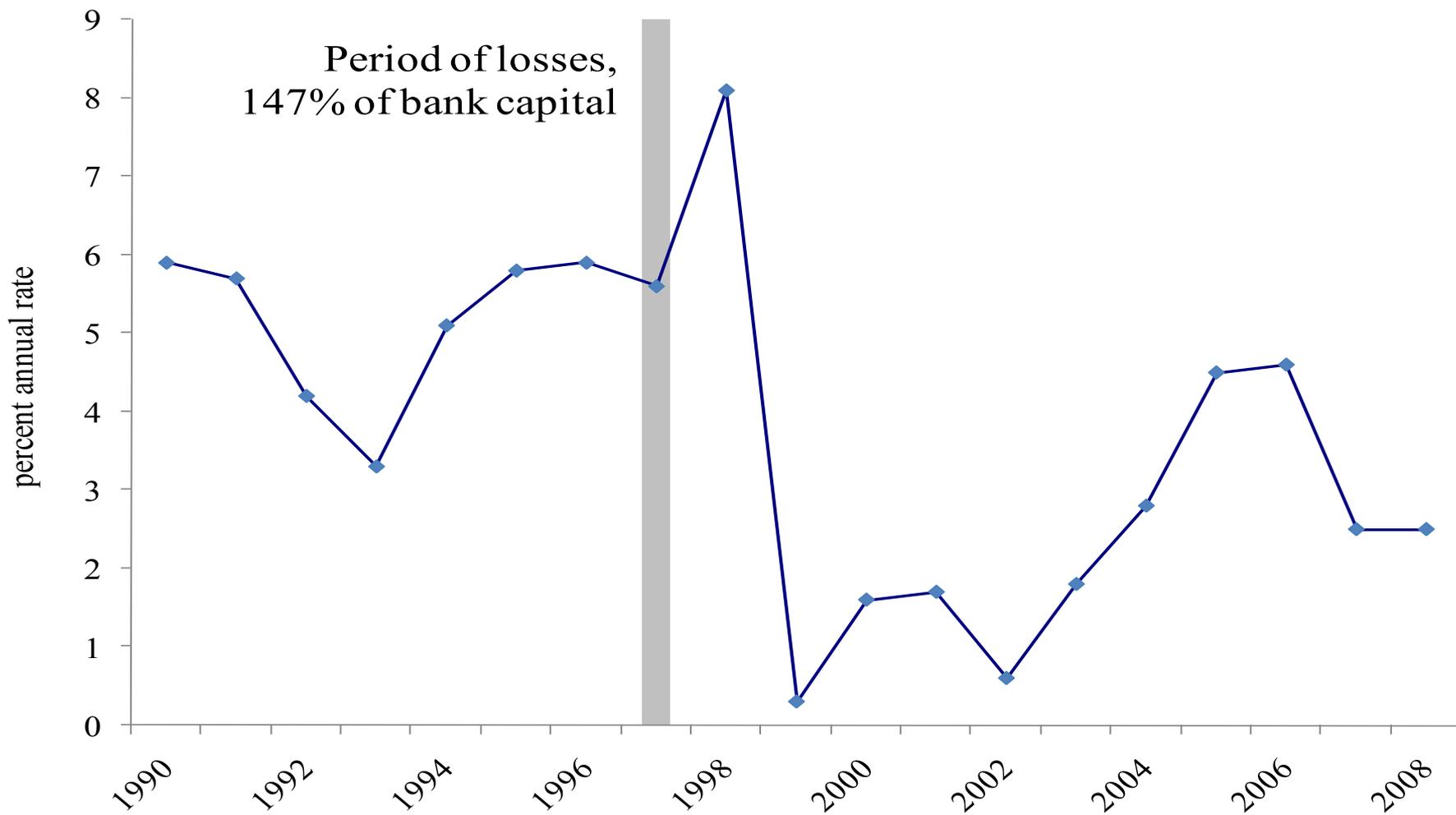
Hungary

recapitalized



Thailand

not recapitalized



Conclusions

- Fed: Lender of last resort → *buyer* of last resort → *risk bearer* of last resort.
- No conclusions, just questions:
 - Will the interventions work?
 - Will the Fed become less independent?
 - Will there be more seigniorage?