EVOLVING LEGAL FRAMEWORKS FOR CENTRAL BANK LIQUIDITY STABILIZATION: THE FED AS A CASE STUDY

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STEPS IN TODAY'S TALK

1. **Minsky:** Provided early theoretical support for **expansive liquidity stabilization** by CB as a **market maker of last resort**.

2. **Fed legalism:** Give a **market-infused reading** of Fed's authority to trade for its own account.

3. **Fed rescues**: Expanded its **liquidity support for shadow banks and structured finance** consistent with its **generative authority** to trade for its own account.

4. **Title XI, Dodd-Frank**: Limited the Fed's **discretion over liquidity stabilization** and may limit the Fed's ability to respond to **future liquidity crisis**.

5. **Tentative response** to Levy Ford report on LLR.

LIQUIDITY STABILIZATION AS LENDER OF LAST RESORT

Bagehot, LOMBARD STREET (1873): Lend freely against good collateral and at a penalty interest rate.

Knickerbocker Trust Company (1907): J.P. Morgan acts as **private lender of last resort**; provides public relations basis to rebut objections to establishment of central bank.

Federal Reserve Act (1913): Intended to be a 'banker's bank'; **rediscounting** commercial paper central to mission; goal is to facilitate **bank funding**.

MARKET MAKER OF LAST RESORT

MARKET MAKING DEFINED: Using proprietary capital to provide **asset liquidity** and **smooth out price changes** by buying in a bear market and selling in a bull market.

FUNDING MARKET SHIFT: Rise of a **securitized credit market** with **shadow banks** and more **inter-bank exposures**; more links between **asset market** and **firm funding liquidity**.

'WHAT IS TO BE DONE?'

CONFERENCE: Governor Rosengren's comments re broker-dealers and shadow banks and exchange about MMLR

MMLR SCHOLARS (EXAMPLES)

BUITER, FINANCIAL TIMES: 2007-2008 editorials calls for CB to provide last resort funding beyond its traditional liquidity clients (MMLR).

MEHRLING, NEW LOMBARD STREET: HOW THE FED BECAME THE DEALER OF LAST RESORT (2011): frames the issue in terms of 'shiftability' of collateral.

MOE, SHADOW BANKING AND THE LIMITS OF CENTRAL BANK LIQUIDITY SUPPORT (2012): 'new Bagehot rule' needed.

EARLY NOTION OF MMLR

A flexible central bank that stands ready to acquire any type of asset it feels is necessary to avoid instability is a major requirement for the successful operation of a complex financial system. The central bank **must follow, and in crisis ratify**, what has taken place in the market. Only in times of stagnation or tranquility can the economy afford a central bank that stands on principle. (emphasis added)

Minsky, *Financial Intermediation in the Money and Capital Markets* (1967)

BARRIER: RISK AVERSION AT THE CENTRAL BANK

Historically, central banks have not been adventurous in expanding the scope of their operations, and the Federal Reserve System is **bound** by a legislative mandate. (emphasis added)

Minsky, *Financial Intermediation in the Money and Capital Markets* (1967)

EXOGENOUS GROWTH OF FED'S TRADING AUTHORITY

1932 Broadening borrower base ('unusual and exigent')

1935 Relaxing of collateral requirements for § 13(3)

1966 Authority to trade government agency obligations

1980 Authority to trade foreign public debt

1991 Broadening collateral eligibility for § 13(3)

2002 Relaxes quorum requirement for § 13(3)

FED'S GENERATIVE AUTHORITY

RELATIONSHIP TO MARKET

- Regulates market by trading **in it**, i.e., buying at a premium and selling at a discount
- Generative authority
- Entitled to great **deference**

INSTITUTIONAL ANALOGIES

- Federal judicial review, e.g., Marbury v. Madison
- **Executive primacy** in foreign affairs: intrinsic authority?

ENDOGENOUS GROWTH OF FED'S TRADING AUTHORITY

1923 **POLICY DECISION**: Benjamin Strong's insight about open market trading of government securities

1953 **POLICY DECISION**: Bills-only doctrine for SOMA

1961 **POLICY DECISION**: Operation Twist

1962 **INTERPRETIVE**: Authority for foreign exchange transactions

1966 **INTERPRETIVE**: Reverse repurchase agreements

2008 **POLICY DECISION**: Liquidity stabilization through 'financial hospitals'

FINANCIAL HOSPITALS

Interbank liquidity stabilization 2007-2008

INPATIENT

- Maiden Lane (Bear – repurchase markets)
- Maiden Lane II (AIG – securities lending)
- Maiden Lane III (AIG – credit default swaps)

LOSS/RISK/RETURN STRUCTURE

- Fed - **senior, liquidated credit interest**
- **First loss** position (Bear $1b; AIG $1b and $5b)
- **Participating upside residual** (shared by Fed and Bear/AIG)

FINANCIAL HOSPITALS

Interbank liquidity stabilization 2007-2008

OUTPATIENT

- Primary Dealer Credit Facility
- Commercial Paper Funding Facility
- Money Market Investors Funding Facility
- Asset-Backed Money Market Fund Liquidity Facility
- Term Asset-Backed Securities Loan Facility

It Worked in Practice: Can We Make It work in Theory?

TERM: Willingness to **hold to maturity** helped to create **synthetic hedged assets**

ASSET MARKET LIQUIDITY: Reanimated **secondary** and **collateral markets** for structured finance

FIRM FUNDING LIQUIDITY: Providing credit and letting firms liquefy assets kept firms liquid.

PRICE DISCOVERY: Followed **fair value** accounting

LOSS-SHIFTING?: Fed **shielded** private investors from financial loss but it **did not shift or bear loss** – it **disappeared** the loss.

Risk of Ossified Legal Authority

Any attempt to settle **finally** upon a mode of operation and a domain of responsibility of the central bank runs the risk that actual change will make the agreed-upon rules **obsolete**. (emphasis added)

Minsky, *Financial Intermediation in the Money and Capital Markets* (1967)

DODD-FRANK RESTRICTIONS ON FUTURE LIQUIDITY STABILIZATION

NEW STATUTORY RESTRICTIONS

- Treasury approval for liquidity stabilization
- Information disclosure about stabilization programs
- Prohibition on single-entity bailout
- Collateral valuation policies
- Regulations

MARKET-MAKING DOWNSIDES

- Limits market agility when **time is of the essence**
- Increases **inter-branch politicization**
- Rules out liquidity support for **single entity**
- Compelling public disclosure of expected values may limit ability to get **best price** when laying off positions

Response to Levy Ford April 2013 LLR Report

REPORT PREMISES AND CONCLUSIONS

- **Accountability deficit** because of secrecy and lack of democratic oversight
- Fed **departed** from a classical understanding of LLR
- Fed still retains **discretion** to conduct liquidity stabilization through 13(3)

TENTATIVE CONCLUSIONS

- Fed's **anti-majoritarian mandate** justifies part of accountability deficit
- Fed's structure already includes **political checks and balances**
- What about the **next AIG,** e.g., systemically crucial single entity?

Thank You