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SPEECH

Restoring Market Liquidity in a Financial Crisis

December 13, 2007

Timothy Geithner, President and Chief Executive Officer

Welcoming Remarks at the Second New York Fed-Princeton University Liquidity Conference

Second New York Fed-Princeton Liquidity Conference ››

Welcome to the New York Fed and to this conference on liquidity. You are addressing some of the most important issues affecting financial markets today. Your timing is good, perhaps too good. We are all going to need some time and perspective before we will know enough to draw conclusions and recommendations from the events of the past six months. The conditions that led to this crisis took a long time to develop and they will take some time to resolve. I think it is appropriate, though, that as central banks act to address the challenges in markets today, we also begin to define the agenda for future research and policy.

On December 12, the Federal Reserve and several other major central banks, announced a series of actions in response to the elevated pressures in funding markets. Together, these actions provide a more flexible and potentially more effective set of instruments, alongside our conventional monetary policy instruments, to help mitigate the risks that liquidity pressures in markets going forward could pose to the broader economy. With this framework of tools, we have the capacity to calibrate our response as market conditions change.

Although the specifics vary across central banks, the approaches outlined have several important common elements. We each have taken actions to provide more financing at terms longer than overnight. We each have chosen to auction funding against a broader range of collateral, collateral other than government securities, and in our case with a broader set of counterparties. And we have activated swap lines to help the relevant central banks provide liquidity in dollars in their markets.

The initial spark to the pressures we observe in markets today was the sharp deterioration in the value of nonprime mortgage securities and the resulting increase in uncertainty about the value of a much larger amount of financial assets exposed to that risk. This was magnified by a substantial increase in uncertainty about the economic outlook and the consequences of that uncertainty for asset values and credit losses. Financial institutions faced a sharp drop in demand for a range of assets, impairing the securitization market as a source of funding. And a substantial amount of these illiquid assets were held in vehicles with implicit or explicit liquidity guarantees provided by banks. This produced a large unexpected increase in demand for funding from banks at the same time banks confronted a reduced capacity to raise financing.

As market participants have adjusted to what has been a very acute change in expectations about economic and credit risk, they have become more cautious in how they use their liquidity and capital. The symptoms of this are apparent in the high risk premia across a range of assets, as well as in the dramatic contraction in the volume of transactions for certain assets and the securities that reference those assets. Elevated term premia in the interbank market has the effect of tightening overall financial conditions, offsetting some of the impact of reductions in the target federal funds rate.

The danger this poses is the risk of an adverse, self-reinforcing dynamic in which concerns about overall liquidity magnify concerns about credit problems. As financial institutions prepare for a more challenging funding environment, in part by conserving capital, and as they anticipate the higher potential losses that would normally accompany an economic slowdown, their response, in aggregate, makes markets and the economy potentially more vulnerable to that adverse outcome. The risk is a greater contraction in the availability of credit beyond what might have otherwise occurred, with attendant risks to growth.

Monetary policy has an important role to play in addressing these dynamics in markets. By adjusting policy proactively as the risk to the outlook changes, central banks can help reduce the probability of the extreme adverse outcome. And this can positively affect the incentives that might otherwise lead market participants to protect themselves against the extreme outcome.

Central banks have been employing a range of different tools to help reduce the incentive for an excessive level of liquidity hoarding by banks that might impede an efficient flow of liquidity among banks. Although the mix of tools and approaches has varied across the major economies, each has tried to provide a more effective form of liquidity insurance to its financial institutions by expanding the capacity of banks to borrow at longer maturities from the central banks against a broader range of collateral.

The actions to address liquidity issues—those we announced this week and those that we have taken over the past five months—can help reinforce our monetary policy actions by providing greater assurance for market participants of access to funding. By allowing strong banks to borrow against collateral that they can no longer easily finance in the market, the central bank is providing an additional source of liquidity to banks as a complement to our open market operations.

The Term Auction Facility gives us a tool that lies somewhere between our open market operations and our primary credit program. It provides a mechanism for expanding the range of collateral against which we provide funds to the market—in effect to change the composition of our balance sheet—in ways we cannot do through traditional open market operations. And it does this in a way that may be more effective in mitigating a broader marketwide liquidity shortage than does the existing discount window facility, in part because of the perceived stigma in recourse to a facility that has come to be regarded as a source of funds for individual institutions facing a temporary, exceptional need for liquidity. Because the quantity of funds to be injected is known in advance, this mechanism poses fewer complications for our ability to reduce volatility in the fed funds rate around the target.

The auction facility and other measures we have taken to address market liquidity problems do not directly address the balance sheet or capital constraints facing financial institutions. Nor can they be expected directly to reduce the perceived risk in exposure to other financial counterparties. But by providing a more effective form of access to liquidity, these new measures can help reduce the uncertainty that gives institutions the incentive to secure liquidity in ways that might lead to a further deterioration on market conditions.

Major financial institutions in the United States and elsewhere entered this period of adjustment with capital substantially above the various regulatory thresholds. These capital cushions have enabled banks to expand their balance sheets as they have met contingent commitments and as the economics of other non-bank financing vehicles have deteriorated. This has been an important part of the adjustment process in markets.

We have also seen some early steps by a range of different institutions to bring new capital into the banking and financial system. This is a healthy development. It reduces the need for further asset sales to preserve capital ratios. And it gives those institutions that acted earlier and on a more substantial scale the flexibility to play a greater role in markets and in the economy going forward.

Finally, let me say something about future challenges in this area that are of special relevance to today’s conference and to the research agenda in which you are all engaged.

We are already involved in a coordinated review with other central banks and supervisors of how we should adapt policy and supervision in the wake of this financial crisis. Two issues are of particular interest in the context of this conference.

The first relates to the incentives we create, through regulation and supervision and other policies, for influencing how financial market participants manage liquidity risk. Several aspects of the existing capital framework and other parts of the policy and regulatory framework affect these incentives. In addition, the evolution of the financial system has altered the role and importance of liquidity provision by banks and how that provision of liquidity responds to different types of stress to the financial system.

The second issue relates to the tools that central banks have at their disposal for providing liquidity in ways that do support our monetary policy objectives. Do we need additional instruments that would better enable us to mitigate marketwide liquidity problems? And how can we mitigate the moral hazard risk inherent in such instruments?

Efforts are underway to address these issues both within the Fed and among our central banking colleagues around the world. We will be looking both to financial market participants and to the academic community for advice.

For now, though, our principal task is to address the challenges of the present. The Federal Reserve Act gives us broad authority to act in response to these types of conditions. We will continue to examine ways to adapt our instruments as market conditions evolve. We will do so in close cooperation with other central banks, as indeed we have since August. And we will do so in the tradition of pragmatism and flexibility that has been one of the defining features of the central bank of the United States.

Thank you.

I would like to thank Jamie McAndrews and Meg McConnell of the Federal Reserve Bank of New York for assistance and comments.