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Yale Program on Financial Stability Lessons Learned

Nathan Sheets

By Yasemin Esmen and Rosalind Z. Wiggins

Between 2007 and 2011, Nathan Sheets was director of the Division of International Finance at the Board of Governors of the Federal Reserve System. He oversaw the operations of the division and advised the Federal Open Market Committee (FOMC) on economic and financial developments in foreign countries. Sheets also regularly represented the Federal Reserve Board at international meetings and in its contacts with foreign central banks. Under his helm, the division was involved in helping establish and manage the US dollar liquidity swap lines with foreign central banks. This Lessons Learned abstract is based on an interview with Sheets on December 11, 2019; the full transcript may be accessed here.

The world's financial system is interconnected. Strong collaboration among US institutions, foreign central banks, and international organizations is key to managing a crisis.

The crisis began in the US financial system, and its effects slowly migrated to other countries, but at first it was viewed as a US problem. Sheets recalled: "When the crisis first erupted, particularly in Europe, it was viewed as a US crisis with some spillovers into the European markets." However, in late 2007, he pointed out, building tensions, spikes in the Libor-OIS spread, and volatility in the fed funds rate were clear signs that the effects had already spread widely, and that global financial markets were desperate for US dollar liquidity. The swap lines and some other tools were necessary to get funds where they were most needed.

At first, Sheets recalled, the European Central Bank (ECB) adopted a laid-back position with respect to the swap line (the first the Fed implemented)—"Originally, the European Central Bank wanted the swap lines structured in a way that made it seem like the ECB was only passively acting as an agent for the Federal Reserve in Europe." However, after the Lehman Brothers bankruptcy in September 2008, there was no question that the impact would be widespread. There were "enormous global spillovers, [and] there was a broader realization that there would be adverse spillovers to other parts of the world, and that other parts of the world had similar kinds of underlying problems in their financial system."

At that point, Sheets explained, "the ECB really became a partner with the Federal Reserve in fighting the crisis," and, in general, the cooperation between the major economies increased:

> It was a little bit uneven and it was a little bit choppy in terms of the global ownership of the crisis and, to some extent, even the global coordination during that first year. However, once you hit that Lehman inflection point, all central banks were 100% in and full partners in fighting the crisis. It was a realization that, yes, maybe there were certain US-oriented features to this, but it was transmitting and escalating around the world because regulatory policies in essentially all of the major economies, at least in advanced economy jurisdictions, had fallen short.

Sheets spoke highly of the extraordinary steps taken by the major countries; the multifaceted coordinated actions eventually stemmed the tide:

> From the swap lines that were introduced in December of 2007 all the way through to the uncapping of swap lines,[1] from the associated policies that were put in place after the Lehman collapse, to the G-7 declaration, where the G7 countries essentially jointly guaranteed the liabilities of their banking systems, which was an extraordinary intervention, none of these interventions had an immediate conclusive effect on the stresses that were being felt and that characterized the financial crisis. However, all of those things put together laid the foundation for an improvement of conditions which we finally saw in the first half of 2009. . .

According to Sheets, the swaps and other actions were well received by the markets: "The market seemed in particular to take heart from the message that the major central banks were aware of the challenges and were working closely together to address the stresses. That was received and was appreciated by market participants."

The structure and price of central bank swap lines can protect the lending central bank and mitigate against moral hazard while effectively providing its currency to financial institutios in other countries.

Sheets recalled that, although the Fed had taken some early steps in 2007 to ease funding conditions and increase liquidity, "it was not clear that this liquidity was getting to the European institutions that were hungry for it as directly as it might." Building tensions; spikes in the Libor-OIS spread, which was an indication of tightness in funding markets; and volatility in the fed funds rate were clear signs that the global financial market was desperate for liquidity, and this led to consideration of the swap lines.

Sheets noted that there was robust discussion in FOMC meetings about the need for the swap lines, whether they would encourage moral hazard, and their risk to the Fed. The FOMC concerns regarding risk and moral hazard were addressed in the structure and price of the lines. The Fed lent to the central bank, not to individual banks in the foreign jurisdiction, explained Sheets: The foreign central bank would then use "its regulatory, supervisory, and other tools to evaluate the credit worthiness of the institutions [in its jurisdiction] that were applying [for loans]." According to Sheets, this structure allowed the Fed to rely on the foreign central banks and their knowledge of their domestic banks while limiting its risk. The Fed was not a party to the loan to the domestic commercial banks, Sheets noted:

[1] In total, during the crisis, the Fed established swap agreements with 14 countries of various sizes. Shortly after the Lehman Brothers, the Fed uncapped its swap lines with five major central banks: the Bank of Canada, the Bank of England, the Bank of Japan, the ECB, and the Swiss National Bank, committing to provide any amount of US dollars that the central banks requested, secured by an equivalent amount of their domestic currency. The swap lines were the most heavily used of all the Fed's crisis facilities and reached a peak outstanding amount in October 2008 of more than $580 billion. A Bank for International Settlements study considered the Fed swap lines to be "very effective in relieving US dollar liquidity stresses and stresses in foreign exchange markets." *Central bank co-operation and international liquidity in the financial crisis of 2008–9* (BIS: May 2010). https://www.bis.org/publ/work310.pdf

> That feature of the structure of the lines was also seen, very importantly, as protecting the Federal Reserve's balance sheet, because the Federal Reserve had exposure to a major foreign central bank, not to any individual institution. If, indeed, some institution had failed, the foreign central bank would have had an exposure to deal with, but that foreign central bank would still have been responsible for unwinding the swap with the Federal Reserve.

Another important factor of concern to the FOMC was moral hazard, which was addressed through the pricing, Sheets said:

> The moral hazard concerns were partially attenuated by the pricing of the liquidity. It was priced above what the liquidity would have cost during normal times, and indeed, as the crisis ended, the rate on the swap line was reduced. So, there was pricing to help with the moral hazard.

The combination of these features, explained Sheets, helped protect the Fed and prompted appropriate, but not abusive, use of the lines.

We need to learn the lessons from the last crisis to be better equipped to deal with the next one.

Sheets identified several lessons that he viewed as critical for making sure that the world's regulators are prepared for the next crisis.

First: Be more curious in an aggressive and thorough manner. Dig deeper than usual. "We must ask what is going on and why, what the underlying drivers are, and not just assume that the markets are allocating optimally."

Second: Strengthen regulation. We need to make sure banks are sufficiently capitalized to maintain a strong regulatory system. And "as we strengthen regulation, [we need] to also make sure that the support for regulation does not get meaningfully watered down—because that tends to be a bit like a swinging pendulum over time."

Third: Develop a familiarity with history, an awareness of what went wrong during the crisis and of how we addressed it. Almost inevitably, shocks are going to happen. "It is really important that the next round of policymakers be aware of, and conversant with, what we did and why, and where they think we got it right and where they think we could have done better."

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