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YPFS Lessons Learned Oral History Project: An Interview with Steven Kamin

Steven Kamin

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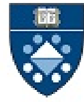

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Lessons Learned Oral History Project Interview

Interviewee Name and Crisis Position	Steven B. Kamin[1] Deputy Director, Division of International Finance at the Board of Governors of the Federal Reserve System
Interviewer Name	Yasemin Sim Esmen (Contractor) Yale Program on Financial Stability
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Introduction

The Yale Program on Financial Stability (YPFS) contacted Steve Kamin by email to request an interview regarding Kamin's time as the Deputy Director of the Board of Governors of the Federal Reserve during the 2008-2009 financial crisis. [2]Kamin was the Deputy Director of the Program Direction Section – International Finance at the Federal Reserve at the time of the crisis. The division is "responsible for basic research, policy analysis, and reporting in the areas of foreign economic activity, U.S. external trade and capital flows, and developments in international financial markets and institutions."

The Federal Reserve responded to the financial crisis as early as 2007. It implemented a number of programs to support the markets. One of the aims of these programs was to ensure liquidity among financial institutions. Among the tools used to ensure liquidity was bilateral currency swap agreements with 14 other central banks. These swap arrangements helped the foreign central banks in their readiness of dollar liquidity so they could act as lenders of last resort to the banks in their jurisdictions.

Kamin is currently the Director of Program Direction Section – International Finance at the Federal Reserve in Washington D.C. His research focuses on open economy macroeconomics, international finance, and development economics.

Kamin joined the Federal Reserve as a senior economist at the Board of Governors of the Federal Reserve System in 1994. He then became chief of the International Development Section, the Assistant Director and later Associate Director of the Federal Reserve System before becoming its Deputy Director in 2008. He has been its director since 2011.

This transcript of a phone interview has been edited for accuracy and clarity.

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[1] The opinions expressed during this interview are those of Mr. Kamin, and not those any of the institutions for which the interview subject is affiliated.
[2] A stylized summary of the key observations and insights gleamed from this interview with Mr. Kamin is available in the Yale Program on Financial Stability's *Journal of Financial Crises*.

Transcript

YPFS: **Did you see the global savings glut as it has started to happen? Because this seems to have affected many countries quite a bit. Were there any indicators?**

Kamin: The answer to that is yes, although the savings glut was, if not fully understood, people clearly knew something was going on. When you say "before," do you mean before the global financial crisis started?

YPFS: **Yes.**

Kamin: Chairman Bernanke gave a speech, around 2005 or 2006, where I think he may have coined the phrase "global savings glut" and talked about the excess of savings around the world and how it was putting a downward tilt to global interest rates. I had been doing a research with a colleague of mine, Joe Gruber, that also discussed the global savings glut and its impact on current account balances. So, the fact that there was a lot of extra capital floating around, I think, was reasonably well understood before the global financial crisis. The implications of it were not so fully understood and they probably are not fully understood today.

YPFS: **Sorry, you said "it is not fully understood even today?"**

Kamin: Let's put it this way, it remains a matter of debate as to what extent and how the global savings contributed to the global financial crisis. Some people believe it was a primary factor. Basically, it did so by creating a lot of savings that were intermediated in our financial system, going into mortgages that were not always well advised and leading to the crash in the financial system.

Other people believe that the fault lies in the fact that the regulation was too loose over the period, that there was the development of poorly understood financing tools, like asset-backed securities (ABS) and that is what led to the crisis. Still other people blame it on excessively loose Federal Reserve monetary policy. So, there is a lot of controversy over what caused the global financial crisis. Some people would pin that on the global savings glut, others would not.

YPFS: **How did the Federal Reserve react to the crisis? Why did they decide to institute dollar swaps early on in the crisis?**

Kamin: As you know, as the crisis unfolded, the Federal Reserve developed a very wide array of tools to address the crisis. Most of those were domestic: development of the Term Auction Facility (TAF) in order to provide liquidity quickly without stigma to financial institutions, there were interventions to get the

commercial paper market functioning, there was actual interventions to help ailing banks and investment banks.

So, there were a very wide array of different measures, all of which were taken in order to keep the financial system functioning. The creation of the dollar swaps was one of those many tools. It had a more international dimension than the others and the purpose of it was to ensure that banks abroad could get the liquidity that they needed in order to continue to function and, among other things, to continue to lend in the United States, because you had a lot of foreign banks that were funding in dollars and lending in dollars.

Then, with the crisis, the ability to borrow in dollars became much more attenuated because people would not lend. And these are banks that had a lot of dollar assets but not so much dollar liquidity and a lot of their liquidity was in local currency. So, this was a mechanism to channel liquidity through their central banks abroad to get the dollars to their hands so that they could continue to lend in the United States and elsewhere, and so the global financial system could continue to function.

YPFS: **Did it work?**

Kamin: Broadly speaking, yes. Let's put it this way: That, along with all the other measures, kept the global financial system from collapsing, kept it functioning, kept dollar lending in United States and elsewhere flowing, and prevented widespread bankruptcies. Did it work as well as it might have? Well, that is hard to know, but I think it did a pretty good job.

YPFS: **Can you comment on the importance of communication and coordination between the central banks around the globe? Why is that important? Why will it be important?**

Kamin: Well, let's put it this way: If you think that the dollar swaps were important, and I think they were, although, as I said before, they were not the only tool but one of many, [you should also realize that] those arrangements could not just materialize out of thin air. In other words, they had to be arranged between all the different parties. In the end, there were 14 central banks that received dollar swap lines. In all those cases you had to have the Federal Reserve cooperating and coordinating with other central banks in order to create these facilities.

Besides the swap lines, as you may recall, in October of 2008, in the turmoil following the Lehman Brothers' bankruptcy, with global markets in turmoil and global economic activities starting to plunge, major central banks cooperated on a coordinated interest rate cut, which was very unusual if not unprecedented.

The purpose of that was basically to not only reduce interest rates in order to support economic activity, but also send a very strong signal that global authorities were cooperating in order to respond forcefully to the crisis. So, again, that took a great deal of coordination and speaks to the importance of central banks and other authorities communicating with each other.

I would also add that as a response to the global financial crisis, other authorities under the aegis of the G20 were getting together and coordinating support via fiscal policy, global activity. So, again, in situations where you have global challenges, coordination globally is very important.

YPFS: **The communication and the cross-country processes between the countries, have they improved since the crisis?**

Kamin: I do not know how to answer that because I feel, certainly amongst central banks, the lines of communication were pretty well established even before the crisis. I would say that it was the swift lines of communication before the crisis that permitted the types of global responses that I was referring to before.

Now, of course, coordination is not just about monetary policy and it is not just about liquidity policy. There is also a great deal of coordination that goes on amongst supervisory authorities to have globally coordinated regulations, as can be seen with the Basel Committee on Banking Supervision. However, that, too, was already in process beforehand. I am sure that our communication among national authorities is as good today as it was before. I am sure it is not worse, it might be better, but, as I said, the communication was pretty good even at the time.

One sort a difference, the biggest perhaps, between now and 15 years ago, is that the G20 has become a more important forum. What that means is that there is probably strains in communication among a broader group of countries now than there was 15 years ago before the global financial crisis.

YPFS: **At the crisis, what happened that was unexpected?**

Kamin: I would say that everything that happened was unexpected.

Well, the one thing that might have been less unexpected was the downturn in our housing market. I am not saying that a lot of people called it for sure, or called the timing, but it was quite well-understood that there was a [housing] boom going on. Lots of people thought that could be followed with a bust, that is pretty natural. But did we expect BNP Paribas to suspend its redemption policy in the summer of 2007? No. Did we expect markets to subsequently freeze up? No. Did we expect the recession by the beginning of 2008? No.

Almost everything that happened was, to some extent, a surprise. Otherwise, we would have hopefully been able to stop it. Certainly, neither Lehman Brothers nor the market reaction to Lehman Brothers was expected, nor the severity of the global downturn that followed. Then finally, nor did most people expect the Euro crisis that erupted a couple of years later (more or less as a consequence of the global financial crisis) to take place. So, as I said, almost everything was unexpected. You will always find some people that did predict it, but most people did not.

YPFS: **One question that arose as we were talking: So, there was a bust expected, especially in the housing market in the U.S., because it was a little too "euphoric." But the level of it, the level of the bust, was not anticipated. Did I get that right?**

Kamin: I do have a paper on this. The reason that I am mentioning this paper is that it has an incredibly relevant title: "How Did a Domestic Housing Slump Turn into a Global Financial Crisis?" [3] It is very relevant to your question.

[In the paper] we looked at a bunch of countries that have a lot of U.S. mortgage-backed securities (MBS.) We found that there was little evidence of direct contagion from the United States to abroad. As we describe in the abstract: "Accordingly, channels of 'indirect contagion' may have played a more important role in the global spread of the crisis: a generalized run on global financial institutions, given the opacity of their balance sheets; excessive dependence on short-term funding; vicious cycles of mark-to-market losses driving fire sales of mortgage backed securities; the realization that financial firms around the world were pursuing similar flawed business models; and global swings in risk aversion."

The last sentence of the paper's abstract is: "The U.S. subprime crisis, rather than being a fundamental driver of the global crisis, may have been merely a trigger for a global bank run and for disillusionment with a risky business model that already had spread around the world." In a more "normal" financial environment that was not subject to a great deal of leverage, a great deal of entanglement, very complicated and hard-to-understand instruments, a lot of exuberance, and probably a lot of insufficient supervision and regulation, the U.S. housing bust would not have had such adverse effects around the world. However, what happened was that there had been the development of this huge global structure of financing all built around asset-backed securities, which people did not really quite understand, and they also did not understand the connections between different counterparties.

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[3] Steven B. Kamin and Laurie Pounder DeMarco. 2010. "How did a Domestic Housing Slump Turn into a Global Financial Crisis?" FRB International Finance Discussions Paper No. 994. April 7, 2010. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1585195.

They did not understand the risks. ABS, asset-backed securities, ended up being the fundamental collateral that was underpinning a great deal of the transactions in the financial system. Then what happened was that the housing bust occurred, lowering the value of a lot of mortgages, and thus a lot of mortgage backed securities. Then, when banks and other financial institutions started to basically try to reduce redemptions of these securities because they were hard to value, which is what happened with BNP Paribas, all of a sudden the value of these securities came into question and the whole global financial system kind of grounded to a halt.

I think that really was the essence of the crisis: This run on these newfangled instruments, and the housing bust was really just the trigger for that. First of all, the housing boom was one of the drivers of the development of the boom in asset-backed securities and the housing bust triggered the paralysis of the financial system.

Now, as I said, other people might have other explanations, but that is the one I am partial to.

YPFS: **And it spreads so much because there were a lot of entanglement, not enough supervision, and people did not really understand it.**

Kamin: Let's put it this way: First, all economies and all financial systems that were heavily integrated into this system of short-term asset-back finance, were immediately affected when that system of finance froze up. Those are the United States, United Kingdom, Germany, and a lot of other advanced economies.

One of the things that I think we did not understand before as well as we know now, and I certainly learned a lot from, was the fact that the freezing up of the financial system had immediate effects in terms of going from Wall Street to Main Street. All of a sudden, car loans were not available, business working capital loans were not available.

So, you had a very fast reaction of the real economy to the freeze up in finance. That, through the global supply chains and global trade networks that are an important part of our global economy, meant a very rapid response to the crisis in the countries that were at the center of the financial crisis, spreading to a lot of other economies that really were not part of the financial crisis but ended up getting hit anyway. Those included manufacturing centers in emerging Asia, and then, through commodity prices, the emerging market economies in Latin America.

So, it started as a financial crisis, and the seizing up of finance led to a sharp retraction of economic activity in the core countries like the United States and

Europe, and that spread much faster than one could have imagined to the emerging market economies.

YPFS: **Were there any common characteristics among the countries that suffered the most in the crisis? You mentioned that producing countries in Asia got affected and then commodity countries in Central America, for example, got affected. But were there any other characteristics, any common vulnerabilities?**

Kamin: The countries that were at the core of the crisis, the United States, the U.K. and many parts of Europe, were the ones that were most fully integrated into the evolving system of asset-backed security finance, coupled with highly leveraged activity by banks, including their extensive involvement in investment banking activities, and involvement in, to varying degrees, the whole shadow banking system of asset-backed security finance.

These countries at the core were also countries, in large part that had pursued deregulation to greater or lesser degrees.

By comparison, Canada, which had relatively few banks that were much more closely regulated and pursued less risky and less leveraged activities, was not hit so hard. Japan is another case of a country where its banks did not participate as fully in this system of ABS, and, again, whose banks tended not to become as leveraged, and they were hit less hard.

Then, of course, I have mentioned all of the emerging market economies, who, again, had not really participated fully in that financial boom that proceeded the global financial crisis. What happened was that, in the first couple of quarters after the crisis, it looked like the whole global economy got hit equally hard.

However, the countries that were at the core of the financial crisis basically recovered less quickly than the ones that were more at the periphery of that crisis, particularly the emerging market economies. Those bounced back relatively quickly. Whereas United States, the Euro area, and the U.K. took a lot longer to bounce back. As memory serves, Canada, again, came back quicker than other countries.

YPFS: **How did the European response to the crisis differ from the American response? I say European because they use a common currency. And did they recover and how did they recover if they did recover? Or is the crisis still going on today?**

Kamin: By European, do you mean all of Europe including the U.K. or are you thinking mainly in the Euro area?

YPFS: **You decide, you are the expert.**

Kamin: One of my impressions is that in some ways, the initial response to the crisis, in terms of monetary stimulus and even fiscal ones were not that different here and abroad, in the sense that, like in Europe, like in the U.K., and I think also the Euro area, there were already facilities to lend to banks more readily than in the United States. I think in both the U.K. and in the Euro area, lending to banks was one of the tools of monetary policy in a way that was not quite as entrenched in the U.S. So, part of the Federal Reserve's job was to figure out how to get the liquidity into the financial system more quickly. That was something, if memory serves, that happened more readily in Europe.

Secondly, all countries, both in the U.S. and abroad, certainly ended up increasing their fiscal outlays in response to crisis. A lot of that, of course, was automatic, when economy falls and there is less revenue coming in, the fiscal deficit automatically gets large. That happened everywhere. That shows that stimulus is also important.

What a lot of observers put weight on was what happened after the first phase of the crisis moved on. In the United States, we have been much more active earlier on in improving the leverage situation of banks. In other words, by strengthening the banks by increasing capital as well as via the stress tests by ensuring they have had adequate liquidity, adequate risk capital and risk management.

Meanwhile, that process certainly took a lot longer in Europe, particularly in the Euro area, where it took years for them to really get at the problem of evaluating the strengths of their banks and putting in corrective measures. I think that was partly because those banks were weaker to start with. So, that, I think, is an important difference in our responses: the rapidity with which we pushed for reforms of the banking sector.

Another important difference, again in the later phases of recovery rather than the earlier phase, were the Federal Reserve's quantitative easing policies, as well as forward guidance policies. The Bank of England went into that pretty quickly, but the Euro area followed suit with much more of a lag.

So, there, we were a lot quicker to provide the stimulus to the economy needed. I would say that those are some key differences. Now, of course, in the case of the Euro area, they ended up having to deal with the second wave of the crisis, the Euro crisis, that we did not have to deal with. That involved lots of constraints on them as well as lots of different measures that we did not have to implement.

YPFS: **Do you think that is somehow connected to their not responding as fast as Americans have?**

Kamin: Well, certainly. In the case of United States, our fiscal balance expanded a great deal. Because the basic fundamentals of our fiscal situation were pretty decent and because the measures were put in place, which may or may not have been fully appropriate to cap our spending, we never faced a fiscal crisis. In Europe, like us, deficits went up everywhere, and then that in turn led, after the discovery of problems with the Greek statistics to the Euro area crisis, to a situation where a number of their economies actually had to be fiscally contracting and there was a huge increase in risk aversion, which made finance very difficult.

In the absence of that crisis, I think they would have definitely had an easier time of it and they would have recovered more quickly. Now, one could ask whether, if the European Central Bank (ECB) had started to do quantitative easing much earlier, like when we and the Bank of England did, might that have helped to either forestall the Euro crisis or at least make it less deep? And I would say that is something that people could think about, but I do not have a good answer to that.

YPFS: Is there anything that you would like to add?

Kamin: Most of the questions you have asked, first of all, were excellent questions and I think quite useful, they tended to be all about the response to the crisis. Going forward, we want to prevent these crises from happening again. So, a lot of the focus in terms of our planning for the future should be not only in terms of crisis response, but also in terms of monitoring vulnerabilities in the financial system in order to prevent the eruption of new crises. That is why the Federal Reserve has started to publish its financial stability report twice a year, which provides an assessment of financial vulnerabilities in our system.

The other thing that you did not ask about, but it is something we are thinking about and references back to your first question, is the global savings glut.

Before the crisis started, when the US had very large current account deficits, there were a lot of observers who thought that those deficits were our key vulnerability and they were worried that, because our deficit was so large, the dollar would have to fall a lot and that fall on the dollar would trigger a financial crisis. We did have a financial crisis, but it was not as a result of a dollar crisis. It was, instead, because of all the reasons we have talked about. At the end, the dollar ended up strengthening, not depreciating. That is another interesting dimension to the issue.

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