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Yale Program on Financial Stability

Lessons Learned

Seth Carpenter

By Maryann Haggerty

Seth Carpenter was a senior staff member of the Division of Monetary Affairs at the Federal Reserve Board during the 2007–09 Global Financial Crisis (GFC), meaning he was part of the team that advised the Board of Governors and members of the Federal Open Market Committee (FOMC) in setting monetary policy. He led the Board team that worked daily with the Open Market Trading Desk at the Federal Reserve Bank of New York to implement policy. He left the Federal Reserve System as deputy director of monetary affairs in 2014 to work at the US Department of the Treasury, where he became the acting assistant secretary for financial markets. This summary is based on an interview with Carpenter that took place on July 30, 2020; the full transcript may be accessed here.

Circumstances evolve: Tools should, too.

While many discussions of the GFC focus on 2008, the "real flashpoint" for the monetary affairs staff was August 2007. Carpenter recalled that "there was acute tightening and liquidity conditions in money markets after a couple money funds shuttered." He noted:

> We ended up—it was a Thursday and a Friday, so August 7th or 8th or in there—doing what at the time was an extraordinarily large open market operation for a single day. Now it kind of looks quaint in comparison, but I think we did something like a $9 billion operation on the Thursday and a $20-something billion operation on the Friday to try to reduce the pressure in, especially, overnight dollar funding markets.

Then the Fed's actions took place mostly through open market operations, adding cash liquidity via the repurchase agreement (repo) markets. At the time, there was a perception of stigma attached to banks borrowing short-term through the Fed's discount window. But markets still needed liquidity. Because of this, the Fed developed new innovative facilities. Carpenter pointed out:

> Over the course of 2007, the Term Auction Facility was developed and the theory of the case was that we can to lend to the banks and try to solve the stigma problem by the structure of it. If everybody understood that this is a facility where you have to bid, so it looks like a market-determined price, where it settles on a forward basis so it doesn't look like anyone is showing up on the day having been caught short, this is just a way of prudently planning for liquidity provision. Then if you do both of those together, the theory of the case was it should reduce stigma because it doesn't look like anybody's in bad shape through borrowing because they can and it's available, and not because they have to or they don't have any other choice.

As Carpenter explained, "the original thought was it seems like there's a problem. Let's use the tools that are currently at our disposal. Once those are in place, also think about trying to develop new tools within the legal framework that we have." He continued:

> Then what we saw over time was that those new tools that were developed got progressively further away from the status quo ante, so the first step, doing what at the time seemed like very large repo operations . . . The small step away, I mean, it's the same tool with the same counterparty. It was just much larger in size. The term auction facility was a further step away. The Fed had since time immemorial lent directly to banks, but never in that structure, and in a way to try to mitigate the stigma. Then obviously as we get into 2008, the steps away from the earlier status quo got bigger and bigger.

As time went on, the Fed developed a number of different ways to add liquidity—notably the Primary Dealer Credit Facility and the Term Securities Lending Facility—and eventually to rescue Bear Stearns and American International Group (AIG).

Go early and go big: Crises call for quick, impactful policy reactions.

The importance of a speedy policy reaction became evident in 2007 and 2008, Carpenter said, and was evident again in 2020.

> Speed matters a lot. When markets start to freeze up, what is initially a liquidity problem can turn into a solvency problem. I think that's a key lesson learned. It also means that I think what we've seen in the past six months or so [of 2020] is that the longer you wait, often the more you end up having to do in terms of restoring liquidity and restoring market functioning. I think we may have seen that coming out of 2007, 2008, because it was initially very incremental, trying to put out one fire after another. As a result, we ended up continually expanding the facilities . . . as opposed to jumping to something bigger earlier on. I think the lesson learned is going bigger earlier is probably a safer route.

Carpenter reflected on the government's 2020 COVID-19 response:

> We get to March [2020] and there's illiquidity in the Treasury market. Yeah, again, I think the lesson that could have been learned a little bit better, is go early and go big.
>
> What they did first in March was to go into the markets with a specific dollar amount that they're going to go up to, and the market said, "Huh, that's not nearly enough," and the illiquidity persisted. Eventually, the Fed dropped the dollar amount that they were willing to do and just started buying massive amounts and eventually liquidity was restored.

Especially in a crisis, multiple perspectives help: Constant dialogue is critical.

Every business day, the Washington-based monetary policy staff of the Board and the New York–based staff of the Open Market Trading Desk (known simply as the "Desk") discuss

specific operations needed to support monetary policy. The Desk conducts trades with primary dealers, who are the government securities dealers with which it has established trading relationships. That constant back-and-forth between people with different perspectives helped improve the Fed's response, according to Carpenter.

> I think the other lesson learned is just the critical need for constant dialogue to understand what positions the big players have, to understand the interconnectedness of the system. We were doing a lot of learning as it was going on. There was often a mindset in the Fed that markets are deep and liquid and efficient, and they distribute liquidity and so you don't have to worry. Then to their credit, a bunch of my colleagues who worked on the [Desk] spoke up. They were used to thinking about the repo market, which was very heavily bilateral and on the phone and relationship driven. That mindset that they had of trying to understand, trace out the flow of the money, I think was invaluable.
>
> Over time, as the financial stability division of the Board was set up, people began to realize how critical interconnectedness was, how critical the actual specific bilateral relationships are. You see that being embodied, for instance, in some of the G-SIB [global systemically important bank] surcharges with the penalty for interconnectedness.

Appearances can deceive: Keep looking deeper.

Treasury security markets and repo markets—especially overnight repo markets—are the world's most liquid. However, Carpenter recalled:

> one of the remarkable things about March 2008 was just how difficult it was for some people to roll Treasury repo, which ought to be crazy . . . If the world is more risky, then Treasuries should be worth more, so you should be able to borrow more easily against Treasuries, not the opposite.

But complex connections among market participants skewed that math, providing "a very, very stark clear lesson to be learned." Carpenter emphasized:

> Never stop peeling back layers of the onion and thinking about who's connected to whom, how much. For instance, in the repo market, how much rehypothecation can go on? Somebody has a Treasury that they lend to get cash and then that Treasury is lent again and then that Treasury is lent again, and so that whole chain, if it has to unwind, there can be lots and lots and lots of people caught short in that unwind process. That's one thing that if I had known before, I would have always been trying to peel back the layers of the onion just one more time.

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