

Ben S Bernanke: Federal Reserve's exit strategy

Testimony by Mr Ben S Bernanke, Chairman of the Board of Governors of the Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 25 March 2010.

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Chairmen Frank and Watt, Ranking Members Bachus and Paul, and other members of the Committee and Subcommittee, I appreciate the opportunity to discuss the Federal Reserve's strategy for exiting from the extraordinary lending and monetary policies that it implemented to combat the financial crisis and support economic activity. As you know, I previously submitted prepared testimony for a hearing on this topic that was canceled because of weather conditions. I request that that testimony be included in the record of this hearing. This morning, in lieu of repeating my previous prepared statement, I would like to summarize some key points from the earlier testimony and update the Committee on recent developments.

Broadly speaking, the Federal Reserve's response to the crisis and the recession can be divided into two parts. First, our financial system during the past 2-1/2 years experienced periods of intense panic and dysfunction, during which private short-term funding became difficult or impossible to obtain for many borrowers. The pulling back of private liquidity at times threatened the stability of financial institutions and markets and severely disrupted normal channels of credit. In its role as liquidity provider of last resort, the Federal Reserve developed a number of programs to provide well-secured, mostly short-term credit to the financial system. These programs, which imposed no cost on taxpayers, were a critical part of the government's efforts to stabilize the financial system and restart the flow of credit to American families and businesses. Besides ensuring that a range of financial institutions – including depository institutions, primary dealers, and money market mutual funds – had access to adequate liquidity in an extremely stressed environment, the Federal Reserve's lending helped to restore normal functioning and support credit extension in a number of key financial markets, including the interbank lending market, the commercial paper market, and the market for asset-backed securities.

As financial conditions have improved, the Federal Reserve has substantially phased out these lending programs. Some facilities were closed over the course of 2009, and most others expired on February 1.¹ The Term Auction Facility, under which fixed amounts of discount window credit were auctioned to depository institutions, was discontinued in the past few weeks. As of today, the only facility still in operation that offers credit to multiple institutions, other than the regular discount window, is the Term Asset-Backed Securities Loan Facility (TALF), which has supported the market for asset-backed securities, such as those backed by auto loans, credit card loans, small business loans, and student loans. Reflecting notably better conditions in many markets for asset-backed securities, the TALF is scheduled to close on March 31 for loans backed by all types of collateral except newly issued commercial mortgage-backed securities (CMBS) and on June 30 for loans backed by newly issued CMBS.²

¹ The exit from these programs is substantially complete: Total credit outstanding under all programs, including the regular discount window, has fallen sharply from a peak of \$1-1/2 trillion around year-end 2008 to about \$71 billion last week.

² The TALF extends three- and five-year loans, which will remain outstanding after the facility closes for new loans. The later scheduled closing of the CMBS portion of the facility reflects the Board's assessment that conditions in that sector remain highly stressed, as well as the fact that CMBS securitizations are more complex and take longer to arrange than other types.

In addition, the Federal Reserve has been normalizing the terms of regular discount window loans. We have reduced the maximum maturity of discount window loans from 90 days to overnight for nearly all loans, restoring the pre-crisis practice. In mid-February the Federal Reserve also increased the spread between the discount rate and the upper limit of our target range for the federal funds rate from 25 basis points to 50 basis points. We have emphasized that both the closure of our emergency lending facilities and the adjustments to the terms of discount window loans are responses to the improving conditions in financial markets. They are not expected to lead to tighter financial conditions for households and businesses and hence do not constitute a tightening of monetary policy, nor should they be interpreted as signaling any change in the outlook for monetary policy.

The second part of the Federal Reserve's response to the crisis and recession, besides the provision of liquidity to the financial system, involves both standard and less conventional forms of monetary policy. After reducing short-term interest rates nearly to zero, the Federal Open Market Committee (FOMC) provided additional monetary policy stimulus through large-scale purchases of Treasury securities, agency mortgage-backed securities (MBS), and agency debt. All told, the Federal Reserve purchased \$300 billion of Treasury securities and will conclude purchases of \$1.25 trillion of agency MBS and about \$175 billion of agency debt at the end of this month. The Federal Reserve's purchases have had the effect of leaving the banking system highly liquid, with U.S. banks now holding more than \$1.1 trillion of reserves with Federal Reserve Banks. A range of evidence suggests that these purchases and the associated creation of bank reserves have helped improve conditions in mortgage markets and other private credit markets and put downward pressure on longer-term private borrowing rates and spreads.

At its meeting last week, the FOMC maintained its target range for the federal funds rate at 0 to 1/4 percent and indicated that it continues to anticipate that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period. In due course, however, as the expansion matures, the Federal Reserve will need to begin to tighten monetary conditions to prevent the development of inflationary pressures. The Federal Reserve has a number of tools that will enable it to firm the stance of policy at the appropriate time.

Most importantly, in October 2008 the Congress gave the Federal Reserve statutory authority to pay interest on balances that banks hold at the Federal Reserve Banks. By increasing the interest rate on banks' reserves, the Federal Reserve will be able to put significant upward pressure on all short-term interest rates, as banks will not supply short-term funds to the money markets at rates significantly below what they can earn by holding reserves at the Federal Reserve Banks. Actual and prospective increases in short-term interest rates will be reflected in turn in higher longer-term interest rates and in tighter financial conditions more generally.

The Federal Reserve has also been developing a number of additional tools it will be able to use to reduce the large quantity of reserves currently held by the banking system. Reducing the quantity of reserves will lower the net supply of funds to the money markets, which will improve the Federal Reserve's control of financial conditions by leading to a tighter relationship between the interest rate paid on reserves and other short-term interest rates. Notably, to build the capability to drain large quantities of reserves, the Federal Reserve has been working to expand its range of counterparties for reverse repurchase operations beyond the primary dealers and to develop the infrastructure necessary to use agency MBS as collateral in such transactions.³ In this regard, the Federal Reserve recently announced

³ Primary dealers are broker-dealers that trade in U.S. government securities with the Federal Reserve Bank of New York.

the criteria that it will apply in determining the eligibility of money market mutual funds to serve as counterparties in reverse repurchase agreements.

As an additional means of draining reserves, the Federal Reserve is also developing plans to offer to depository institutions term deposits, which are roughly analogous to certificates of deposit that the institutions offer to their customers. A proposal describing a term deposit facility was recently published in the *Federal Register*, and the Federal Reserve is finalizing a revised proposal in light of the public comments that have been received. After a revised proposal is reviewed by the Board, we expect to be able to conduct test transactions this spring and to have the facility available if necessary thereafter. The use of reverse repos and the deposit facility would together allow the Federal Reserve to drain hundreds of billions of dollars of reserves from the banking system quite quickly, should it choose to do so.

When these tools are used to drain reserves from the banking system, they do so by replacing bank reserves with other liabilities; the asset side and the overall size of the Federal Reserve's balance sheet remain unchanged. If necessary, as a means of applying monetary restraint, the Federal Reserve also has the option of redeeming or selling securities. The redemption or sale of securities would have the effect of reducing the size of the Federal Reserve's balance sheet as well as further reducing the quantity of reserves in the banking system. Restoring the size and composition of the balance sheet to a more normal configuration is a longer-term objective of our policies. In any case, the sequencing of steps and the combination of tools that the Federal Reserve uses as it exits from its currently very accommodative policy stance will depend on economic and financial developments and on our best judgments about how to meet the Federal Reserve's dual mandate of maximum employment and price stability.

In sum, in response to severe threats to our economy, the Federal Reserve created a series of special lending facilities to stabilize the financial system and encourage the resumption of private credit flows to American families and businesses. As market conditions and the economic outlook have improved, these programs have been terminated or are being phased out. The Federal Reserve also promoted economic recovery through sharp reductions in its target for the federal funds rate and through large-scale purchases of securities. The economy continues to require the support of accommodative monetary policies. However, we have been working to ensure that we have the tools to reverse, at the appropriate time, the currently very high degree of monetary stimulus. We have full confidence that, when the time comes, we will be ready to do so.