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THE FEDERAL RESERVE'S TOOLS FOR RESPONDING TO FINANCIAL DISRUPTIONS

Frederic S. Mishkin, Member, Board of Governors, The Federal Reserve System

Disruptions to the U.S. financial markets over the past year have challenged the Federal Reserve's efforts to stabilize the country's economy, according to Frederic S. Mishkin, member of the Fed's board of governors. But the central bank has risen to this challenge, he said, "acting in a decisive, timely, and flexible manner in fostering the objectives of price stability and maximum employment." These actions comprise four tools. Three of them—open market operations, overnight lending through the discount window, and the term auction facility—support market liquidity. The fourth—changing the target federal funds rate—addresses macroeconomic risk.

- **Open Market Operations.** Mishkin noted that this is the most powerful and often-used tool to keep the federal funds rate close to the Federal Open Market Committee's target rate. Although the Fed could accomplish this by buying or selling any type of asset, Treasury securities are ideal, he said, because the central bank can access them quickly, conveniently, and in whatever volume it needs to keep the federal funds rate near the target rate.

- **Overnight Lending through the Discount Window.** The Federal Reserve makes available to banks fully collateralized overnight loans via the lending facilities at each of the regional Federal Reserve Banks. These facilities are known as the discount window. Mishkin noted that unlike open market operations, loans through the discount window are made directly to individual institutions with specific needs for liquidity and can be made against a wide range of collateral. But the loans do have two limitations. First, fear that others in the market might perceive overnight loans as a sign of shaky financial condition may prevent some banks from borrowing, thus reducing the discount window's effectiveness in easing money market strains. Second, borrowing may be difficult to predict during periods of financial market disruption, complicating the Fed's efforts to keep the federal funds rate close to its target.

- **Term Auction Facility.** Introduced in December 2007 to ease year-end pressures, the term auction facility (TAF) allows the Fed to auction off to eligible borrowers a pre-announced amount of credit for a longer period than overnight. The first two auctions involved a term of one month. Both auctions were successful, attracting a large number of

banks and a high total value of bids. And because the amounts to be auctioned off were predetermined, Mishkin said, there was minimal uncertainty about how the operation affected bank reserves. Isolating the TAF's impact is not easy, he noted, but term markets' interest rates "provide some evidence that the TAF may have had significant beneficial effects on financial markets."

- **Changing the Target Federal Funds Rate.** The Fed responded aggressively to macroeconomic risk by cutting the target federal funds rate—by 1 percentage point in fall 2007 and another 1.25 percentage points in January 2008. But financial and economic conditions can change quickly, he noted. And the Federal Reserve must be as concerned with inflation, which is significantly influenced by the public's expectations about what will happen, as it is with growth. Thus, "the central bank must be ready to hold steady or even raise the policy rate if the evidence clearly indicates a significant rise in inflation expectations."

"While the current strains in financial markets are likely to persist for some time," Mishkin concluded, "there have been instances when financial markets have turned around quickly, and we must be prepared for such a possibility in this instance."

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(603) 646-0556; intl.business@dartmouth.edu