Lessons from the Crisis and Post-Crisis Experience

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Any views expressed here are my own and do not represent those of the D. E. Shaw group.
1. **The Fed needs to have an effective set of standing tools for providing liquidity.**

   - The Fed showed remarkable innovation during the crisis.
   - But that success came mostly from introducing new facilities rather than from standing facilities.
   - And the Fed faced several constraints that might have slowed its response.
   - Framework should be able to more effectively provide liquidity to the banking sector through standing facilities.
   - Also important to consider whether facilities should include a wider set of counterparties.
Liquidity Provision During the Financial Crisis

2. The Fed needs to have the capacity to do large-scale asset purchases.

- Asset purchase programs can be an effective policy instrument
- Central banks need to retain the option to do asset purchases because of the lower bound on short-term interest rates
- Operational capacity to do LSAPs should be maintained
- Framework should allow a smooth transition to an expanded balance sheet
Fed's Holdings of Treasury Securities

3. **The Fed should consider a larger balance sheet in steady state, with the policy rate managed in a floor system.**
   - Key aspect of framework debate will be whether to operate in floor or corridor system
   - Possible to have large steady-state balance sheet and rely on IOER and RRP to control the policy rate
   - There are some advantages to maintaining large balance sheet (more liquidity in the financial system)
4. The composition of the Fed’s steady state portfolio of Treasuries should be optimized.

- Before the crisis, the Fed’s balance sheet holdings were governed by Treasury issuance patterns
- Fed should optimize the composition of its Treasury holdings for policy-oriented objectives
- Argument for holding bills: provides flexibility to drain quickly if needed
Anticipated Adjustments to Fed's Treasury Holdings

5. **The Fed can effectively control the policy rate even with a large balance sheet.**

- Control of short-term interest rates is most important aspect of framework; Fed needs to have an effective floor
- Fed has demonstrated impressive control of short-term interest rates
- Allows it to make decisions about balance sheet without compromising control of monetary policy
- IOER alone does not provide a hard floor, but the combination of IOER and RRP seems to be working well
Behavior of Short-term Interest Rates Since Lift-off

### Short-Term Interest Rates

<table>
<thead>
<tr>
<th>Source: Bloomberg, BNY Mellon.</th>
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#### Median Expectations from FRBNY Primary Dealer Survey, 12/7/2015

<table>
<thead>
<tr>
<th>Rate Type</th>
<th>Immediately After Lift-off</th>
<th>1 Year After Lift-off</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fed IOER Rate</td>
<td>0.50%</td>
<td>1.25%</td>
</tr>
<tr>
<td>Effective Fed Funds Rate</td>
<td>0.34%</td>
<td>1.11%</td>
</tr>
<tr>
<td>Treasury Tri-Party O/N Repo Rate</td>
<td>0.30%</td>
<td>1.06%</td>
</tr>
<tr>
<td>Fed O/N RRP Rate</td>
<td>0.25%</td>
<td>1.00%</td>
</tr>
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Source: Federal Reserve Bank of New York.
Immediately After Liftoff

1 Year After Liftoff

O/N RRP Demand

$300 bn

$350 bn

O/N RRP Cap

$600 bn

$450 bn

Median Expectations from
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Source: Federal Reserve Bank of New York.
6. **RRPs should be a regular part of the Fed’s policy framework.**

   – Hard to understand the desire to phase out RRPs as quickly as possible
   
   – Concerns about the Fed’s footprint in markets were not fully explained
   
   – Best framework for ensuring effective control of short rates probably involves combination of RRP and IOER
   
   – Current configuration of administered rates has some shortcomings
7. **The Fed should consider an alternative target variable.**
   - The federal funds market currently has a limited amount of activity
   - If want an unsecured rate, the OBFR likely dominates the federal funds rate
   - Fed could also consider a secured rate or its administered rates as the target
   - Fed likely has concern about a broader configuration of money market rates beyond its single target variable
8. The Fed should clarify if negative rates are part of the policy toolkit.

- Prospect of negative interest rates is already affecting market prices
- Fed could communicate whether negative rates are part of the toolkit and indicate the threshold to which they would be willing to adjust rates
- Knowing the Fed’s views on negative rates would help markets more efficiently price policy prospects
Market Pricing of Negative Rate Outcomes

*Based on options on eurodollar futures contracts. Source: Bloomberg.*