ECONOMICS MADE EASY 09

A Journalism Workshop

Understanding Credit Policy

John Weinberg

October 21, 2009

THE FEDERAL RESERVE BANK OF RICHMOND
RICHMOND • BALTIMORE • CHARLOTTE

An Oversimplified Description of the Credit Crisis

- In 2007, it became apparent that significant losses on housing-related assets were likely.
- These losses would require a wide array of financial institutions to deleverage or meet liquidity needs by selling assets, further depressing asset prices.
- Depressed asset values constrain lending to and spending by businesses and households.
  - Lenders' capital
  - Borrowers' collateral

THE FEDERAL RESERVE BANK OF RICHMOND
RICHMOND • BALTIMORE • CHARLOTTE

2

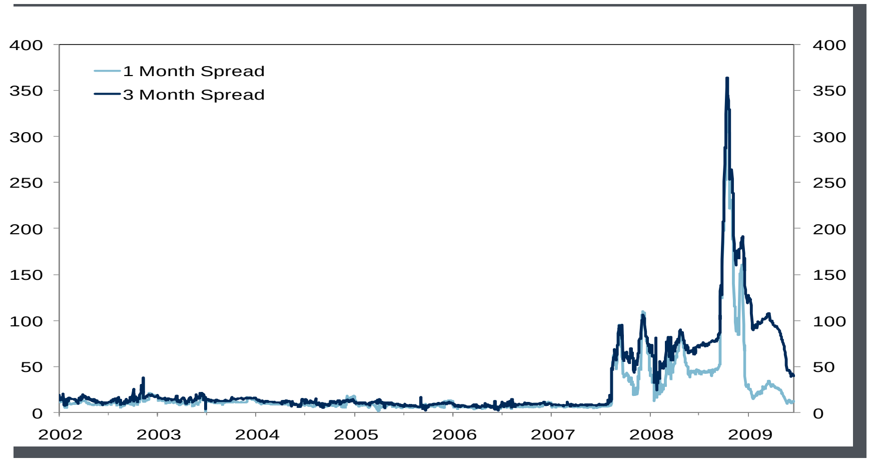
A Different Oversimplified Description of the Credit Crisis

- In 2007, it became apparent that significant losses on housing-related assets were likely.
- Uncertainty about the size and distribution of these losses depressed asset prices and made “wholesale” credit more risky.
- Uncertainty, depressed asset prices, and a large housing inventory overhang contribute to a severe slowdown in overall economic activity.
- Slower economic activity makes “retail” credit more risky and reduces the flow of credit.

THE FEDERAL RESERVE BANK OF RICHMOND
RICHMOND • BALTIMORE • CHARLOTTE

3

LIBOR-OIS Spread

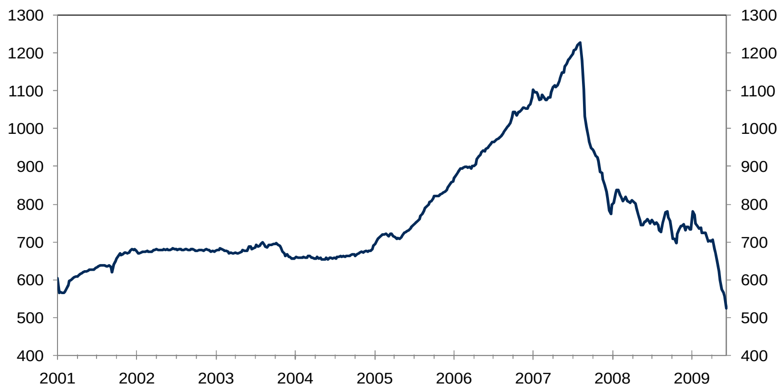


Source: Bloomberg

THE FEDERAL RESERVE BANK OF RICHMOND
RICHMOND • BALTIMORE • CHARLOTTE

4

Asset-backed Commercial Paper Outstanding

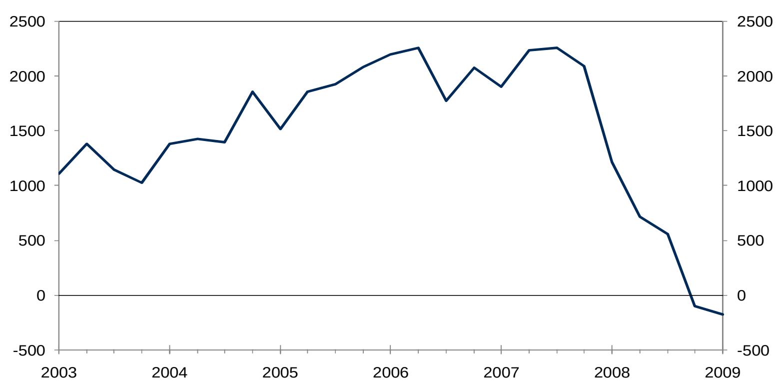


Source: Board of Governors, Federal Reserve System

THE FEDERAL RESERVE BANK OF RICHMOND
RICHMOND • BALTIMORE • CHARLOTTE

5

Private Nonfinancial Borrowing



Source: Board of Governors, Federal Reserve System

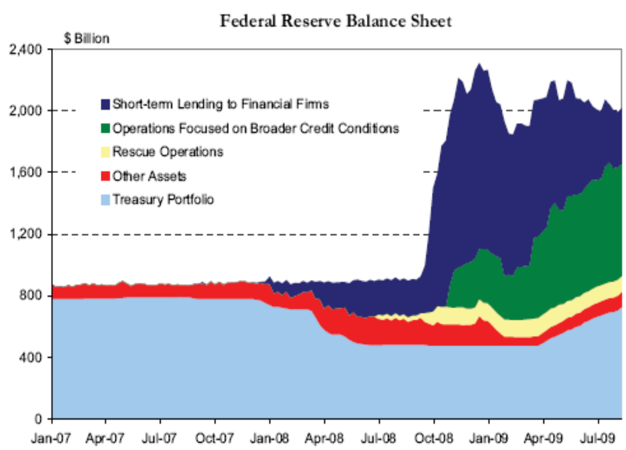
THE FEDERAL RESERVE BANK OF RICHMOND
RICHMOND • BALTIMORE • CHARLOTTE

6

What Causes What?

- Credit contraction causes economic contraction?
  - Implies policy should target credit markets?
    - “Credit easing”
- Economic contraction causes credit contraction?
  - Implies policy should target general economic stimulus?
    - “Quantitative easing”

The Fed’s Response



Source: Macroeconomic Advisors

Effects of Fed Lending

- Increased monetary base (bank reserves)
- Reduced cost of credit for targeted market segments
- Effect on cost of credit in non-targeted segments?
- Moral hazard?

THE FEDERAL RESERVE BANK OF RICHMOND
RICHMOND • BALTIMORE • CHARLOTTE

9

Walter Bagehot

The Public is never sure what policy will be adopted at the most important moment: it is not sure what amount of advance will be made. The best palliative to a panic is a confidence in the adequate amount of the Bank reserve. And until we have on this point a clear understanding with the Bank of England, both our liability to crises and our terror at crises will always be greater than they would otherwise be.

Lombard Street: A Description of the Money Market, Walter Bagehot (1873)

THE FEDERAL RESERVE BANK OF RICHMOND
RICHMOND • BALTIMORE • CHARLOTTE

10

ECONOMICS MADE EASY 09

A Journalism Workshop

THE FEDERAL RESERVE BANK OF RICHMOND
RICHMOND • BALTIMORE • CHARLOTTE