General Discussion: Building a More Stable Financial System: Unfinished Business

Chair: Lisa D. Cook

Mr. Dudley: Not surprisingly, I agree with almost all of your comments. What I'd like you to address is this whole issue of broad access to a repo facility versus narrow access, the so-called moral hazard problem. Strikes me that one benefit of broad is it then becomes an attribute of the Treasury security itself—that the benefits accrue to the federal government in terms of lower financing costs, if you allow more restricted access, the benefit goes to the institution that has that restricted access. Where do you come out on that debate about moral hazard, broad versus narrow?

Mr. Kohn: Bill (Dudley), it's a hard question though, it's not maybe as hard as it might sound. The repo facility takes off a financing tail risk. The Fed is not taking on the duration risk of buying securities. Instead of a repo facility, the other thing that people have talked about is having a backstop purchase facility, that, it seems to me, raises many more questions. I do think the repo facility itself does raise some moral hazard questions. We talked about that a lot. We came up with trying to charge the people with access to the repo facility a very small fee that would cause them to internalize the externalities, and the fee tied to their potential use—an ex-ante fee tied to the potential use. The other way would be to restrict it to more regulated institutions. I prefer to open it up and figure out some way through haircuts, through fees to mitigate the small amount of moral hazard that would be involved in a repo facility. The underlying point, the importance of having this market operate smoothly is just huge. I think we can come up with something in which those benefits far outweigh whatever small costs there might be.

Ms. Forbes: Don (Kohn), I was hoping you could draw on your many years of practical experience and roles in different central banks to fill in what's a pretty big hole in the academic literature. That is the question of how tightening different monetary policy tools might affect different financial stability risks. Let's say we get to a point where the economy's doing well and we are more concerned about financial stability risks. Rates have been low for an extended period and there has been a lot of QE. If a central bank decided to tighten policy by raising interest rates, would that reduce some of these financial stability risks more than if it tightened policy by unwinding QE? Do you have any evidence on the impact of different tools on financial stability risks? Or how could we think about that?

Mr. Kohn: I think I share the concern somebody expressed on the panel this morning about purchasing MBS and stimulating the mortgage market in particular. I do think having the QE plus the interest rate guidance does give you two tools to use at the effective lower bound on rates. You can at least tilt one of those tools toward the financial stability risks you saw. I think if you saw broad financial stability risks related especially to low interest rates, you might tilt a little bit towards interest rates first, but if you saw it particularly narrowly focused on something that was affected by your QE, you could focus on winding that down first. I do think it gives some flexibility that central banks didn't have before to tailor the unwind to the particular circumstances.

Mr. Obstfeld: Don, in your speech, which I broadly agree with also, you mentioned relaxing the SLR for reserves. Unless I misunderstood you, you did not recommend relaxing it for Treasuries. Obviously, this gets into Basel III. I wonder what your view is on that?

Mr. Kohn: I think relaxing it for reserves would probably be enough. Certainly, it would take out that potential conflict between QE, either the QE being done now, or the QE might be undertaken in some future crisis, and the SLR. I would do that, and I think that would be enough, particularly with the amount of reserves in the system these days. That's what we did at the Financial Policy Committee at the Bank of England after the Brexit referendum result and the Monetary Policy Committee, which I think included Kristin (Forbes) at the time, I don't remember exact timing, was undertaking QE. We said, "We'll get out of the way of that QE by taking reserves out of the leverage ratio." Now, we made a small adjustment to raise the leverage ratio against everything else, so that didn't free up any reserves. I would do that, in part, by tightening up the risk-based capital. I'd rather rely on the risk-based capital. I would tighten up that slightly to make sure that it wasn't releasing reserves and the system remained quite resilient.

Mr. Blinder: You offered, as we all expected, an extremely intelligent list of valuable reforms. I'm wondering about distinguishing between what you might call "quiet reforms" and "noisy reforms." That is, the way you delivered this was a hair-on-fire speech, which I'm sure you never would have said if you were still vice chairman of the Fed. So, I'm wondering if you want to distinguish between those, and especially in the noisy category. Every time I hear, "go to Congress," that sends a shiver up my spine.

Mr. Kohn: Right. So, I think there are a bunch of things the regulators can do, and the SEC right now is looking at open-end funds, for example. And I think they're concentrating on money market funds, I would expand that to the bond and loan funds and the general issue of mismatched liquidity in mutual funds. So, I think there's a bunch of stuff that can be done by the regulators. It's encouraging that they're doing this. I think they can also do some of the reforms to processes and regulations without Congress. I agree that legislation is tough and getting Congress to act, particularly in this highly divisive environment, would be very hard, but there are things that can be done, and the Treasury and the New York Fed are looking at the Treasury market. I think there's a bunch of things that can be done without legislation. And you're right. It was a bit of a hair-on-fire thing because I just look at the environment, this is the point Gita (Gopinath) made this morning. Look at the environment, and I think there are just a bunch of fat tails out there. If things don't evolve as the financial markets expect, there could be quite a bit of mayhem on these.

Mr. Brunnermeier: I think you raised a lot of important points, and rightly so. I just was wondering about what you said concerning swing pricing and gates. Isn't there a danger, if you put gates up that people react even faster and run even faster on funds? How would you deal with that?

Mr. Kohn: Right. Maybe I misspoke. I think I've got it written right, anyhow. I want to take the gates away. So, the gates, the possibility of gates, contributed to the run on the money market funds and that's got to be changed. So, I totally agree with you.