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Panel Discussion at the European Central Bank:  
Emerging from the Crisis: Where Do We Stand?

Remarks by

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at the

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The last time I was here at the European Central Bank (ECB), almost exactly two years ago, I sat on a distinguished panel much like this one to help mark the 10th anniversary of the euro. Even as we celebrated the remarkable achievements of the founders of the common currency, however, the global economy stood near the precipice. Financial markets were volatile and illiquid, and the viability of some of the world's leading financial institutions had been called into question. With asset prices falling and the flow of credit to the nonfinancial sector constricted, most of the world's economies had entered what would prove to be a sharp and protracted economic downturn.

By the time of that meeting, the world's central banks had already taken significant steps to stabilize financial markets and to mitigate the worst effects of the recession, and they would go on to do much more. Very broadly, the responses of central banks to the crisis fell into two classes. First, central banks undertook a range of initiatives to restore normal functioning to financial markets and to strengthen the banking system. They expanded existing lending facilities and created new facilities to provide liquidity to the financial sector. Key examples include the ECB's one-year long-term refinancing operations, the Federal Reserve's auctions of discount window credit (via the Term Auction Facility), and the Bank of Japan's more recent extension of its liquidity supply operations. To help satisfy banks' funding needs in multiple currencies, central banks established liquidity swap lines that allowed them to draw each other's currencies and lend those funds to financial institutions in their jurisdictions; the Federal Reserve ultimately established swap lines with 14 other central banks. Central banks also worked to stabilize financial markets that were important conduits of credit to the nonfinancial sector. For example, the Federal Reserve launched facilities to help stabilize

the commercial paper market and the market for asset-backed securities, through which flow much of the funding for student, auto, credit card, and small business loans as well as for commercial mortgages. In addition, the Federal Reserve, the ECB, the Bank of England, the Swiss National Bank, and other central banks played important roles in stabilizing and strengthening their respective banking systems. In particular, central banks helped develop and oversee stress tests that assessed banks' vulnerabilities and capital needs. These tests proved instrumental in reducing investors' uncertainty about banks' assets and prospective losses, bolstering confidence in the banking system, and facilitating banks' raising of private capital. Central banks are also playing an important ongoing role in the development of new international capital and liquidity standards for the banking system that will help protect against future crises.

Second, beyond necessary measures to stabilize financial markets and banking systems, central banks moved proactively to ease monetary policy to help support their economies. Initially, monetary policy was eased through the conventional means of cuts in short-term policy rates, including a coordinated rate cut in October 2008 by the Federal Reserve, the ECB, and other leading central banks. However, as policy rates approached the zero lower bound, central banks eased policy by additional means. For example, some central banks, including the Federal Reserve, sought to reduce longer-term interest rates by communicating that policy rates were likely to remain low for some time. A prominent example of the use of central bank communication to further ease policy was the Bank of Canada's conditional commitment to keep rates near zero until the end of the

second quarter of 2010.<sup>1</sup> To provide additional monetary accommodation, several central banks--among them the Federal Reserve, the Bank of England, the ECB, and the Bank of Japan--purchased significant quantities of financial assets, including government debt, mortgage-backed securities, or covered bonds, depending on the central bank. Asset purchases seem to have been effective in easing financial conditions; for example, the evidence suggests that such purchases significantly lowered longer-term interest rates in both the United States and the United Kingdom.<sup>2</sup>

Although the efforts of central banks to stabilize the financial system and provide monetary accommodation helped set the stage for recovery, economic growth rates in the advanced economies have been relatively weak. Of course, the economic outlook varies importantly by country and region, and the policy responses to these developments among central banks have differed accordingly. In the United States, we have seen a slowing of the pace of expansion since earlier this year. The unemployment rate has remained close to 10 percent since mid-2009, with a substantial fraction of the unemployed out of work for six months or longer. Moreover, inflation has been declining and is currently quite low, with measures of underlying inflation running close to 1 percent. Although we project that economic growth will pick up and unemployment decline somewhat in the coming year, progress thus far has been disappointingly slow.

In this environment, the Federal Open Market Committee (FOMC) judged that additional monetary policy accommodation was needed to support the economic recovery and help ensure that inflation, over time, is at desired levels. Accordingly, the FOMC

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<sup>1</sup> Recent work at the Bank of Canada (see He, 2010) suggests that the bank's forward guidance may have pushed back expectations of when policy accommodation would be withdrawn. For a differing view, see Chehal and Trehan (2009).

<sup>2</sup> For the United States, see Gagnon and others (2010), D'Amico and King (2010), and Hamilton and Wu (2010); for the United Kingdom, see Joyce and others (2010).

announced earlier this month its intention to purchase an additional \$600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about \$75 billion per month. The Committee also will maintain its current policy of reinvesting principal payments from its securities holdings in longer-term Treasury securities.

Financial conditions eased notably in anticipation of the Committee's announcement, suggesting that this policy will be effective in promoting recovery. As has been the case with more conventional monetary policy in the past, this policy action will be regularly reviewed in light of the evolving economic outlook and the Committee's assessment of the effects of its policies on the economy.

I draw several lessons from our collective experience in dealing with the crisis. (My list is by no means exhaustive.) The first lesson is that, in a world in which the consequences of financial crises can be devastating, fostering financial stability is a critical part of overall macroeconomic management. Accordingly, central banks and other financial regulators must be vigilant in monitoring financial markets and institutions for threats to systemic stability and diligent in taking steps to address such threats. Supervision of individual financial institutions, macroprudential monitoring, and monetary policy are mutually reinforcing undertakings, with active involvement in one sphere providing crucial information and expertise for the others. Indeed, at the Federal Reserve, we have restructured our financial supervisory functions so that staff members with expertise in a range of areas--including economics, financial markets, and supervision--work closely together in evaluating potential risks.

Second, the past two years have demonstrated the value of policy flexibility and openness to new approaches. During the crisis, central banks were creative and

innovative, developing programs that played a significant role in easing financial stress and supporting economic activity. As the global financial system and national economies become increasingly complex and interdependent, novel policy challenges will continue to require innovative policy responses.

Third, as was the focus of my remarks two years ago, in addressing financial crises, international cooperation can be very helpful; indeed, given the global integration of financial markets, such cooperation is essential. Central bankers worked closely together throughout the crisis and continue to do so. Our frequent contact, whether in bilateral discussions or in international meetings, permits us to share our thinking, compare analyses, and stay informed of developments around the world. It also enables us to move quickly when shared problems call for swift joint responses, such as the coordinated rate cuts and the creation of liquidity swap lines during the crisis. These actions and others we've taken over the past few years underscore our resolve to work together to address our common economic challenges.

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