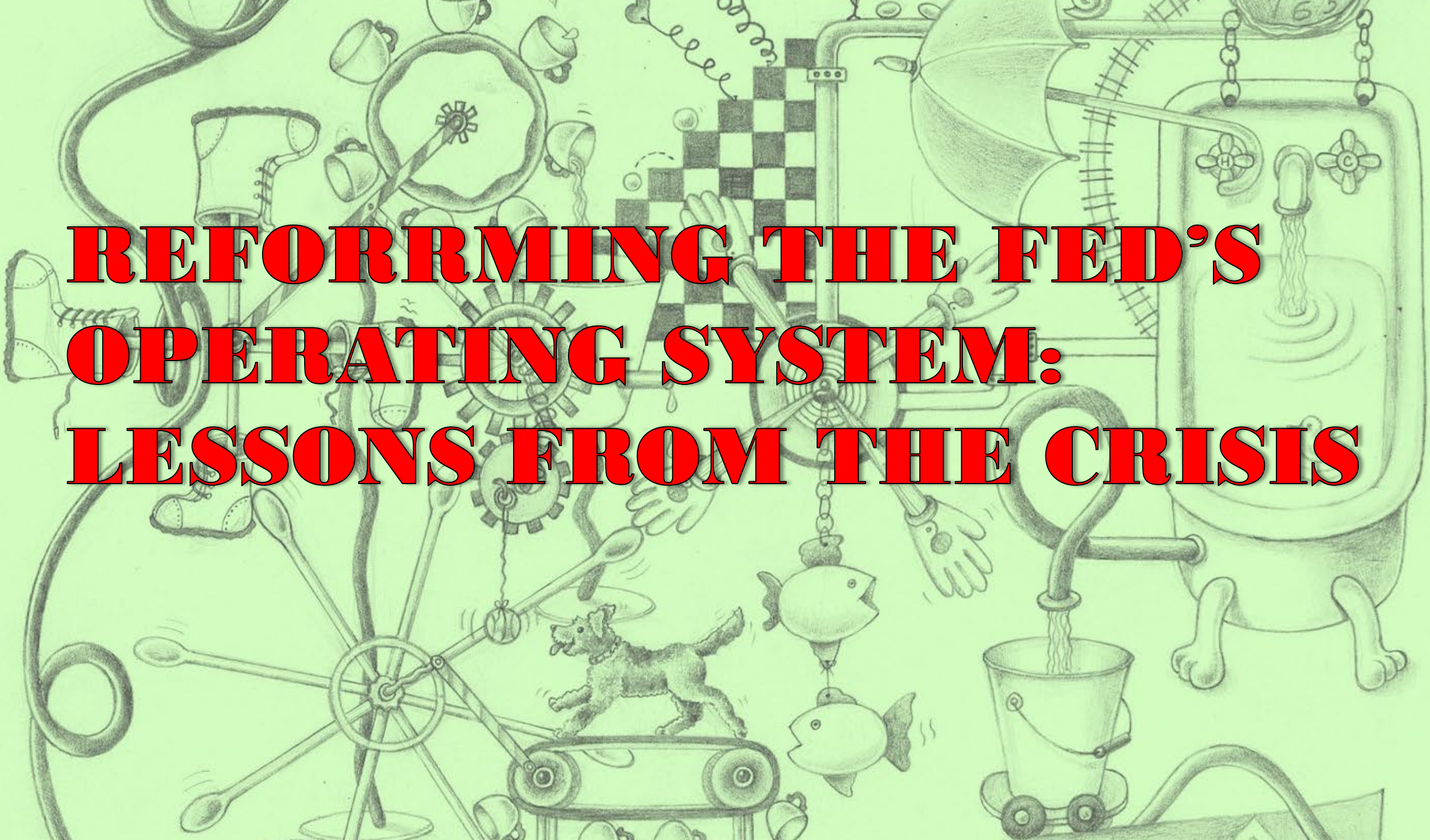
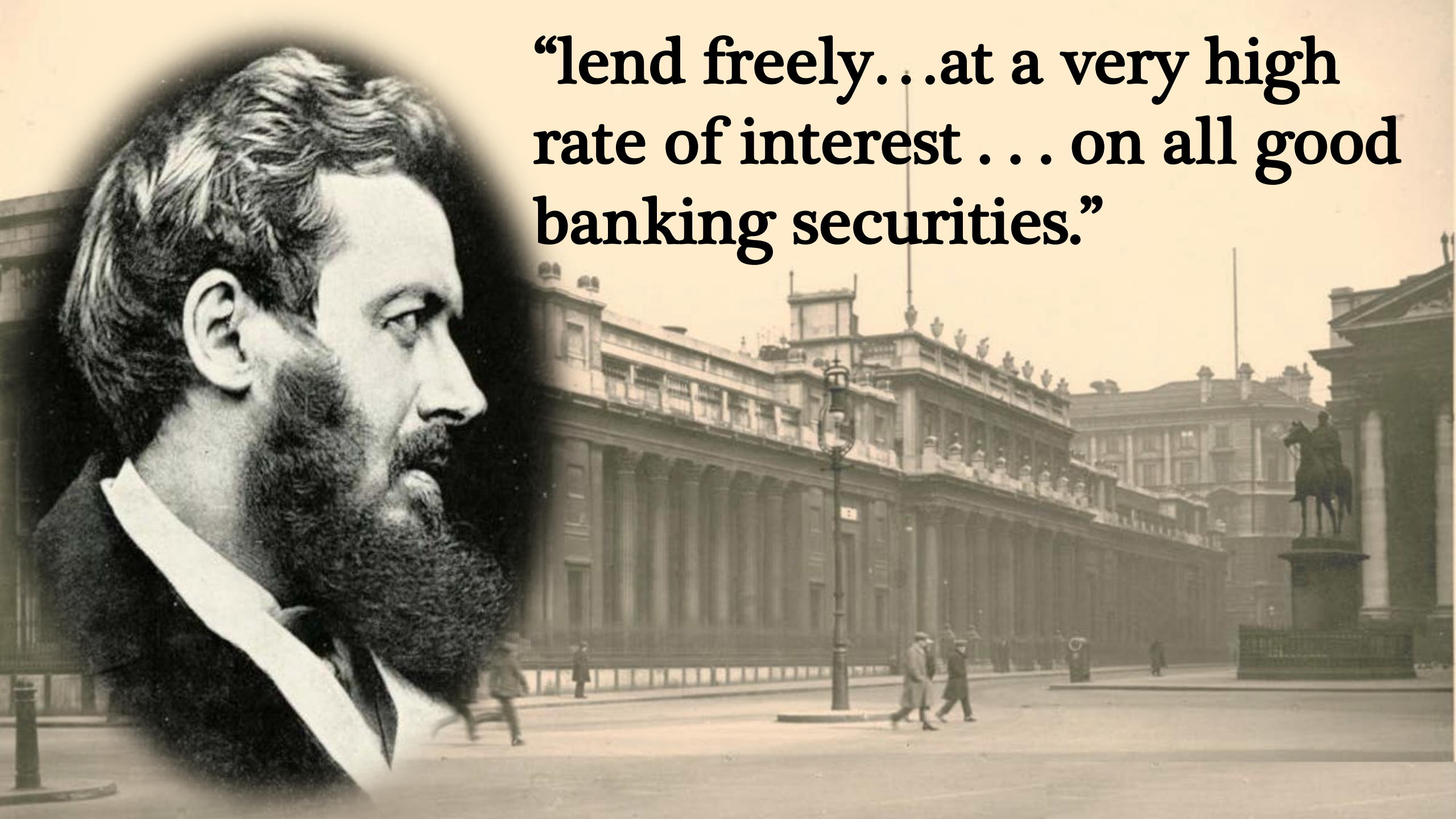
REFORRMING THE FED'S OPERATING SYSTEM: LESSONS FROM THE CRISIS



The Fed's Responsibilities:

- Monetary Control
- Emergency Lending


“lend freely…at a very high rate of interest . . . on all good banking securities.”

Ultimate Sources of Fed Funds:

- Open Market Operations
- Discount Window

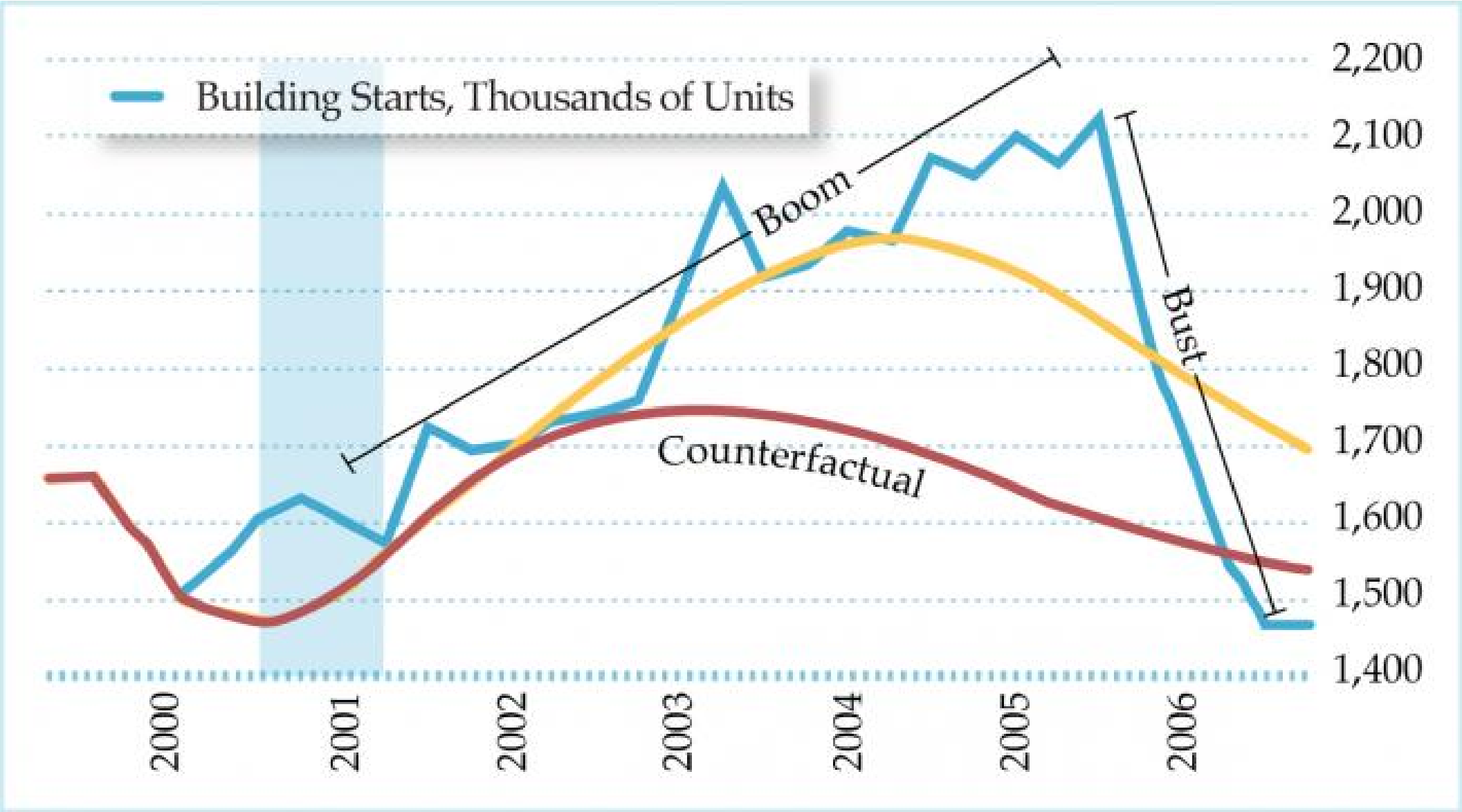
HOUSE
FOR SALE

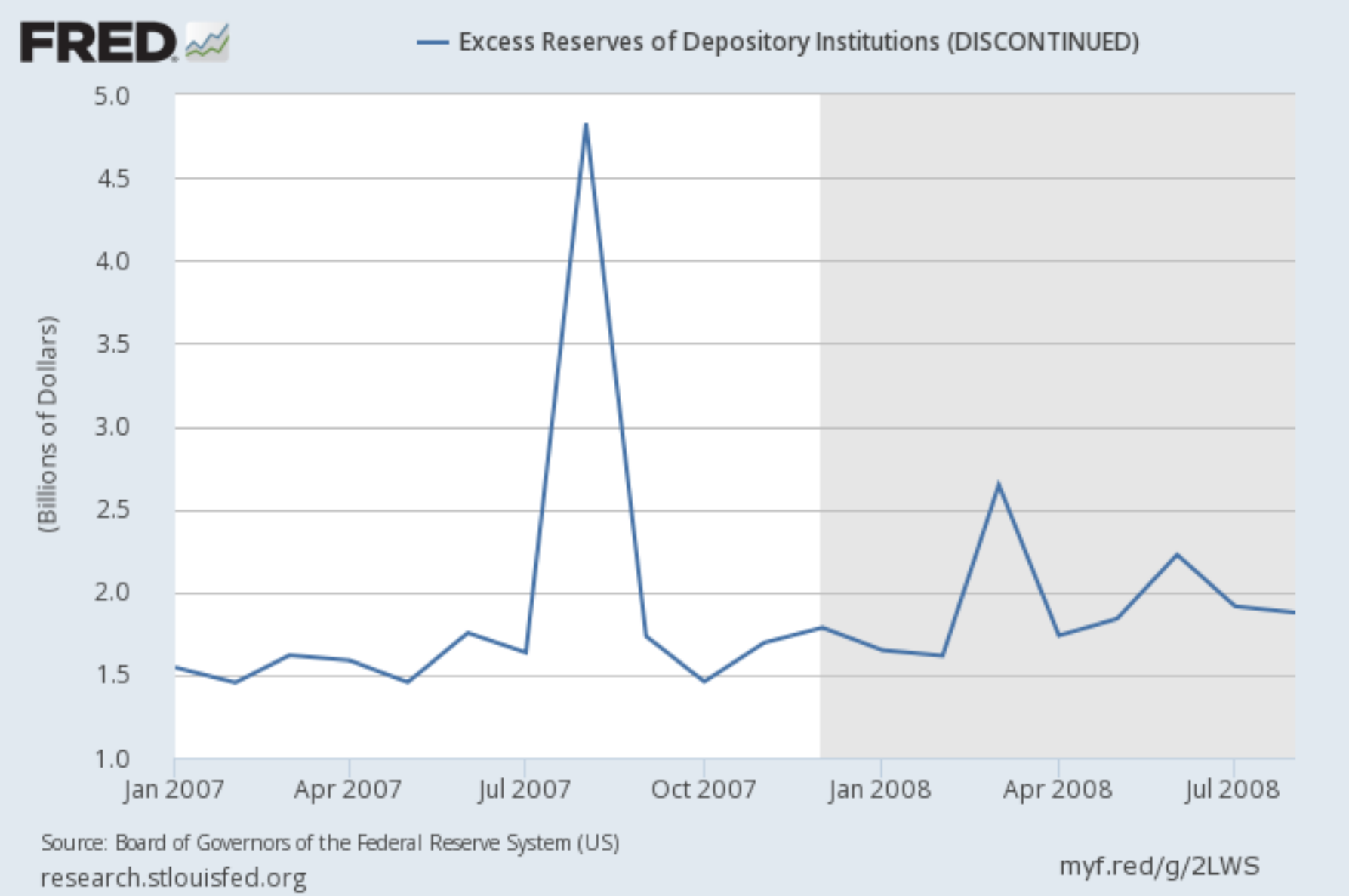
NON-TARP GOVERNMENT SUPPORT OF THE FINANCIAL SECTOR — FEDERAL RESERVE SYSTEM ($ BILLIONS)

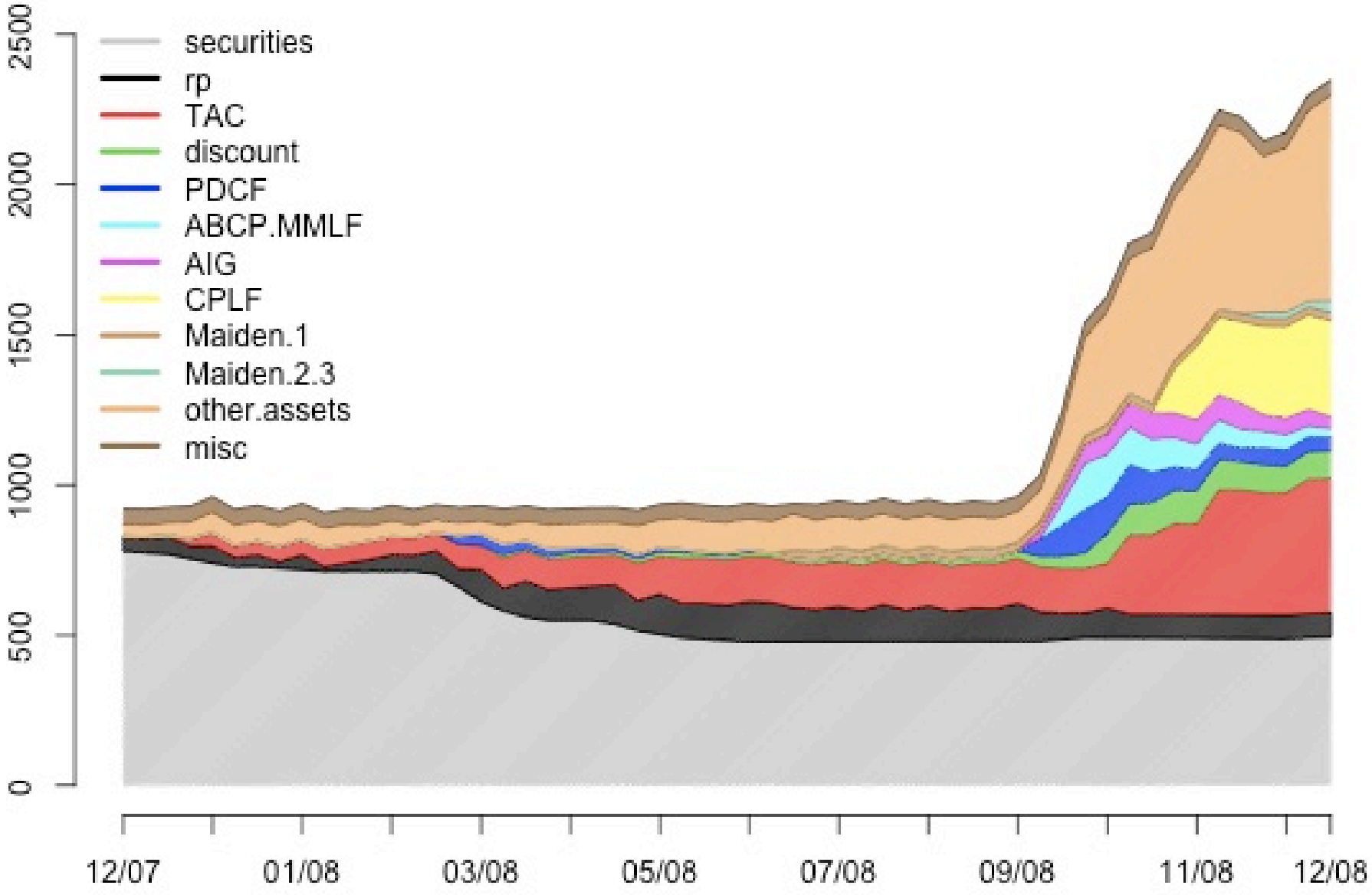
Program	Coverage	Current Balance	Maximum Balance as of 6/30/2009	Total Potential Support Related to Crisis*
Term Auction Facility ("TAF")	Banks	$282.8	$493.1[a]	$900.0[b]
Primary Credit ("Discount Program Modification")	Banks	39.1	111.9[c]	≥ 111.9
Tri-Party Repurchase Agreements	Banks	—	124.6[d]	≥ 124.6
Commercial Paper Funding Facility ("CPFF")***	Corporate Debt Markets	128.1	349.9[e]	1,800.0[f]
Money Market Investor Funding Facility ("MMIFF")	Money Market Mutual Funds	—	—	600.0[g]
Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility ("AMLF")***	Money Market Mutual Funds	16.7	145.9[h]	≥ 145.9
Term Securities Lending Facility ("TSLF"), TSLF Options Program ("TOP")**	Primary Dealers	8.0	233.6[i]	250.0[j]
Expansion of System Open Market Account ("SOMA") Securities Lending[k]	Primary Dealers	14.7[l]	25.9[m]	32.0[n]
Primary Dealer Credit Facility ("PDCF"), credit to other primary dealers***	Primary Dealers	—	147.7[o]	≥ 147.7
Purchase of Direct Obligations of GSEs	GSEs	92.1	92.1[p]	200.0[q]
Purchase of GSE Guaranteed Mortgage-Backed Securities[r]	GSEs	467.1	467.1[s]	1,250.0[t]
Foreign Central Bank Currency Liquidity Swaps	U.S. Markets	121.6	582.8[u]	755.0[v]
Treasuries Purchase Program	Private Credit Markets	174.5	174.5[w]	300.0[x]
Credit to AIG	Specific Institution	42.6	89.5[y]	122.8[z]
Maiden Lane LLC (Bear Stearns)***	Specific Institution	25.9	29.8[aa]	29.8
Maiden Lane II LLC (AIG)***	Specific Institution	16.0	20.1[bb]	22.5[cc]
Maiden Lane III LLC (AIG)***	Specific Institution	20.1	28.1[dd]	30.0[ee]
Other Credit Extensions (JPMorgan, Bear Stearns bridge loan)**	Specific Institution	—	12.9[ff]	12.9
Total		**$1,449.3**	**$3,129.5**	**≥$6,835.1**

SOURCES OF TROUBLE:

- Primary Dealer Failures
- "Treasuries Only"
- Discount Window Stigma
- Bagehot's Principles Violated
- Wrong Overall Policy Stance


Building Starts, Thousands of Units
Boom
Bust
Counterfactual
2,200
2,100
2,000
1,900
1,800
1,700
1,600
1,500
1,400
2000
2001
2002
2003
2004
2005
2006


FRED
Excess Reserves of Depository Institutions (DISCONTINUED)
(Billions of Dollars)
5.0
4.5
4.0
3.5
3.0
2.5
2.0
1.5
1.0
Jan 2007
Apr 2007
Jul 2007
Oct 2007
Jan 2008
Apr 2008
Jul 2008
Source: Board of Governors of the Federal Reserve System (US)
research.stlouisfed.org
myf.red/g/2LWS


securities
rp
TAC
discount
PDCF
ABCP.MMLF
AIG
CPLF
Maiden.1
Maiden.2.3
other.assets
misc
0
500
1000
1500
2000
2500
12/07
01/08
03/08
05/08
07/08
09/08
11/08
12/08

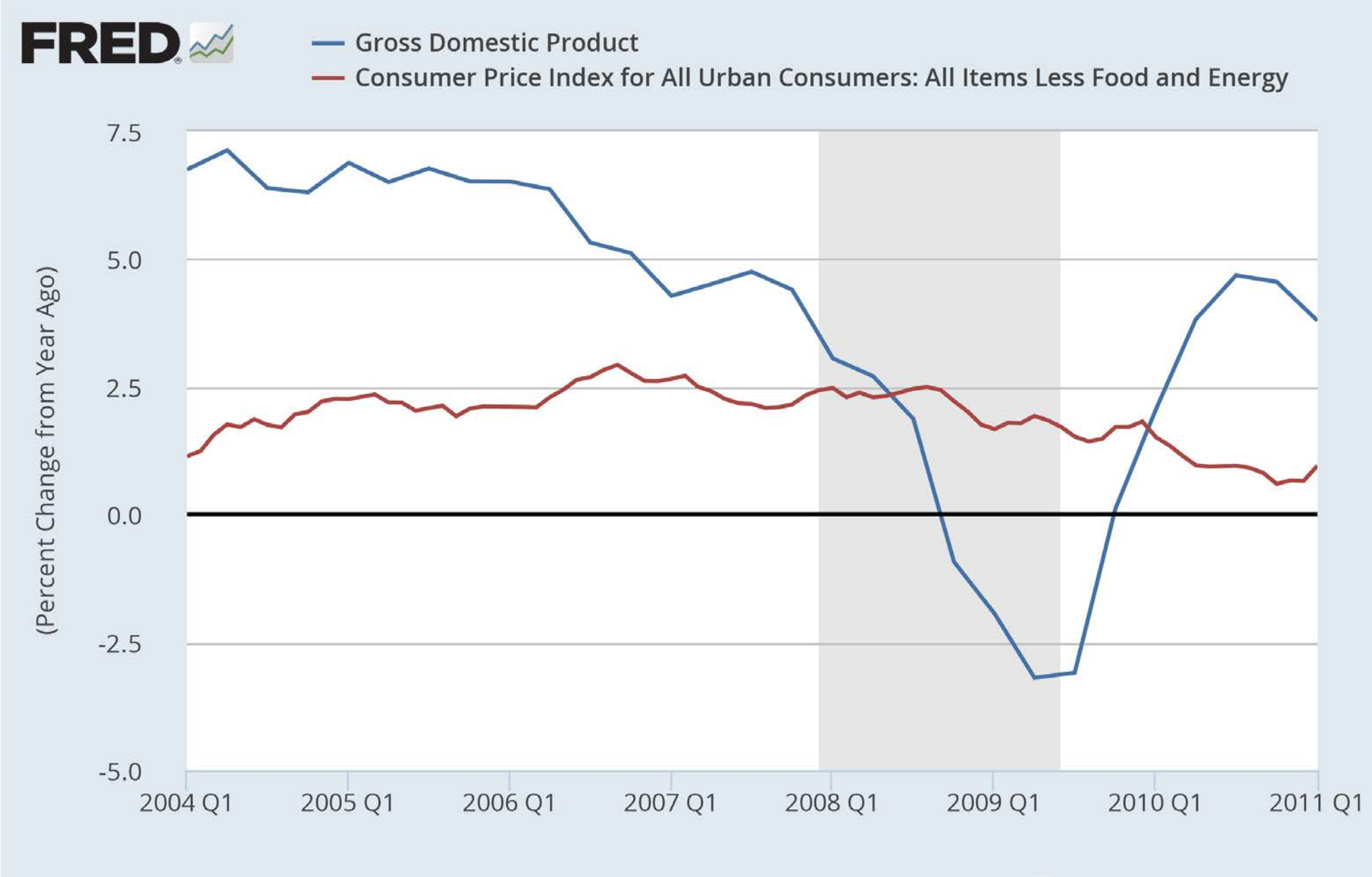
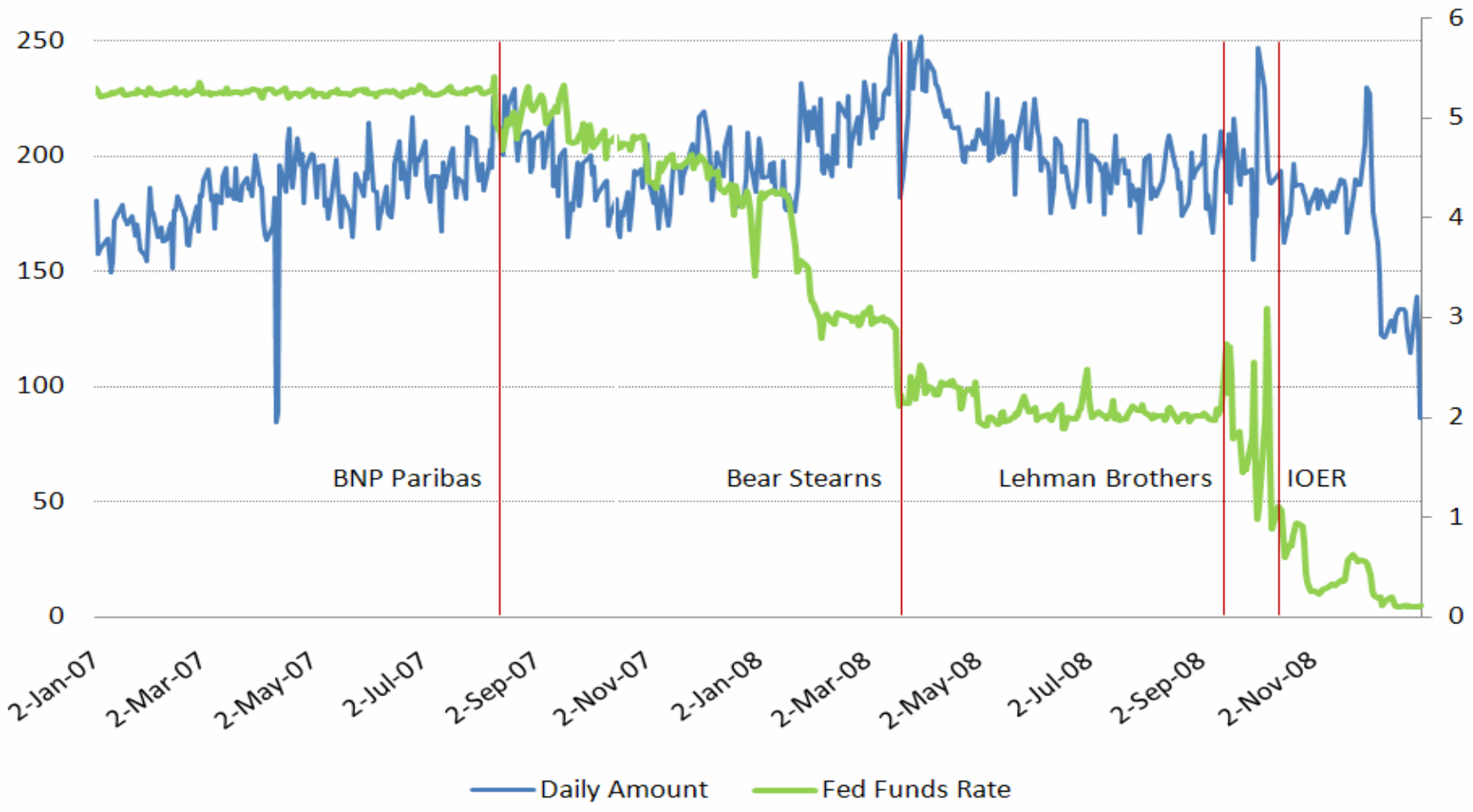
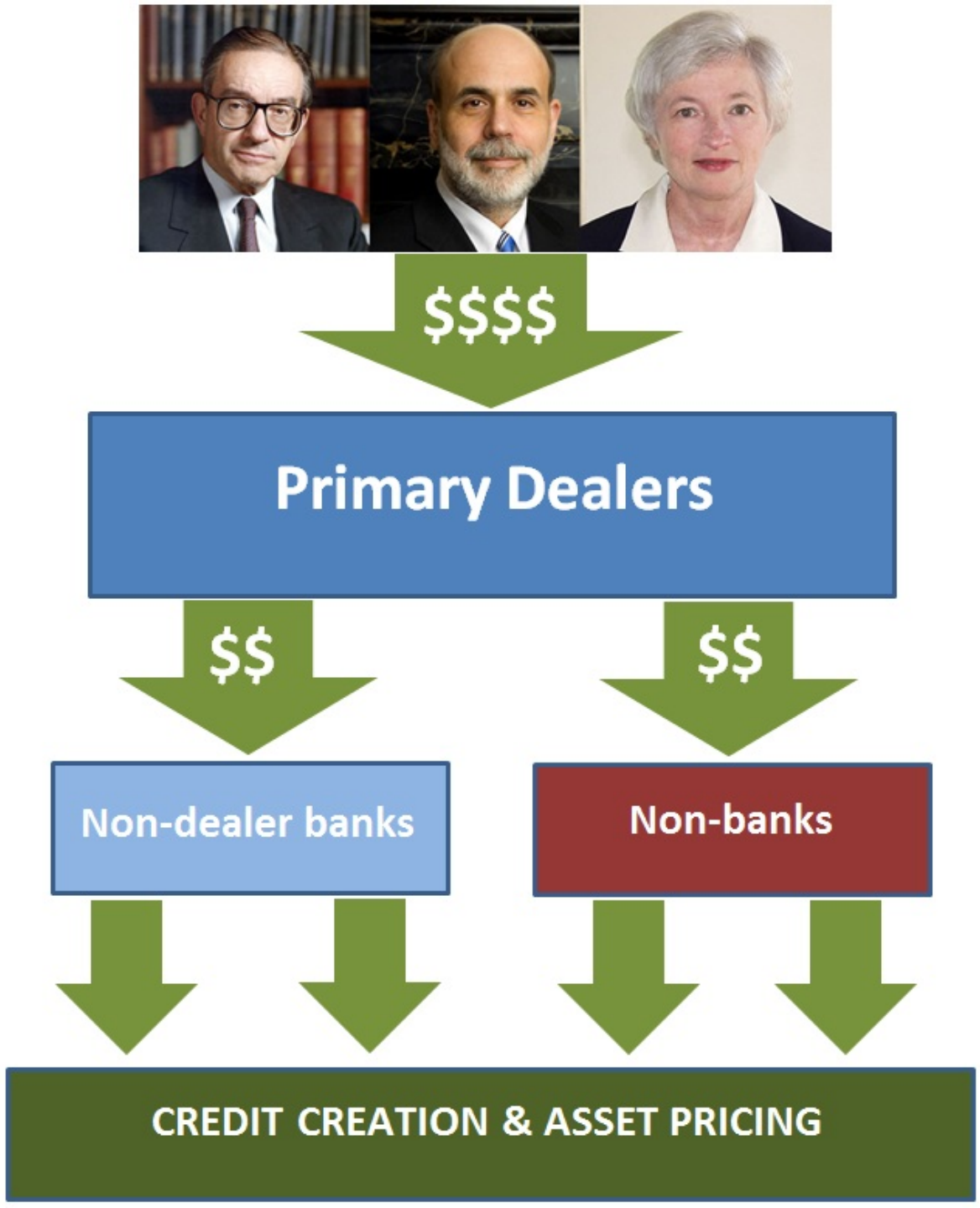

FRED
Gross Domestic Product
Consumer Price Index for All Urban Consumers: All Items Less Food and Energy
(Percent Change from Year Ago)
7.5
5.0
2.5
0.0
-2.5
-5.0
2004 Q1
2005 Q1
2006 Q1
2007 Q1
2008 Q1
2009 Q1
2010 Q1
2011 Q1

PHOTO: OLI SCARFF/GETTY

DEER PARK


250
200
150
100
50
0
6
5
4
3
2
1
0
BNP Paribas
Bear Stearns
Lehman Brothers
IOER
2-Jan-07
2-Mar-07
2-May-07
2-Jul-07
2-Sep-07
2-Nov-07
2-Jan-08
2-Mar-08
2-May-08
2-Jul-08
2-Sep-08
2-Nov-08
Daily Amount
Fed Funds Rate


$$$$
Primary Dealers
$$
$$
Non-dealer banks
Non-banks
CREDIT CREATION & ASSET PRICING

MF Global

ebay®

United States Treasury
TREASURY
FINANCIAL MANAGEMENT SERVICE
06 14 11
2310
86

RUNNING THE "MACHINE".

May 5 1865

UNCLE SAM'S PET PUPS!

Or, Mother BANK'S last refuge.

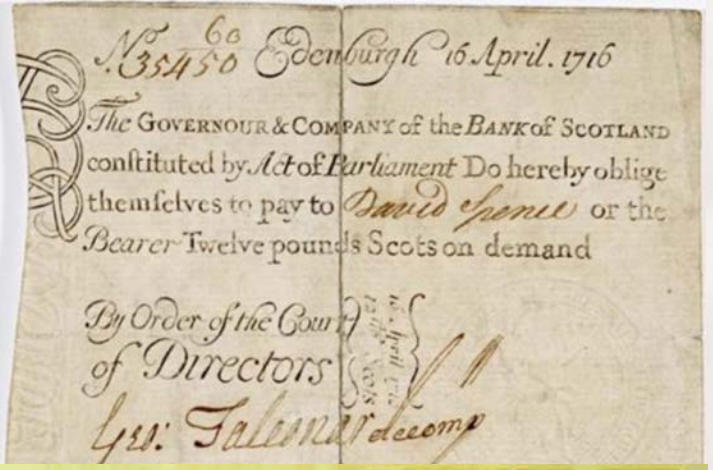
Sold at ELTON'S, 18 Division-Street, New-York.

AIG

I have tediously insisted that the natural system of banking is that of many banks keeping their own cash reserve, with the penalty of failure before them if they neglect it. I have shown that our system is that of a single bank keeping the whole reserve under no effectual penalty of failure. And yet I propose to retain that system...

I can only reply that I propose to retain this system because I am quite sure that it is of no manner of use proposing to alter it... You might as well, or better, try to alter the English monarchy and substitute a republic, as to alter the present constitution of the English money market.

THE UNION BANK OF SCOT
2nd August 1951
ONE POU
D/29 722379


No 35450 Edenburgh 16 April. 1716
The Governour & Company of the Bank of Scotland
constituted by Act of Parliament Do hereby oblige
themselves to pay to David Spence or the
Bearer Twelve pounds Scots on demand
By Order of the Court
of Directors

SPECIMEN
NOTE
Clydesdale
FIVE
By order of the Directors
FIVE

PURSUANT TO
ACT OF PARLIAMENT
ONE
POUND
20th February 1922
THE ROYAL BANK OF SCOTLAND
ONE POUND
R.B.S.

EDINBURGH
1st April 1865
The British Linen Company
PROMISE TO PAY ON DEMAND TO WILLIAM SPENCE
OR BEARER One Pound STERLING
By order of the Court of Directors
SPECIMEN
Manager
Accot

State of the Money Market.

England.

Scotland.