Settlement Liquidity and Monetary Policy Implementation — Lessons from the Financial Crisis

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Morten L. Bech (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=280113)
Bank for International Settlements (BIS) - Committee on Payments and Market Infrastructures

Antoine Martin (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=294317)
Swiss National Bank

James McAndrews (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=2629008)
Wharton Financial Institutions Center

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Abstract

The U.S. dollar clearing and settlement system received little attention during the recent financial crisis, mainly because it performed reliably, processing record volumes and values of trades made in stressed financial markets. This article shows how Federal Reserve policy measures aimed at providing liquidity and stability to the financial system during and after the crisis had a major impact on settlement liquidity and thus on the efficiency of clearing and settlement system activity. The measures led to a substantial decrease in daylight overdrafts extended by the Federal Reserve and a quickening of settlement relative to the pre-crisis period. The decrease in daylight overdrafts reduced credit risk for the Federal Reserve and the earlier time at which payments settled suggests important efficiency gains as well as diminished operational risks. Interestingly, both improvements were the focus of the revisions to the Federal Reserve's Payment System Risk policy, adopted in late 2008 and implemented in March 2011. To a large extent, the desired outcome had been achieved ahead of the policy change. The authors explain that as the amount of reserves available to the banking system and the opportunity cost of holding such reserves are at the center of any framework for implementing monetary policy, the recent experience offers important lessons for policy going forward.

Keywords: monetary policy, liquidity, Fedwire, credit risk, payment system, monetary policy

JEL Classification: E50, E52, E58, E59

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