Economist Nathan Sheets, director of the Federal Reserve Board’s Division of International Finance, puts a global perspective on the current economic crisis and the Fed’s response to it.

Q. For more than a year, we’ve been trying to contain a global financial crisis. What went wrong?
A. The global economy has sustained the most intense and far-reaching financial shock in at least 50 years, a truly phenomenal financial shock. A number of factors have contributed to it. Most important, our major financial institutions weren’t managing risk in a careful and prudent way. There’s plenty of blame to go around. We should also include credit rating agencies, the regulators, corporate boards and investors. There was a breakdown in the capacity to analyze and understand the risk in the system.

A lot of folks see this crisis as first and foremost about housing. I see housing being more of a trigger that brought this failure of risk management to light.

Q. What does all this mean for your bailiwick—international finance?
A. The implications for the financial system are profound. We’ve seen a huge increase in risk aversion among investors. We’ve seen marked stresses in various kinds of financial markets, ranging from very short-term interbank markets all the way to longer-term debt markets. Equity prices have fallen significantly. There aren’t many markets that have escaped the blow.

We’re now seeing those financial shocks having a real impact on spending, production and GDP across the globe. I see this occurring through three important channels.

First, banks’ willingness to lend has significantly deteriorated, so firms and individuals aren’t getting the credit they need.

Second, we’ve seen a huge adverse wealth shock. With stock markets down as much as 50 percent and housing prices falling in a number of countries, people don’t have the balance sheets to sustain spending.

Third, the financial developments have hit consumer and business confidence. It’s true in the U.S., U.K. and euro area, where the financial shock has been intense, but it’s also true in emerging-market economies, where they didn’t have the financial exposure.

Q. How has the accelerating globalization of recent decades shaped this crisis?
A. The fact that we’re more globalized now has been one of the extraordinary features of this crisis. You look at trends in many financial markets—the U.S. line, the U.K. line, the euro-area line, the Japan line—and they’re all moving together more or less in lockstep. The degree of integration has been phenomenal.

Part of that is a reflection of the fact that our financial markets were highly integrated, so subprime loans issued here ended up on foreign balance sheets. We’re also very integrated through trade channels, meaning that the slowdown that’s occurred as a result of this financial shock has hit other economies and fed back into ours.

One way of framing this is the debate about decoupling. If the U.S. economy slows or U.S. financial markets encounter problems, what does that mean for the rest of the world? There really was quite an argument about decoupling until about six months ago, centered on the question of whether other countries could avoid the troubles brewing in the United States. Now, it’s clear that we rise and fall together.

Given the degree of integration and similar failures of risk management across the world, I think this episode is in some sense deeper than it would have been otherwise.

That doesn’t mean that there aren’t many positive factors from globalization. There are important efficiency gains, for example, but we’re seeing that we’re tied together and that we have many common vulnerabilities and shortcomings. We need to work together to manage these challenges and the responses to them.

Q. How does the international dimension affect the Fed’s analysis and actions?
A. Let me give you a concrete example. Many financial institutions outside the U.S. have had significant demand for short-term dollar funding. They made loans to corporations in dollars or bought U.S.-denominated assets, and they needed dollars to fund those assets. I can’t think of a previous instance of financial stress associated with such pronounced demand for dollars outside our borders.

The interbank markets these institutions depended on for funding essentially froze up last fall, and it created huge excess demand for short-term dollar liquidity abroad. Many of these foreign institutions would come to New York or other U.S. markets in search of dollars, so it would at times spill over into our markets and create stresses.

In response, the Fed joined with other major central banks to create a network of swap facilities, where we provide foreign central banks dollar liquidity and they give us an equivalent amount of their currencies. They then lend these dollars to financial institutions in their economies that need them. There’s very little risk for the Fed. We have claims on the foreign central banks as well.
“The global stresses we’ve been facing have made it all the more important that central banks interact to keep each other informed and, where possible, even coordinate policy.”

as holdings of their currencies to protect us. We have had to extend the scope and influence of our liquidity facilities beyond our national borders, and that’s been a new challenge.

Q. Has globalization put greater emphasis on cooperation with other central banks?

A. Absolutely. Central banks regularly communicated through mechanisms that were already in place, but the global stresses we’ve been facing have made it all the more important that central banks interact to keep each other informed and, where possible, even coordinate policy.

The swap agreements are an important example of this. Another is the coordinated interest rate cuts by the Fed and other central banks in early October. Easing monetary policy was in the interest of each of these economies, but there’s a strong additional statement that’s made when central banks show they’re cooperating to address global problems.

Q. What else will help us deal with global financial threats?

A. These aren’t just Fed issues but matters of the broader financial architecture. We need better mechanisms to address problems faced by very large institutions that can be seen as too big to fail. We also need a well-articulated resolution process for a wider range of financial institutions. We have a good mechanism for addressing commercial banks under stress, but there’s nothing comparable for some other types of institutions.

Q. More broadly, has globalization affected the way the Federal Reserve does its job?

A. It’s certainly different. These dollar-funding pressures I mentioned earlier are a manifestation of just how much things have changed. We see this increased interdependence among economies and the need for collaboration among central banks and regulators in various countries.

Some people have argued that the effectiveness of monetary policy is being diminished, and I don’t see that. Globalization has shifted the range of variables and the things you need to think about. You need to focus not only on what’s going on within your own borders and your own financial markets but also on what’s going on in the rest of the world and in global financial markets. There are feedback effects that are significant for assessing economic conditions and making policy decisions.

We’re constantly trying to expand our analytical tool kit and improve our understanding of how economies and policies work. It’s not explicitly global, but one issue we’re thinking hard about at the moment is the so-called financial accelerator effect, where sharp declines in asset prices hit the balance sheets of firms and individuals and make them less creditworthy. This can be a mechanism through which these kinds of financial shocks eat into the economy and become quite intense.

Another current issue is the zero lower bound. What are the implications for policy and the economy once short-term interest rates, the traditional tool for monetary policy, have been cut to nearly zero. What’s the next step?

Q. How will this financial crisis affect the pace of globalization?

A. If anything, it may accelerate globalization in the sense that we’re now very aware that we need to work closely together with other countries on such things as financial-sector supervision and rating assets. Major financial institutions are truly global in scope, and if we’re approaching things one way and the French another and the Germans another and the British another, it creates dissonance in the global economy.

The leaders of the G-20 economies met in November in Washington, and they’re going to meet again in early April in London. They’re in the midst of addressing many of these issues in a global way, and I think we’ll find that process has some staying power. We’ll end up more integrated, more coherent and more consistent across countries than we were before this crisis erupted.

Along the way, there’s risk of protectionism emerging. History teaches that we’re more prosperous if we’re open rather than closed—especially at times like this. Think about what happened in the Great Depression, when countries put up sizable tariffs and global trade collapsed. That can start a downward spiral for the global economy, so we have to guard very forcefully against protectionism.