The U.S. Economy: A Report from Main Street

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Any opinions expressed here are my own and do not necessarily reflect those of the Federal Open Market Committee participants.

Topics

- Main Street, Wall Street, and Washington.
- Regulatory Reform.
- The State of the Economy and Monetary Policy.

Main Street, Wall Street, and Washington

The Nation's Third Attempt at a Central Bank

- The first two central banks in the U.S. were discontinued.
- The nation had no central bank during much of the 19th century.
- The evidence from the 19th century is generally regarded as unfavorable.
  - There was far too much financial instability.
- This led to the founding of the Fed following the Panic of 1907.

The Founding of the Fed

- The Federal Reserve has three parts.
- Washington: Board of Governors.
- New York: One bank in the nation's financial capital.
- Main Street: Eleven banks in the rest of the nation.
- The regional structure was designed to keep some power out of New York and Washington.
  - Input on key policy questions from around the U.S.A.
  - *Successful*.

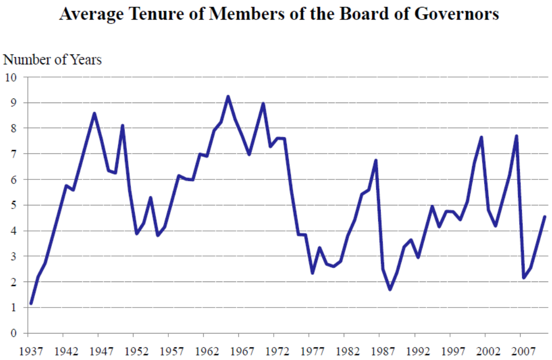
Ultimate Authority in Washington

- The Board of Governors members are appointed by the President and confirmed by the Senate.
- The Board of Governors has oversight authority for the Fed.
- This includes budget authority.
- It also includes authority over key appointments in the Fed.
    - This means Presidents, First Vice-Presidents, as well as the Chair and Vice-Chair of the Board of Directors at each Bank.
- There is considerable accountability in the Roosevelt-era re-design of the Federal Reserve.

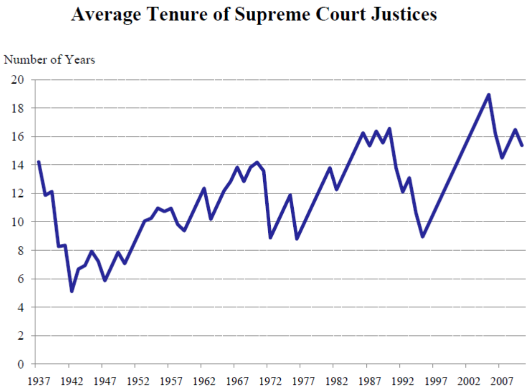
Arms Length from Politics

- The Board members are appointed to staggered 14-year terms.
- Actual tenure of most Board members in recent years has tended to be much shorter than 14 years, limiting the effectiveness of this provision.
- Allowing short-term politics to mix too closely with monetary policy leads to poor economic outcomes.
- This has occurred frequently in the developing world over the last 50 years.

Average Tenure on the Board of Governors



Average Tenure on the Supreme Court



Accountability

- Monetary policy is vigorously debated everyday, both inside and outside the Fed.
- The Fed is extensively audited—our rough estimate is about 425,000 hours annually:
  - Internal audit function.
  - Board of Governors oversight.
  - External auditor (Deloitte).
- Each hour of audit time requires staff time for compliance.
- In addition, the Fed is subject to auditing by the GAO, the investigative arm of Congress.
- Additional audits are welcome, so long as they do not constitute political meddling.

Regulatory Reform

The Fed and Banking Supervision

- The U.S. has a primary regulator system for the nation's 8,000+ commercial banks and thrifts.
- The primary regulator has the key authority for the regulation of the bank.
- As of January 2007:
  - The Fed had primary regulatory responsibility for about 12 percent of the banks.
  - About 14 percent by assets.
- The remaining 85 percent of the banks had non-Fed primary regulators.

The Fed and the Financial Landscape

- Banks are only one part of the financial landscape.
- Non-bank financial firms turned out to be the most troublesome entities in this crisis.
- The Fed had no supervisory authority over these entities:
  - Investment banks like Goldman Sachs and Bear Stearns.
  - Insurance companies like Prudential and AIG.
  - Financial hybrids like GE Capital and GMAC.
- Bottom line: *The Fed had a limited view of the financial landscape as the crisis began.*

The Crisis Unfolds

- As the crisis began, all eyes turned to the Fed as the lender of last resort.
- This always happens in a crisis—only the central bank can play the lender-of-last-resort role.
- But the Fed had detailed knowledge only of part of the financial landscape: that for which it had supervisory authority.
- The Fed had limited access to information on institutions outside its supervisory authority, especially non-bank financial firms.
- Many of the critical lending decisions involved the controversial non-bank financials like Bear Stearns.

The Reform Response

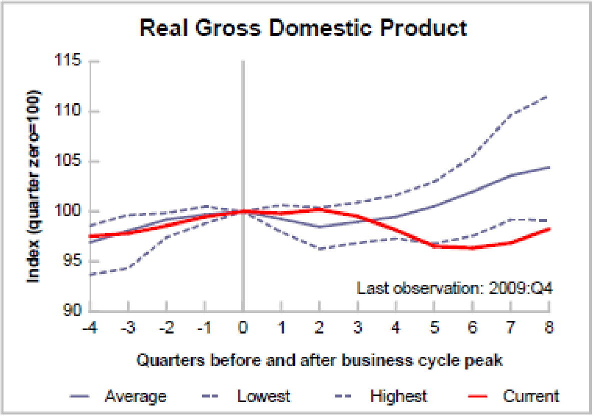
- The clear lesson is that the Fed had insufficient access to information about the financial landscape going into the crisis.
- The Fed did not fully understand the potential for feedback between the financial sector and the rest of the economy.
- Yet, the Fed will also be at the center of all future crises because of its lender of last resort role.
- The reform response should be to provide the Fed direct access to detailed information across the entire financial landscape going forward, not less as is the focus of current policy discussions.
  - *A future Fed, with an appropriately broad regulatory responsibility, may be able head off a future crisis.*

The State of the U.S. Economy and Monetary Policy

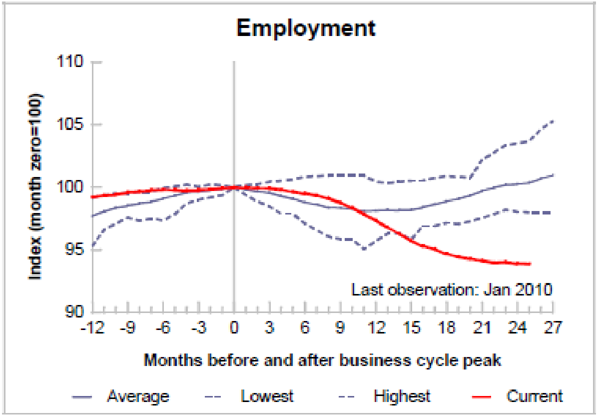
U.S. ECONOMIC RECOVERY

- Two consecutive quarters of positive real GDP growth in the U.S.
- Unemployment is high, and labor markets are lagging.
- Housing sector is stabilizing.
- Financial market stress has abated substantially since 2008 Q4.
- Bottom line: The U.S. recovery remains on track.
- But inflation expectations are rising.

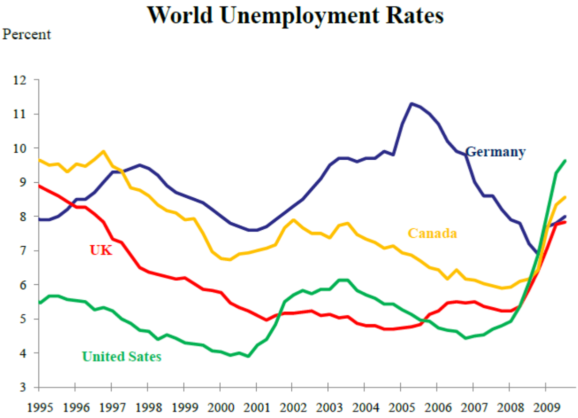
Output growth relative to past recessions



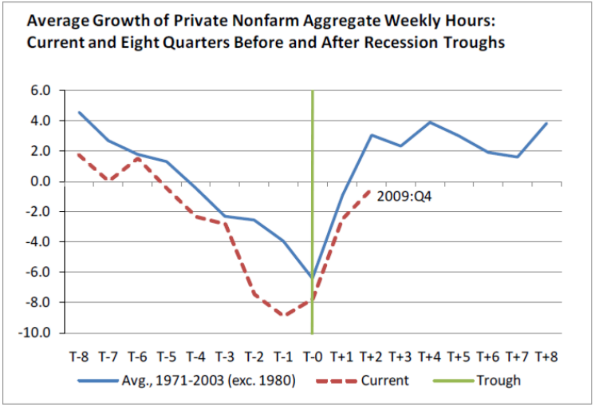
Labor markets remain weak



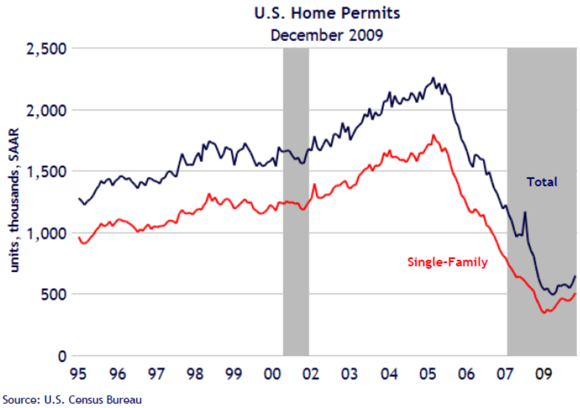
Unemployment is high



Hours worked are stabilizing



THE HOUSING SECTOR IS STABILIZING



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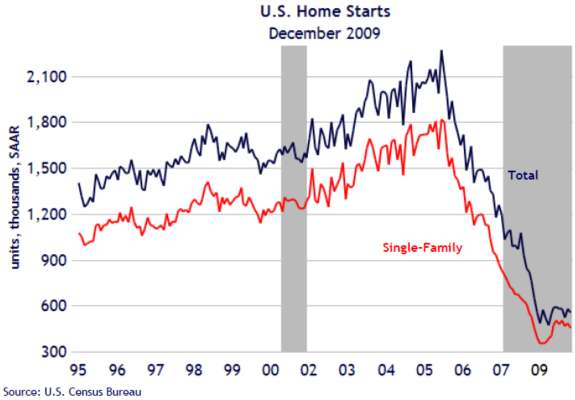
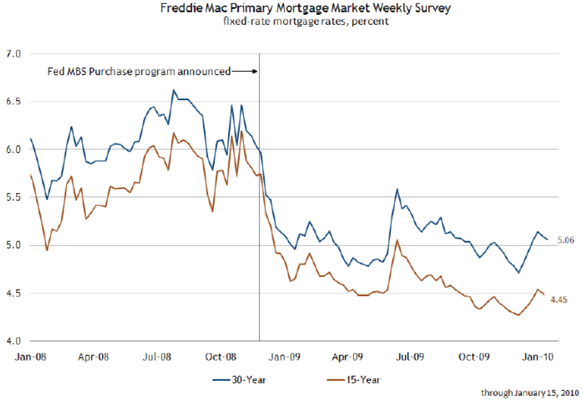
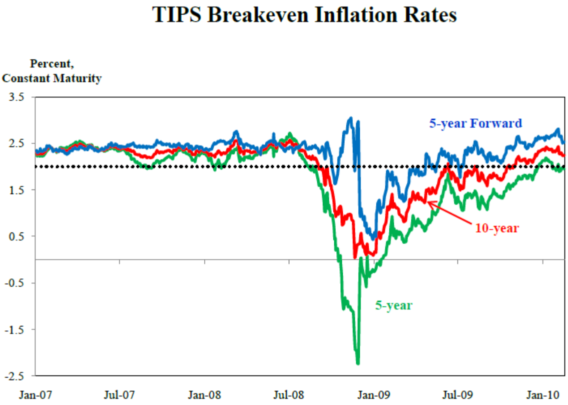


Mortgage rates remain low



Source: Federal Home Loan Mortgage Corporation/Haver Analytics

INFLATION EXPECTATIONS ARE RISING



Conclusions

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- The Fed's structure was designed to keep some power out of Washington and New York.
- Regulatory reform efforts should look to provide the Fed with direct access to financial information so it can know and understand more, not less, about the financial landscape and the feedback between the financial system and the macroeconomy.
- A future Fed, with an appropriately broad regulatory responsibility, may be able to head off a future crisis.
- The recession in the U.S. was severe, but the economic recovery remains on track.

Federal Reserve Bank of St. Louis
stlouisfed.org

Federal Reserve Economic Data (FRED)
research.stlouisfed.org/fred2/

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research.stlouisfed.org/econ/bullard/