FEDERAL RESERVE BANK OF ST. LOUIS

The Fed at a Crossroads

CENTRAL to AMERICA'S ECONOMY™

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

Crossroads

- The fallout from the financial turmoil of 2008 and 2009 is placing the Fed at a crossroads on three dimensions:
  1. The political independence of the Fed is at risk.
  2. Regulatory reform legislation threatens to hamstring the Fed's ability to respond to a future crisis.
  3. The Fed adopted a near-zero interest rate policy and successfully carried out its stabilization policy through quantitative easing.

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 most of the 19th century.
- The evidence from the 19th century is generally regarded as unfavorable.
  - There was far too much financial instability: The economy was characterized by repeated, serious panics.
  - Contemporaries were dissatisfied.
  - Monetary stability was a major political issue in the late 19th century.
- 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.
  - It allows for input on key policy questions from around the U.S.A.
  - *This system has been very successful.*
- The current crisis has created a loud protest from the nation.
- It would be ironic indeed if the response to that protest were to further centralize power in New York and Washington.

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.

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.

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.
- This has placed the Fed closer to day-to-day politics than the intent of the law.
- Politics ebbs and flows.
- If political shifts translate into monetary policy, the result is more and unnecessary volatility in the U.S. economy.

THE INTERNATIONAL EXPERIENCE WITH CENTRAL BANK INDEPENDENCE

- 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 past 50 years ...
  - ... and long before that.
- In the U.S., erosion of Fed independence could result in a 1970s-style period of volatility.
- The consequences for the U.S. and the global economy would be large.
- No one would be served well by this outcome.

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.
- More than 85 percent of banks and assets had non-Fed primary regulators.

The Fed and the Financial Landscape

- Banks are only one part of the financial landscape.
- As the crisis began, 20 firms accounted for about 80 percent of S&P 500 financial sector assets in the U.S.
- About 1/3 of this total was in banks.
- About 2/3 of this total was non-bank financial firms: Government-sponsored enterprises (Fannie Mae and Freddie Mac), investment banks, insurance companies, and thrifts.

THE FED WITH BLINDERS ON

- 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.
- The Fed had blinders on coming into the crisis:
  - Primary regulatory authority for only some of the banks, and none of the troublesome non-bank financials.
- Bottom line: *The Fed had a severely 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 severely 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.
- Neither the Fed nor anyone else fully understood 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 with an appropriately broad regulatory authority, so that the central bank is well-informed about the entire financial landscape.
    - *A future Fed, with an appropriately broad regulatory responsibility, provides the U.S. with the best chance to head off a future crisis.*

Smaller Bank Regulation Remains Important

- Regulation works well for the thousands of smaller banks in the U.S.
- The system features deposit insurance plus prudential regulation.
- The system allows failure, but prevents bank runs and the associated panic.
- *Smaller banks did not cause the crisis and do not need to be re-regulated.*

The Fed and Smaller Bank Regulation

- Changing this part of the regulatory environment as we are trying to cope with high financial stress makes little sense.
- The FDIC has been pushed to its funding limits by the crisis.
- The Fed should remain involved with smaller bank regulation so that it has a view of the entire financial landscape and does not become biased toward the large, mostly New York-based institutions.
- One critical role of regulation is to provide a level, competitive playing field for institutions of all sizes.
- Smaller banks tend to fund smaller businesses, an important source of job growth for the economy.
- Understanding this process helps the Fed make sound monetary policy decisions.

Monetary Policy by Different Means

Three Parts to Current Monetary Policy

- Liquidity programs, which are now mostly ended.
- A near-zero interest rate policy.
- A quantitative easing policy.

Near-zero policy rates

- Policy rates were reduced to near-zero across the Group of Seven in late 2008 and early 2009.
- The FOMC has said it will keep the federal rate funds target near-zero "for an extended period."
- Any movement on this is contingent on both inflation and real economic developments.
- How should the FOMC conduct stabilization policy during the period of near-zero policy rates?
- Answer: There are many interest rates that the Fed can influence.

THE NEW FACE OF STABILIZATION POLICY

- The Fed is very capable of conducting stabilization policy when policy rates are near zero.
- The quantitative policy should be conducted in a manner analogous to interest rate policy.
- This means adjusting the policy according to incoming information on the economy.

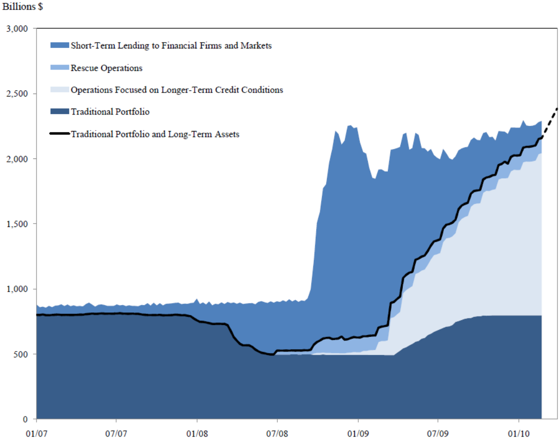
OUTRIGHT ASSET PURCHASES

- The FOMC has announced more than $1.7 trillion in outright asset purchases.
- The purchases are in agency debt, agency MBS, and longer-term Treasuries.
- This is being financed by reserve creation: "printing money."
- The monetary base has expanded rapidly.
- In contrast to the liquidity programs, the expansion of the monetary base associated with the asset purchase program is likely to be very persistent.
- This has created a medium-term inflation risk.

The medium-term inflation risk

- Very large increases in the monetary base are inflationary under ordinary monetary theory.
- The actual effects depend on at least two factors.
- One factor: Private sector expectations of the future level of the monetary base.
    - Large increases that are expected to be temporary, as with the liquidity programs, are not inflationary.
    - Large increases that are expected to be more persistent may be inflationary.
    - The increase in the base associated with asset purchases is more persistent.
- A second factor: The speed with which the monetary base is translated into changes in the money supply.
    - This is not occurring very rapidly right now.

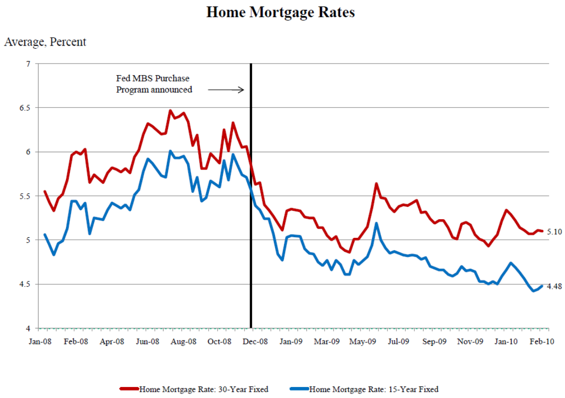
The composition of Federal Reserve assets



Asset purchases as quantitative easing

- The asset purchase program began in January 2009.
- The program substituted for additional easing that could not be accomplished through the policy rate.
- It is generally considered successful in further easing monetary conditions after the zero bound was encountered.

Mortgage Rates



Conclusions

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- The Fed's structure was designed to keep some power out of Washington and New York.
- The reform response should be to provide the Fed with an appropriately broad regulatory authority, so that the central bank is well-informed about the entire financial landscape.
- The financial landscape includes the nation's smaller banks, and the Fed should continue to play a key role as a regulator for this group.
- A future Fed, with an appropriately broad regulatory responsibility, may be able to head off a future crisis.
- The Fed's quantitative easing program has shown that stabilization policy can be carried out effectively even when policy rates are near zero.

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