The Fed and the Coming Redefinition of Government Regulation

James Bullard
President and CEO
Federal Reserve Bank of St. Louis

Weathering the Storm: The Challenges and Opportunities of a Global Slowdown

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Any opinions expressed here are mine and do not necessarily reflect those of other Federal Open Market Committee members.
The state of the economy.

Proposals and priorities for regulatory reform.

The Fed and financial stability.
THE FIRST PHASE OF ECONOMIC RECOVERY

- Real GDP growth has recently turned positive in the U.S.
- Global growth has surprised on the upside, especially in Asia.
- Household consumption expenditure has stabilized.
- Financial market stress has abated substantially since 2008 Q4.
- Unemployment is high, and labor markets are lagging.
- Bottom line: The U.S. is in the early stages of recovery from a very serious recession.
Smaller banks are not the problem

- 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.
- The FDIC has a robust resolution regime for these institutions.
- Smaller banks did not cause the current crisis and do not need to be re-regulated.
The rise of the shadow banking sector

- The regulations in commercial banking gradually pushed activity into less regulated firms.
- Large, global non-bank financial institutions took on bank-like activities and a large fraction of all financial intermediation in the U.S.
- Some institutions borrowed short—on collateral—to fund longer-term investments.
- The crisis showed that runs on non-bank, non-deposit-taking financial institutions are possible as well as very destructive.
- This was not previously considered a problem.
- There is no analog of deposit insurance to solve this problem.
The crisis showed that large financial institutions worldwide were “too big to fail.” (TBTF)

- Really, “too big to fail quickly.”

If we let large financial firms fail suddenly, global panic ensues.

- Again, these firms are not necessarily banks.

Reform efforts must focus on getting this intolerable situation under control.

- TBTF is very costly to the macroeconomy as well as unfair.
- We need laser-like focus on this problem.
Proposals addressing TBTF:

- Systemic risk regulation: A council with the Fed having implementation responsibility.
- A resolution regime for large financial firms.
- Split up large firms.

There are important global coordination issues.

Difficulties in design suggests a “go slow” approach.

- The crisis will not soon be forgotten.
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 regional structure was designed to keep some power out of Washington and New York.
Despite the current crisis, the track record of the Fed and financial crises is reasonably good during the past 25 years.

At least four major threats:

- Latin American debt crisis in the 1980s.
- The Thrift Crisis in the late 1980s and early 1990s.
- The Asian Currency Crisis in the 1997-1998 period, leading to the collapse of Long Term Capital Management.
- The collapse of Enron and WorldCom in the early part of this decade.

Despite these threats, the period was one of the most tranquil on record for macroeconomic performance.
The Fed provided important warnings before this crisis began.

William Poole (FRB-St. Louis) argued during the early 2000s that Fannie Mae and Freddie Mac were ticking time bombs that could badly damage the U.S. economy.


These types of warnings show that the Fed is well aware of systemic risk concerns in real time.

The problem is what to do in terms of concrete policy action when times are good.

Disrupting good times in the name of mitigating possible future problems is usually very unpopular.
The Fed is the nation’s lender of last resort. The role of Fed lending in mitigating the current crisis has been substantial. The Fed needs to have a role in regulating institutions to which it may lend.
THE FED AS THE NATION’S MONETARY AUTHORITY

- To run an effective monetary policy, the Fed needs to know the condition of the financial system.
- The need to know the status of financial markets has been underscored by recent events.
- This also argues for a substantial Fed role in the regulation of these firms.
- The U.K. model, putting the FSA in charge of regulation and the Bank of England in charge of monetary policy, did not work well during this crisis.
  - The crisis in the U.K. has been even worse in some dimensions than in the U.S.
Fed independence is vital in maintaining credible monetary policy. Non-independent central banks, historically, have been forced to finance large government budget deficits through money creation. This can be very inflationary. The U.S. has large government budget deficits right now. Talk of eroding Fed independence can be counterproductive for economic recovery.