The Fed at a Crossroads

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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.
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 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.
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

Home Mortgage Rates

Average, Percent

Fed MBS Purchase Program announced

Jan-08 Feb-08 Mar-08 Apr-08 May-08 Jun-08 Jul-08 Aug-08 Sep-08 Oct-08 Nov-08 Dec-08 Jan-09 Feb-09 Mar-09 Apr-09 May-09 Jun-09 Jul-09 Aug-09 Sep-09 Oct-09 Nov-09 Dec-09 Jan-10 Feb-10

- Home Mortgage Rate: 30-Year Fixed
- Home Mortgage Rate: 15-Year Fixed
Conclusions
**Conclusions**

- 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.