If Fed Becomes Super Regulator, Politicians Would Be Its Kryptonite

By Sharon K. Blei

Drawing upon long-dormant emergency powers as lender of last resort, the Federal Reserve has taken unprecedented steps to shore up the financial system. If, as a result of these precedents, the Federal Reserve's role as a regulator is expanded, the central bank will probably face new challenges in executing its traditional responsibilities and preserving its independence against political pressure. Thus, changes in the role of the Federal Reserve should be carefully considered, bearing in mind the importance of its role in monetary policy and the payment system—and the importance of protecting these functions from political and financial pressures.

The Fed Responds to Crisis

The challenges presented by the subprime meltdown and the subsequent strain in global financial markets have dramatically reshaped the financial landscape in the U.S. Since the onset of the crisis in August 2007, the country has witnessed a series of prominent bank failures: Countrywide, IndyMac and Washington Mutual (by far the largest commercial bank failure in American history); the demise of America's five major investment banks; the bailout of mega-insurer American International Group (AIG); and the decline of mortgage titans Fannie Mae and Freddie Mac. Faced with these extraordinary developments, the Federal Reserve—to which all eyes were turned for rescue—took upon itself the mission of managing and containing the crisis.

Assuming responsibility not only for those banks under its supervision, but for the financial system as a whole, the central bank drew upon long-dormant emergency powers and took bold steps: It enhanced financial institutions' access to liquidity by deploying an array of new short-term liquidity facilities; expanded reciprocal currency arrangements with foreign central banks; engineered and backed JP Morgan's takeover of ailing investment bank Bear Stearns; agreed to lend to Fannie Mae and Freddie Mac; provided an emergency credit line to AIG; and worked out with the U.S. Treasury an ambitious $700 billion emergency rescue package for the American financial services industry.

Thus, the Federal Reserve, established nearly a century ago as lender of last resort to tackle financial panics, emerged in a new, broader guise—that of the nation's financial system savior.

A Systemwide Regulator?

Why has the Federal Reserve assumed this extended role? The reasons appear to be multiple. First, the Federal Reserve is the lender of last resort and has a monopoly over the supply of liquidity to the financial system. This role provides the central bank with both the tools and the expertise for managing and containing systemic disruptions. Second, the Federal Reserve plays a key role in providing payment services and overseeing the payment system, the integrity of which is essential to financial stability. The Federal Reserve also enjoys an unmatched reputation for technical skill and nonpartisanship, the ability to wield moral suasion and a unique "primus inter pares" (first among equals) status among federal regulators, placing it in the prime position for leading national rescue efforts. In the global arena, its close relationship with foreign central banks and its high international acclaim enable the Federal Reserve to coordinate multinational endeavors to shore up crumbling financial markets. Faced with the dramatic developments in the financial system, the Federal Reserve answered a call no other federal agency was better-suited—or willing—to answer.

To date, regulators of financial institutions in the U.S. have been mandated to focus on the prudential issues, namely, business conduct and financial conditions of individual institutions. The recent financial shakeout vividly demonstrates the need for a systemwide, "macro-prudential" approach to financial regulation. Unlike micro-prudential regulation, which focuses on the financial condition of single institutions, the systemwide approach's field of vision is the financial system as a whole, focusing on common exposures, linkages and interdependencies among financial institutions.

It has been suggested that a systemwide regulator, entrusted with the responsibility for maintaining financial system stability, should be able to either collect or access the information required for the evaluation of the systemic risks associated with certain industry-wide practices, common exposures or default by a financial institution, and should be able to wield both the authority and the tools to intervene when needed. In the eyes of many, the Federal Reserve is the natural candidate for the role. A "blueprint" for regulatory overhaul released by the U.S. Department of the Treasury last March (the Paulson plan) recommends mandating the Federal Reserve as "market stability regulator."[1]

Whether formalized or not, the Federal Reserve's extended role in financial oversight, alongside its long-existing roles in maintaining price stability and promoting economic performance, raises important challenges. One such challenge is the potential conflict between micro- and macro-prudential regulatory objectives. Micro-prudential regulation is pro-cyclical by nature—both

because capital requirements and accounting rules enhance the pro-cyclicality already inherent in credit markets and also because prudential regulators tend to be stricter in times of economic weakness and laxer during expansion. The systemwide approach to regulation, on the other hand, aims to stabilize systemic shocks to financial markets and is, therefore, counter-cyclical by definition. Regulatory measures that are desirable from a micro-prudential point of view may seem, therefore, detrimental from a systemic standpoint. (For example, taking corrective action against a financial institution might be well-justified as far as prudential regulation goes, yet undesirable from a system-wide perspective, since doing so may further deteriorate that institution's financial condition and increase the risk it poses to the system.)

Acquiring the information essential to executing the role of systemwide regulator—namely, real-time data about a vast array of financial institutions, their financial condition, structure and the contractual linkages between them—presents additional challenges. First, there are the technical difficulties and non-negligible costs associated with collecting and processing such complex data—both to supervisors and institutions. Then, there's the need for close collaboration with other regulators (public, private and even foreign), who may not be willing to cooperate.

Whither Independence?

Another major concern is that broader responsibilities over the financial system might subject the Federal Reserve to excessive political pressure and, thereby, compromise its independence in the conduct of monetary policy. Independence against narrow political and commercial pressures, that is, being relatively immune to the danger of "captivity" by interested parties, is crucial to the Federal Reserve's monetary policy role. Politicians have always sought influence on the Federal Reserve, especially at times of economic turmoil; they have pressured it to favor certain sectors or industries or to lower interest rates.

An extended role in financial regulation could arouse an even greater appetite for influence among politicians. In addition, such a role entails using taxpayer money and affecting the allocation of credit in the economy and, thus, would inevitably lend fiscal and political nuances to the central bank's actions; that, in turn, would spur demands for greater transparency and closer congressional scrutiny.

Testifying before the Congress' Joint Economic Committee last May, former Federal Reserve Chairman Paul Volcker remarked that broadening the Federal Reserve's authorities beyond the supervision of commercial banks and their bank holding companies would be "a way of destroying the Federal Reserve in the long run because it does need independence." Volcker further wondered whether "such a large responsibility [should] be vested in a single organization, and should that organization reasonably be in the Federal Reserve without risking dilution of its independence and central bank monetary responsibilities?"[2]

Volcker's query broaches yet another challenge facing the Federal Reserve, that of balancing its re-interpreted role in the financial arena with its monetary responsibility. Monetary policy instruments—the interest rate, reserve requirements, short-term liquidity facilities and the discount window—can potentially affect both price and financial system stability, yet in opposite directions. Whereas tight monetary policy may combat inflationary pressure, it may also reduce the availability of credit and may jeopardize borrowers' creditworthiness, thus, potentially weakening the credit market. Hence, in the short run, there may be tradeoffs between achieving the goal of price stability and maintaining a healthy credit market. Having played the role of banking supervisor since its establishment in 1913, the Federal Reserve is no stranger to this tradeoff.

Further Thoughts

If the Federal Reserve is given a systemwide role in financial regulation, the many challenges it might present to the central bank would call for reassessment of its different functions and objectives and for careful planning. Sound conceptual and structural regulatory foundations, successful implementation of a financial stability mandate and continuous adaptation to the ever-changing financial environment would pave the way to a safer economic future. Ω

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ENDNOTES

[1] See the Treasury Department.
[2] See Volcker.

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