Financial Reform Stirs Debate: How Much Power to Give Fed?

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President Obama's financial overhaul not only expands the Federal Reserve's powers but restricts them as well, underscoring the central bank's critical-yet-awkward role in the nation’s regulatory framework and overall economy.

Though many expected the Fed to be given a role in the systemic risk council as well as new powers to oversee and regulate too-big-to-fail firms, the White House’s decision to impose restrictions on the Fed's emergency lending authority is something of a surprise.

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“It shows an attempt to pander to the Congress—some in Congress think the Fed had too much power, some think the Fed needs more power,” says Allan Meltzer, a professor of political economy at Carnegie Mellon and leading Fed historian, who’s quick to add the central bank has “a strong, well-developed, political machine” to support its agenda.

For all the debate over the idea of giving the Fed more power over the biggest institutions, critics and supporters alike suggest it was really the only option.

“The Fed has great expertise in its areas. There's no other way around it,” White House Economist Austan Goolsbee told CNBC Wednesday. "What would the alternative be?”

“The Fed didn't do a real good job in this one [crisis],” counters economist Dean Baker, co-director of the Center for Economic and Policy Research. “It raises concerns but it’s hard for me to envision someone else doing it.”

Baker, Meltzer and others say the Fed has done a poor job supervising bank holding companies, some of whose commercial bank subsidiaries—**Citigroup** , **Bank of America** —have required huge bailouts.

“History tells us the Fed is never there first—and usually much later than its needs to be,” complains Meltzer. "Put the risk on the banker. If you get rid of too big to fail, then he bears the risk."

What The Fed Gains

The new powers—though certainly greater—are not that much different than the Fed’s existing ones, say analysts. Currently, the Fed has the authority to order corrective actions if such firms are violating safety and soundness rules.

“You think of the major institutions, the ones that have gotten into serious trouble—almost all were New York-headquartered institutions,” says Gerald O’Driscoll, who held senior positions with the Dallas Fed and Citigroup. “The Fed was well aware of their activities."

The Obama proposal would extend the Fed's authority to any large ”interconnected” financial firm—including those which have insurance (**AIG**) and investment bank subsidiaries (**Goldman Sachs** ,for instance)—if their potential failure were deemed to present a threat to the overall system.

The plan says if “risk management does not meet standards” then the central bank can “compel corrective actions” and has “emergency authority to take enforcement action.”

“The job they've done has been questionable and we want to load further responsibilities on them?” asks Mark Calabria, a former senior staffer for the Republican side of the Senate Banking Committee, who—along with Driscoll—is now at the Cato Institute.

Supporterr and even some critics counter that the Fed's failures were no worse than any other regulator during the boom-and-bust period that led to the financial crisis.

“No one got it right, so why pick on the Fed?" says Robert Brusca, chief economist at Fact & Opinion Economics. “The question is: Is the Fed going to take a more aggressive approach? If you want to deter banks they need to know there is someone out looking to shut them down. They need a tough regulator.”

Shutting down a big institution, which some in and out of government have recommend be the case with both Citi and AIG—is also addressed in the Obama reform plan, and the Fed would have a vote of sorts in that. Such resolution authority would be reserved for special cases, and not replace bankruptcy law.

Republican lawmakers in particular are skeptical such an action would ever take place and that the resolution authority will be just another bailout instrument.

What The Fed Loses

If the new regulatory authority constitutes a vote of confidence in the Fed, another proposal in the Obama plan represents something of a new check on the powers of the central bank.

That would limit the emergency lending authority under section 13.3 of the Fed’s charter, which the Fed has used widely during the crisis to essentially leverage its balance sheet as an alternative monetary policy tool.

“You really have to make them more accountable,” says Baker.

In the process of leveraging its balance sheet to the tune of some $2.2 trillion dollars, the Fed has raised concerns on both sides of the aisle on Capitol Hill.

Critics say the lending constitutes a violation of the Constitution because it is a form of federal spending, which can only be legislated by Congress.

“This is not emergency lending,” says Driscoll. “It is long-term fiscal policy.” For these reasons and others, some would narrow the Fed's mandate to conducting only monetary policy.

The Obama administration proposal would require the Fed to get written prior approval from the Treasury on “any extension of credit” under the "unusual and exigent circumstances" mentioned in section 13.3.

Driscoll agrees with a House GOP proposal that would require the lending activity be transferred to the Treasury’s balance sheet. It would also require regular audits by the General Accounting Office.

Others say the government needs to tread carefully in this area, given what they consider the Fed’s successful use of its balance sheet in the recent crisis.

“If the banking system is panicking and hoarding cash and not lending to each other, the only way to dig out is to take the Fed’s massive and unlimited balance sheet and substitute it for the banking system,” says long-time Fed watcher David Jones of DMJ Advisors.

Even before the Obama administration’s intention on the Fed lending issue became known, there's been ample talk in Congress ovre the years of reigning in the powers of the central bank.

“I think there's bipartisan support to rethink the Fed, but not on the details,” says Calabria, “but I don’t think there's a broad majority consensus to reform the Fed in specific ways. It’s a tough vote.”

Some in Washington say restricting the Fed’s power—even going to far as to limit it to monetary policy—is as good for the integrity of the financial system as it is the Fed’s independence.

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