Backgrounder

Debating a New Role for the Fed

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1. Introduction
2. The Federal Reserve's Role
3. Holes in the System: Origins of "Systemic Risk"
4. Proposed Changes to the Fed's Role
5. Conflict of Interest Concerns
6. Accountability vs. Independence

Introduction

The role of the Federal Reserve has come under increasing scrutiny in the wake of the global financial crisis. While the U.S. central bank took unprecedented actions to mitigate the effects of the crisis, some experts argue that its policies over the past decade actually contributed to the financial meltdown by encouraging excess borrowing and exercising loose regulatory oversight of banking activity. As Congress considers legislation to overhaul supervision of U.S. financial institutions, some policymakers have called for a substantial expansion of the Fed's regulatory authority to monitor so-called "systemic risk" and prevent future crises. Others have suggested stripping the Fed of its responsibility to oversee banking institutions, monitoring expanded Fed powers through a government audit, or broadening how Fed policies are measured and reported to increase its accountability. While most experts agree that regulating systemic risk is a needed element of financial reform, many disagree about whether assigning this task to the Fed, along with individual bank regulation and monetary policy, would strengthen or weaken the overall financial system and the Fed's performance.

The Federal Reserve's Role

The Federal Reserve, established in 1913 after a series of financial panics in the United States, has two main

responsibilities. The first is to manage U.S. monetary policy; the second is to regulate bank holding companies and other member banks, which include state-chartered banks and foreign banks operating in the United States.

- **Monetary Policy:** Historically, the Fed's main tool for conducting monetary policy has been to vary its fed funds target by altering its purchases and sales of U.S. Treasuries and federal agency securities. The purpose of the fed funds target is to achieve the central bank's so-called "dual mandate," which, as defined by the Federal Reserve Act of 1913, is to maximize price stability and minimize unemployment while maintaining moderate interest rates. The current benchmark for judging the aptness of Fed policy is the so-called Taylor's rule, a formula developed by Stanford economist John Taylor which indicates that interest rates should be raised when inflation or employment rates are high and lowered under the opposite conditions.
- **Bank Regulation:** The Fed also has authority to decide what constitutes allowable financial activities within bank holding companies and member banks and which banks should be allowed to merge. This authority came from the Gramm-Leach-Bliley Act of 1999, which legalized the merger of securities, insurance, and banking institutions that were formerly separated under the 1933 Glass-Steagall Act. It supervises the day-to-day activities of these bank holding companies and some banks and is responsible for ensuring banks' soundness by enforcing existing "micro-prudential" or individual bank regulations such as minimum capital requirements, banking consumer protections, anti-trust laws, and prevention of money laundering.

Holes in the System: Origins of "Systemic Risk"

Experts have sought to identify the key drivers of so-called "systemic risk," or the financial interdependencies that allowed a seemingly limited subprime mortgage crisis to culminate in widespread financial panic in the United States and abroad, as well as the failure of some of the country's most prominent financial institutions. Some critics of Fed policy consider its actions from 2003 to early 2005 at least partially to blame. During this period, the Fed, under the direction of then-chairman Alan Greenspan, kept the federal funds rate at a low 1 percent and allowed for significant credit expansion. In the 2009 book *The Road Ahead for the Fed*, Carnegie Mellon's Tepper School of Business professor Allan Meltzer writes that, judging by the Taylor's rule guidelines on setting interest rates, Greenspan's Fed policy was too expansive, considering that short-term interest rates remained negative as the economy continued to grow. Greenspan attributed this policy to his belief that the U.S. economy faced a risk of deflation (a decline in prices due to a tightening supply of credit) similar to Japan's experience in the 1990s.

Other experts point to the 1999 repeal of the Glass-Steagall Act, which led to a significant escalation in the number of non-bank institutions responsible for issuing credit. The share of credit extended by banks in the United States dropped from 60 percent half a century ago to 20 percent in 2009. Mauro Guillén, professor of management at the University of Pennsylvania's Wharton School of Business, says the repeal of Glass-Steagall was part of a regulatory "race to the bottom" between Britain and the United States in the 1980s and 1990s as they competed to woo financial firms. Federal Reserve Chairman Ben Bernanke has also cited lax government regulation and gaps in oversight as causes of the crisis. In a March 2009 speech at the Council on Foreign Relations, he said, "The risk-management systems of the private sector and government oversight of the financial sector in the United States and some other industrial countries failed to ensure that the inrush of capital was prudently invested, a failure that has led to a powerful reversal in investor sentiment and a seizing up of credit markets."

Proposed Changes to the Fed's Role

Some see the Federal Reserve as an ideal candidate for monitoring systemic risk, since it already acts as a regulator of market cyclicality through its monetary policy. Others say using the Fed in this role would reduce accountability in financial regulation, since the Fed is not overseen by Congress and many attribute past crises to its light touch regulation. "A strong single regulator with a Senate-confirmed head would be better able to avoid gaps in coverage and improve accountability," says Brookings Institution senior fellow Martin Baily. The three main proposals on reforming the Fed's role are outlined as follows:

WHITE HOUSE: Under the Obama administration's proposal (PDF), the Fed's

"A strong single regulator with a

responsibilities would expand to include supervising all institutions that could pose a threat to financial stability, such as insurance conglomerate American International Group or large hedge funds, rather than just bank holding companies and member banks. The Fed would be responsible for monitoring both the day-to-day operations of individual banks and systemic risk and would be advised by a new Financial Services Oversight Council, chaired by the Treasury secretary to identify firms that could pose systemic risk.

Senate-confirmed head would be better able to avoid gaps in coverage and improve accountability. " – Martin Baily, Brookings Institution

SENATE: The Senate bill (PDF), spearheaded by Banking Committee Chairman Christopher Dodd (D-CT), would curb the Federal Reserve's power. The bill proposes a separate single banking regulator to monitor the day-to-day operations of all federal banks, a council of regulators to monitor systemic risk and the country's biggest and most complex financial institutions, and the creation of a Consumer Financial Protection Agency to regulate consumer financial products such as mortgages and credit cards. The plan would limit the Fed's ability to offer emergency loans to companies and eliminate its banking supervisory powers and banking consumer protection oversight. It would also give Congress and the White House some authority on determining how the Federal Reserve's twelve regional banks are governed.

HOUSE: The bill sponsored by Financial Services Committee Chair Barney Frank (D-MA), which passed in December, supports the Obama administration's proposal to have the Fed regulate systemically important institutions and a Financial Services Oversight Council to monitor emerging systemic risks. The bill also gives the Government Accountability Office more oversight power to audit all aspects of the Fed's balance sheets and its regional banks, while exempting Fed interest rate discussions from the audit. The Fed would have to disclose after one year the names of recipients of emergency lending and would curb its authority to lend money to individual institutions in "unusual and exigent" circumstances, requiring the Council's and Treasury's approval. The bill also removes consumer protection power from the Fed, transferring it to a new Consumer Financial Protection Agency.

Conflict of Interest Concerns

Were the Federal Reserve charged with overseeing systemic risk, experts question how it could best respond to systemic threats while still being held accountable for its "dual mandate" of taming inflation and unemployment. Some argue that managing monetary policy (by varying the fed funds rate) and systemic risk simultaneously would make it more difficult to define a clear set of objectives for the Fed and assess its performance.

"It's fair game to say the Fed reached to the edges of its authority, but had it not done so, there's little doubt we'd be in a far more tragic situation today. " – Darrell Duffie, Stanford University

In a September 2009 Cato Institute paper**,** American Enterprise Institute visiting fellow Charles Calomiris writes that under these circumstances, the Fed might be able to justify straying from its fed funds targets based on the need to maintain financial stability. Its departure from the Taylor rule from 2002 to 2005, says Calomiris, encouraged easy credit and "helped set the stage for the subprime crisis." More recently, its decision to hold interest rates near zero and then take further steps to purchase and support various private securities makes it "extremely hard to predict monetary policy, or to hold the Fed accountable to achieving its unannounced and unobservable goals." For these reasons, Calomiris argues that policy tools to respond to systemic risk should not be factored into measurements that assess the Fed's monetary policy, as some economists have proposed. Instead, he says systemic risk regulation--whether conducted by the Fed or another regulator--should be measured and evaluated in terms of increased minimal capital standards, provisioning standards, and reserve requirements.

But Darrell Duffie, professor of finance at Stanford University, says conflicts with monetary policy would exist regardless of whether the Fed regulates systemic risk, since it would be in charge of providing liquidity to systemically important banks in distress regardless of whether another agency were identifying those risks. Duffie also notes that the Fed's biggest shortcomings during the recent crisis resulted from its lack of authority over systemically important

financial firms, rather than incompetence. "It's fair game to say the Fed reached to the edges of its authority, but had it not done so, there's little doubt we'd be in a far more tragic situation today," he says.

Accountability vs. Independence

Experts also question whether the Fed should be subjected to more oversight, given its unprecedented actions during the financial crisis and the potential fallout for the American taxpayer. By increasing its balance sheet from roughly $800 billion at the outset of its bailout plan to more than $2.2 trillion a year later, and by purchasing an unprecedented amount of illiquid assets, some lawmakers and economists say the Fed worked too closely with the Treasury department, sacrificing its independence and leaving the country vulnerable to the risk of inflation. Others say the Fed's inconsistent decisions, allowing some institutions to fail while arranging supports or takeover for others, encouraged the problem of "moral hazard," whereby banks take on more risk and increase leverage assuming that Congress, the administration, or the Fed will bail them out, since there is no clear policy to follow.

"It's not obvious to me that [the Fed] can or should take on the role of manager of the entire financial system and remain both obscure and independent." – John Cochrane, University of Chicago

Some members of Congress, led by Rep. Ron Paul (R-TX), support legislation that would require the Government Accountability Office to audit all Fed activities. Many economists strongly oppose this idea. In a November 2009 Wall Street Journal op-ed, University of Chicago Business school professor Anil Kashyap and Columbia University business school professor Frederic Mishkin argue that subjecting the Fed to the political pressure of GAO monitoring might lead the central bank to seek to lower unemployment more in the short run, ignoring the long-term threat of inflation. In a July 2009 petition signed by more than four hundred economists, Kashyap and Mishkin said such oversight would put upward pressure on interest rates without lowering unemployment in the long run, raising the risk of inflation and causing borrowing costs to rise.

Rep. Mel Watt (D-NC) has proposed an alternative amendment (PDF) to allow the GAO to audit the Fed's new lending facilities while exempting the Fed's normal monetary policy actions from such oversight. The proposal would disclose the borrowers from these facilities one year after the facilities close, enabling Congress to oversee them without creating a "stigma problem," in which borrowing from emergency lending facilities makes it harder for borrowers to operate because investors know the borrower is having financial difficulties.

Others question whether the Fed should be taking on emergency measures at all. Carnegie Mellon's Meltzer says the Fed's role should be pared down to monetary policy and serving as the lender of last resort for distressed banks, "provided they have good collateral. If not, the [banks] should fail," he says. John Cochrane, professor of finance at the University of Chicago, says the Fed's independence has historically been predicated on its powers being limited to monetary policy. "It's not obvious to me that [the Fed] can or should take on the role of manager of the entire financial system and remain both obscure and independent," he says.

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Site Index

REGIONS
Africa
Americas
Asia
Europe/Russia
Middle East
Polar Regions

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Defense/Homeland Security
Democracy and Human Rights
Economics
Energy/Environment
Global Governance
Health, Science, and Technology
International Peace and Security

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Experts
Research Projects
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Daily Analysis
First Take
Daily News Brief
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Interviews
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