Chapter 3[*]

Central Bank Independence and the Role of the Fed

The Fed and the Crisis

The actions or inactions of the Federal Reserve figure prominently on many lists of the causes of the financial and economic crisis of 2007-2009. At the same time, the rapid and creative responses of the Fed are widely credited for limiting the spread and depth of the crisis. Amid the accolades and criticisms, there is agreement that the Fed's role and structure need to be reviewed in the light of recent experience. Financial regulatory reform legislation pending in both the House and Senate would significantly change the way the Fed operates, as well its ability to respond to crises.

Congress created the Fed in 1913, after all too frequent crises and banking panics in 1873, 1884, 1890, 1893, and 1907. European nations, following Englishman Walter Bagehot's 1873 articulation of the idea of a "lender of last resort," had already established central banks and experienced fewer crises than the United States. Central bank lending provides liquidity when and where it is needed to maintain systemic stability or to prevent a run on one financial institution from leading to a systemic panic. Financial crises obviously have not disappeared since the Fed was established nearly a century ago, but they have become far less frequent.

In the wake of the Great Depression of the 1930s, the Fed's powers were centralized and broadened. It gained the authority to respond to emergency situations among nonbanks and nonfinancial firms by lending to them against appropriate collateral (section 13(3) of the Federal Reserve Act). After the Depression, these powers were not used again until March 2008. The Fed's use of this authority in regard to Bear Stearns and AIG has been criticized as an unjustified bailout and has motivated legislative proposals to curb these special lending powers. What is missing from the public debate is an appreciation of why a central bank has such lending authority in the first place.

Current Proposals

Current legislative proposals to alter the functioning of the central bank would emasculate some key central bank functions that have served the U.S. economy well for many years. If approved, the ability of U.S. authorities to respond quickly to an economic crisis would be seriously impaired. If the lending operations of the Fed in 2008 had to conform to legislation now proposed, the Fed might well have been unable to forestall a cascading failure of financial institutions and a collapse of financing for businesses and households alike. Furthermore, the proposed legislation compromises the ability of the central bank to maintain a credible long-run monetary policy that reflects its mandate to maintain stable prices and maximum sustainable employment.

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Our initial premise is that the government has a clear mandate to maintain financial stability. This provides the rationale for regulation and examination of financial institutions to be conducted by a central bank, by regulatory agencies or by a combination of the two. The premise also provides the rationale for a central bank with the authority to lend to financial institutions. Historically, the Fed's discount window provided liquidity to the banking system when there were no other sources. Other common sources of liquidity, such as the federal funds market, the secondary market in government securities and the repurchase agreement market are later inventions. Toward the end of the 20th century, discount lending virtually disappeared, but the lender of last resort aspect of discount lending remained important. At various times, such as the failure of Continental Illinois Bank in 1984, the stock market crash of 1987, and the disruption of many financial operations in the days following the September 11 attacks, the Fed used the discount facility vigorously and successfully to prevent systemic crises from emerging.

Maintaining the Fed's role as an effective lender of last resort is vitally important. Although the proposed legislation leaves the Fed's traditional lending facility intact, both the Senate and House proposals would nonetheless inhibit the ability of the Fed to conduct such lending.

The Senate proposal would remove all bank regulatory and examination functions from the Fed. If that happens, the Fed would have no reliable way of monitoring or evaluating potential borrowers at the discount window. Although the legislation allows the Fed to request information from a new regulatory agency or to ask to participate in examinations, it would be far removed from information regarding potential borrowers and ill-prepared to make sound judgments about them. Under the House bill, the Fed has a continuing role in financial regulation, but the Chairman of the Board is only a member of the new systemic regulator, the Financial Services Oversight Council, which would determine when emergency lending by either the Fed or the FDIC is warranted.

The risks involved in separating lending authority from oversight are illustrated by the experience of the Bank of England and the Financial Services Authority in 2008, when Northern Rock collapsed. Insufficient exchange of information between the lender, the Bank of England, and the regulator delayed an effective response, magnifying the damage from the collapse.

There are elements of both the House and Senate proposals that would politicize monetary policy and crisis management operations of the Fed in ways that could easily prove counterproductive to economic stability. Both bills call for reviews or audits of lending programs introduced in response to the crisis with only limited restrictions on maintaining the confidentiality of information. The House bill, which now incorporates provisions of the Paul-Grayson amendment, calls for an immediate and extensive audit of the Fed's responses to the crisis and also removes the exclusion of monetary policy deliberations from regular audits in the future.

Recommendation

Understanding three pillars of central banking theory and practice would better meet the legitimate objectives of reform:

First, the central bank should have an ongoing role in financial sector regulation. Central bankers need to know about the institutions that borrow from them. This does not mean that the

Fed should be the sole regulator of those institutions. Plans to consolidate the fragmented array of bank regulators in the U.S. into a new agency or agencies promise to make financial regulation more effective. But this should not eliminate the regulatory and supervisory roles of the central bank. Similarly, plans in both the Senate and House bills to establish new systemic regulatory authorities are commendable, and the authority to identify systemic risks and recommend regulatory responses can be shared between the central bank and regulatory authorities. However, the central bank's monetary policy decisions, which include concern for aggregate credit growth and, at times, asset prices, are closely related to concerns for systemic stability.

Second, there is a need for a broad-based emergency lending facility. A lesson of the recent crisis is that central bank lending is needed to provide funding liquidity when markets cease operating and institutions cannot roll over their funding sources. Widespread short-term funding problems in 2007-2009 created enormous systemic problems. Hence, using the Fed's 13(3) emergency powers, the lender of last resort facility was extended to investment banks, money market funds, insurance companies, and in the case of commercial paper issuers, to nonfinancial firms. In a future crisis, funding problems with potential systemic implications may arise in institutions that are still outside the formal purview of the central bank, such as critical financial clearinghouses, exchanges or, possibly, in institutions that have yet to be invented. Thus, it is important that the central bank continue to have a mechanism for providing an emergency response to funding problems that have systemic implications.

The experience of the crisis does suggest ways to improve the Fed's emergency lending authority. The systemic risk regulator (either within the Fed or externally) defines solvency criteria for financial institutions. Those that are deemed insolvent should be put in the hands of the resolution authority. Any institution that does not meet the solvency criteria in a stress test conducted by the Fed, and is not likely to after using the lender of last resort facility, is not eligible for access to the facility.

Pending legislation would severely limit the ability of the Fed to respond to emergencies. The Senate bill would allow emergency lending by the Fed only to institutions that the newly formed Agency for Financial Stability deemed to be systemically important. The House bill would allow for emergency lending, but only after the systemic regulator has asked the President to certify that an emergency exists and only if those voting for the loans believe that there is "a 99 percent likelihood that all funds dispersed or put at risk …will be repaid" (H.R. 4173, section 1701). Such standing facilities, however, are not designed for unexpected shocks or to aim lending in an emergency in an unanticipated but needed direction.

Broad-based emergency lending by the Fed would be severely hampered or, at best, politicized and delayed. The government would be left without a direct means of response to a financial crisis even in the event of war or terrorist attack. Emergency lending powers are a potent tool, of course, and must be subject to careful controls. Hence, any Fed lending to individual nonbanks should require the approval of the Secretary of the Treasury, as well as a majority of the members of the Board of Governors of the Federal Reserve. Moreover, to preserve the independence of Federal Reserve monetary policy, the Treasury Secretary should be required to propose a supplementary budget for Congressional approval that would remove such lending from the Fed balance sheet at face value within one year.

Third, central bank independence -- both in terms of monetary policy decisions and lending activities -- should not be compromised. A hallmark of an effective central bank is its independence. There are two good reasons to value such independence: (1) monetary policy decisions should be made outside of the political arena because history shows that elected governments have a strong bias toward inflation; and (2) independence is needed so that both regular and emergency lending authority can be used without any fear of political influence.

That politics and the effective functioning of a central bank do not mix is borne out by experience. Throughout U.S. history, fears that the central bank might be overreaching its proper boundaries -- whether expressed through Congress or the White House -- have led to bad results. In 1811 and 1832, such fears put then well-functioning central banks out of existence. In 1913, when the modern Fed was created, it was structured as a decentralized "system" of regional banks, which functioned sub-optimally -- notably in the 1930-33 Depression -- until the modern, centralized governance structure was created in 1935. Even then, the Fed remained subordinate to the Treasury and was not formally granted independence until the 1951 Accord, a circumstance that effectively fueled higher than desirable rates of inflation during the years immediately after World War II.

Provisions of the House bill, in particular, would seriously compromise the independence of the Fed. Subjecting monetary policy deliberations and decisions of the Fed to an external audit by the Government Accountability Office (GAO) would move the process squarely into the political realm. While governments around the world have worked to insulate monetary policy from political influence, this legislation would reverse that progress in the U.S. and weaken the credibility of the Fed's commitment to keep inflation low and stable.

Provisions in the Senate bill affecting the governance of the regional Federal Reserve Banks are aimed at encouraging accountability. However, the changes (section 1202) would essentially make the leadership of the regional banks political appointees and risk undermining the Fed's anti-inflation credibility.

Over the past 20 years, the Fed has slowly, often reluctantly, increased the transparency of its monetary policy decision making. More can be done in this regard. Other countries and central banks publish more detailed policy objectives, alternative scenarios and risks of forecasts than the U.S. does at present. The Fed should take further steps in that direction. But increased transparency in the conduct of monetary policy can, and should, be achieved without compromising the independence of the decision makers to articulate their views and reach their own conclusions.

Similarly, to function effectively as a lender of last resort, the Fed must be able to resist political pressures. Requirements in legislation pending in the Senate (section 1201) that Fed lending (amounts, terms, names of the borrower, etc.) be reported to Congress within seven days would make central bank lending a political decision. Although the proposals allow the Fed to request a delay for up to one year, that would do little to reaffirm the independence of lending decisions. Experience tells us that making such information public could easily have a destabilizing influence. In 1932 and early 1933, Congress required the Reconstruction Finance Corporation to reveal names of the recipients of its loans. The effect was to exacerbate the catastrophic run on a fragile banking system, rather than to stabilize it.

Transparency and accountability should accompany independence. Greater transparency about the objectives and future path of Fed policy can anchor expectations and lead to better policy outcomes. But transparency should be enhanced without compromising the independence of monetary policy decision makers.

Conclusion

In sum, proposed legislation would compromise three important tenets of central banking: (1) the ability of the lender of last resort to have detailed knowledge about those who borrow from it; (2) the ability of the central bank to respond in a timely and effective fashion to extraordinary crisis situations; and (3) the ability of the central bank to keep policy making out of the political arena. Rather than working to strengthen the U.S. financial system or to make monetary policy more effective, we believe that current legislative proposals in these three areas would achieve the opposite outcome.