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# THE FED IN THE 21ST CENTURY: INDEPENDENCE, GOVERNANCE AND ACCOUNTABILITY

Washington, D.C.

Monday, March 2, 2015

PARTICIPANTS:

**Welcome:**

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**The Twelve Federal Reserve Banks: Governance and Accountability in the 21st Century:**

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President and Chief Executive Officer
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**Financial Stability in the Broader Mandate for Central Banks: A Political Economy Perspective:**

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**Panel Discussion:**

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Former Congressman (D-MA)
U.S. House of Representatives

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P R O C E E D I N G S

MR. WESSEL: Good morning; I'm David Wessel. I'm Director of the Hutchins Center of Fiscal and Monetary Policy here at Brookings. I appreciate that you all made it despite yet another weather delayed, weather frustrating day in Washington. I'm ready for global warming myself. (Laughter)

The Hutchins Center's mission is to improve the quality of fiscal and monetary policy and public understanding of it, and today's discussion is very much in furtherance of those aims. I want to emphasize that there is no Hutchins Center or Brookings Position on these issues. We don't necessarily agree with what the papers we've commissioned have to say. In fact we don't even always agree among ourselves here in Brookings, and that's very much in the spirit of open and honest inquiry. We're very grateful to Glenn Hutchins who is the benefactor of the Hutchins Center and who will be here later. Glenn is a model donor. He has been very supportive of us and given us a lot of advice, but is not involved in choosing the topics we discuss or the people who discuss them. And that's important because Glenn happens to be on the Board of the New York Fed and I don't want anybody to think that he has any influence over this. And after you hear Peter Conti-Brown you will know that he didn't. (Laughter)

The subject today of the Federal Reserve accountability and governance is particularly important. It's got a lot of prominence lately. Partly that's because of the nature of the Fed, an institution of enormous economic power given goals by Congress, and then designed to be independent of elected politicians in pursuing those goals. But I think that in recent days some of the discussion has been untethered by facts, infused with partisan venom, and demeaning to the public servants who work diligently in pursuit of the statutory mandates of the Federal Reserve Act. And we will not participate in that kind of discussion. But the Federal Reserve Act is not perfect, Fed officials are not divine, neither are members of Congress, and an essential compliment to having an independent central bank is that it must be accountable to the elected leadership of the nation and to the public at large. And we see today's discussion as very much in that spirit. We're going to ask some questions, perhaps answer a few about the Federal Reserve

Act itself, about the governance of the Fed, about the nature of independence given the Fed's expanded mandate to avoid financial instability, about the relationship between Congress and the Fed, about whether there are better ways to hold the Fed accountable, about whether there are better ways that Congress could do its job. And we will do that with reason, with evidence, and with civility.

Now I want to explain to you a little bit about the order of our program which is weather impaired. We're going to begin with a presentation by Peter Conti-Brown who I'll introduce in a moment, followed by a response from Charlie Plosser who is enjoying the first day of his retirement as the President of the Federal Reserve Bank of Philadelphia, and his wife wouldn't let him stay in the house so he came down here. Our second paper is by Viral Acharya at NYU who didn't make it this morning, so he'll be participating by phone as will his discussant, Jeremy Stein, who is snowed-in in Boston. We've decided not to do anymore events in February. (Laughter) And after that we'll have a panel discussion with Ben Bernanke, Sarah Binder, Barney Frank, and Ruth Porat. Three out of the four of them are here and Barney fortunately is coming from Atlanta not from Boston so he will be here shortly.

So we're going to begin with Peter Conti-Brown who is a lawyer, a Ph.D. student in economic history at Princeton, and will as of July 1 be an Assistant Professor at the Wharton School at the University of Pennsylvania. We're very pleased to have him discuss the Federal Reserve Act, governance of the regional Fed banks. Peter, why don't you come up?

MR. CONTI-BROWN: Well, thank you for that introduction. It's an honor to be here to speak today with so many leaders in the intellectual and practical world of central banking. When I sent today's program to a good friend of mine he wrote back by quoting Sesame Street, "One of these things is not like the others, one of these just isn't the same." You probably had the same reaction when you opened your program; I certainly did. So my warmest thanks to David Wessel and Kerry Grannis and others at Brookings for the honor to be here and participate.

Now to answer my friend's question on the Sesame Street joke, in addition to having a much lower profile than the other presenters today I am also different in that I'm a legal scholar and a financial historian. And so I look at these questions of central banking governance accountability and independence from a slightly different methodological approach than the macroeconomists who dominate the field. I think those differences methodologically are useful, and I hope to persuade you of that too as we discuss some of the history and norms that we'll be discussing today.

So does anyone feel like the Fed is out to get us, (laughter) so asks Senator Rand Paul recently to a group of presidential vetters in Iowa. The question is part of his most recent campaign to subject the Fed to a public Congressional audit. There is much to criticize about this proposal, not least the fact that the usual vocabulary of balance sheets and assets and profits and leverage are useful at best metaphorically only when we're talking about the Fed, and given too that the Fed is already subject to an annual audit, it is very easy to dismiss this proposal and the impulse behind it as the product of so much confusion. So it has been dismissed frankly. Here is Richard Fisher, President of the Federal Reserve Bank of Dallas, who in their right mind would ask the Congress of the United States who can't cobble together a fiscal policy to assume control of monetary policy.

Well, the answer to President Fisher's question is well, a lot of people. And this isn't just a right wing conspiracy. Audit the Fed began on the populist left, and today critics on the left and the right are profoundly uncomfortable with it regard as the combination of the Fed's extraordinary power and utter opacity. So audit the Fed and related proposals, tap into a very old, still very salient impulse that we want economic prosperity and financial stability, but still want to participate in the formulation of the policies that provide those. Now as long as there have been the United States we've had this debate. I'm noting the irony of having Andrew Jackson and Thomas Jefferson on the face of Federal Reserve Notes here as they square off in fact and intellectually against Alexander Hamilton.

Now the financial crisis and the post crisis monetary response have only exacerbated these perennial debates. As a consequence there has been no shortage of discussion during and unceasingly since the crisis about how to reform the Fed. Now most of these discussions there have to do with reforming the Fed's functions. That is changing the way it lends money in an emergency, how it determines which financial institutions are systemically important, and on and on and on. Audit the Fed is just one of them. There's Taylor Rules, the Urban Amendment, Volcker Rule, Liquidity Coverage Ratio, et cetera, et cetera, et cetera.

What I want to talk about today though is the Fed's structure and its governance, the topic of today's conference. And it is raises a different question, not what should the Fed do, but who is the Fed? Public and scholarly attention on the Fed usually focus on the monolithic "it", and often in fact a personal "he" or "she". In fact the standard grammatical practice I'm following today, and everybody will, is to refer to the Federal Reserve as though it were a proper noun. This is grammatically incorrect. The Federal Reserve is a compound adjective, it modifies other nouns, like Federal Reserve Banks and Federal Reserve Notes, there's a Federal Reserve Board historically; and taken together a Federal Reserve System created by the Federal Reserve Act. There's not Federal Reserve by itself. And this question is actually more than just a pedantic grammatical point, it stresses that the Federal Reserve System is in fact an ecosystem of institutional actors and individuals with different kinds of incentives, and layers upon layers of governance.

The problem with this kind of governance opacity as you see here in this slightly dated pre Dodd-Frank chart is that when people feel a reflexive desire to understand, even criticize, the Federal Reserve they are not exactly sure to whom they should point. This is why all debates end up spiraling very quickly into first principles about the gold standard, the coinage clause, U.S. Constitution, the democratic virtues of Thomas Jefferson, or the venal tyrannies of Alexander Hamilton and yes, also about audit the Fed.

I've written a book. It's called the Power and Independence of the Federal Reserve, and it takes up the largely descriptive questions of what is this ecosystem. Today though I want to talk about a specific question, both historical and legal, about the nature of this governance system and whether it's operating the way that we would want it to operate. As you note from the disclaimer that David gave I don't think that it's operating the way that we should want and have a few different proposals in what we should do to fix it.

So in place of this complicated governance structure I would recommend extending public accountability in a way that protects the essential buffer between central banking functions and the day to day of electoral politics, but that still gives us better understanding and access to the personnel, the individuals who are pulling these levers of power. The proposals, just to front load things a little, the different proposals that I'll float is number one, subjecting all the reserve bank presidents, there are 12 of them, to the Constitutional Appointments clause process, which means the U.S. president nominates, the Senate confirms. Alternatively selecting just one of them, the New York Fed's president, and subjecting him or her to that same process. And the third -- I like both of these, but the third I like the best would be turning the Reserve bank presidents into branches of the Board of Governors, effectively giving spirit to the letter of one of the most profound amendments to the Federal Reserve Act which occurred during the New Deal in 1935.

Now first, we need a little bit of history. In the years following the panic of 1907, one of the largest financial panics that we had had in our history, there was a great debate in this country about banking. Now contrary to popular misconceptions this wasn't a slap dash, crisis driven, Congress responding to populist pressure kind of debate. The panic of 1907 happened in 1907 and the Federal Reserve Act of 1913 happened -- I don't mean to pick up the suspense, but 1913. So there were six years between these two key events, six years, two presidential elections, three congressional elections. In the six years between there was a very thorough international quest to understand our banking system and other banking systems, and to understand what kind of system we should have. Structurally these focused on two debates. One was centralization versus decentralization. Should we have a central bank that is focused in one place or disbursed throughout the country. The second debate was should it be public or should it be private. There were many who didn't want a central bank at all and they were thinking well, we've already got essentially that, the U.S. Treasury. So it's a public centralized system. That was sort of the status quo. The alternatives here were the Aldrich Plan which had the longest process of vetting and incubation which was the republican plan. I'm taking of course not a picture drawn by Nelson Aldrich in defense of his plan, but drawn by his critics. That was going to be centralized and private; centralized in New York City under the control almost exclusively of private bankers on the 40 person Board, 3 would be governmental appointees, not including anyone with an executive function. The other side was the Glass Plan. As the democratic tides were turning the democrats took first the House, then the Senate, and the White House in 1910 and 1912 respectively. And his vision was to have a decentralized system with as many as 50 reserve banks. The number he actually threw around most often was 20, but his idea was that we want to decentralize private system, and here's his quote for why: "United States, with its immense area, numerous natural divisions, still more numerous competing divisions, and abundant outlets to foreign currencies, there's no argument either in banking theory or of expediency which dictates the creation of a single central banking institution, no matter how skillfully managed, how carefully controlled, how patriotically conducted."

Neither of those plans won. In its place came the Wilsonian Compromise. And Wilson thought himself something of a James Madison, as an institution builder and constitution maker. He was a political theorist and a historian, and this was his constitutional moment and he seized it. The result was the Federal Reserve System that was quite unlike the one that we have today, quite unlike the Aldrich Plan and quite unlike the Glass Plan, and that was that we would have eight to twelve Reserve Banks, the number was eventually set at twelve after the legislation, with a Federal Reserve Board that consisted of public appointees, chaired by the administration's secretary of the treasury ex officio. And then these Reserve Banks spread throughout the country. So on this graph which you should have in the papers that you've been given, this chart, we've got these two polls, centralized versus decentralized, private leadership versus public leadership, Wilsonian Compromise right in the middle. And in the tradition of other great constitutional type compromises this one was utterly ambiguous as to who would wield the power, and as a consequence became something of a failure. Now when I say that it failed and failed miserably in the sense of from a governance perspective I'm not putting a gloss on history. And nearly everyone agreed that from the very beginning, before the Fed even opened its doors there were contests for power among the Reserve Banks, between the Reserve Banks and the Federal Reserve Board.  And this lasted until the New Deal.

Now one of the biggest questions for economic historians is what caused the great depression.  As then Princeton economist Ben Bernanke put it, this is the holy grail of research questions for economic historians.  I'm very suspicious of mono causal explanations, but roughly no one in economic history disputes the Fed's role in at least exacerbating the great depression.  And while the critiques are almost always on the functions of the Fed, I think this was also a governance failure.  So in comes, Marriner Eccles and Franklin Roosevelt.  Marriner Eccles, one of the most colorful figures in Fed history, was a Mormon millionaire banker from Utah, son of a bigamist, and someone more radical than Franklin Roosevelt.  He was Keynesian before Keynes in his ideas about the government's role in responding to economic depression, financial depression, made him far to the left of virtually everyone within the administration.  He was offered what was then called the governorship of the Federal Reserve Board and he rejected it, absolutely not, why would I take that.  His direct quote is, "I wouldn't touch it with a 10 foot pole unless fundamental changes were made to the Federal Reserve System."  As his assistant, Lauchlin Currie, said, "Such an organization as the Fed, it's almost impossible to place definite responsibility anywhere.  The layman is completely bewildered by all the officers, banks, and boards, even the outside experts know only the legal forums."

So here came the 1935 Act.  This was a radical restructuring of the Fed.  It demoted the Federal Reserve banks; they got not the regal term governor to apply to themselves, but the more pedestrian president.  Governors instead were reserved to the newly created Board of Governors established in 1935.  One of my favorite items that I have in my research on the Fed is a mug that was issued in 2013, it says, "Board of Governors, Federal Reserve System, 100 years."  I love this mug so much because it's telling us all a very malicious lie.  The Board of Governors was founded in 1935, not 1913, and this point is a very profound one.  Going back to this chart, the Banking Act undid the Wilsonian Compromise.  I should say undid it by rendering the Reserve Banks subordinate to the newly formed Board of Governors in all matters regulatory and supervisory. Had Eccles had his way the Reserve Banks would have had absolutely no role in national policy making. Eccles disobeyed that rule from applied philosopher Omar Little, if you're going to attack the king you best not miss. And he came attacking the king -- that's a reference to The Wire. Thank you for the one person who watches The Wire (laughter); I appreciate that. He missed. He came at the king and he missed. He was a terrible politician. Carter Glass, that great patriarch of the Reserve Banks placed them in a minority position on the FOMC even as the statute made crystal clear that will all matters supervisory and regulatory they were in fact subordinate. But again because they continued in this role their ability to influence national policy has continued.

Now what's the problem with this? Well, in good times not much. I mean the Reserve Banks serve a vital function. Their presidents are placed there under a pre Dodd-Frank almost exclusively under the influence of private bankers, post Dodd-Frank still largely under the influence of private bankers. And then during good time they served a vital information gathering and coordination function. But in this way I think they are much like the gall bladder of the American financial system. (Laughter) They serve an important but non vital function in good times, and in bad times they can threaten to bring down the entire system. And as with gall bladder I'm wondering if we shouldn't have something of a surgery here and do something about the Reserve Banks.

I'm going to save for the paper and my other work exactly what I think the problems are, and let me go very, very briefly as my time is out on what we should do. So number one, just increase the public accountability by making the Reserve Bank presidents presidential appointments. There is a Constitutional issue in fact that I discuss in the paper that would be resolved in this way. They are principal officers arguably of the United States government, but they're put there by bankers. That seems kind of an odd structure. This proposal has the demerit of having a 19 person committee deciding so much of our monetary and regulatory policy is kind of unwielding. So an alternative might be one that's pending before the Congress which is just focus on the New York Fed President. He is unmistakably first among equals within the system, so just change his role to being appointed not by New York bankers, but by the President and confirmed by the Senate. I like this proposal too. One, the aspect of it that I don't like is then, you know, Bank of America is a banking juggernaut as is Wells Fargo, neither of whom is regulated by the New York Fed. Would we be less concerned about their governance structures? I don't think so, but again I like this trend in that direction. The one I like the best and the one I'll leave you with is that we just finish the job that Marriner Eccles and Franklin Roosevelt started by rendering the Reserve Banks plainly and unmistakably subordinate to the Board of Governors. Carter Glass' original conception was not even to have 12 banks. Why do we need two in the State of Missouri and only one west of Dallas? Instead we can have them wherever the Board of Governors wants to put them and have them be branch offices of the central bank.

Now out of interest of self preservation I'll say -- because my respondent is the former Philadelphia Fed President Charles Plosser, I think this proposal really should just be to 11 of the Reserve Banks (laughter); Philadelphia should stay where it is.

I'm going to leave you there. Thank you. (Applause)

MR. PLOSSER: So good morning, everybody. I'm delighted to be here. This is a wonderful place to come talk. It's a fascinating conference and I want to tank David for inviting me. I asked him why he wanted me to come talk about this paper, and he said because I thought you would have a different perspective. (Laughter) And indeed I certainly do have a different perspective. And so now we can for something completely different.

You know, I think this paper is fascinating. It's a run read, I learned a lot of history, or at least history at least through Peter's lens. And I think the title sort of tells it all. It says, "The problem of the Federal Reserve Banks." And Peter's view seems to be that no matter what lens he looks through Reserve Banks are a failure. And then he asserts at the end, and he said this in his remarks, that they can threaten the entire system under the wrong circumstances. So again I think there is a lot of interesting material. It's a fun read, but I confess that at the end I didn't find his arguments very compelling. I didn't think his evidence was very persuasive to support the kind of conclusions he's come to.

And so what I'm going to try to do in my discussion is try to give you where those doubts come from. And since I don't have terribly long I'm going to try to make them brief. I'm going to start up front by saying I am not a lawyer and I have no stand on the Constitutional issues that occupy a fair amount of that paper; I don't have any particular insights into that, and it wouldn't be useful for me to go there. I would simply make one observation about the legal entanglements, and that is that Federal Reserve Banks have been around for 100 years, FOMC has been around for 80 years. There have been many revisions to the Federal Reserve Act over the years, and you'd think that if there was true economic or policy harm being done by this governance structure you might have thought that over 100 years somebody could have made the cogent case well enough to either have the Federal Reserve Act changed or taken to the Court mechanism. So I guess as a positive statement maybe he is right, but as a practical statement it seems like there hasn't been enough evidence to really push the Courts or Congress into doing something different.

So I agree with Peter, I think there is a huge element of this centralization versus decentralization in the nature of the founding of the Federal Reserve in the 1913 Act. It was obviously a reaction to very centralized first and second banks of the United States which didn't work out so well from many people's perspective. And so there was this tension between centralization and decentralization. But I would also remind the audience that we were still under a gold standard. Monetary policy wasn't a particularly important function at the time. And indeed the Federal Reserve Banks were set up more to create an elastic currency. And they were modeled in a practical sense after the clearing houses. Private clearing houses scattered throughout the country actually worked pretty well in many circumstances. Not always, but these clearing houses provided a kind of like elastic currency to the banks that were members of the clearing houses. So these Reserve Banks were anticipated to provide a clearing house function for the nation at large backed by a sort of systematic way of doing that. But the model was a private model, a model where banks joined the clearing house, put in capital, subjected themselves to oversight by some degree of the clearing house, and then the clearing house provided for redemption circulation currencies it needed to help prevent bank runs and panics, and even just seasonal variations in the demand for cash. So it wasn't such an unusual concept from my perspective about why they were set up the way they did. And again monetary policy being under a gold standard played less of a role.

Now one of the themes of this paper is the claim that the private dimension of the Reserve Banks has led the Banks and the presidents in particular to be captured by the bankers in their districts. And I think it's really this feature that he stresses the most in his claim that the system has failed. Doesn't really help us very much in saying well why does the system that he proposes fix any of these problems. We'll come back to that in a minute.

And it also talks about the 1935 and 1937 reforms. They were profound repudiations of if you will of the Reserve Bank model. I guess here too I see history a little bit differently. In the mid 1930s we had left the gold standard, so the role of the Fed now was taking on a different function above and beyond just kind of reacting to the gold standard and acting as a clearing house. So the role of the Fed was changing, monetary policy and price determination in terms of their interaction with the central bank was beginning to change. So the world had changed and the model was adjusted accordingly. I would note that the increase in authority provided to the new centralized Board of Governors was also not unusual for the time. This was Roosevelt, this was the New Deal. All across the board the Roosevelt government and administration was consolidating authority in Washington, granting more power. One might look at this event as just one more example of that movement in history towards a more centralized authority. Whether that was the right thing to do, a good thing to do, a bad thing to do is a question we could debate, but I'm not going to do that here. So it has certainly been shown that some of that consolidation of centralizing authorities isn't always beneficial or desirable.

I'll also make one more brief observation. Most economists think that it was the Fed Treasury Accord in 1951 which was the central event in establishing Fed independence. Excessive inflation following World War II came in direct conflict with the political desires to keep interest rates low. That led to a conflict between the fed and the administration. And these efforts manifested themselves in the Fed Treasury Accord, granting independence to the Fed to conduct monetary policy. Now efforts such as this to politicize the decisions of the Fed are not new, and I would argue often times lead to bad outcomes. Peter seems to suggest that independence is some quirky notion that arose in the 1980s and '90s. I don't agree with that. The Bank of England was independent long before, for many hundreds of years before World War I, when it lost its independence under World War I, but independence was not a unique phenomenon that just arose in the latter half of the 20th century. In fact most economists would argue that in fact independence -- we are in favor of -- many economists tend to be in favor of independence because independent central banks have better outcomes.

So I want to talk for a few minutes now about well what are the three biggest Fed failures. Now this is not a unique list. I'm just going to come up with three topics that I think are largely attributed to failures of the Federal Reserve System. And I think it's worthwhile to think about that and then ask the question whether these failures somehow were caused by the Reserve Banks and their governance structure, and if so, or not, would have the proposals that Peter suggested change any of those outcomes.

Let me first talk about the great depression briefly. So I'm talking three of them. The Fed clearly didn't act very well in providing elastic currency in the great depression. Its big failure of course was letting banks fail. Now of course it was torn in that episode because it was struggling with following the rules of the gold standard which told it to do one thing, trying to stop what it perceived as speculation in the credit markets, and the falling price level of the banks in trouble. It was struggling with those. I think it's fair to say that economists and the Fed didn't really understand the complexity of those sets of issues. I think our models and theories about that were not well understood, and as a result the Fed allowed hundreds of banks to fail. Now if you're allowing hundreds of banks to fail it's pretty hard to argue that you must have been captured by the private bankers on the boards and yet you still went ahead and let all these banks fail. So I think it doesn't necessarily -- it's not such like strong evidence that it was capture and it was the private nature of this structure that was really important. I'm not sure that's a compelling case for something wrong with the structure.

Let me turn to the great inflation. High rates of inflation in the '70s and early '80s can also be considered one of the Fed's major failings. Here again it's hard to argue that the failure was due to the governance structure. The story whether a (inaudible) or literally true, was that President Johnson took William McChesney Martin by the lapels and shook him until he was ready to say yes, we'll support the great society and the War in Viet Nam with easy money. And of course that wasn't much better a lesson between Arthur Burns and Richard Nixon following.

So whether the political pressure was so blatant as that or not I don't really know; I've heard that was true, but the effect was the same. The failure was an outcome of too much political control, not of insufficient political control. Why would the governance model suggested in this paper have yielded a different outcome in that circumstance?

So much of the arguments in this paper rest on the financial crisis, and that's what I'll talk about last. Rest on the presumption that the financial crisis and the presumed failings of the Fed in the regulatory arena, not the monetary policy arena, the regulatory arena, that there's assertion that Reserve Bank presidents are captured by their boards and bankers, and this governance structure is a major threat to good policy. First and foremost, and Peter mentions this, regulatory authority is a delegated authority to the Reserve Banks. Reserve Bank presidents play no role particularly in regulation. They have staffs or boots on the ground if you will, but they are not deeply involved in the regulatory issues directly. So why does changing the make-up of the FOMC effect this problem? I don't think it does. The governors have the authority even to remove a president for cause, and a good cause would be the president failing to deliver on the regulatory directions and authorities that the board intended it to have.

So my point is not to absolve the Board of Governors or the presidents of any responsibility for regulatory mishaps. We clearly made some. Capture is a real concern for regulatory agencies, of all sorts and must be guarded again. What I will argue is that there's no compelling evidence that says the structure of the Fed was an important factor. If in fact the crisis arose from excess deference to bankers then it was shared by a lot of people, not just the Fed.

Consider the other regulatory agencies. The OCC, they regulate and supervise national banks, including JP Morgan and Citibank. The OTS, Office of Thrift Supervision, who is responsible for the thrift industry. AIG was a thrift holding company. WaMu, Countrywide, huge failures of both oversight and responsibility. The FDIC has responsibility for state chartered non member banks. The SEC had responsibility for investment banks including Bear Stearns, Lehman Brothers. And the old office of -- I think it was called OFAO if I recall had responsibility for the GSEs. Now these agencies did not have the governance structure that Peter despises so much in the Fed. Their leadership and supervisors had a direct line of sight so to speak and yet they missed important dimensions of excess risk taking and the OTS was obviously most egregious.

Indeed in the early 2000s it was Alan Greenspan and Bill Poole, who was President of the St. Louis Fed, who repeatedly warned of the financial fragility of the GSEs and urged Congress to require more capital in those agencies. Congress refused to comply. Think of the other countries, the UK, the FSA failed, Northern Iraq, Lloyds of London. My point is that one is hard pressed I think to make the claim that it's the Fed's governance structure that was the source of all these problems or failures. Every agency, regardless of the governance structure fell short. Plus I don't see much evidence that imposing a different governance structure on the Fed would have led to any different outcome than we had.

So in summary I see this paper as a solution in search of a problem. From my perspective some of the biggest Fed failures over time have come from the excessive political influence, not the lack of political control. Here I see the Reserve Banks as offering, from my perspective, somewhat of a buffer to protect political control from Congress.

The Federal Reserve is an interesting institution, but like many institutions in and out of government it has evolved and changed over time, and it continues to do so. Ben Bernanke addressed very important issues of transparency, accountability, and independence. These are good principles and I believe the Fed will continue that journey. The biggest danger I see is the risk of making the Fed less independent, more susceptible to the short-term political whims that constantly buffet Washington. That is where true policy risks are likely to come from.

Thank you. (Applause)

MR. WESSEL: Thank you very much, both of you. As a reporter covering the Federal Reserve I have often been in search of new and different metaphors, but it never occurred to me to describe the Federal Reserve Banks as the gall bladder of the American economy. (Laughter) So if for nothing else we got that something for coming out today.

I want to mention, and I should have, that Peter's paper is on our website, or if it isn't it will be shortly, and as he suggested it has a lot of more institutional detail and a big discussion of the Constitutionality of the Reserve Banks which he questions. Viral's paper in the second section is not going to be on the website, but it will be in a couple of weeks.

Charlie, let me just ask you, start with one question to you.

MR. PLOSSER: I thought this was about his paper.

MR. WESSEL: It is. (Laughter) I wanted to ask about something you said and then I'm going to -- so do you see any questions of legitimacy that the Federal Reserve Banks are not government institutions and this perception which Peter shared that somehow they are controlled by the bankers? Do you think that that has any role to play in the political antipathy to the Fed?

MR. PLOSSER: A lot of things can play a role in the antipathy towards to the Fed. I think they can come from lots of different sources. My own personal reaction is that a lot of the antipathy --

MR. WESSEL: My fault, I started it wrong.

MR. PLOSSER: Yeah, you started it.

MR. WESSEL: Hostility.

MR. PLOSSER: Hostility towards the Fed has not emanated from the Reserve Banks, it's emanated from the general policy decisions. I mean if you think about the bailouts under Section 133, Reserve Banks, that's a Board function, it's a Board decision.

MR. WESSEL: Right, but the public doesn't always think of it that way.

MR. PLOSSER: I understand that. So the question then becomes I think it is a question about understanding the Fed and being more transparent about what decisions get made and how they make them. I agree with that, but I legitimacy I think is not quite the right way to think about it. I mean I said I wasn't going to get involved in the legal stuff because I can't make those arguments, but we are created by an Act of Congress, so in some sense it's legal. Now whether or not you can find a better institutional design, perhaps, but it seems to be you've got to relate that better design to sort of where the failings are and make sure that your new design, whatever it happens to be, fixes the problems.

MR. WESSEL: Peter suggests having the presidents appointed by the Board of Governors.

MR. PLOSSER: So you'd make presidents sort of senior staff people essentially.

MR. WESSEL: And you think that would be a bad idea?

MR. PLOSSER: I don't see what it would accomplish. Ridiculous.

MR. WESSEL: And what about Dick Fisher's --

MR. PLOSSER: So just to elaborate that a little bit, I think many of the failings that Peter alludes to, and other people allude to, in many cases in the realm of regulatory and supervisory actions of which the presidents are mostly out of the loop anyway. I think the criticisms of monetary policy, maybe they're good, maybe they're bad, regardless of what I think of them individually. Certainly 133 lending bailouts are the responsibility of the Board. So I think the question then becomes you can't lump from my perspective monetary policy and regulatory policy into the same discussion. I think they're different, and you have to recognize that they're different.

MR. WESSEL: So, Peter, I'm going to ask you one question about something you said and then let you respond to what Mr. Plosser said. You suggested that the Reserve Bank presidents are under the influence of private bankers.

MR. CONTI-BROWN: Yes.

MR. WESSEL: Now I know there is that perception, but do you really think that's true? I mean there is a Board of Directors at each Federal Reserve Bank, there are nine people, six of them are appointed by the banks, the bankers themselves on the Board no longer play a role in the selection of the president, the Board of Governors essentially has veto over the appointment of any president. Do you really think that that's the problem, the Reserve Bank presidents are "under the influence" of bankers?

MR. CONTI-BROWN: I really do. Again, the legalistic formulism is important here, amended in Dodd-Frank as you're alluding, but it's not true that the bankers on the Board have absolutely no role in their selection. They are sitting on a Board with their friends and talking to each other. They're going to talk over coffee and snacks about what do you think of this candidate versus another. We don't have a formal vote, but that doesn't mean that their influence isn't felt. And we know this analogously on the FOMC. The FOMC isn't a 12 person committee, it's a 19 person committee, it's just that 12 vote. The other seven are actively participated in that discussion. So I think the bankers are absolutely still in that mix, participating in the discussion of who the Reserve Bank presidents will be. And importantly Dodd-Frank did nothing to change who gets to fire summarily the Reserve Bank president. It's ambiguous as to whether the Board of Governors can fire for cause the Reserve Banks because the Federal Reserve Bank has another provision that says that the Board of Directors, all three classes, can fire at pleasure the Reserve Bank president or any other officer within the Reserve Bank.

So I think you play for them that brought you. And the Reserve Banks are coming through the active formal, legal, and active informal non statutory participation of bankers who are participating in that. Now does that mean they're just schilling for the banks, that they're puppets? No, absolutely not. And I'm not just saying that because Charles Plosser is sitting to my right, but Reserve Bank presidents are distinguished academics and increasingly macroeconomists who are absolutely a part of this system. The question is that kind of influence and whether we in the public can say, you know, this was a decision that was reached by the Fed, who participated in that decision and how can I participate in a political process if I don't like it.

MR. WESSEL: And Mr. Plosser suggested that you paper is a solution in search of a problem. Do we have any reason to believe that the decisions that the Fed has made on either monetary policy or supervisory policy would have been different with a different governance structure?

MR. CONTI-BROWN: You know, counterfactuals are the historians' playground, so I would be delighted to talk at great length about some of those. A couple of examples where I think differences would have been -- could have occurred. So Mr. Plosser says that 133 is a Board function, that the Reserve Banks have nothing to do with that and that's true as the law is written, except that 133 requires the participation of the Reserve Banks. The Reserve Banks have to be satisfied that the collateral presented before the Board can even vote on this emergency lending, something that hasn't been changed by Dodd-Frank. And so I think you see in Tim Geithner's excellent memoir just how actively the New York Fed President was participating in these kinds of decisions. And if I have a problem with those I can at least direct some of my ire to the Board of Governors, but that doesn't change the fact that you can fire every one of the Governors and then Reserve Bank presidents still are there participating in those decisions, influencing them, and then, not trivially, implementing them. And it's in the implementation where things can get really --

MR. WESSEL: But that's all hypothetical? He says but what would have been different? So you think if Tim Geithner had been appointed by the Board of Governors that somehow Lehman's collateral would have been seen as more worthy do you think?

MR. CONTI-BROWN: Yes. I think that that is -- I mean I can't make that point definitely in the counterfactual, but I would be very interested in a time machine and a new statute to go back and see how that would have played out differently. I think the idea that it would not have played out differently is not likely.

MR. WESSEL: Okay. Mr. Plosser, so Peter mentions and Richard Fisher has been pushing this notion, well the New York Fed is so important that that ought to be a presidential appointment. You think that's a good idea? What's the advantage of --

MR. PLOSSER: I'm out of this job for one day. (Laughter)

MR. WESSEL: I know.

MR. CONTI-BROWN: You can speak freely now. (Laughter)

MR. WESSEL: Mr. Plosser said to me why do you want me, I will have retired, and I said that's why I want you. You have no excuse not to answer the questions.

MR. PLOSSER: So I think it's a legitimate question to ask the following, and that is that what's the role you want the presidents to play, okay, what's the right role, what function do they serve. I happen to believe they serve an important function in helping preserve independence as well as executing monetary policy. After all the Board of Governors doesn't have a balance sheet, doesn't have any income. It all comes from the Reserve Bank's balance sheets. So I think it's important to talk about that. I think that there's an argument to be made that if you want a more decentralized structure then you can make the argument that maybe you really want the presidents to play more of a role, not less of role, be even less political than they already might be, or less beholding to a particular interest. I think it's a tough choice, but I think the Reserve Banks have had a history of contributing positively to monetary policy debates. It's a source of I think innovation in policy making and monetary theory where they bring new ideas to the table. They aren't always accepted, but you often times see over time where those ideas begin --

MR. WESSEL: I don't think I heard the answer to the question. So you think it's a good idea to have --

MR. PLOSSER: Well, I got good training at the Fed. (Laughter)

MR. WESSEL: So?

MR. PLOSSER: So I have argued that I think -- I made this argument in a couple of speeches -- it might not be a bad idea to have all 12 Reserve Banks participate equally rather than giving special stature to the New York Fed. Rotate all six of them every other year. I don't think that would necessarily be a bad outcome, and it would actually achieve some of the goals that Peter at least mentioned about the fact that the New York Fed is sort of head and shoulders --

MR. WESSEL: Wouldn't making the President of the New York Fed a presidential appointee sort of elevate the New York Fed even more over the other Reserve Banks?

MR. PLOSSER: Probably.

MR. WESSEL: Yeah. And let me just -- so --

MR. PLOSSER: No, not probably, yes. (Laughter) I'm sorry. I didn't need to (inaudible) on that.

MR. WESSEL: So why is it important to have these private sector Boards of Directors? The Bank of England was essentially nationalized during World War II, the European Central Bank has a model of decentralization in that the Reserve Banks of the member countries --

MR. PLOSSER: Modeled a lot off the Fed.

MR. WESSEL: Right. But they are all government appointees. If Peter says that private sector boards raise some legal issue, and I suggest that it adds to public perception that somehow the Central Bank is not operating exclusively in the public interest, what purpose is served by this 80 year old atavism of having private sector directors in the banks?

MR. PLOSSER: Look, I would be open to consider other structures for our Boards of Directors, but I would argue that (a) three of the Directors are appointed by Washington already, three of them are non bankers, elected by bankers but non bankers and only three are bankers. I could see changing that mix under some circumstances. And I would be open to discussions about how that -- but I think that -- but part of how the Fed I believe maintains its independence to conduct monetary policy is part and parcel of the interaction that the Reserve Banks have in their districts, with their business communities, with their bankers for sure, but business communities, community leaders, and the person on main street. I think that is a source of a buffer if you will to help preserve our independence. And I think it would not be a good thing to lose that because we've already seen over history that many times it's the political influences that drive the decisions.

MR. WESSEL: So isn't it true that in recent times the presence of the Reserve Bank presidents has given the Fed an insulation against political interference? I mean Dodd-Frank is a case study and the Reserve Bank presidents were deployed by the Board because they had more clout.

MR. CONTI-BROWN: Absolutely. The Reserve Bank presidents and these very directors. I mean just imagine this, if you've got a -- you know, in the 12 Reserve Bank districts you've got 9 directors, then not to mention the 6 directors on each of the branches who are pillars of their community. So even if they are arch conservatives, if they are a part of the Reserve system and they're calling up their conservative senators and saying, you know what, Ben Bernanke is my guy, then you're getting a very different political dynamic. And this isn't speculative; this is exactly what happened during --

MR. WESSEL: But did that serve to help the Central Bank to be independent of politicians if they had this broader base of support?

MR. CONTI-BROWN: I mean this is why I think so much of the discussion of Central Bank independence is almost incoherent. You mean by injecting so completely into the political system, they were independent of politics? That is very, very confusing to me.

MR. WESSEL: No, if you helped talk Congress out of doing things it would have made it more difficult for the Fed to pursue an independent monetary policy?

MR. CONTI-BROWN: No. And here's why, because where they were focusing a lot of that attention was on changes to regulatory and supervisory functions. So taking out of the Federal Reserve System entirely bank regulation for banks under $5 billion. And this was something that was going to occur until the Reserve Banks stood up and said no.

MR. WESSEL: Okay. So I'm going to take about five minutes worth of questions, and we'll have more time at the end for more questions. I'm going to gather three questions and then we'll answer. There's one in the back here, and Phil Wallach in the front, and Krishna Guha.

MR. VERRET: Good morning. I'm J.W. Verret, Chief Economist at the House Financial Services Committee and I work on our Federal reform efforts. I want to ask a quick question about the paper and of Dr. Plosser. It seems that a dimension that the paper doesn't fully appreciate to me is the differences between the Federal Reserve Bank of New York and the other districts banks. And to talk specifically about 133, it appeared from reading the FOMC minutes of 2008 where some of the special liquidity facilities were discussed, it seemed like all the opposition to that came from the district banks, particularly President Lacker at the Richmond Fed. And that seems to me to be a counterpoint to your argument about the district banks sort of dancing with the one that brung you. And so I wonder if it -- just to ask Dr. Brown if he's sort of missing -- as you focus on that vertical dimension of Board versus district bank, you're missing some of the horizontal disagreement where the New York Fed differs very much from the Richmond Fed and maybe the Philly Fed and maybe the Kansas City Fed and, you know, some of the other very different institutions within the regional banks.

And I want to ask Dr. Plosser, you've spoken a lot about 133, you mentioned today some thoughts about how the district banks can help the Fed's independence. I wonder if you think there might be a role to play for the district banks in 133, specifically currently the Dodd-Frank Act requires a super majority of the Board to approve extraordinary lending? Would there be any good sense in requiring a super majority at the district banks to also approve lending before that 133 turnkey is turned? So I just want to throw that out there for discussion.

MR. WESSEL: All right. Phil Wallach here. Phil, can you raise your hand? Krishna, can you raise your hand so the mic can come to you?

MR. WALLACH: Hi, Phil Wallach from Brookings. I'm just wondering if Mr. Plosser can talk a little bit more descriptively about what the connection with the local communities that the regional Feds get is like. I think that' rather obscure to a lot of us trying to understand exactly what role the regional Feds play.

MR. WESSEL: You mean what the actual function is?

MR. WALLACH: No, not the function but the connections with the local banking communities.

MR. PLOSSER: Banking communities or the broader community?

MR. WESSEL: Banking community or the community --

MR. WALLACH: Or the broader communities. You know, you said that the regional Feds act as a source of good ideas coming sort of from different perspectives. If you could just give us a little bit more color about how that might happen through those connections.

MR. WESSEL: Okay. Krishna?

MR. GUHA: Thank you. Krishna Guha, formerly with the New York Fed, but speaking here only for myself of course. A comment and a question if I may. The comment is that I thought the paper raised some -- I had a very interesting and thoughtful discussion of the Constitutional issues, principal offices, appointments, clauses, and so forth. By contrast I was actually very troubled by what I thought was an inaccurate and partial narrative around the role of the New York Fed in recent years. All I would say is a lot of this discussion has been very difficult because of legal confidentiality, but I can vouch from personal experience for instance that the New York Fed specifically played a very prominent role in the stress test and development of SECA which has been very tough on the banks, held back dividends and so forth, and in the creation of new risk capital standards where the New York Fed specifically was at the forefront globally by pushing for very tough changes to risk capital weight. So I would encourage you to develop a sort of more balanced discussion of the issues there.

The question here really has to do with whether the kind of proposals that you recommend, and indeed believe it constitutionally required, might not have unintended and negative consequences of their own. And here I really worry about the supposition that having a stronger political role in the selection of senior Fed officials will lead to better outcomes. I point to the SEC as an institution that has been really hampered by the politicization of its independence in ways where we can show concrete cost to society. One might also say that the Supreme Court frankly has been at least exposed to some of those similar critiques in recent years. When you look at political influence, banks do not think this runs exclusively or even primarily through Boards of Directors, it importantly runs through Congressional committees. And you'll see that there has been much discussion of late for instance about the derivatives push-out clause. So I would urge you to be very careful that you don't worsen a problem through the remedies that you propose.

MR. WESSEL: Krishna, you sound a little skeptical about the (laughter) birthplace of democracy here. Let me start with you on some of them and then we'll go to Mr. Plosser.

So particularly I think the gentleman from the House Committee made the point that some of the Reserve Bank presidents who are not from New York were pretty hard on the banks.

MR. CONTI-BROWN: So just a correction so that my advisor doesn't kill me when I go back to Princeton, I'm not Dr. Brown yet, just to be clear. But the --

MR. WESSEL: Well, JD.

MR. CONTI-BROWN: JD if we want to call it, which I do not. The horizontal dimensions. So this is referring to -- I recommend anyone interested in this to read the 2008 transcripts. There is a very dramatic moment between the Richmond Fed President Lacker versus Tim Geithner where it's a gotcha moment, where Lacker is asking are you having the secret conversations with including member banks in my district about 133, and Geithner says not, and then he says well, actually you are and here is the evidence. It's really a pretty dramatic moment. And so I think that that's a really good instance. Why is that tethered to the governance structure, right? Why is that tethered to the fact that these -- as opposed to just a multiplicity of voices? And so I would wonder about that.

Can I respond to the stress test question?

MR. WESSEL: Let me go to Mr. Plosser first and then back to you.

So, Mr. Plosser, one, should the banks be more involved in 133 and how do you actually interact with the communities in which you --

MR. PLOSSER: So Ben and Don have heard me talk about 133 before for many years, but I actually have a different perspective on 133. I actually believe that the Fed should be as separated from fiscal policy decisions as we possibly can be. And that means 133 lending from my perspective was a worrisome activity for the Fed because we were making fiscal choices about who to bail out or who not to bail out, who to lend money to, what creditors to protect, and which ones not to protect. I find that problematic for the Fed to be doing. I'd rather have a different structure where in emergencies the Treasury would instruct the Fed to carry out an operation perhaps of that kind if needed to be. But then if the Fed acquired the underlying securities, that they would immediately be swapped for Treasury securities to keep the Fed out of the playing ground of winning and so I'd just prefer a different structure for 133.

In terms of the community, you know, all the Reserve Banks have advisory committees of various kinds, they have community outreach programs, we do surveys, we interact with everything from schools to businesses to not for profit organizations. So we have a team of people, not just the president, but a lot of other people doing outreach, doing things about the business community. So in some sense the richness and the engagement of Fed personnel with their local districts is pretty extraordinary. And it brings to the table I think a picture of the economy that is very hard for the Board of Governors to see because they just don't have the time, the mechanisms for actually doing a lot of that. So I think it's a very -- and I think most -- and this is maybe perhaps to Peter's political point, in most Fed districts what you find is that the people in the districts, the average day person who hears a speech by somebody from the Fed or goes to talk to them, they have a much more positive view of their Reserve Banks than they do of the Fed as a whole. And I think that speaks to sort of part of what this is all about.

MR. WESSEL: And finally do you want to respond to the last point?

MR. PLOSSER: Oh, I'm sorry, can I make one more point?

MR. WESSEL: Yes, please.

MR. PLOSSER: We talked about bringing new ideas, the question was asked. Part of the new ideas really is about the fact that the Reserve Bank presidents do have a research staff and they are free -- and what the Reserve Bank's research staffs do along with their presidents is help prevent the Fed or try to put a check on what I would describe as the dangers of group think. Walter Lippmann once said, you know, where all men think alike no one thinks very much. And I think that the research staffs and the functions of the presidents are in part a mechanism for making sure a variety of ideas and things get discussed and put on the table. That doesn't mean they're always accepted. Of course not, but it means we have the debate about them.

MR. WESSEL: And so, Peter, last word on the New York Fed, it's not captured, and what about Krishna's point that getting the politicians more involved may not lead to better policy, even though it's nicer for a lawyer?

MR. CONTI-BROWN: Sure. So I wouldn't say that the Constitution is just something that's nice for lawyers. I think that's pretty important too. And we had an almost David Frost-Richard Nixon moment where we said if the Congress does it, it must be legal. I'm resistant to that conclusion. (Laughter)

But to the point we raised here that the New York Fed is not all bad, I totally and completely with this. The New York Fed -- and this isn't just kind of a -- I'm not a politician so you can know that this isn't a politician's glib comment, extraordinarily talented people work in the Reserve Banks doing public facing, public oriented work. The problem is that even that work I can't as a citizen evaluate and say yes, this is what I like and so I'm going to participate in this work by saying I like the Reserve Bank President Bill Dudley because he did this thing on the stress test that was very important. As I'm voting in this mix of issues on presidential and congressional elections, this is something that's important to me. It's off the table and it's wrapped in opacity. You talked about questions of legal sensitivity, and as a lawyer and as a scholar I think the Reserve Banks actually go aggressively too far even there, saying you can't even know what our doomsday book is in the event of a crisis because that's too secret. And I think there a little bit more transparency would go a very long way.

And this is actually a good way to summarize it. First of all, Dr. Plosser, I think that your comments and responses were very, very good. I'm grateful that you read the paper as closely as you did and had your feedback. I think my point to all of this is to say not would this have prevented the great depression, would it have prevented the financial crisis, the question is instead is is this giving us the central bank that exists away from the day to day of electoral politics without creating in appearance and in fact the fodder for conspiracy theories that this is the creature of Jekyll Island, that this is the many-headed hydra that works for the banks. Rand Paul was not asking the question do you ever feel like the Fed is out to get you to a group of bankers, he was asking a group of Iowans this. And I think that question gets a lot less wind in its sails when the answer is look, I know exactly who put the key decision makers there and I'm going to vote for those candidates or against them because of the way that those policies shake out against my (inaudible).

MR. WESSEL: Thank you. Thank you very much. Leave your mics behind.

(Recess)

MR. WESSEL: Now, we are going to have a technological experiment. So, we had invited today Viral Acharya, who is a Professor of Finance at New York University to speak about, I think, a new development in central banking that harkens back to its origins, the origins of the Federal Reserve.

I speak of this expanded mandate for financial stability, some of it implicit in the law -- explicit in the law, some of it implicit, that we have asked the Fed to do, I think, more than we had before, that is it is not enough to maintain price stability and aim for maximum sustainable employment, we have also asked them to make sure we don't have to go through anything as wrenching as we did before.

Now, of course, as Mr. Poser mentioned, this is very much in the origins of the Federal Reserve, the financial stability was one of its original purposes, I think. So, what we are going to do if this all works, Viral is on the phone, he is going to speak. He has slides. Cary Grant is here and is going to turn the slides.

He has promised me to limit his presentation to 15 minutes, and I am going to get up here and interrupt him if he doesn't.

Then Jeremy Stein, a former member of the Fed Board of Governors, a Professor of Economics at Harvard, will respond. Then we are going to try to have a little dialogue. I am going to be assisted by my colleague, Don Kohn, also formerly with the Federal Reserve, now in the Financial Policy Committee of the Bank of England, and we will see if we can have a little bit of a conversation even though two of our participants are remote.

With that, Viral, are you with us?

MR. ACHARYA: Yes, hi, David.

MR. WESSEL: Excellent.

MR. ACHARYA: Hi. Good morning, everyone. Sorry I can't be there thanks to the weather alert in Washington, D.C.

What I want to talk about today is a slightly different take on the central banking design than the first paper. Maybe a little bit closer to Charlie Poser's remarks that maybe the biggest issue we ought to worry about is the political economy influences on central banking decisions, and to guard against that, how should we design central banking, especially the financial stability mandate.

The view I am going to present is really sort of an institution view that is very common in the law and finance literature and finance and economics, and it is the idea that in a democracy, for things to work well, you have to identify specific problems to solve and design institutions that are sort of tailor made to solve those problems, and then once they are designed, you don't have too much influence from the political system on these institutions.

I would argue that financial stability is one set of problems that need to be solved. Central banks broadly designed are an institution to solve this problem, and that we are to design it in a manner that we can limit political economy influences.

The point I want to stress is that this political independence of the central bank is something that is managed by the central bank pretty much on an ongoing basis. The more they are forced to venture into an area to maintain political stability, that is going to risk political interference, it leads to inaction, and this is something that can be undesirable from the standpoint of financial stability in the long run.

Let me move to the second slide. Charlie Plosser alluded to the 1907 crisis and so did the first speaker. I think it's interesting to think back as to what really brought about the Federal Reserve after the 1907 crisis, and we had well functioning, vibrant commercial bank clearinghouses at that point, but there were entities other than commercial banks that were getting into trouble.

These were trust companies, and they looked very much like the broker-dealers or investment banks in the most recent crisis.

Both the Treasury liquidity as well as the private liquidity that the bankers put together in the end to save the banking was essentially distributed by John Pierpont Morgan at that point, and when that happened, there was some question as to whether he derived some private gains for companies supported by his banks, and more importantly, it was felt should the allocation of public liquidity be outsourced to a private entity, should financial stability be outsourced to a private entity.

It is my reading of “The House of Morgan” by Ron Chernow that this was one of the reasons behind the creation of the Federal Reserve, to have an institution that is designed to stabilize the inter-bank market, stabilize panics, in order to get a grip on crises and panics.

What the Federal Reserve does has evolved substantially over time. In the financial stability mandate, it does crisis management through a lender of last resort function, it does crisis prevention, through supervision and other kinds of regulatory tools that it deploys.

Other objectives of the mandate, such as long run price stability, employment, and so on, and I will come back to these a bit later.

Now, one popular central banking perspective is that the problem that central banks are trying to solve and therefore, how we should design central banks, is about how to solve a problem that we have a crisis every now and then because of private sector excesses, and we are to find some good ways of dealing with them.

It’s a time inconsistency problem, which is that central banks can be the lender of last resort in the midst of a crisis, and it is desirable that they do this to an extent in order to preserve the financial sector.

This creates a moral hazard problem which is that entities that benefit from lender of last resort might not shy away from taking high risk, high leverage in good times, so then the central bank has to design macro-prudential regulation, design capital requirements, liquidity requirements.

It is not enough to do this because the private sector will find some ways around it, through regulatory arbitrage, so you get shadow banking with banks connected to shadow banking.

Talking about other tools that central banks might want to employ, they may want to lean against the wind by using an interest rate policy. The advantage of such a policy is it affects everybody. It raises the returns to holding liquidity for all parts of the financial sector, and this can actually be a very powerful tool.

The other approaches, and I think I'm going to come back to this, you need to rethink how we design central banking tools because it would be better to regulate by function rather than form. For example, just limit leverage at the level of mortgages rather than trying to regulate mortgage lenders or commercial banks.

We should think about clearinghouses and setting minimum margin requirements rather than trying to design regulations.

All of this traditional perspective ignores the fact that in practice when central banks are afraid, they are constantly thinking about what is it that we can and cannot do, and this is of course governed by the laws in the system, in the economy, that allows it to conduct financial stability in a particular way.

Let me go to slide four that is going to talk a little bit about this. It is clear that the central bank could operate these tools such as macro-prudential regulation or interest rate policy freely in order to get financial stability.

In particular, certain actions are not allowed and are not explicitly mentioned under the limits of the central bank. If the central bank gets into this territory, it worries that it would lead to certain questions in the political system. It might then lead to political interference, and therefore, a certain amount of inaction may actually be desirable because you can preserve your political independence over a longer period of time.

Now, as I think was stressed quite heavily by the first speaker, I think it is natural in a democratic system that any institution that you design to solve a particular problem must have democratic accountability. Of course, better governance, accountability, better transparency for the central banking system as well.

The concern that I want to raise is that the political system might want to restrict central banking scope and financial stability, so that the central bank is constantly asking this question, should I raise interest rates, and maybe shy away from doing some of these things because they are afraid that such actions are in the gray zone of its limit, and then it might actually preserve political interference.

How should we design the central banking system to actually limit this sort of a problem? Let me go to slide five.

I think I want to put on the table that maybe we need a formal political economy perspective to think about the issues. I think the best way to think about this, at least the one I can come up with, is that we really have a divergence in horizons and objectives between the political system and between the central bank horizons and objectives.

Political horizons in many points in time can become rather short term and they can become quite populist. They might want to serve interests of the contingencies they are trying to attract votes from or raise funding from.

In contrast, I think it is fair to say that central bank horizons can be relatively longer term and certainly less populist given they don't face the sort of election cycles at the same frequency and certainly not as fervently fought as the political elections are.

This divergence in horizons and objectives creates a potential tension, which is that every time in a crisis management, a central bank has to step in and use a balance sheet or lender of last resort to undertake certain actions, it can set the stage for political interference.

Political systems might not necessarily affect the actions at the point they happen, but once these actions happen, they create the stage, it frees it up for certain political outcomes down the road.

Similarly, if a central bank tries to prevent a crisis in good times, for example, by raising interest rates to lean against the wind, reach the dark corners of shadow banking, tries to get money market funds which look like a banking function but is really happening outside the sort of standard regulated mandate of the U.S. financial sector, but if it does all these things, some of these things might be unpopular and it might be prevented from undertaking these actions in good times.

This might happen from the financial sector putting pressure on the political system or it might happen directly through the political system because they like certain things like maintaining high house prices that maybe creates a shortage of jobs, even though that may be unsustainable growth in the economy in the long run.

I wanted to think about how we might limit these kinds of political head winds. Let me move to slides six and seven that talk about possible design of the central banking institution to get around this problem.

I have four big ideas. First, I would actually be in favor of relying on rules in the crisis management part of what the central banks do. I think it would be good for central banks and the institution in the long run to shy away from quasi-fiscal actions to the extent it can.

I would actually broaden the scope of central banks. I think it should be able to do lender of last resort of just a depository institution to markets at large, but I think it should be able to ensure that whoever is channeling liquidity is maintaining minimum solvency requirements.

What do I have in mind? Think about Lehman Brothers. The Federal Reserve probably had no choice but to extend lender of last resort to broker-dealers, Lehman Brothers, but what it didn't have was a tool to ensure that Lehman Brothers would actually pick up the offers coming to buy its equity from some foreign banks.

I think the central bank should not try to provide liquidity without addressing solvency. Importantly, shying away from such actions would be crucial to actually not having political interference down the road as to what its mandate should be and what it should be doing and what it should not be doing.

If you are going to do lender at last resort at large, you can't do that without regulating the growth and leverage in shadow banking. That is my second point. It should recognize that shadow banking in the end will come under the scope of central bank's crisis management operations and therefore, the central banks should be able to maintain minimum solvency standards in the shadow banking and when new innovations come about, they are proactive to keep the shadow banking intact.

I would say the scope should actually cover solvency requirements of state owned and government sponsored entities in the financial sector as well, given that they might also be particularly important.

Third, and I think is continuing with this theme that central banks should have a broad scope of financial stability, it seems to me almost a given that financial stability should be an explicit mandate. In fact, it should be the first mandate along with the other ones in my view for the central banks.

I think what it does is that even though central banks might have a long horizon, it introduces an explicit longer dimension that the central banks can appeal to while trying to defend certain actions they would like to take for financial stability.

For example, if house prices are going too strong, housing activity is too excessive, the central bank should be able to lean against the wind by raising rates.

My sense is that the Fed might have shied away from doing this as quickly as it might have at other times because if it's not in the explicit mandate to do such things for financial stability, it makes its case a little deeper for doing this.

The last thing and I think this goes along the lines of what Charlie Plosser was relating to, I didn't think about it in terms of division of the Fed responsibility and within different Reserve Banks, but I would actually prefer there being a certain extent of multiple regulatory agencies, because it limits the extent of the political system to cram down the entire agenda on the entire regulatory system.

Of course, one needs to balance this need with the coordination needs and jurisdictional arbitrage.

I realize I'm out of time, but I wanted to say a few quick words on what Dodd-Frank probably did right and did not do right. In my view, there was some hits and misses in the way it was written.

I am for the limit and restrictions on 13(3) exceptions, but not in exactly the way they are worded in Dodd-Frank. I don't think limiting targeted action for non-commercial banks is the right objective. I think limiting targeted action against any one entity should be limited. I think the central bank should be trying to keep markets open and therefore, it should lend to the system at large.

As I said, I would like to see minimum solvency standards. Restrictions, yes, but maybe not on specific forms of entities, but to the system at large and minimum solvency standards.

Second, Dodd-Frank creates the Financial Stability Oversight Council and SIFI designation. I view this as a very big positive. It is an attempt to maintain multiple regulators but at the same time achieve coordination on financial stability issues. It allows the designation of non-banking entities to be important. Many of them clearly are, so that is a plus.

One question I have here is what about housing. Aren't GSEs the most systemic entities of our financial sector, and why isn't their regulation harmonized with the objectives are for financial stability on other parts of the financial sector.

I think explicit in the Federal Reserve mandate for financial stability would be good in my view because then it has a mandate to do this, because otherwise it is never going to touch it because it's an action that is going to give rise to immediate political interference if you try to touch the housing or GSEs directly.

I was a bit disappointed that Dodd-Frank in the end didn't put financial stability explicitly in the Federal Reserve mandate. In fact, the early drafts that were proposed for the Dodd-Frank Act did have financial stability as a third mandate, but it was inexplicably dropped from the final wording of the Act.

I'm concerned this may be a desire in the political system to keep financial stability at bay and leave it in the gray zone of the central banking so that when interest rates need to be kept low because boom times are looking very good, central banks feel a little less free to raise interest rates.

Let me stop there. I think financial stability is key to economic growth, it is a necessary condition for much of what central banks have achieved in modern times, transmission of monetary policy.

In my opinion, it should explicitly be part of the central banking mandate. Tools that central banks need to maintain this in my opinion should be given to them in a charter, and it should recognize that crisis management actions are limited in terms of them looking like bailouts, and at the same time central banks should be able to restrict leverage for anyone in the financial sector. It should have a very broad scope over shadow banking.

Importantly, it should be able to take actions and able to defend them in good times, in short, so jobs are not compromised in the long run.

I realize it is a delicate balance, but central banks often do not undertake certain actions to maintain independence. The smaller we can make this set of inactions, the better it is for financial stability in my view.

Let me stop there.

MR. WESSEL: Thank you, Viral. Jeremy, are you with us?

MR. STEIN: I am.

MR. WESSEL: The floor is yours.

MR. STEIN: Thanks, David. Thanks very much. It's a pleasure to be here, I guess, virtually.

MR. WESSEL: There's a little bit of laughter because we put a picture of you up on the screen, but it's not the picture of you as a gymnast, so you're okay. (Laughter)

MR. STEIN: Boy, thanks for that. There's a lot to discuss on this paper. I'm going to pick and choose. I'm going to try to say a few words about four of the issues that Viral has raised.

The first of these is the interplay of monetary policy and potentially time varying macro-prudential tools, like capital requirements and LTV ratios.

The second is the question he put quite a bit of emphasis on, which is should the Fed have an explicit financial stability mandate.

Third, governance and accountability issues around the lender of last resort, and fourth, to what extent should it be the central bank's job to regulate the non-bank financial sector broadly defined.

I will see if I can touch on each of those.  On the first, on monetary policy and macro-prudential tools, what are the respective responsibilities of these two when we have time varying financial market conditions, hot and cold markets of various sorts.

I think the conventional view here, and it is widely accepted, is you should try to do as much as you can with the macro-prudential tools in an effort to take the burden off monetary policy.  This is the idea that monetary policy is too blunt and you don't want to impact the aggregate economy in an effort to contend with risks that are merging in just some segments of asset markets.

For example, if say housing markets are booming, you might want to use time varying LTV requirements, or if banks are lending very aggressively in a particular area, C&I, commercial real estate, you could imagine time varying capital requirements.  Indeed, you might want to have a committee that meets regularly to do something like this as the Bank of England's Financial Policy Committee does.

Let me start by saying I don't disagree with any of this.  I think the conventional economic argument makes a lot of sense, but I think in the spirit of this conference this approach does raise some relatively delicate political economy issues, and these may be more challenging in some countries than others.

When I think about the case for Fed independence, particularly in terms of its monetary policy functions, I think of it as being built on two pillars, which on the one hand you are trying to solve a time consistency problem, which is why independence is valuable, and monetary policy is not too fiscal, which is why independence is not too problematic.

Not being fiscal in turn has two elements to it. First, taxpayer loss exposure is minimized, and second, redistributive or allocative consequences are also relatively minimal.

That's why it seems to make sense to me that as compared to monetary policy, the regulatory rulemaking process inside the Fed is much more consultative, much more open, there is much more public comment, and it's much more slow moving.

I think given that, there is a tension if you want to make high frequency policy changes in capital or LTV requirements after you spent a couple of years writing the rules, seeking public comment, it's a little weird to think about then turning that dial on a discretionary basis at that high frequency, precisely because you're getting into sort of a more redistributive area.

If you couch it that way, the bluntness of monetary policy, while it is undesirable from a purely economic perspective, may actually be somewhat desirable from a political economy one.

If you lean against an incipient overheating by tightening bank capital and you do so strongly enough to make a difference, you know, you're hurting the banks at the expense of the shadow banks and you're hurting bank dependent borrowers at the expense of those who can go to the capital markets.

As a matter of economic policy, that's not necessarily a bad thing, but it may be more fiscal in nature and hence more challenging to do without an open public discussion, whereas if you raise rates, the bluntness means its broader brush in its impact and maybe more easily delegated therefore to an independent central bank.

This is all in the spirit of a second best political economy argument which suggests there is some scope for monetary policy to carry some of the weight, I think.

Having said all this, I'm going to say something that may sound a little bit contradictory, and I think I'm going to sort of disagree with Viral here, insofar as monetary policy specifically goes, I don't think I would want to have a separate financial stability objective.

Now, to be clear, that doesn't mean that monetary policy shouldn't be attending to issues of financial stability, but if you think really of the Fed's objective function, which we now think of as kind of a loss function around deviations of unemployment and inflation from their targets, I wouldn't want to have a third item in the loss function.

I think the right way to think about the issues here is to think about the fact that you care about unemployment and inflation, but very importantly, you care about them over time.

If financial stability creates problems, so if an overheated credit market, let's say, is going to lead to some kind of a reversal and some kind of damage further down the road, that goes in insofar as it affects unemployment and inflation.

I think there is a lot of valuable discipline in nesting it that way. I think if you have a third leg in the mandate, it's very hard to know what weight you put on it. In other words, if unemployment is away from target and you have a tension between these two things, how much do you favor the financial stability leg of the mandate.

I think if you model it in this kind of more intertemporal way, the weights emerge naturally, and you will naturally have sensible conclusions such as you put less weight on financial stability when unemployment is far from target and it starts to loom more heavily when unemployment gets closer to target.

So, there is a discipline there which I think is valuable and which I wouldn't want to lose, and it puts the burden on people like me who actually want to make the empirical case that financial market froth can matter for future real activity, but we have to make that case affirmatively, and I think that is how it should be.

Let me say a few things briefly about lender of last resort, which is really sort of a very difficult and completely central issue. I mean that is why we have central banks at some level, and at the same time, in a crisis, there's inevitably some degree of fiscal exposure. There is sort of a straightforward tension.

My model for this is pretty straightforward. I would make being under the regulatory umbrella an absolute prerequisite for access to the discount window. If you can't govern the moral hazard problem and you don't know the firm to whom you are lending, I think it's very difficult from sort of a governance perspective to do lender of last resort.

Having said that, given that the Fed now does regulate the largest broker-dealer firms and subjects them to the same stress testing regime as it does the banks, I believe, as was talked about in the Wall Street Journal this morning, Dodd-Frank may have gone too far in erecting impediments to the access of broker-dealer firms to the discount window.

I would have been inclined to treat regulated depositories and regulated broker-dealers more symmetrically on the back end with respect to the lender of last resort, to the extent that I could treat them symmetrically ex-ante, that is to say with respect to the rules of the game.

On that point, of course, I agree there should be rules. There are some subtle issues about whether the rules of the sort Viral discusses are bright line rules that Congress puts down or rules that essentially state Congress' intent, but leaves some room for judgmental interpretation based on the facts of the case.

I think there is more to be said about the issue of what does it exactly mean to have a set of congressionally specified rules for the lender of last resort.

Finally, a couple words about the central bank and the shadow banking system. I think Viral is completely on target when he emphasizes the pervasiveness of regulatory arbitrage and the corresponding importance of paying close attention to the shadow banking system.

Here, I think the only issue we're thinking hard about, the only issue that is really difficult, is how does one divide up the responsibility among the different agencies. Consistent with Viral, I think the Fed is clearly going to play an important role in many cases, but in my view, it is not obvious that you always want to have the Fed in the lead on every one of the shadow banking type of issues.

Let me just give a concrete example. Suppose you are concerned about the growth of the asset management business, and in particular, you are assumed about open end bond and loan funds that invest in illiquid credit assets, and you worry that something disorderly could happen, some kind of sharp widening of spreads or something like that, that could damage the real economy.

Let's take that as a given. Suppose you have that worry and suppose you want to entertain a policy to address this issue. For example, you might want to think about the prospect of imposing exit fees on withdrawals from these bond funds to mitigate run incentives.

Suppose this is the SEC's turf and suppose just for the sake of discussion it's something they are not inclined to be forward leaning on, and maybe the FSOC process is not having the kind of impact you might have hoped for.

The question is the answer to say you know, this is frustrating and I wish the Fed had jurisdiction over this. Maybe the Fed is better situated to take into account systemic externalities.

My instinct here is no. I wouldn't want to just keep piling these sorts of responsibilities onto the Fed. I mean there are a variety of reasons, some of which Viral has alluded to. My view is if that's your diagnosis of the problem, I think the right move from an overall design of institutions' perspective is you need to work to strengthen both the mandate and the culture of the SEC so they are better able to internalize the sorts of systemic considerations that you are concerned about.

I know that Don Kohn is there, and I know he has spoken at some length about some of these issues. I've read what he said and I basically find myself in agreement with a lot of that.

Let me stop there.

MR. WESSEL: Thank you very much, Viral and Jeremy. I'm going to get us caught up, back on schedule. I'm going to ask Don Kohn in a moment to respond to some of this and then we are going to bring the panel up. I think some of the issues that are raised by Viral and Jeremy are well suited to the panel, and it seems better to have the in person discussion than trying to do this remotely.

Don Kohn, who as I said is on the Financial Policy Committee with the Bank of England, which doesn't apparently require you to be a citizen to make policy there, that's one thing -- I don't know how Peter Brown would deal with that. (Laughter)

Don, Viral said two things that I'm interested in your reaction. One is he says that the Fed should have more rules for how it acts in a crisis because that will make it more politically acceptable, and I wondered is that practical. Jeremy referred to this.

Secondly, do you worry about giving the Fed ever more financial stability responsibilities and it becomes the kind of uber regulator of everything that has a dollar sign next to it?

MR. KOHN: I think on the first one, I'm skeptical that you can set out -- I agree with Jeremy. I agree with Jeremy on the rules situation. I think it would be very, very difficult to set out a set of rules that would restrict behavior in a meaningful sense ex-ante beyond what the law has already done.

I do think because every crisis is different, every situation you're facing is different, and what you need to do is not going to be easily spelled out by rules, that under Dodd-Frank, the Fed was required to talk about what it would do on a 13(3). It did kind of a minimum job. I was hoping that it would take that opportunity to spell out more proactively about why this kind of lending was necessary.

I agree with Jeremy that it ought to be to institutions that are already supervised to deal with moral hazard and the broker-dealer's subs of the bank holding companies might be the first in line for that kind of thing, but I think the Fed could have done a better job talking about how it would use 13(3), but I think rules in any constrictive sense would be very, very hard.

MR. WESSEL: Is it too much, are we asking the Fed to do too much?

MR. KOHN: I guess again as Jeremy said at the end, I don't think putting all this in the Fed -- I think it would be a lot to put all the shadow banking regulation in the Fed, and I think my first preference, as he said, would be to change the way the SEC does business and the CFDC, so give them a financial stability mandate.

There are institutions that need financial stability mandates in their legislation, and work to make the institution rather than the chair of the organization part of FSOC, see if you could come up with a better way of making decisions and in viewing those institutions with financial stability rather than just the protection of investors, not instead of, but in addition to the protection of investors, and guarding the funds of the people who put stuff in there.

If I could make one more comment.

MR. WESSEL: Please.

MR. KOHN: This countercyclical macro-prudential and allocative aspects of that. We had an interesting situation on the Financial Policy Committee. The government asked us what tools we wanted as macro-prudential regulators, and when the committee was initially formed, we asked for countercyclical capital, we asked for the ability to raise and lower capital requirements on real estate, particular sectors that might be having problems.

We didn't ask for LTV, LTI, type of regulations for home mortgages initially because we were concerned about the political blow back on that, and the fact that it could have an allocative aspect.

I was uncomfortable because I recognized that the high LTVs and high LTIs were a major contributor to the problem in the United States but I recognized the political problems. While there has been some discussions, the Chancellor of the Exchequer invited us to ask again, and we have asked for LTVs and LTIs.

But I think it is important that the elected person, the Chancellor of the Exchequer, asked us to think again about whether we wanted these things, and we have requested them.

There has been some political dimension. We acted to reign in some potential deterioration in credit, not credit allocation but terms of credit last June. I was pleasantly surprised at how little political blow back there was. I think we trailed it well. We advertised what we were doing, why we were doing it. It wasn't intended to take people out of loans. It was just to prevent a deterioration.

I think it is possible to run countercyclical macro-prudential policy in a democracy, but it does require the right dialogue with the elected representatives.

MR. WESSEL: Thank you for that. Can I ask the panelists to come up here and take these four seats closest to me? I will introduce them as they come up.

Jeremy and Viral, if you would like to stay on the line and participate, feel free. Just interrupt, if you would like to, but if you can't, I understand.

One of our goals here today is to think about the relationship between Congress and the Federal Reserve. After all, the Fed is a creature of Congress and has to be held accountable to Congress.

PANEL DISCUSSION

MR. WESSEL: I'm joined here by really a distinguished panel. Sarah Binder is a Senior Fellow here in the Governance Studies Unit of Brookings and Professor at George Washington University, and has written a lot about the relationship between Fed and Congress over the years.

Ben Bernanke, Distinguished Senior Fellow in Residence at Brookings, and of course, former Chairman of the Federal Reserve.

Ruth Porat, who the Chief Financial Officer of Morgan Stanley and happens to be a member of the Advisory Council of the Hutchins Center.

Barney Frank, who I'm tempted to say needs no introduction, but I heard somebody do that once and Barney once said just for once, I'd like to hear the introduction that people don't think I need. (Laughter) Barney Frank is the former Chairman of the House Financial Services Committee, and was God's gift to financial and economic reporters. He wasn't always very nice to us but he always had just the absolute perfect quote, and for that alone, we miss him, as well as his other contributions. I'm not sure he misses Washington.

MR. FRANK: You weren't always very nice to us. (Laughter)

MR. WESSEL: Sarah, maybe I can start with you, if I may. There seems to be a lot of animosity between Congress and the Fed these days. Some people in this room think the Fed saved us from the second great depression, but at least some members of Congress don't seem to think that worked out very well.

How do you account for what's going on on the Hill now? Is it unusual or is it just another episode in partisan argument?

MS. BINDER: I'd put it into a mix of policy and a mix of politics, and it's always hard to separate the two of those on Capitol Hill. First and foremost, congressional tension to the Fed tends to be countercyclical. If the economy is doing well, Congress really doesn't pay much attention. If the economy falters in a big way, it's not surprising that Congress wants to return to the Federal Reserve Act, perhaps to fix the problem, perhaps to find someone to blame.

Certainly, the rise of the financial price and economic prices rejiggered and opened up congressional eyes to trying to look at the Federal Reserve Act again.

I think what is really important here as well is to think about this particular crisis and what the policy response was. When interest rates hit zero, you have to turn, as I've learned, to unconventional monetary policies, and that potentially crosses the boundaries, as the previous panel was talking about, between monetary and fiscal policy.

It seems to the public and perhaps to law makers that the Fed might be in a position of choosing winners and losers, whether it's with 13(3) or with large scale asset purchases, and that triggers congressional tension.

Finally, of course, we are in a period of tense partisan polarization, whether that is ideological or just partisanship, and it has no boundaries in Washington, I think, as anyone who might have watched the hearing last week.

House members, they hear voter anger, and there is concern about whether or not the Fed deserves the type of independence and lack of scrutiny that it often has enjoyed.

MR. WESSEL: Mr. Frank, is this time different or is this just another reason why?

MR. FRANK: It's different. I was struck during the earlier part that I was able to get, I had plane trouble, too, "populous" was always a bad word. When you are in an atmosphere in which people suggest that worrying about public opinion is a negative, you're going to have some tension.

Beyond that, I think this is different. There is a greater philosophical gap in Washington today than there has been in a very long time. I think you have to go back to the Civil

War to see it. That is the fact that the Republican Party has moved to a much more coherent, intellectual, ideological position.

Obviously, everyone in office is looking for voters, but as vehemently as I disagree with many of these people, I can tell you they are very sincere. This is what they believe.

I think the root of the issue at this point -- I guess I could sum it up in two words - Humphrey and Hawkins. What you have on the part of the dominant forces in the Republican Party today is the vehement objection to the dual mandate. That is really what is at issue.

I think many Republicans do understand that the atmospherics of appealing the unemployment part of the mandate would be very bad, but they are opposed to it ideologically and philosophically. They resent it.

I believe that is at the root of the problem. That is what the objection to quantitative easing is. It is not they are abusing the mandate, frankly, but that they are carrying it out. I think that's the issue.

The other thing I would say is people should not under estimate in terms of public reaction. I have never feared for the stability of the United States in all the time I have been in this business, except in that period in 2009 when the AIG bonuses were announced. I mean it was like one of those scenes from a bad Frankenstein movie. They were out there with the pitchforks and the torches. There was a degree of anger and I really feared for our capacity to govern. I did a couple of dumb things because of it.

I'm particularly struck now that Mr. Greenberg is suing the Federal Government. The only way I can describe it is the arsonist is suing the fire department for water damage. (Laughter)

The anger that was there was so deep rooted, but it is very fundamental. There was an objection to this whole notion of the dual mandate. That, I think, makes this more than just a personal thing. There is the deepest philosophical difference that I can recall being argued out here.

MR. WESSEL: Mr. Bernanke, one of the points that was made in Peter Conti-Brown's paper was we ought to think about a different way to govern the Federal Reserve and the Federal Reserve Bank presidents are somehow an atavism, that we ought to take out.

You missed this, Mr. Frank. He referred to the Reserve Bank presidents as the gallbladder of the American economy and said we should do surgery. (Laughter)

There is a tradeoff here between the assets of having a decentralized intelligence gathering and a rather unusual form of appointment of the presidents. Do you think we need to change this system?

MR. BERNANKE: Well, I disagree the way they are selected is the source of all the anger. I really don't think that's important. I think as Charlie Plosser said, for many people, their local Reserve bank is the friendly face of the Fed, and they do have excellent community relationships and relationships with leaders in the business community and so on, and I'm sure Barney will confirm that was an important factor in the politics around Dodd-Frank.

The question is, again to quote Barney, the Hedy Young principle, compared to what, what's the alternative. Now, I guess that Mr. Brown would like to see presidential appointments and Senate confirmations. As a practical matter, the Board of Governors have been operating basically at about two-thirds capacity for the last 10 years because of the problems with the confirmation process.

I also wonder whether the general public would feel more confident in the Fed because the Congress is more engaged in the selection of local Reserve Bank presidents. This is a sound track. (Laughter) This is why we need Federal Reserve Bank presidents. (Laughter)

I recognize the issue. I don't think it's at the heart of the political problems right now, but a direction that might be worth thinking about, and I have not explored this and I'm not making recommendations, but maybe there is a way to get broader input and participation but still have a sense that the local area is making the decision as opposed to Washington making the decision.

MR. WESSEL: Mr. Frank, you once talked about changing --

MR. FRANK: As I understand the paper, Senate confirmation was not his preferred choice. His preferred choice was a substantial diminution of their independence. I did file a bill at one point saying they should just not have a vote on the FOMC. I do believe there is no way you can justify under the American Constitution these private citizens -- my guess is it survived only because it would be very hard to find someone to bring the case.

I raised that with Alan Greenspan who said well, you couldn't get people to take the job if they didn't have a vote on the FOMC. I don't know if that is accurate.

My general view if I'm appointing people, if they think they're doing me such a big favor, I probably don't want them around. (Laughter) Only five at any one time have it, much of the time people don't have it. I would say leave them participating in the debate, doing the research, but take the vote away.

Now, I understand there is a problem with regard to the confirmation, but it exacerbates the problem. I think the paper pointed out the norm now is for the Bank presidents to be the majority on the FOMC. They are appointed more by bankers than anybody else.

My response would be, what I proposed, was they do that. The other thing we did do in the legislation, we tried to be very careful, where we were giving increased powers, they went to the Board of Governors, not to the regional banks. I do remember that.

I don't remember, I will tell you, I have no idea what happened to financial stability in the mandate. We don't remember it. I will say in defense that legislation which has one of its major pieces the creation of a financial stability oversight council has some defense against the argument that we ignored financial stability. (Laughter)

I do think that if it did come up, it was what Jeremy Stein said, fear of dilution of the two existing mandates, and maybe getting into the ideological battle of the dual mandate once you throw a third mandate in there, and we had enough to fight about.

MR. WESSEL: Ms. Porat, one of the features of Dodd-Frank, there was concern that the Fed had gone too far in some of the bailout's, that the Fed had too much leeway in making these calls, so the law limited some of the power of the Fed a bit, limited some of the power of the FDIC.

When you look at this from your point of view, from the banking point of view, have we put the managers of financial stability in a straightjacket here? Do they have enough freedom to fight the next crisis, do you think?

MS. PORAT: I believe they do. I think when I look at the biggest assault on financial stability back in 2008, it was really the speed of collapse of these institutions, and there were two terms that were used quite a bit back in 2008, which was the “weekend event” and “too big to fail.”

To me, the biggest risk was really this weekend event, the fact that in 24 hours, 48 hours, we saw the collapse of major institutions, and when you are collapsing that quickly, there is no time to look for self help, to adjust, to do any sort of risk mitigation. What you do is you look for some sort of a bailout, and that puts the taxpayers at risk.

What was really needed is what both Dodd-Frank and the Federal Reserve and BASEL have done, which is put in place a very comprehensive system that addresses, I think, head on this risk of a weekend event.

It has three components to it. The starting point is we need to strengthen institutions in a business as usual sense, which means higher capital, all the capital stress testing, CCAR. It means more liquidity, the liquidity stress testing. All the changes and activities that came out of Dodd-Frank.

It required to me one of the most important things, this notion of what I call “extending the runway,” provide more time so institutions don’t fail overnight, in 24/48 hours, but you extend the runway.

Finally, at the end of last year, we had the rule codified that went to a long term measure of liquidity. Go back to 2008. The discussion was liquidity is oxygen for financial institutions. I believe that to my core.

Finally, we now have terms around what is called the "net stable funding ratio," a one year measure of liquidity. That coupled with again coming out of Dodd-Frank, the resolution planning, recovery planning, which I think was so critical, there's more talk about resolution and recovery, but recovery you're more likely to hit than the need for resolution.

MR. WESSEL: "Recovery?" Define the term.

MS. PORAT: A recovery plan is what's the playbook for an institution if you find yourself under stress, what are you going to do. What is the self help? What are the steps you are going to take, in my words, to extend the runway. You have a recovery plan before you get to you know what, if that doesn't work, then you have a resolution plan. That's part three.

Finally, at the end of last year, final codification of what is the amount of securities that need to get built in. I think we now in an aggregate have a much more robust system. At this point, I would say the most important thing is to digest and assess these rules. We have probably overshot in some areas and undershot in others. It's been such a fundamental transformation.

I would agree with some of the prior speakers who said that's one part of the equation but we also need to think about shadow banking and what's moved outside of the regulated world, again, a core part of Dodd-Frank in my view is derivatives reform, but one of the potential unintended consequences is much of this risk is moving outside of the regulated world to clearinghouses. Let's make sure we don't have the next crisis.

Rather than just focusing on the last one, let's now focus on the next one, and what I'll just add is then what are the ticking time bombs out there that could come from anywhere. Fannie and Freddie were ticking time bombs.

I would suggest in student lending, we have another ticking time bomb. It's a trillion three program, just like Fannie/Freddie, it's a socially well intentioned program, but I would suggest by its design and execution, it's going to hurt those it is intended to help, and the taxpayers are going to be left holding the bill.

That's a broad answer to your question but I do think for financial stability, we need to start with the regulated world and then think about where the other sources of risks are.

MR. FRANK: Are you worried about auto's?

MR. WESSEL: Auto lending?

MS. PORAT: Auto lending? Not as much as student lending, but I think again any place where credit is mispriced or there is a risk of mispricing credit, it's problematic. My concern on student lending is this notion that I agree with, that education is a passport to social and economic mobility, no question about it. That presumes you get a degree. We have 68 percent of kids going to for profit colleges who don't have a degree, so they have no degree and all the debt. That's why I put that one up high on the list. It's just a well intentioned program that's gone astray.

MR. WESSEL: Mr. Bernanke, do you think that the Fed and the FCIC have enough power to avoid a repeat of Lehman weekend, or where would you like to see more or less constraints?

MR. BERNANKE: Well, I think the really important part of Dodd-Frank was the resolution authority or the liquidation authority. That took the Fed out of AIG weekend type situations, which was really good for the Fed and good for the country and gives a bunch of tools which are still not perfect, still have not been completely worked out internationally, et cetera, but certainly much better than what we had in 2008, so I'm glad the Fed is out of that.

I think on the margin that other changes that were made pulled back a little bit on the flexibility the Fed had and others as well, for example, the provision that the FDIC's bond guarantee authority requires congressional approval and tightening up the collateral requirement on the Fed and things of that sort, I think on the margin, those things are a bit of a problem.

I guess the one I would mention, which is totally understandable, one of the big conflicts -- this is a political economy issue -- in a lender of last resort situation, institutions will not borrow if they think they are going to be disclosed. The good compromise was a two year lag. I would have gone for three or four, but anyway, that's one of those tradeoffs that you have.

I think in general, we still do have the authorities. I think there is a problem. Viral talked about rules, and rules are important for setting expectations and creating legitimacy, et cetera. The problem, as Don mentioned, financial crises tend to have a certain chaotic element to them.

The Constitution gives the President considerable flexibility to respond to military situations, for example, because of that very thing. I'm sure it's not politically possible but it would be worth thinking about to give the President some ability to declare emergencies or take extraordinary actions and not put that all on the Fed.

MR. FRANK: When Ben talks about the resolution authority and finds it reasonable, let me say I'm not surprised he thinks it's a good idea because he and Paulson were the ones that came to us and said here's what you have to do. (Laughter)

I'm going to mention a word not often heard today, the process by which we responded in 2008 to the crisis and went on to drafting the legislation was as bipartisan an effort as Congress has ever engaged in in peace time, which included Bush appointees, both Ben, Sheila Bair, and some others in that whole framework.

The other point I would make is with regard to the problem with the institutions. I think you have to separate out two issues with the failures. One is -- this is the one we felt was a public responsibility, how you prevent the negative consequences of an institution who owes a lot of people a lot of money and not being able to pay any of them and causing that serious ripple effect.

What we do do is to say the institution may well go out of business, and that's fine. As I recall, Ben and Hank Paulson said to us with Lehman and AIG, they had a problem under the law, that they had two choices, they could pay none of the debts or all of the debts, and each one was criticized.

What we gave them was the ability -- the regulators -- to pay only as much of the debt as was needed to prevent a further kind of cataclysm with the money recovered from other financial institutions.

MR. WESSEL: Sarah, do you think all this uproar about the Fed is going to go away as the unemployment rate keeps falling or do you think we are going to end up with some legislation that will significantly change the governance or the authority of the Fed?

MS. BINDER: I think the question here -- I don't think the problems are going away. I think as the Fed and FSOC tries to implement the expanded mandates under Dodd-Frank that the questions of transparency, the question of accountability, I'm hard pressed to see those resolving even if the economy improves. The economy improving will help, but I think on the regulatory and supervision side, those problems really aren't going away.

The question I guess for Congress is does it have the capacity to legislate and is there some kernel of agreement between the parties, and as last week's episode showed us, we tend to underestimate the differences between the House and the Senate.

The question is there a common interest between the two chambers and is there bipartisanship at all in these issues.

MR. WESSEL: The answer is no.

MR. FRANK: That conflict that she talked about, there is a conflict, and this you are going to see play out to some extent within the Republican Party, which is where a lot of the energy is today, there is this conflict. You are going to see it on trade, and you see it very much on the Fed.

There was a conflict between the more traditional mainstream conservative business wing of the Republican Party and the more energized Tea Party wing. I do not see that ending. That could even well play out I think for the first time in a long time. The Fed is going to be an issue in a presidential nomination contest, because it is a very serious issue that divides the two major factions in the Republican Party.

MR. WESSEL: It got a little attention the last time around, as I recall. Rick Perry had some suggestions for Ben Bernanke. (Laughter)

MR. FRANK: Rick Perry didn't get much attention. (Laughter) You're right. I think it is going to be even more serious at this point. I think what you are going to see, and I'll make a prediction, if the Republicans would win the presidency, the House and the Senate, they will be under great self generated and external pressure to repeal the unemployment part of the mandate. I continue to believe that it is the profound fundamental disagreement with that second section of the mandate that is driving a lot of this.

MR. WESSEL: Ben Bernanke, would it make a difference if we had a single mandate with price stability as the only goal?

MR. BERNANKE: It would make a difference under some circumstances, but it wouldn't have made much difference over the last few years. The Fed did three rounds of quantitative easing, zero rates, forward guidance and all those things, and the inflation rate is still below target.

It would be hard to argue the Fed could have not done those things. Of course, there would be circumstances when the two conflict. I think in practice, if you look at the Bank of England, for example, and other inflation targeters, they do take into account economic conditions. I don't think it's as stark a difference as you would think.

There would be circumstances, I think, in which it would make a difference to policy; sure.

MR. WESSEL: Ruth, do people on Wall Street care about this argument about accountability and auditing the Fed and governance or is this just a slide show to the more important issues like are we ever going to get out of this bad economy?

MS. PORAT: It's a serious issue because the notion of politicizing the Fed for all the reasons, I think, articulated this morning, are spot on. The inability to actually come up with a budget deficit and to take the country to the brink as often as we did is problematic. To do that with monetary policy, I think we need to have monetary policy as protected as it has been, and I think elements of transparency that have increased over time under Ben Bernanke's leadership have been critically important.

Yes, it's important because what we need is a well functioning market and a well functioning economy for us to play the role that banks do.

MR. WESSEL: Ben Bernanke, how good a job does Congress do in holding the Fed accountable?

MR. BERNANKE: We hold ourselves accountable, I think, pretty well. The dual mandate has gotten enormous attention. We have added a lot of transparency, as you know, in terms of projections, in terms of press conferences, and the things that existed already like Humphrey-Hawkins' testimonies.

The Fed is all about explaining where the economy is and where they think the economy is going and what needs to be done to meet those mandates. I don't think Congress has a problem -- sorry. I don't think Congress has failed to make the Fed accountable on those grounds. What the Congress objects to, I gather, is some of the tools that have been used.

MR. FRANK: I agree with Ben that in fact with a lot of people in power, it wouldn't make a difference if you explicitly said unemployment or not. You have people who in fact would like to structure the institution so that it did not pay that much attention to unemployment.

The argument would not be well, there is no monetary policy argument against quantitative easing because inflation is still low, but if you were only looking at price stability, there would be no reason to do it.

They would say the whole fact that we had quantitative easing owes a good deal of its justification to concern about unemployment and there are people -- I would agree -- they think with a mandate, they can deal with it.

I want to go back, these are people who deeply believe. Ron Paul was one of the most genuine men of integrity around. He believed everything he said. The whole accountability thing is being used, it's a proxy for making the Fed pay less attention to unemployment because people think it's too much government intervention and potentially too inflationary.

Here's the argument. We did, as Ben said, in the legislation and through some things that the Fed did unilaterally, created complete transparency. For example, there was a lot of argument if you go back during AIG and Bear Stearns and others, who are they making deals with. One part of the conspiracy theory was that the Fed people were doing favors, they were making financial deals with friends of theirs.

I believe it's the case that there is no transaction the Fed can have with a private entity that will not at some point be made public, which was a very important safeguard against it. As Ben said, in some cases, there is a two year lag, so it doesn't affect trading on that issue.

That's a very explicit policy. No Fed transaction with any private entity will remain secret forever. They know that.

The controversy of auditing comes out on one issue, because everything else is pretty well audited, and that is the monetary policy making. What you have are people that want to be able to put pressure on the FOMC not to be so concerned about unemployment, and in effect, to get to a single mandate, and you say well, probably people wouldn't do that anyway, but I believe that's what is driving it.

There was a philosophical view that said the Fed is doing much too much about unemployment, it is doing much too much in that sort of soft area, and we want a Fed that deals only with monetary policy, and that is pretty tough about it. That's at the root of the audit thing. The audit claim, nobody thinks you're pocketing money or Janet is or you were helping your friends. I think we have dealt with that. The audit concern is part of this argument that you're doing too much, you're too activist, and you ought to stop it.

MR. WESSEL: Ben Bernanke, another piece of legislation would require the Fed to disclose how it is making policy relative to the Taylor rule. John Taylor is here. That is a formula that includes the output gap, kind of like unemployment, and an inflation target.

Do you think that would change anything? Do you think that would be a good idea or bad idea?

MR. BERNANKE: I don't think the legislation, and John can correct me, specifies the Taylor rule. I would argue the Fed has already done it. The Fed put out a policy statement which provided both its objectives and its objective function and it supports that with forecasts, projections, including projections of interest rates.

I think that within a reasonable range, that has already been done. I don't think you can get much more precise than that because you can't deal with the uncertainties and the many special factors that occur in actual policy making, in particular, as John understands, the Taylor rule would have been not very helpful in thinking about quantitative easing and financial stability impact on the economy and things like that that happened over the last few years.

MR. FRANK: I have one confession. One sort of long-standing argument I had with Ben -- it wasn't long-standing because he convinced me -- I was nervous about the notion of inflation targeting and the two percent, and I will confess it was because historically that had been used as kind of a restraining factor on the economy.

Ben convinced me that he did not intend to do it that way, and I think the way it has worked out, that kind of two percent, has actually made me happier than almost every Republican or at least -- (Laughter) I think that kind of flexibility was very helpful.

MR. WESSEL: Thank you. There is a question from John Hilcernaff.

QUESTIONER: John Hilcernaff from the Wall Street Journal. I have a couple of questions directly for Congressman Frank. The first one is about the law that bears your name requires the Executive Branch to nominate a vice-chair for supervision at the Fed and for the Senate to confirm that person. We are more than four years past the passage of the law and there has never been a nomination.

I was wondering if you think that's a problem and how that plays into the discussion we are having about accountability today for the Fed.

The second one is about this point that David raises about the Taylor rule. You say the Congressional Republicans want a single mandate, but a Taylor rule inherently looks at both sides of the Fed's mandate. Doesn't that contradict the argument?

MR. FRANK: No, I didn't say the Republicans wanted the Taylor rule. Our Ranking Member filed the bill to repeal the unemployment part of the mandate. In fact, a large number of the Republicans on the House Financial Services Committee would have liked to repeal it, but I think were told by the leadership, look, we have enough problems, we're not going to go out there and explicitly say we don't want anybody worried about unemployment.

The House Republicans and the Taylor rule were somewhat distinct in this regard, and there is without question objection on philosophical grounds -- by the way, the dual mandate was not there from the beginning. I acknowledge it came from Humphrey and Hawkins. It didn't come from Hayek and von Mises. I understand what their concern is. (Laughter)

There is no contradiction at all in noting the fact that there is great opposition and I believe if you look at the objections to quantitative easing, every stated objection has been disproven. The unstated objection is what the hell is the Fed doing worrying so much about unemployment and distorting its focus on just keeping inflation down.

As to the first point, no, I don't think the failure to designate a vice chairman in charge of regulation in the bill they all voted against is any reason why the Republicans are upset about what's going on. (a) they didn't like the regulation, and (b) they wouldn't like the vice chairman.

I don't know why they didn't do it. I think de facto it's in place.

MR. WESSEL: Dan Turello.

MR. FRANK: Yes, Dan Turello. My guess is that what you have is people in the Administration decided a couple of years ago that one of the worse things in the world was to try to get somebody confirmed and therefore weren't going to do any confirmation that wasn't necessary, that might have changed when the filibuster was broken, but now it's too late for that. Yes, we did it and I thought it was a good idea but not a terribly important one.

I don't think there is any practical consequence in the fact that hasn't been designated and frankly, I think if you asked a lot of my colleagues who are very upset about what's going on in the Fed, they wouldn't remember we named a vice president for regulation.

MR. WESSEL: Alice Rivlin?

QUESTIONER: I wanted to ask how deflation plays into all of this. If it turns out that in fact over the next few years, we don't have a tendency toward inflation, we have a tendency toward deflation, this Republican concern about too much emphasis on unemployment would seem to go away, but how do they feel about deflation?

MR. FRANK: I think they think the fear of it is exaggerated. I've not been in intimate contact with any of these people for four years now or three, but I would say this, I'm just judging.

I do not think that what you are saying will not the fact of deflation being much more serious a potential problem than inflation, and I don't mean this to denigrate, you are talking here about a deep philosophical principle that will not easily be changed by short term fact patterns. I think that is basically what it is.

You have seen that already, because I think if somebody were to do -- I wish the media would do more than this -- I think they don't hold us accountable enough for people particularly who make predictions of bloom and doom, and two years later, tell me what happened. I think people get away with predicting bad things and the media does not go back and say look what they said was going to happen, it didn't happen.

I think that has been the case, as you look at the debate over quantitative easing, virtually every substantive argument that was made by the political community has fallen flat but that has not diminished the volume of the complaints.

MR. WESSEL: Do you want to add to that, Ben?

MR. BERNANKE: No, I agree with that. (Laughter) It's unusual though to have a political system demanding that the central bank have easier credit, isn't it usually the other way around.

It's backwards. In the 19th Century, populous were all in favor of inflation, and now they are in favor apparently of deflation. I don't know exactly. I don't think you can explain this. Barney will certainly correct me.

I think this is less interest and more ideology. From an interest perspective, why would you want to get rid of the unemployment part of the mandate. From an ideology perspective, you might believe that central banks are about price stability only.

MR. FRANK: This is a deep coherent mindset. I wasn't kidding when I mentioned Hayek and von Mises. These are people who really believe that government is the greatest threat to our freedom.

Thad McCotter, a very honest guy, did a major speech during the time of AIG and Lehman and he said, look, it may be this is necessary to prevent a catechism, but that's the price we will pay for freedom. I think you are talking here about the Fed -- it's not policy specific, it's based on this world view.

QUESTIONER: I am a visiting scholar from Finland and working at the CTR think tank. This event has mainly focused on U.S. internal politics but the Fed has also very global aspects since U.S. dollars are used in world trade.

What would be the consequences for U.S. economics if another currency would take over dollar as the world currency, and my second question is in terms of information war, is there an attempt by foreign powers to undermine the Fed and create mistrust among the public, is this a future risk for Fed, and how does the Fed confront this attempt?

MR. WESSEL: Ben?

MR. BERNANKE: Well, there was a lot of talk a few years ago about the dollar being displaced, and it's not looking like a real near term issue right now.

The economic effects of the dollar being world currency are very complicated. It probably lowers U.S. interest rates, it probably strengthens the dollar, which is not great for an export position. Again, I think it's a hypothetical at this point.

There has been foreign criticism of Fed policies at various times, including the quantitative easing, for example, for a variety of reasons, including concerns about spillovers and just for ideological reasons in some cases.

I guess I could take the rest of the time to talk about the substance of those criticisms, which I think can be answered, but again, Barney will correct me, I don't think that your typical American congressman pays a great deal of attention to Wolfgang Schauble or the Brazilian Finance Minister.

MR. FRANK: In fact, it's the other way around. If you look where the criticism is coming from of the Fed, this comes from people who do not want them to pay that much attention to international activity. Remember, when the IMF and ECB were intervening in the European crisis early on in ways we thought were very helpful when the Fed was doing its currency swap, many of the people who were most critical of quantitative easing were denouncing that and a bill actually passed the Senate saying we would cut off our IMF contributions if they didn't stop trying to deal with the situation in Europe.

In fact, none of the people being critical of the Fed domestically on this side of quantitative easing -- the notion that the Fed is being unfair to foreigners, they don't want to choose between the Fed and foreigners, a plague on both the houses.

MR. WESSEL: Yes. John Taylor.

MR. TAYLOR: Just a couple of things. This theory that is the dual mandate, I don't see it that way. The legislation that is on the table now doesn't have that. It has, for example, the Fed should report its strategy for setting interest rates. Sort of trying to get at some of these issues in a more direct way.

To the extent that the dual mandate comes up, it is almost always in the case that it's worse for unemployment in a way.

MR. FRANK: They are against it.

MR. TAYLOR: The efforts that have been -- if you look at history, the times the Fed has specifically focused on unemployment, it has actually turned out to be counterproductive. I think that is what people are thinking about.

I think on quantitative easing, there is a great deal of disagreement about its impact, whether it has been successful. Some people are worried about inflation, some people are worried about it being a drag on the economy. The evidence is not very clear cut that it has been beneficial.

I think it is somewhat more complicated, and the actions that I see on the Hill, they are addressed, I think as you say, to different views about how policy should work, how centralized it should be, but it's not something well done.

MR. WESSEL: Are you troubled at all by how partisan the debate is on the Hill?

MR. TAYLOR: I have never seen it this partisan. I've testified in your committee in the past. I've testified in the committee with the current chairmanship. One side of the aisle is completely supportive of the Fed, the other completely against what the Fed is doing. Again, I have never seen it this way. I don't think it's good.

MR. WESSEL: Is that a concern? Why is it not good?

MR. TAYLOR: In many respects, these issues are kind of arcane. They don't lend themselves to different political philosophies. Democrats can agree in certain cases and Republicans disagree. I don't think it's good for the institution. It can flip. Attitudes can flip. I think it's a very important institution. Its independence is important.

If it gets dragged into political partisanship --

MR. FRANK: Why monitor monetary policy, why the demand for the audit to extend to the way monetary policy is formulated? To actually talk to these guys and sort of influence how they set monetary policy, what is that connected to?

MR. TAYLOR: I think it's what Peter referred to this morning, they don't know what the Fed is doing and they want to know. I'm not arguing that should be the way to go.

MR. FRANK: I think the problem is they do know what the Fed is doing and don't like it. I don't see how you can possibly argue this is based on them not knowing what the Fed is doing. They have been very explicit about the quantitative easing. They don't like it.

I understand part of your argument. I think the clincher for me is it's a demand to audit monetary policy, i.e., they don't like the monetary policy and quantitative easing. The other thing I would say is I understand some of the legislation doesn't talk specifically about the dual mandate.

Having been there, that's what they talk about amongst themselves, and to me, Ed Royce, after he filed the bill, I believe they have quite sensibly pulled back a macro-prudential strategy here, I don't get to use that word since I left. (Laughter)

It's not just the question of the dual mandate. We're talking about a group of people who are -- there is a House/Senate difference -- who very much believe that the Federal Government is much too deeply involved in virtually every aspect of our lives, that it's a threat to freedom, and the Federal Reserve being as active as it is part of that. The dual mandate is part of that, that a properly behaved central bank -- inflation only is a much more minimis thing.

I'm not trying to denigrate that. They believe this very deeply philosophically. I disagree. Again, I don't know how it is -- the demand for auditing monetary policy has nothing to do with not knowing what they are doing. It is in fact fueled by disagreement with what they know they are doing.

MR. WESSEL: John, do you have a view?

MR. TAYLOR: I would prefer if they do this strategy policy, report the strategy of the Fed.

MR. FRANK: Are you for or against the bill? People used to ask me that all the time. I get to ask other people. (Laughter)

MR. TAYLOR: I'm not in favor, I'm in favor of an alternative.

MR. FRANK: You're against the bill?

MR. TAYLOR: I'm in favor of an alternative; yes.

MR. FRANK: We should swap. (Laughter)

MR. TAYLOR: Vote for me. (Laughter)

MR. WESSEL: Peter Hooper.

MR. HOOPER: Charlie Plosser made the point earlier that people hate the Fed but not Federal Reserve Banks because they are out talking to the public, schmoosing, et cetera. Could the leadership do a better job of schmoosing on Congress or that's not going to do any good?

MR. FRANK: Two things. I think you exaggerate that a little bit. The average citizen, and there is a very small number of people who differentiate between the regional bank and the institution, and they do it because the regional banks provide services that are very important. These are entirely legitimate.

We are talking about such profound philosophical differences now that nobody can talk anybody out of anything. This is not what is going to happen. No, I don't think it is that people at the local level are more charming than Ben or Janet. (Laughter)

Part of it is that they are an institution, they do conferences, they provide help, and there is a legitimate service function that the regional banks can do which makes people happier. Even with that, I do not think anybody in my 32 years ever said to me, you know, that Boston Fed, they're doing a hell of a job. (Laughter)

MR. WESSEL: In the back?

QUESTIONER: Thank you. I have a question for Congressman Frank. Mark Spindel from Potomac River Capital. Some of the most outspoken and biting criticism of the Fed lately has come from Democratic Senators, including your own Senator Warren, Senator Brown, particularly with respect to leaks, regulatory capture, lingering opacity at the New York Fed.

Since Senator Warren and company would seem to line up nicely with your politics, Congressman Frank, I was just wondering what do you make of her concerns? She characterized the difference in perspective of President Dudley versus the cop on the beat or the fire warden, and wouldn't their concerns suggest that Senator Shelby might have some traction at increasing transparency on non-monetary policy issues?

MR. FRANK: No, because in the first place, I think there is a pretty complete legal requirement for transparency on non-monetary issues. We responded. When you look at the complaints, one complaint was these guys are making deals with their friends, helping out this group and that group, why they paid Goldman too much and they paid these debts and not the others.

Every single transaction that the Fed has with a private party will at some point be made public, with a time lag to insulate it against having sort of market impacts.

As to the specific criticisms of Elizabeth Warren, I did think Bill Dudley made a very poor choice of words. I advise people against metaphors, they get you in trouble. I think that was one of them.

I have to say that business with the woman who got fired was troubling to me, so I was bothered by that.

As to the more systemic criticisms, I do not spend my day to day time looking at that. I'm a great supporter and fan of Elizabeth Warren. I do not think we should bring Glass-Steagall back, which for example, she does, although she does acknowledge it was not because of the crisis. I have some differences with Elizabeth Warren on some of those things.

Yes, I thought the firing of Carmen Sierra was unfortunate. Beyond that, I haven't followed it closely enough to make a more systemic judgment.

QUESTIONER: J.W. Verrett, House Financial Services Committee. I work on the Federal Reserve issues for the committee. I just want to ask the panel, in the discussion about the role of Congress in overseeing the Fed and the role of the legislation that has been proposed, and I appreciate the discussion that has gone on differentiating between the legislation that Mr. Huizenga introduced, the rule based policy bill, and the audit of the Fed legislation that was introduced by someone not currently on the committee.

Hasn't there been at least some -- as the debate has focused on talking points, hasn't there been some lack of recognition about the fact that traditionally independence has always been understood as originating from the Executive Branch, not the Legislative Branch.

In Larry Summers' original paper, he talks about the Executive Branch. He defines independence in originating that empirical literature as independence from the Executive Branch.

All the great stories about the independence from the past have come from stories about interactions between the Fed Chairman and the President. Folks are all familiar with them. The great Treasury Fed accord of 1951, about the Treasury Department and the Fed.

Isn't there at least some willingness to accept the fact that a rule based policy approach like Professor Taylor talks about, not necessarily the Taylor rule, but a rule requirement, could help to protect the Fed's independence from the Executive Branch, if there was any coordination going on between those two, wouldn't a rule based policy requirement help to demonstrate that?

MR. FRANK: Let me make two points. First, I do not oppose a rule based policy on the grounds that it interferes with Fed independence. I have never been a great believer. I would disagree that the argument has always been the Fed must be independent of the Executive. I spent much of the time in the 1980s and 1990s being critical of the Fed and being told shush, that's not your job. I was critical.

In fact, Paul Volcker, with whom I collaborated greatly in our legislation, did remind me that I wasn't always so nice to him. I often differed with Alan Greenspan. Go back to the Greenspan era. No, Congress was not supposed to question him either.

Having said that, I don't impugn the legitimacy of those concerns. When the question came should the Fed have rules for how it is going to respond to a crisis, and it just struck me if they knew enough to have good rules about how to respond to the crisis, they could have prevented the crisis.

The answer is it not true the concern about Fed independence was only from the Executive Branch. It got expressed more because people saw the Executive Branch as more in a position of influence.

If you go back to the 1980s and 1990s, Congressmen were told no, you don't get involved, you are not supposed to comment on interest rate decisions.

My objections to a rule are substantive, not that it is somehow an intrusion on the Fed's prerogative. I do think they overlap in the sense that ties people's hands too much in a situation that requires fluidity.

MR. WESSEL: Ben Bernanke, there were two things in that question, one was is there more risk of political interference from the Executive Branch and it's not Congress you worry about, and secondly, if there was legislation that made you define a rule or explain a rule and why you are not following it, what would be so bad with that?

MR. BERNANKE: Logically, independence means political independence, and there have been times when Congress was asserting undue influence and times when the Executive was asserting undue influence. I don't think from the point of view of giving the Fed the independence to take the necessary actions to achieve its mandate, I don't think it makes that much difference.

I have two objections basically to the FRAT bill. The first is that the presumption that the Taylor rule is the right rule or the right kind of rule, I think, is no longer state-of-the-art thinking. There is an excellent paper by Lars Svensson called "What's the Matter with Taylor Rules," where he argues that they are not robust responses in complex situations.

The Fed has a rule. The Fed's rule is we will go for a two percent inflation rate, we will go for the natural rate of unemployment, we put equal weight on those two things, we will give you information, but our projection on interest rates, that is a rule. That is a framework that should clarify exactly what the Fed is doing.

My second objection to the bill is I think that while in principle, yes, it's about the Fed setting its own rule, and I think in practice, it would be used to some extent to constrain policy in ways that would not be correct at the moment.

Any rule is going to be a problem when the circumstances change in a way that the rule didn't contemplate, and if the Fed is always taking actions like that and Congress is pushing back and saying no, you're violating the rule, I think that is less directly an audit to Fed, but I think it still is a way in which Congress would exert undue influence on monetary policy.

MR. FRANK: I have one important distinction to make, and I know you didn't mean to overstate this. We say no coordination, we don't want the Treasury and Fed working close together. Here's part of the problem. We do in regulation. I admire Ben Bernanke and Hank Paulson for the extent to which they worked together and there were no turf battles and things in 2008 and into 2009.

There is this problem. You don't want the Executive being as directly involved in the formation of monetary policy but they have to work closely with the Fed in terms of regulatory macro-prudential financial stability. There is tension there that I think you have to be aware of.

MR. WESSEL: Despite your admonition about metaphors, Stan Fisher's comment on that at an IMF conference was that anybody who thinks you can't be independent on one thing and not independent on another has never been married. (Laughter)

Last question, gentleman in the back.

MR. FRANK: Well, fortunately, that no longer applies to me. (Laughter)

QUESTIONER: Christopher Goins, American Spectator. Mr. Bernanke, I just wanted to know, if the Fed raises interest rates in the latter part of this year, do you think the economy will go into a recession?

MR. BERNANKE: I'm not going to comment on monetary policy.

MR. WESSEL: Nice try though. I'm afraid we have to end it here. I really appreciate everybody coming despite the weather, and I want you to join me in thanking not only these panelists but the previous panelists. (Applause)

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