Hutchins Center
on Fiscal & Monetary Policy
at BROOKINGS

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

Hutchins Center on Fiscal and Monetary Policy
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Stanford Law School

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Audit the Fed


Sen. Rand Paul (R-KY)

“Anybody feel that the Fed’s out to get us?”

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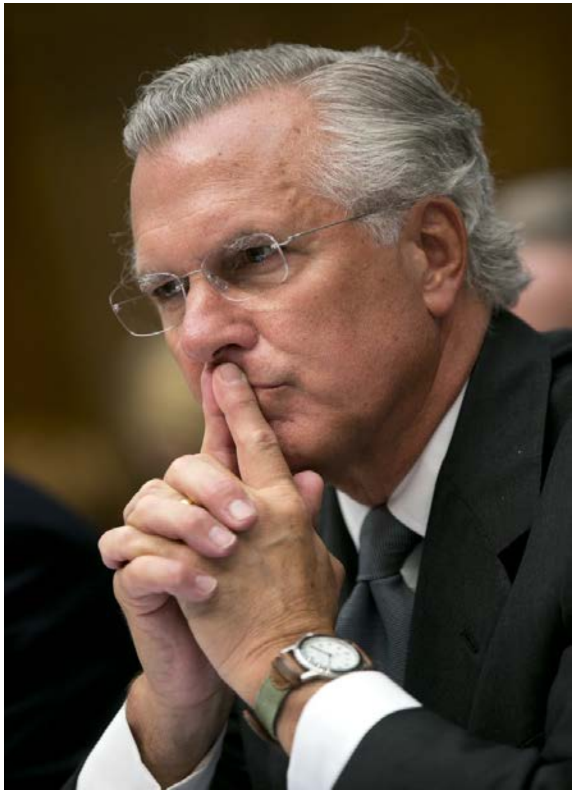
Congressional Monetary Policy?

"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?"



Richard Fisher, President
Federal Reserve Bank of Dallas

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The Perennial Contest

v.

Functional Reform

Taylor Rule

Durbin Amendment

Audit the Fed

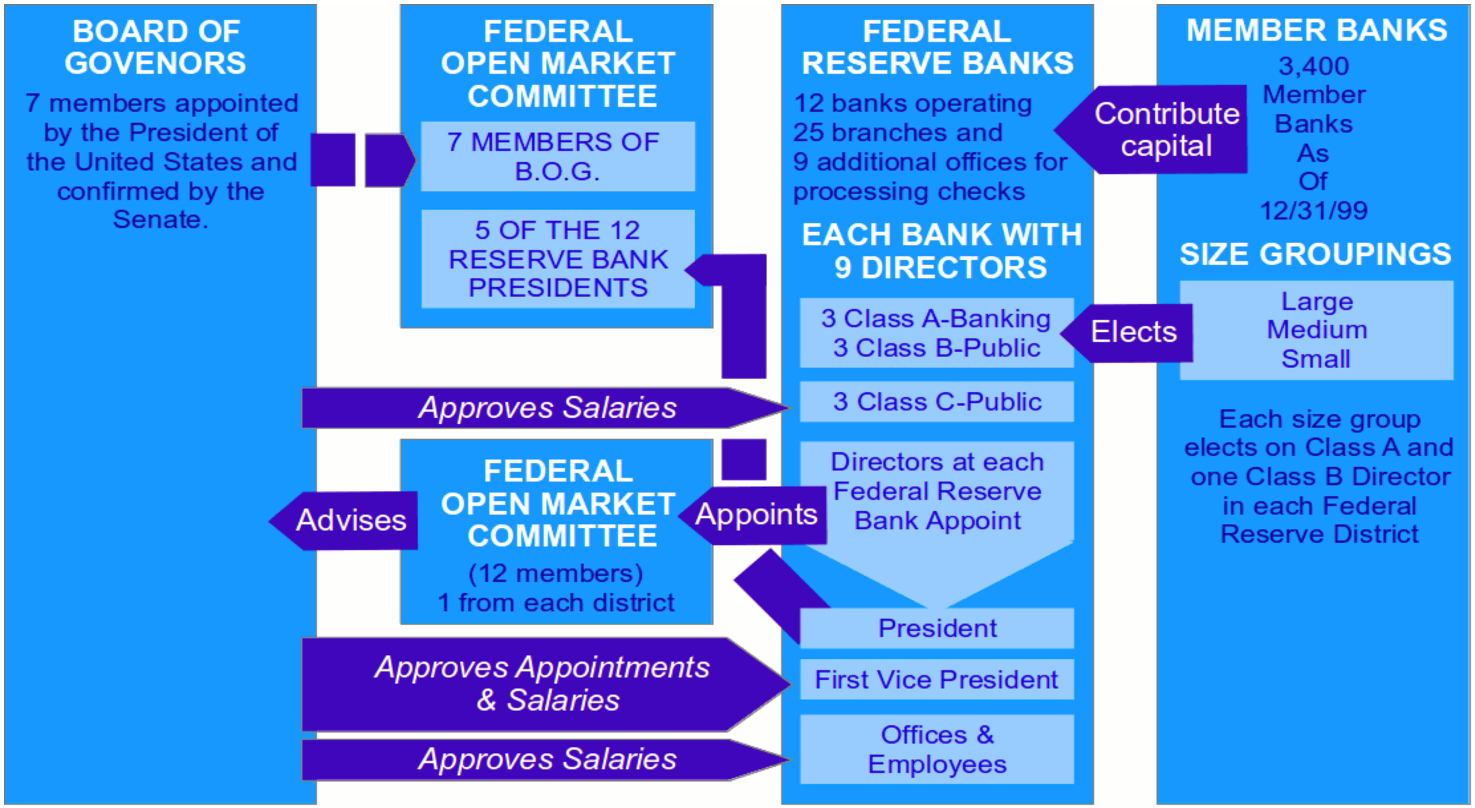
Liquidity Coverage Ratio

Volcker Rule

Swap Push-out Rule

Capital Adequacy

Structure/Governance



Source: Board of Governors of the Federal Reserve System

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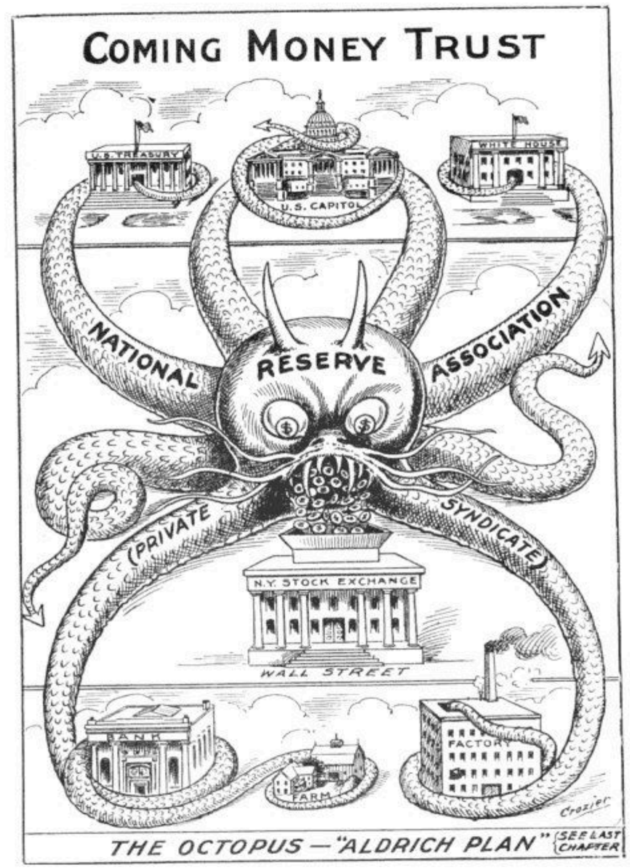
1913: The Two Debates

- Centralization versus Decentralization
- Public versus Private

The Proposals: The Aldrich Plan

- Centralized
- Private



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Proposals: The Glass Plan

- Decentralized (as many as fifty Reserve Banks)
- Private
- “In the United States, with its immense area, numerous natural divisions, still more numerous competing divisions, and abundant outlets to foreign countries, there is no argument, either of banking theory or of expediency, which dictates the creation of a single central banking institution, no matter how skillfully managed, how carefully controlled, or how patriotically conducted” Carter Glass

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Wilsonian Compromise

- Features of public and private, centralized and decentralized

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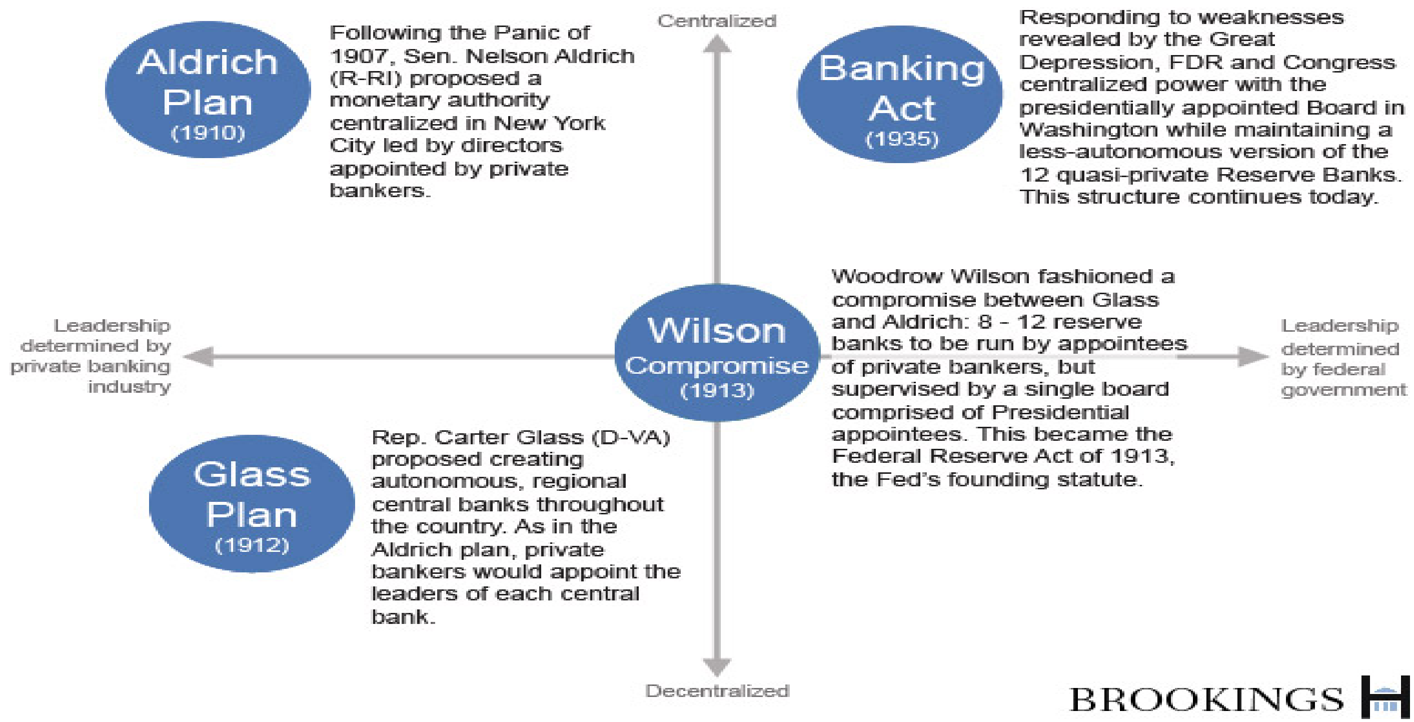
The Proposals

The Evolution of the Fed

The original structure of the Federal Reserve was a compromise crafted by President Woodrow Wilson which led to the creation of 12 powerful regional, quasi-private Federal Reserve banks. After the Fed's mistakes in the Great Depression, President Franklin Roosevelt and Congress reorganized the Fed and strengthened the presidentially appointed Fed Board of Governors in Washington.



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Failed Experiment

- Ambiguity and power vacuums
- Great Depression

Marriner Eccles

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Confusion and Accountability

- With such an organization [as the Federal Reserve System] it is 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 forms.
- —Laughlin Currie, in a letter to Marriner Eccles, 1934

The Proposals

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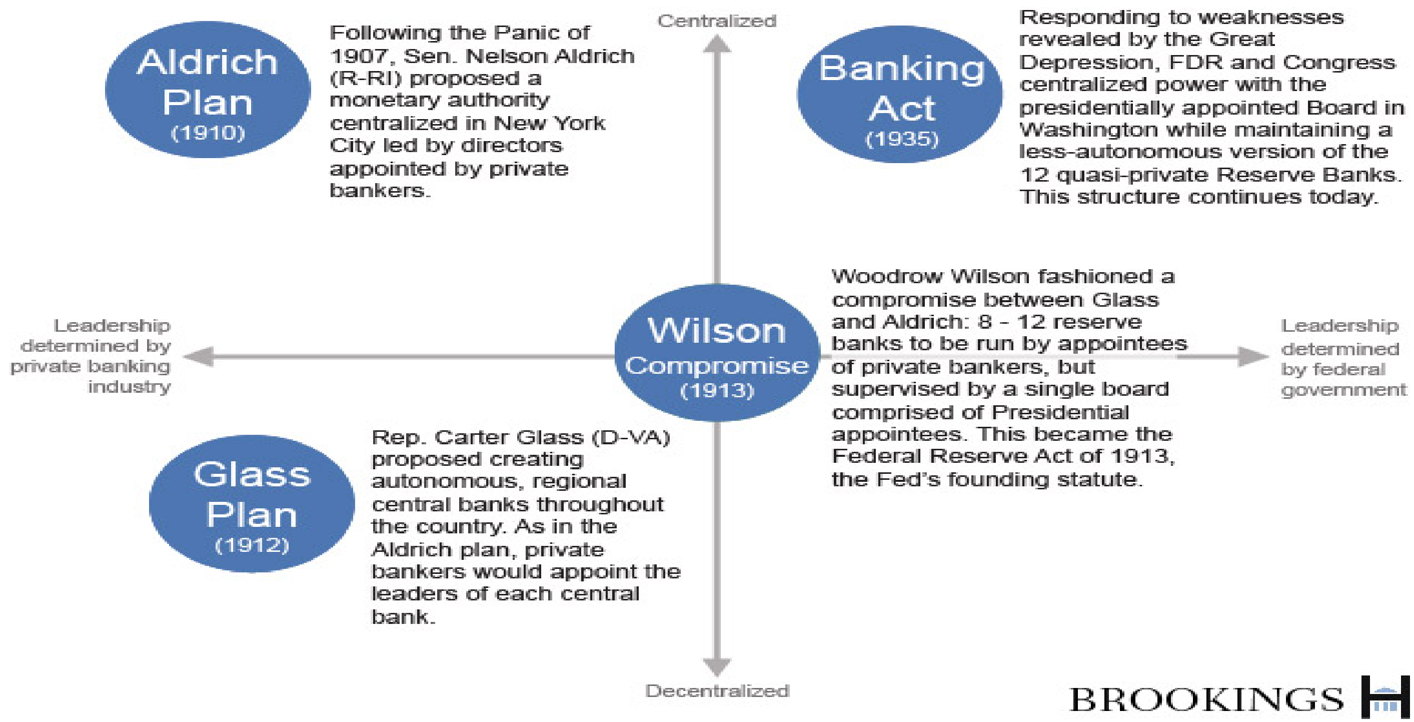
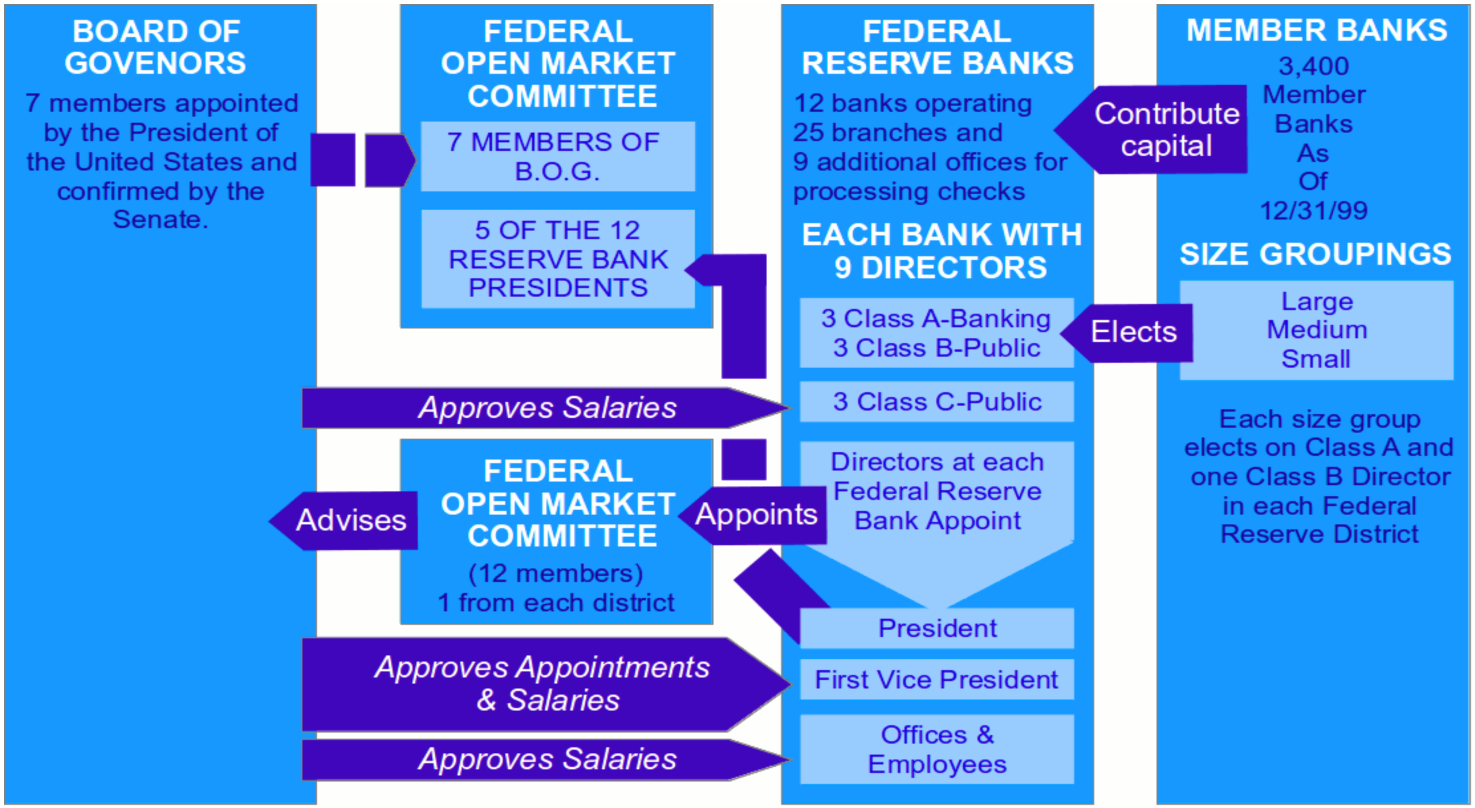


Structure/Governance



Source: Board of Governors of the Federal Reserve System

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Solutions

- Presidential Appointments for all Twelve Reserve Banks
- Presidential Appointment for the New York Fed
- Turn the Reserve Banks into branches of the Board of Governors

Solutions

- Turn the Reserve Banks into branches of the Board of Governors

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Financial Stability in the Broader Mandate for Central Banks: A Political Economy Perspective

Viral V Acharya

NYU Stern School of Business

Presentation at the Brookings, March 2 2015

Central Banks and Financial Stability

- 1907 Crisis: commercial banks, trust companies, commercial bank clearinghouse
  - John Pierpont Morgan played the lender of last resort, but derived private gains
- <u>Should the allocation of public liquidity be outsourced to a private entity?</u>
- The creation of the Federal Reserve
  - Stabilization of the inter-bank rates during crises and panics
- What the Federal Reserve does has evolved substantially over time
  - Financial stability:
    - <u>Crises management</u>: Lender of last resort
    - <u>Crises prevention</u>: Supervision
  - Other objectives:
    - <u>Long-run price stability, employment</u>, …

Traditional Central Banking perspective

- <u>Time-inconsistency</u>: It is not credible to be tough in the midst of a crisis
  - Financial sector is crucial to payments and settlements, trade, growth
  - Disorderly system-wide collapses in the financial sector socially costly
- <u>Moral hazard</u>: Reduces market discipline on financial sector risk / leverage
  - Crises prevention may be the best way to approach financial stability
- What tools should a Central Bank employ for crises prevention?
  - <u>Macro-prudential regulation</u>: Capital and liquidity requirements
    - Regulatory arbitrage: Shadow banking, Banks connected to shadow banking, …
  - <u>Interest rate policy</u>:
    - Leaning against the wind, reaching the corners of the financial sector
  - <u>Regulating by function rather than form</u>: LTV and DTI limits, clearinghouses / margins

Central banking in practice

- Central bank must operate within the law and strive for independence
  - What tools does the law grant it to conduct financial stability?
  - How freely can it operate these tools?
  - Would certain actions, even if within the law, lead to political interference

    and cause the central bank to lose some of its tools?
- Political system requires central banks to have democratic accountability
  - Governance
  - Accountability
  - Transparency
- However, political system may want to overly restrict central banking scope in order to ensure its own freedom in meeting political objectives

A Political Economy perspective

- Divergence in horizons and objectives create a potential tension
  - <u>Political horizons are often short-term and objectives populist</u>
  - <u>Central bank horizons are relatively longer-term and objectives less populist</u>
- Crises management:
  - Quasi-fiscal action; targeted entity assistance (13(3) exception to Federal Reserve Act)
  - Can set the stage for political interference and in future independence
- Crises prevention in good times may also fall prey to political headwinds:
  - Low interest-rate policies attractive for housing activity and housing price growth
  - Weak housing markets can slow down current growth and job prospects
  - Keeping shadow banking (money market funds, over-the-counter derivatives) out of central banking reach may achieve similar objectives

Guarding against the political headwinds - I

1. Reliance on rules in crises management policies:
   - Broad scope but limit the extent of quasi-fiscal actions
   - LOLR to market at large, but with minimum solvency requirements
   - Do not provide liquidity without addressing solvency
   - Crucially, limit the extent of ex-post political questioning of central bank actions
2. Broad scope for central banks to regulate growth / leverage in shadow banking:
   - Recognize the regulatory arbitrage incentive of the financial sector
   - This incentive can manifest as lobbying efforts to leave shadow banking unregulated
   - Without capacity to maintain minimum solvency requirements, rules in crises management cannot function well
   - Would lead to proactive regulation of shadow banking as innovations appear
   - Scope should cover state-owned and government-sponsored entities in financial sector

Guarding against the political headwinds - II

3. Explicit role for financial stability in the central banking mandate:

- Introduce an explicit long-run dimension that central banks can appeal to
- Layering financial stability as an additional responsibility with primary mandates being price stability and employment do not suffice
- Inflation and job growth measures for the long run are hard to come by
- This creates pressure not to resist financial sector excesses in boom times
- Explicit mandate can create an interest-rate policy that “leans (more) against the wind”

4. Sharing of crises management and prevention responsibilities among regulators:

- Create some manageable separation of activities among regulators, e.g., FDIC and the Federal Reserve
- The goal is to prevent cramming down of an entire agenda on regulators
- Must be balanced with the need to coordinate and avoid jurisdictional arbitrage

The Dodd-Frank Act: Hits and Misses

1. Restrictions on 13(3) exceptions:
   - Limiting targeted action for one entity desirable; but why just against non-depositories?
   - Lender of last resort to market at large desirable; but need minimum standards?
2. Financial Stability Oversight Council (FSOC) and SIFI designation:
   - FSOC a good attempt to maintain multiple regulators and at the same time achieve coordination on financial stability issues
   - Designation as SIFIs from commercial banking and shadow banking sectors a plus
   - Housing? Why aren't the GSEs designated SIFIs and regulated by FSOC?
3. No financial stability in the explicit Federal Reserve mandate:
   - Early drafts proposed financial stability as a third mandate of the Fed
   - Inexplicably dropped from the final wording of the Act
   - Desire to keep financial stability at bay in the interest of current jobs?

Are financial boom and bust cycles inevitable?

- Laws that take account of the political economy headwinds on central banking are best implemented following a crisis
  - Financial stability concerns are paramount
- Over time, however, these laws can themselves fall prey to politics
  - Repeal of Acts and laws passed in crises times once economic fortunes recover
- Political intervention in financial stability decisions
  - Direct government presence in politically attractive parts of finance, e.g., housing
- <u>Political arbitrage of financial stability regulation can become as big – or bigger – an issue than private sector's regulatory arbitrage</u>
- Low-frequency boom and bust cycles in the financial sector become inevitable
- Only obdurate central banking can save the day!

Conclusion

- Financial stability is key to economic growth
- Financial stability is necessary condition for transmission of central bank policies
- <u>Financial stability should therefore explicitly be part of central banking mandate</u>
- Tools given to central banks to maintain financial stability and resolve it should
  - Recognize the time-inconsistency and moral hazard from crises management actions ("Rules")
  - <u>Enable the central bank to take tough crises prevention actions for financial stability even if they do not serve short-term and populist political objectives ("Discretion")</u>
- It is a delicate balance…
- 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!

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