

CHAPTER 2

The Power of Central Banks and the Future of the Federal Reserve System

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The Federal Reserve System was born of a financial crisis, the Panic of 1907. Major changes in the structure and powers of the Federal Reserve were the result of subsequent crises, most notably the Great Depression of the 1930s. It is not surprising then that the financial crisis of 2007 to 2009 should lead to further changes in the power and scope of the Fed. The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 mandates major changes in the role and responsibilities of the Federal Reserve System. The Fed will have enhanced responsibility for systemic risk assessment and regulation, and it will house and fund a new Bureau of Consumer Financial Protection (BCFP). The policy mandate of the Fed is also expanded. In addition to price stability and full employment, the Fed must now make financial stability an explicit goal. In addition to expanding the powers of the Fed, the Dodd-Frank bill also sets some new limits. In particular, the Fed's ability to lend and provide liquidity in a crisis will be curtailed, and its operations and lending programs will be subjected to more scrutiny.

The recent financial crisis highlighted the extraordinary power of the Federal Reserve and other central banks to intervene in the economy in a

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crisis. Not surprisingly, the interventions led to a vigorous public debate about the choices the Fed made, the proper role of the Fed in a crisis, and the transparency of its actions. Never has a central bank been so deeply involved in providing liquidity to a weakened financial system.

The role of a central bank in financial crises is a topic with a long history. With the help of Walter Bagehot, the Bank of England learned in the 1860s and 1870s that proper behavior on the part of a lender of last resort is to furnish liquidity *to the market* by discounting freely when presented with good collateral, at a penalty rate of interest to provide incentives for borrowers to repay as soon as they are able and for banks to maintain adequate liquidity. In the recent crisis, the Fed developed a range of Bagehot-like facilities to deliver liquidity when and where it was needed.

But the Fed and some other central banks also went well beyond what Bagehot taught a century and a half ago. In addition to lending to the market, they lent to particular institutions in trouble, sometimes on dodgy collateral. Whenever a central bank acts as a lender of last resort, the decision to do so on behalf of particular institutions—no matter how dispassionately and professionally arrived at—has political ramifications.

Even in lending to the market, the Fed intervened to an unprecedented degree, reacting quickly to create vast reserves and shoring up institutions in novel ways to prevent a wholesale collapse of the U.S. financial system. The Fed expanded its traditional role as lender of last resort to become *an investor of last resort* as well. One could argue that this was an appropriate means to prevent a widespread systemic collapse of the financial system. Yet it was bound to add to concerns about the range of Fed powers.

However else these decisions are judged, the political fallout from what were intended as prudent professional decisions cannot be denied. We should not be surprised that when unelected leaders of powerful, independent financial institutions make political decisions, they invite a popular backlash. In the United States, public suspicion of seemingly unchecked power of banking authorities dates back to the colonial period.

Not surprisingly, Congress has turned its attention to ways to improve financial sector regulation and avert future crises. The changes to the role of the Fed that are introduced by the Dodd-Frank Act arise mostly out of serious thought about the role of central banks and the appropriate scope of their activity. But there also are lingering reflections of the public anger triggered by the crisis and the Fed's role in it. We will try to distinguish between the two.

We start with some historical background that highlights the long-standing American tradition of opposition to central banks. We then turn to the Dodd-Frank Act and distinguish between the expressions of public anger

and the substantive issues that are worthy of scrutiny. To foreshadow our conclusions, we argue that the most egregious populist elements of the prior House and Senate reform drafts have been eliminated from the Dodd-Frank bill. At the same time, the bill weakens or eliminates some Fed powers that played an important role in mitigating the recent crisis. Instead, it relies heavily on new, complex, and potentially unwieldy regulatory and resolution mechanisms to prevent and tame future crises. If these new structures prove ineffective, the absence of emergency authority for some forms of Fed lending could make future crises even more devastating than the recent one.

2.1 THE HISTORICAL BACKGROUND

Hamilton and the First Central Bank

Widespread resistance to a powerful central bank is at least as old as the United States. When Treasury Secretary Alexander Hamilton proposed in 1790 that Congress charter a Bank of the United States for 20 years, he set off a controversy that would echo throughout U.S. history. A strong, centralized state such as Britain had recently posed a grave threat to American liberties. So had the Bank of England, which aided Britain's war efforts and operated under the British government's auspices. To many Americans, Hamilton appeared to be trying to create similar threatening institutions in the United States. They thought it better to have a more limited and weaker federal government, and smaller local financial institutions created by the states.

Issues of political power—rather than competing theories of economics—framed the debates among the founders regarding the role and structure of the federal government. In the various state constitutions, the powers of the executive were severely curbed, and under the federal Constitution, the central government's executive authority was to be hedged by a legislature that represented states' rights and interests. That the executive branch should sponsor an institution that represented a large concentration of financial power would prove immediately controversial.

Hamilton, however, was both more an economist and more accepting of an "energetic" central government than his opponents. He envisioned that the Bank of the United States would serve as an important adjunct to federal public financing operations. In a country with only three small local banks at the time, it would also serve the private sector as a bank of discount, deposit, and note issue with a nationwide system of branches. The Bank was to be a large private corporation, a feature aimed at the modern goal of limiting short-run political influences on it, what today would be called

central bank independence. At the same time, Hamilton proposed that the federal government take a 20 percent stake in the corporation to signal its public ties and responsibilities, and he imposed on it an obligation to report on its condition regularly to the Treasury secretary.

Congress debated Hamilton's proposal in early 1791 and quickly passed the bill embodying it. In the House debates, however, where members were more sensitive to their constituents, James Madison argued that the Constitution had not conferred on Congress an explicit power to establish any corporation, including a bank. Edmund Randolph, the attorney general, and Thomas Jefferson, the secretary of state, furnished President George Washington with opinions that the proposed Bank of the United States was unconstitutional.

Hamilton responded with a lengthy defense of the bank, relying upon the "necessary and proper" clause of the Constitution, exposing flaws in the reasoning of his fellow cabinet members, and setting down for the first time the doctrine of a constitution's "implied powers" that later became an important worldwide principle of constitutional law. Washington was persuaded and signed the Bank of the United States bill into law.

The Bank served the U.S. economy well. It was an efficient fiscal agent for the Treasury. And since it received the note and deposit liabilities of a rapidly expanding system of state-chartered banks in payment of federal taxes, it could effectively regulate the U.S. banking system and credit conditions. It also took on limited lender-of-last-resort functions by aiding a few banks with temporary reserve deficiencies.

Nevertheless, Congress failed to renew the Bank's charter when it came up for renewal in 1811. In addition to issues of constitutionality and concentration of power, interest group lobbying also played a role. State-chartered banks—which numbered more than 100 by 1811—had the opportunity to rid themselves of a regulator and a competitor. With no Bank of the United States, they stood to gain the federal government's banking business. The self-interest of state-chartered banks prevailed over the preferences of now President Madison and Treasury Secretary Albert Gallatin, both of whom supported renewal of the Bank's federal charter.

The Second Bank

Without a Bank of the United States, financing the War of 1812 grew complicated and embarrassing. Except in New England, state banks suspended convertibility of their liabilities to base money, and there was considerable inflation. Chastened by the experience, Congress moved quickly after the war ended in 1815 to charter a second Bank of the United States, again for 20 years, starting in 1816. The second Bank was an enlarged version of the

first. The federal government again took a 20 percent stake, and now it also appointed a fifth of the Bank's directors.

The second Bank of the United States performed as well as the first. It aided the Treasury in restoring convertibility of the currency after the war, although it was blamed for the period of tight credit necessary to reach that goal, as well as for the panic of 1819 prompted by the credit contraction. In the 1820s and early 1830s, Nicholas Biddle, the talented but arrogant Bank president for much of this period, was a true central banker. Biddle became so personally identified with the Bank that its friends and enemies alike could focus on a personality, a mixed blessing for the institution. Under Biddle, the Bank managed domestic and international payments systems, helped the Treasury to manage its debt, prevented the major British financial crisis of 1825 from spilling over into the United States, and presided over a period of rapid, noninflationary economic growth.

Nonetheless, when Congress approved a renewal of its charter in 1832, President Jackson vetoed it. His veto message, a classic of populist rhetoric, raised all the old arguments about the Bank's constitutionality and the threats posed by a large and powerful financial institution with a monopoly charter, as well as some new ones that included the specter of foreign ownership of the Bank's capital stock. Jackson severed the government's relationships with the Bank of the United States. The country would not have a central bank again until 1914.

Making Do without a Central Bank

The United States developed various substitutes for a central bank, but these failed to promote financial stability as well as the two Banks of the United States had done.¹ After 1836, some central banking functions were performed by the Treasury, by clearinghouses of banks in major cities, and—after the 1863 advent of the National Banking System during the Civil War—by large national banks in leading cities, especially the central reserve city of New York. The Treasury held its own reserves of base money and could inject them into the banking system to prevent or alleviate liquidity crises. Clearinghouses could issue loan certificates among their members during crises to make more base money reserves available to meet demands of panicky depositors.

Under the Bank of the United States regime, the country experienced only two banking crises, in 1792 and 1819, or one every 20 years. Thereafter, banking crises occurred on average about every 10 years: in 1837, 1839–1842, 1857, 1873, 1884, 1893, and 1907. Until the twentieth century, none of these crises was sufficient to overcome political resistance to more centralized control of banking and monetary policy. U.S. society remained



largely rural, and most people could fall back on local resources in times of crisis. Those circumstances would change with mass urbanization and more economic specialization and interdependence in the twentieth century.

Introduction of the Federal Reserve

By 1907, the U.S. economy was the largest in the world, and it was embarrassing that it had more frequent banking crises than did European countries with central banks. In the 1907 panic, J. Pierpont Morgan, a private banker acting as a quasi central banker, effectively coordinated the means to stem the panic. That kind of power in private hands was as disconcerting a prospect as lodging it in the public domain. In the wake of the panic, Congress therefore set in motion the machinery that would lead to passage of the Federal Reserve Act in 1913, and the opening of the Fed in 1914. After 1914, banking crises did not disappear, but they once again became less frequent. The Federal Reserve Act reflected the crosscurrents of American history: It created a decentralized central bank.

The decentralized Federal Reserve, however, failed to prevent or mitigate the greatest financial crisis that ever confronted the United States. To a considerable extent, the depth and duration of the Great Depression reflected a widespread collapse of the U.S. financial system. The Fed did little to ease credit as the money supply and the price level plummeted. If anything, its perverse actions under the gold standard probably helped transmit the crisis abroad. Much of the problem was institutional. When it had been set up in 1914, the Federal Reserve System was all too federal, reflecting states' rights sentiments in Congress; that is, it was a weakly governed collection of regional Reserve Banks with the New York Reserve Bank taking the de facto lead in matters of money-center and international finance.

The decentralized structure of the Federal Reserve System helps to explain the lack of concerted action to stave off the massive bank runs and failures that ballooned into the thousands from late 1930 to early 1933. Not until 1935 did Utah banker Marriner Eccles preside over a restructuring of a more centralized, systemwide Board of Governors, based on banking legislation that, among other regulatory features, established most of the centralized Fed's powers as we know them today. Eccles used the new structure and his personal authority to stake out more central bank independence from the Treasury. Yet, the new Fed extended the Depression by its premature actions in 1936 and 1937 to absorb excess reserves. As a result of that experience and the Fed's efforts to help the Treasury finance wartime expenditures at low interest rates, the central bank became, in effect, a vassal of the Treasury until the Treasury Accord of 1951 began to restore Fed independence.

As far as broader U.S. finance was concerned, states' rights claims and populism were by no means gone. Until late in the twentieth century, American banks could have branches in at most one state. Many were confined to one city or even one office (so-called unit banking). Congress and federal regulatory authorities continued to defer to state and local preferences in finance. Powerful members of Congress representing constituencies for whom easy credit was important could be relied on to praise the Fed whenever it lowered interest rates, and to condemn it whenever it raised them. Only after the Fed's easy money policies led to soaring inflation and unprecedentedly high nominal interest rates in the 1970s did American populism enter a temporary quiet period. The independence of the Fed and the primacy of its price stability objective earned virtually universal support.

2.2 THE FEDERAL RESERVE AND THE DODD-FRANK BILL

Lingering Populism

The financial crisis that began in 2007 triggered widespread criticisms of the dramatic Fed interventions aimed at mitigating the economic fallout from the financial collapse. While the Fed has much to account for, members of Congress also found it convenient to blame the Fed for lapses before and during the crisis. Some observers singled out former Fed chairman Alan Greenspan as the single most culpable villain because of the long period of low interest rates on his watch that they contend led to an unsustainable bubble in housing prices. While most of the legislative provisions reflect a serious effort to improve the effectiveness of financial regulation, some portion of the legislation reflects lingering congressional anger about the crisis.

It is not difficult to find examples of the reaction. Congressman Ron Paul, a modern Andrew Jackson, wants to “end the Fed,” and has a best-selling book with that title. His arguments have appealed to a much wider audience than his libertarian populist base. The Grayson-Paul amendment introduced in 2009 would have subjected Fed decision making to audits and quick second-guessing by Congress. Although the Dodd-Frank bill mutes the Paul proposals, it still poses a risk to Fed independence. For example, the comptroller general is asked to provide Congress with a full audit report of Fed activities in the recent crisis, as well as an evaluation of Fed governance. In addition, the bill allows the Government Accountability Office to perform additional audits of all lending activities of the Fed without explicitly exempting monetary policy operations. Such audits may seem a coercive threat to Fed policymakers who anticipate congressional second-guessing



of policy decisions. While public anger regarding the Fed's actions may be on the wane as the economy recovers, these provisions could bode a return of politically motivated pressures on monetary policies that were regular features in U.S. financial history.

New Constraints on the Lender of Last Resort

Congress has added an explicit mandate for financial stability to the list of Fed objectives. It also has strengthened the Fed's focus on supervision by establishing a new vice chairman for supervision at the Board of Governors. And it has—at least implicitly—ratified the Fed's aggressive creation of broad-based Bagehot-like programs to provide liquidity during the crisis. At the same time, it has significantly altered the tools available to secure financial stability, sharply curtailing here, and adding substantially there. It is impossible to assess the comprehensive impact of these changes, partly because many of the changes will have to be spelled out by a newly formed group of regulators responsible for systemic regulation, the Financial Stability Oversight Council (FSOC).

At least some of the legislative changes will make it more difficult for the Fed to intervene in crises in a timely way when they occur. Specifically, there are limits placed on the Fed's emergency lending powers to nonbank entities. Beginning in the spring of 2008, the Fed relied repeatedly on the emergency lending powers expressed in Section 13(3) of the Federal Reserve Act, which allowed the central bank to extend loans to nonbanks ("individuals, partnerships, and corporations") in a financial exigency. To opponents of the Fed, its emergency loans to specific institutions (such as Bear Stearns and AIG) epitomize the central bank's willingness to use public funds to bail out financial institutions, and to do so beyond the scrutiny of any elected officials. To defenders of the central bank, this authority enabled the Fed and the U.S. government to respond quickly when the financial system faced a wave of defaults. Applied carefully, it can be consistent with Bagehot's approach of lending to anyone offering good collateral at a penalty rate. In the financial crisis, lending under the Fed's 13(3) authority probably helped prevent the turmoil from spreading beyond Lehman Brothers and AIG to other large, connected, and vulnerable institutions.

The Dodd-Frank Act markedly narrows this authority. First, the bill prohibits lending to specific nonbanks. Emergency lending can no longer be provided to any "individual, partnership, or corporation" but only to "participant[s] in any program or facility with broad-based eligibility." Second, it states that "any emergency lending program or facility is for the purpose of providing liquidity to the financial system, and not to aid a failing financial

company, and that the security for emergency loans is sufficient to protect taxpayers from losses and that any such program is terminated in a timely and orderly fashion.” The goal of these restrictions is presumably to reduce the moral hazard of so-called too-big-to-fail shadow banks and to prevent taxpayer assistance for the restructuring or liquidation of shadow banks. Such restructuring of nonbanks will be driven through the new Federal Deposit Insurance Corporation (FDIC)-led resolution mechanism created by the legislation (see Chapter 7 for an analysis of this facility).

Third, under the new Dodd-Frank regime, Fed programs that allow for the efficient distribution of liquidity in a crisis (*à la* Bagehot) to solvent financial institutions with acceptable collateral, such as the extraordinary facilities developed in the crisis, would require the approval of the Treasury secretary. It is not clear why the Treasury secretary should be involved in programs that are designed to provide liquidity *without* cost to the taxpayer. This approach adds to concerns about Fed independence. It also creates a new distinction between banks, where the Fed can provide liquidity without Treasury approval and without utilizing its authority under Section 13(3), and shadow banks, where approval and emergency authority are required.²

It is doubtful that the optimal approach to Fed emergency workout-related lending is to forbid it outright. By doing so, the bill eliminates (rather than just raises the cost of using) a policy safety valve that has been available for more than 75 years in the event of unforeseen circumstances. In effect, Congress is counting on other regulatory reforms and the new resolution mechanism to prevent or tame financial crises. Alternative policy approaches to Fed emergency lending might have been to require prior presidential approval (along with notification to Congress) of workout-like loans, to limit the size of such Fed lending without prohibiting it, or to require the President to include in an emergency supplementary budget proposal an appropriation to acquire all the workout-related assets from the Fed.

Some combination of these alternatives would mitigate the inevitable conflict between requiring accountability for quasi-fiscal actions by the central bank and securing the independence of monetary policy, while allowing a timely crisis response. In our view, a better approach would be to require the Treasury to facilitate removing non-Treasury or nonagency debt from the Fed’s balance sheet in a timely way following any crisis stabilization effort. This approach would make it clear that the Fed can act temporarily in extremis as the government’s bank when it serves as investor of last resort but cannot hold these assets on its balance sheet for long. Nothing in the Dodd-Frank bill directly addresses this confounding of fiscal and monetary policy.

The focus on limiting emergency funding only for nonbanks also appears misplaced. The problem of too-big-to-fail creating a moral hazard originated

with the Fed lending to a large *bank* in distress (Continental Illinois in 1984). Yet the legislation does not constrain Federal Reserve lending to individual *banks*. The reason may be that the most unpopular Fed actions in 2008 were its moves to bail out the creditors of nonbanks (particularly those of Bear Stearns and AIG). The legislation seems designed to prevent a recurrence of these extraordinarily unpopular emergency actions.

Yet, from either an analytic or a commonsense perspective, there is little reason why the lender of last resort should distinguish between a bank and a nonbank if both pose an identical systemic threat. Why should the lender of last resort fail to underpin the financial system because of the legal label borne by a financial institution, regardless of its function? Bagehot articulated this pragmatic functional view back in the nineteenth century: “The holders of the cash reserve . . . must lend to merchants, to minor bankers, to ‘this man and that man’ whenever the security is good.”³ Conceivably, one effect of the new rules may be to prompt shadow banks on the verge of trouble to convert into banks to facilitate access to Fed lending facilities—just as Goldman Sachs and Morgan Stanley did in the wake of Lehman’s 2008 failure. If so, the goal of mitigating the too-big-to-fail problem could remain elusive. There is a related question of whether the bill as structured creates a stronger presumption for pushing a challenged nonbank through the resolution process than it does for a similarly situated bank. Will there be greater (perceived) forbearance for banks?

To be sure, a central bank in a democratic society must be subject to review and held accountable by elected officials. Its potent tools need to be carefully monitored. Thus, we would prefer a procedure that achieves political accountability for the central bank while maintaining its ability to make timely interventions in the interest of financial and economic stability. This problem could have been addressed by having a preauthorized standby authority (possibly limited in scale) to be used when a need arises in a crisis, accompanied by monitoring procedures that would spring into action as the standby authority came to be employed.⁴

Emergency lending facilities enable the Fed (and the government) to respond rapidly to unexpected systemic shocks. The proposed structure could delay and politicize decision making, especially compared with a parliamentary system where the executive branch can implement fiscal changes virtually overnight. It is not difficult to imagine an instance where the inability to act in a timely way on the part of the lender of last resort would pose a risk to national security, as well as to the financial system and the economy. One need only look at the experience of the Great Depression of 1930 to 1933 to see the negative consequences of inaction and delayed action by the Fed.

New Fed Disclosure Requirements

The Dodd-Frank bill makes some dramatic changes in the conduct of central bank business by requiring full public disclosure of the details, terms, and counterparties involved for virtually all Fed transactions. Such disclosure pertains to emergency lending programs as well as traditional forms of discount lending and open market operations. In all cases, disclosure occurs after a significant delay, one year after the end of a special lending program and roughly two years after each regular discount window or open market transaction. These information releases will make a plethora of data available to the research community and will keep the public fully informed about central bank transactions. It is hard to take issue with provisions that make the actions of an independent government agency transparent with a reasonable lag. The bill's disclosure delays should avoid the kind of instability that premature disclosure requirements helped spark during the Great Depression.⁵

However, it is reasonable to ask how the bill's new disclosure requirements will affect the Fed's policy tools. In our view, the bill's new disclosure requirements will tend to weaken discount window lending as a crisis-management tool. Banks have always feared that disclosure of borrowing from the Fed's discount window would signal their fragility and trigger a run. Partly as a result, discount window lending has been negligible in recent decades, outside of crises. And, of course, fears of a run are much greater in a crisis. Notably, Fed efforts since the 1990s to encourage greater use of the discount window and to strengthen its value as a policy tool have had little effect. The new disclosure requirement may make it even more difficult than in the past for the Fed to persuade banks to use the discount window when the financial system is threatened by an extraordinary liquidity shortfall.

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Expanding Other Fed Powers and Changing Governance

The other major feature of the Dodd-Frank Act that relates directly to the Federal Reserve is the introduction of a new mechanism for the regulation of systemically important financial institutions. The Financial Stability Oversight Council (FSOC)—consisting of the major regulatory authorities—will be advised by a new Office of Financial Research within the Treasury. The Office will have broad authority to collect and analyze information on systemic risks in the financial system. The Council will have the authority to instruct the Federal Reserve to impose regulations on nonbank financial companies that present systemic risks.

The Fed's new FSOC-determined authority, along with the Board of Governors' new vice chairman for supervision, institutionalizes a heightened emphasis on financial regulation and stability within the Fed. This shakeup of previous regulatory arrangements will help to avoid the benign neglect of systemic issues that prevailed before the crisis. Yet it remains to be seen how well the new, complex apparatus will respond dynamically to the evolution of the financial industry, which will continue to have powerful incentives to take on systemic risks.

Some observers argue that the Fed has always had the ability to extend supervision over shadow banks and that these new structures are superfluous. However, the recent crisis highlights the need for explicit recognition of systemic risks arising in the shadow banking system. The Council will have the authority to direct the Fed's attention to areas where risks warrant additional regulation and to instruct the Fed to act. A key uncertainty is how effectively the various regulators will coordinate their activities among an analytic group (the Treasury's Office of Financial Research), a deliberative body (the Council that votes to extend regulation and authorize Fed action), and the regulator (the Federal Reserve). It also is unclear how far regulators will go to empower market discipline—through transparency and through charges for implicit government subsidies—as a means of revealing and taming systemic risk.

The Fed also plays a secondary role in a newly developed mechanism led by the FDIC for the orderly liquidation of failing financial institutions. The goal of the process is to unwind systemically significant failing companies without invoking “too big to fail” or imposing any costs on the taxpayers. The decision to start the liquidation process requires that the Treasury, the FDIC, and the Fed all agree that the institution in question is of systemic importance. The FDIC can then provide guarantees of deposits and other liabilities to the extent to which it anticipates being repaid. Naturally, this process is both complex and untried. Once again, its effectiveness will have to be proven by experience.

Finally, in contrast to earlier draft legislation, the Dodd-Frank bill avoids governance changes that could have seriously politicized top appointments at the Federal Reserve district banks and threatened Fed independence. The limited changes in the bill may be viewed as a cautious reaction to what some perceive as a too-cozy relationship between the financial sector and the Federal Reserve System. For example, the Government Accountability Office will conduct a study of the current system for appointing Federal Reserve Bank directors, to examine conflicts of interest and the effectiveness of public representation. The bill also prohibits the Federal Reserve Bank directors appointed by member banks (Class A directors) from voting for the Bank president.⁶ Earlier proposals for more draconian changes (including

one to make the president of the Federal Reserve Bank of New York a presidential appointee subject to Senate confirmation) are not included in the final legislation.

Consumer Financial Protection

A major ingredient of the Dodd-Frank legislation is the creation of a Bureau of Consumer Financial Protection (BCFP), an independent consumer watchdog housed at and funded by the Federal Reserve. It would have the mandate to ensure that American consumers get the clear, accurate information they need to shop for mortgages, credit cards, and other financial products, and protect them from hidden fees, abusive terms, and deceptive practices. We discuss consumer finance protection separately in the next chapter, but it is worth commenting briefly on the implications for the Fed that stem from having that bureau located there. On the surface there are no implications, since it is to be funded by the Fed but is to have an independent director, appointed by the President and confirmed by the Senate. Because it is designed to be independent, it should have few implications for the normal functioning of the Fed. At the same time, there is no logical reason to house it in the Fed. Clearly, this is the result of some political wrangling. It enabled the framers of the legislation to essentially hide the costs and avoid having to seek appropriations to cover them. There is potential for conflict. Consumer protection is inherently highly politicized because there are so many constituents—both businesses and consumers. That is why it has such populist political appeal. The logrolling circus that led up to the passage of the Dodd-Frank bill should be evidence enough that politicians can put tremendous pressure on regulators to protect consumers and business interests in particular ways without concern for the larger consequences. It is not difficult to imagine circumstances in which actions taken—or not taken—by the BCFP could engender further political intrusions on the Fed.

2.3 THE POSTCRISIS ROLE OF A CENTRAL BANK: A BENCHMARK FOR MEASURING DODD-FRANK

Since the late seventeenth century, the role of central banks has always been in flux. In their earliest years, the primary function of central banks was to act as fiscal agents for governments. Later, in the nineteenth century, Walter Bagehot articulated the importance of the lender-of-last-resort function. The central bank's policy role in economic stabilization—setting policy interest rates and managing money growth—did not emerge as a key function until the middle of the twentieth century. Around the same time, central banks in

many countries took on much of the responsibility for the supervision and regulation of banks. Most central banks also assumed responsibility for the integrity, efficiency, and accessibility of the payments and settlement systems.

The Dodd-Frank bill reflects changing views of the role of a central bank in the postcrisis world by providing an explicit new goal for the Federal Reserve. In addition to its existing mandate to attain maximum employment and stable prices, the Dodd-Frank Act gives the Federal Reserve an explicit financial stability function; Section 1108b states that “The Board of Governors shall identify, measure, monitor, and mitigate risks to the financial stability of the United States.”

What Is a Central Bank Function and What Is Not?

Modern central bank functions fall into three areas: monetary policy, the supervision and regulation of individual financial institutions, and systemic regulation of the financial sector as a whole. This latter function includes both the traditional concern for the functioning of the payments system and a new set of concerns about systemwide risk arising from the increased complexity and interconnectedness of financial institutions and markets.

With these roles in mind, there are important elements in the structure of the Federal Reserve that inevitably limit its independence. The Fed is answerable to Congress, which created it. Its top officials are nominated by the executive branch and confirmed by the Senate. Unlike the European Central Bank (ECB), the Fed’s mandate can be altered by a simple congressional majority. At the same time, the 12 Federal Reserve district banks are governed by independent boards and are formally owned by the member banks, making the Federal Reserve System subject to regulatory capture by the banks that it is supposed to supervise. Add to that the need to work closely with the Treasury in times of crisis, and you have a system that must always be sensitive to the risks of political interference in the setting of monetary policy. Keeping inflation expectations low and stable in this setting requires sustained policy vigilance.

While it forbids some quasi-fiscal actions by the Fed and adds to the possible range of Fed supervisory authority, the Dodd-Frank bill does not materially alter this reality. The Federal Reserve System remains the pragmatic result of decades of evolution and haggling to balance the public’s mistrust of bankers with its similar mistrust of politicians. However imperfect, the Fed is widely viewed as among the most independent of government agencies. The same can be said when comparing the Fed with many other central banks in the industrial world. Even its fiercest critics typically admire the integrity, devotion, and expertise of the Fed’s personnel.

Monetary Policy

Very few argue with the idea that monetary policy aimed at economic stabilization should rest in the hands of an independent central bank. Although there are those (such as Ron Paul and other libertarians) who advocate the abolition of central banks, economists and historians have amply documented that independent central banks achieve lower and less volatile inflation rates than those that are beholden to governments in power, and that they do so at no long-run cost to economic output.

The central bank can use its tools to guide the economy toward goals set forth by the government. In the United States, the Fed has a dual mandate to maintain stable prices and full employment. Many other central banks—the ECB is a notable example—have a single mandate to maintain price stability. A central bank influences interest rates and the growth of money and credit in order to attain its specified goals. An independent central bank can pursue these goals without concern for an election cycle that might tempt elected policymakers to pursue short-term goals, such as unsustainably high employment and real growth with little concern for longer-run inflationary implications.

Some argue that the function of a central bank should begin and end with monetary policy, and that any other obligation would distract the central bank from achieving its primary goal of economic stabilization. Indeed, an early Senate draft suggested just that, removing all other functions except the formulation of monetary policy from the central bank. However, this approach ignores important links between monetary policymaking, financial regulation, and prudential supervision that favor a wider role for a modern central bank.

Supervision, Regulation, and the Lender of Last Resort

As noted earlier, in the nineteenth century Bagehot introduced the idea that the central bank should serve broadly as a lender of last resort to the financial system. In fact, the modern notion of monetary policymaking evolved out of the central bank's lending activities. Traditionally, the central bank provided liquidity to the financial system. Its lending to the banking system influenced the aggregate economy even before the macroeconomic role of the central bank was acknowledged. Indeed, one of the first and rather successful policy efforts of the new Federal Reserve System was the provision of funds to counter seasonal funding shortfalls associated with the agricultural cycle. When special liquidity problems threatened the operation

of the banking system, the central bank also would act as the lender of last resort. It is only logical that such a lender should have sufficient information about borrowers to be able to make sound loans. Thus, it is no accident that bank regulatory and supervisory functions are often associated with the lender of last resort.

Even as it circumscribes the Fed's emergency lending powers, the Dodd-Frank bill in other ways strengthens the connection between the lender of last resort and regulatory and supervisory functions. It enables the Fed—subject to recommendation from the new FSOC—to supervise systemically important nonbanks. It also ratifies the Fed's ability to provide nonbanks with emergency liquidity through facilities with broad access (but not with lending to individual nonbanks).

Some economists have claimed that the lender-of-last-resort role for central banks is obsolete.⁷ They argue that in the presence of modern, well-developed financial markets, there should be no such thing as an illiquid but solvent firm. Solvent firms should always be able to arrange financing in the interbank market, the repo market, or longer-term credit markets. In the aftermath of the 2007 to 2009 crisis, this view, which harks back to the arrangements in place prior to the panic of 1907, seems to reflect an overly optimistic faith in the ability of financial markets to avoid collapses.

Conceivably, the supervision and regulation of individual banking institutions need not be a central bank function. In some countries, it is housed in other government agencies. And in the United States, the Fed has always shared these functions with state and national agencies responsible for chartering banks, as well as with the deposit insurance agency.

However, as the U.S. lender of last resort, it is crucial that the Fed be able to obtain timely information about any potential borrower. This is a linchpin of the argument that the central bank should have a leading role in bank supervision and regulation. One might ask whether the real issue is effective communication between the Federal Reserve and any other agencies with supervisory authority. In practice, however, instances where the role of supervisor and lender of last resort have been separated—such as in the United Kingdom, where the Bank of England acts as lender of last resort and the Financial Services Authority oversees the potential borrowers—have highlighted how difficult it is to communicate effectively in a crisis. As a result, UK Chancellor George Osborne recently announced plans to eliminate the Financial Services Authority and return a leading role in bank supervision to the Bank of England.

More importantly, the benefits of linking the lender of last resort and the role of supervision go beyond the advantages of rapid communication. The skills and expertise developed in the course of regulation and supervision may help the lender of last resort to innovate when necessary in a liquidity

crisis. For example, the rapid, emergency introduction of several new Fed lending facilities during the crisis of 2007 to 2009 (e.g., the Treasury Auction Facility and the Primary Dealer Credit Facility) would have been difficult in the absence of extensive hands-on experience in the financial system on the part of Fed supervisors. Similarly, experience in regulation and supervision may be critical for the development and informed use of so-called macroprudential powers, which aim to curb systemic financial threats.

Against this background, it is important to distinguish among the types of organizations to be supervised. The lender-of-last-resort role probably is of greatest relevance in dealing with institutions whose instability would pose a direct threat to the financial system as a whole. It is possible for a wide array of small financial institutions to pose such a systemic threat if they face a common exposure that makes them collectively vulnerable. The experience of money market mutual funds (MMMFs) in the recent crisis provides a case in point. Yet, there are few such examples. Even the thrifts crisis of the early 1980s was not truly systemic. Moreover, the experience of the recent crisis suggests that large, complex financial institutions (LCFIs) are more likely to be sources of systemic disruption. For this reason, there would appear to be a stronger case for linking the lender of last resort to the supervision of LCFIs than to the supervision of other financial institutions.

The Dodd-Frank bill largely preserves the supervisory role of the Federal Reserve district banks even with regard to small banks. The district banks were naturally reluctant to give up their supervisory role, since it is one of their major activities. Ensuring the soundness of banks large and small is viewed as integral to economic health of the regions they serve. Confidential information obtained in the course of supervising banks can be of use in setting monetary policy, especially when it helps policymakers to anticipate demand for and supply of credit. Nevertheless, the case for Fed supervision of smaller banks remains far less compelling than the case for supervision of systemically important financial institutions (SIFIs), including nonbanks.⁸

Systemic Risk Regulator

Although systemic risk is not a new idea, the notion of an explicit systemic risk regulatory function is new. Addressing systemic threats was an implicit function of the Fed because its lender of last resort facility was the only tool available to respond to systemic risk problems. When clearing failures, Y2K concerns, or the terrorist attacks of 9/11 threatened the operation of the financial system, the Fed's discount window was the tool available to address the problems. Until the crisis of 2007 to 2009, the biggest use of the Fed's discount window occurred in the week after 9/11, when the

Fed successfully met heightened liquidity needs that otherwise could have threatened financial system stability.

The Federal Reserve also had the authority to lend widely (that is, to nonbanks) in times of widespread financial exigency in order to manage a systemic threat. Until March 2008, however, these powers were hardly known and little understood because they had not been used after the 1930s, when they were created and employed. With the benefit of hindsight, we see that the evolution of discount lending authority in the twentieth century gave the Fed a valuable tool for responding to systemic risks. However, it did not make the Fed the actual systemic regulator with an obligation to monitor and prevent the rise of systemic risk. In fact, the recent crisis highlights what can happen when there is no one authority unambiguously responsible for responding to systemic risks.

The establishment of a systemic risk regulator is an important component of the Dodd-Frank bill. To be effective, such a regulatory authority has to have influence that stretches out in multiple directions. First, the systemic regulator needs to augment the oversight and supervision of institutions that are so large and interconnected that any insolvency would create systemic problems.

Second, it must be able to address systemic problems that can arise from smaller institutions facing a common vulnerability. For example, the 2008 run on money market mutual funds (MMMFs) highlights the risk posed by so-called shadow banks—those that lack deposit insurance and a lender of last resort even though their funds can be withdrawn at face value with little or no notice. A similar funding vulnerability affects those institutions—such as broker-dealers—that are dependent on the collateralized repo market. The FSOC should grant to the Fed the authority to regulate such risk-laden market funding practices, in addition to the behavior of any institution that itself can generate systemic risks.

Third, economic conditions can give rise to systemically risky activity. The extended period of low interest rates in the early 2000s created an environment that promoted rapid credit expansion and some of the excesses, particularly in the mortgage markets, that generated the crisis. In addition, new elements of monetary policy—so-called macro-prudential powers—constitute an important potential element of systemic risk management.

It is uncertain whether the Dodd-Frank FSOC will become the powerful systemic regulator that is needed. Rather than exercising direct authority, the FSOC will be able to authorize explicit Fed supervision of SIFIs. Such authority makes it possible in theory to rein in the systemically risky activities of any financial institutions—shadow banks, hedge funds, and insurance companies, for example—including ones that are not otherwise subject to regulatory oversight. If the behavior of any financial institution creates systemic threats, the regulator has reason to be concerned.

However, the Council is only a loose umbrella organization with the mission, among other things, “to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace” and “make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets.”

The Council will play a largely indirect role: instructing regulators to tighten oversight when it deems that systemic risks warrant action. Thus, the systemic regulator is removed from the direct issues of systemic concern—supervision of institutions that can create systemic risks and monetary policy. And the Federal Reserve will be only one participant among several in the FSOC, without a leading role. The argument for giving the Federal Reserve System a more central role in systemic regulation is that so many of the functions and concerns of a systemic regulator are closely related to essential Fed functions.⁹ The Fed monitors markets constantly and has to ensure the integrity and viability of the payments system. Business and financial cycles are closely linked: It is impossible to secure economic stability without a modicum of financial stability. Given its expertise and its degree of independence from the government, the Fed is a natural location for assessing the possible trade-offs between these two policy goals. It already has key tools for managing systemic threats and is developing new ones.

The bill preserves the Fed’s role as the principal regulator of the largest banks. And it permits the Council to grant the Fed supervisory authority over other SIFIs. If the Council acts effectively in this way, most key issues of systemic concern eventually will be brought under the wing of the central bank. Still, the Dodd-Frank bill significantly narrows the Fed’s emergency lending authority. A key issue some time in the future will be whether the new restrictions on emergency lending to individual nonbanks will inhibit a prompt and timely response to a crisis with potentially systemic implications.

2.4 SUMMARY

To many observers, the financial crisis of 2007 to 2009 had its roots in mistakes made by the Federal Reserve under Alan Greenspan. When the Fed wielded its enormous power to try to stem the financial meltdown, it strayed far from the normal precincts of monetary policy. It is not surprising,

then, that financial reform should include some serious rethinking of the role of the Fed. A strong and independent central bank is an anomalous entity in a constitutional democracy that emphasizes accountability and the responsibility of elected officials.

Nevertheless, the Dodd-Frank Act leaves the independence of the Federal Reserve reasonably intact. Some of the challenges to central bank independence that were introduced in earlier congressional discussions were misguided and potentially counterproductive expressions of public anger regarding the recent financial crisis. Anger is a poor basis on which to craft effective reforms. Fortunately, the Dodd-Frank bill dropped the most egregious attacks on the Fed. However, it introduces restrictions on emergency lending and new structures for responding to systemic risks that will have to be judged when tested by events. It is far from clear that these complex new structures will be able to mitigate crises when they occur.

Finally, there is no escaping the fact that there are competing goals that make the role of the central bank difficult to determine. Although everyone agrees that monetary policy is a central bank concern and the *raison d'être* for central bank independence, there are wide differences of opinion regarding the extent to which the Fed should also have responsibility for the supervision and regulation of individual financial institutions and for systemic regulation of the financial sector as a whole. While a modicum of financial stability is necessary for economic stability, there are potential conflicts among the mandates of the central bank. Even the European Central Bank, which has the sole mandate of price stability, has been drawn into an expanded role by its decision (in the face of some fierce opposition) to hold the sovereign debt of member states that faced serious funding challenges, such as Greece, Spain, and Portugal.

We contend that strong linkages among the three functions of a central bank are sufficiently compelling that, with proper oversight, the central bank should have broad authority in all three of them. The Dodd-Frank Act goes some way in this direction, but not as far as it could or should have. A key concern is the prohibition or weakening of some Fed crisis-management tools before it is clear whether the new and potentially unwieldy apparatus to prevent and mitigate financial crises will prove effective. The bill also prevents use of some of the crisis-management tools that the Fed employed to mitigate financial instability in the recent crisis, at least until they might be authorized via the FSOC. Delayed crisis interventions could well prove to be less effective than timely ones. The history of financial crises indicates that strong leadership and timely interventions separate well-managed from poorly managed economies. It is far from clear that a new, and hence untested, oversight council can provide stronger leadership in a crisis situation than would an experienced central banker.

NOTES

1. Banks in the United States were numerous and small by world standards. Well into the twentieth century, despite their federal charters, even New York's money-center "national" banks were constrained to function with a state and local focus, highlighting the continued concerns about size and power in the financial system and the continued influence of local banking interests. See George David Smith and Richard Sylla, "Capital Markets," *Encyclopedia of the United States in the Twentieth Century*, vol. 3, edited by S. I. Cutler (New York: Scribner, 1996).
2. The prohibition on Fed lending to swaps entities other than those associated with depositories further distinguishes between banks and nonbanks. The rationale appears to be that regulators can more easily contain the risks taken by swap entities associated with banks, but that remains to be seen.
3. Walter Bagehot, *Lombard Street*, page 51, as cited in Brian Madigan, "Bagehot's Dictum in Practice: Formulating and Implementing Policies to Combat the Financial Crisis," speech to the Federal Reserve Bank of Kansas City's Annual Economic Symposium at Jackson Hole, Wyoming, August 21, 2009.
4. For example, to restrict Fed assumption of credit risks and make the central bank accountable, Martin Feldstein has proposed that Congress explicitly authorize Treasury funding of such longer-term private credit allocations by the Fed. See Feldstein, "What Powers for the Federal Reserve?" *Journal of Economic Literature* 48 (March 2010), 134–145, at 135–136.
- 5.
6. These changes appear to reflect congressional dismay over the actions of the former chairman of the board of directors of the Federal Reserve Bank of New York, Stephen Friedman, who simultaneously served on the board of Goldman Sachs when it became a bank holding company. Friedman came under criticism for personal financial transactions (for which Fed approval had been granted), while serving in both of these roles and while leading the search for a new president of the Bank, who, as it happened, came from Goldman Sachs.
7. For example, Marvin Goodfriend and Robert G. King, "Financial Deregulation, Monetary Policy, and Central Banking," in *Restructuring Financial Services in America* (Lanham, MD: AEI Studies, 1988), 481.
8. Alan Blinder ("How Central Should the Central Bank Be?" *Journal of Economic Literature* 48 [March 2010], 123–133, at 132) agrees with us that the case for Fed supervision of small banks is less than compelling and "peripheral to its core mission."
9. It is notable that the ECB is expected to enjoy such a central role in the new European Systemic Risk Board.

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