THE FEDERAL RESERVE'S (INCONSISTENT) CONTRIBUTION TO MACRO AND FINANCIAL STABILITY

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Federal Reserve Monetary Policy under the Gold Standard

- Fed inflationary finance of WW I at low interest rates
- From Oct 1919 to June 1920 Fed raises short term interest from 4% to 7% to defend minimum required gold reserve against its note and deposit liabilities
- Recession from Jan 1920 to July 1921—unemployment rose from 4% to 12%, industrial production fell from 39 to 30, 40% deflation reversed wartime inflation
- Fed traumatized by public, political reaction
- Fed moved by 1923 to loosen link between interest rate policy and gold reserve requirement

Federal Reserve Monetary Policy under the Gold Standard

- Fed builds “free gold” above required gold reserve ratio
- Fed allows “free gold” to accommodate fluctuations in gold demand at fixed dollar price, sterilizes the monetary effects of gold with securities operations (Friedman 1961)
- Fed creates bank reserves and currency independently of gold to smooth short-term interest rates against liquidity disturbances
- Spikes of over 10 percentage points occurred on eight occasions between the Civil War and the founding of the Fed in 1913; five of these spikes were associated with major banking panics
- Fed eliminates sharp fluctuations in short interest rates; introduces high degree of persistence into short interest rates unknown previously manages interest rates to stabilize inflation and employm
- Fed sets stage for unstable, adverse inflation and employment consequences of monetary policy (Great Depression, Great Inflation)

Federal Reserve Monetary Policy under the Gold Standard

- Fed set up and run “in the public interest”
- Given “operational independence” over its balance sheet and “financial independence” to fund itself from its interest income
- Fed interest income after expenses transferred to fiscal authorities
- Fed absorbs interest lost from holding free gold instead of interest-bearing securities as reduced seigniorage transfers to fiscal authorities

Go-Stop Monetary Policy

- By mid-1960s, inflationary money creation eroded Fed's free gold
- Congress eliminated gold reserve requirements
- US floated the dollar price of gold in 1973
- Fed subjected to incentives that produced increasingly inflationary go-stop policy
- Acting in public interest, Fed inclined to be responsive to shifting public concerns between inflation and unemployment

Go-Stop Monetary Policy

- Fed prioritizes low unemployment over low inflation
- Fed switches to fighting inflation only after inflation moves persistently above previous trend
- Pricing decisions embodying higher expected inflation prompt the Fed to act against inflation
- Aggressive interest rate actions then needed to bring inflation expectations and inflation down
- Narrow window of public support for fighting inflation
- Window closed when unemployment moved higher
- Fed settled for higher trend inflation with each go-stop policy cycle

Go-Stop Monetary Policy

- Public anticipated rising inflation, Fed became evermore expansionary with each policy cycle
- Necessitating evermore contractionary recessions to fight inflation
- Go-stop policy produced rising inflation and unemployment, and more volatility of each
- Credibility crisis by late 1970s—loss of Fed “room for maneuver” between inflation and recession
- In 1979, Volcker Fed recognizes better to reverse priorities—justify actions to stimulate employment against commitment to low inflation

Go-Stop Monetary Policy

- Since Volcker disinflation of 1979-1982, priority for low inflation enabled monetary policy to reduce both inflation and unemployment
- Preemptive interest rate policy actions worked for the first time in 1983-4 and in 1994 to hold the line on inflation, reversed inflation scares in bond markets without increasing unemployment
- Set stage for two of the longest expansions in US economic history
- Fed adopts 2% inflation objective in 2012

Federal Reserve Emergency Credit Assistance

- Federal Reserve Act (FRA) of 1913 authorized Fed to extend credit only to member banks
- In Great Depression, Section 13(3) of FRA amended in 1932 gave Fed authority to lend to "individuals, partnerships, and corporations" in "unusual and exigent circumstances" by vote of at least 5 members of Board of Governors
- But little lending under 13(3) during Great Depression due to highly restrictive collateral requirements [Congress regards expansive credit policy as inappropriate for the independent Fed.]

Federal Reserve Emergency Credit Assistance

- Congress establishes Reconstruction Finance Corp in 1932, allocates credit widely to nonbanks [Credit policy regarded as fiscal policy!]
- Following 1987 October stock market crash and 1980s US banking turmoil, Board of Governors asks Congress in 1991 FDICIA to amend Section 13(3) to grant "virtually unlimited authority of the Federal Reserve to lend in unusual and exigent circumstances" (Greenspan) [Ironic, virtues of self-discipline with regard to inflation not seen relevant for credit assistance.]
- Subsequently, computing/info technical progress, regulatory capital arbitrage, SEC regulatory permissiveness, securitization, structured finance of illiquid cash flows in money markets via shadow banking grow to rival depository intermediation in scale by mid-2000s [Facilitated by expanded Fed lending reach.]
- Fed lending reach not accompanied by Fed sup and reg of money markets and shadow banking (SEC oversees non-depositories)

Federal Reserve Emergency Credit Assistance

- Bagehot's Rule worked for 19th century Bank of England but does not discipline Fed emergency credit assistance
- "Lend freely at high rate on good collateral"—worked for 19th century Bank of England because problem was to satisfy public's desire to convert deposits into currency at Bank Rate ceiling; BoE needn't assume credit risk to do so
- Private BoE earned profit and bore losses, so would lend freely at a high Bank Rate, against abundant safe bills of exchange or Consols; disciplined by UK Treasury relaxation and re-imposition of minimum gold reserve requirements
- Bagehot's problem was to encourage the Bank to lend freely at high Bank Rate in a banking crisis—needed to overcome BoE reluctance to profit from banking distress

Federal Reserve Emergency Credit Assistance

- The problem today is the opposite—it is to limit the independent Fed's expansive lending in financial crisis
- Fed is inclined to lend, even if against poor collateral at inordinately low interest rates, rather than risk panic in a crisis because its own funds are not at stake; Fed has implicit backing of taxpayer funds to absorb losses
- Fed puts taxpayers at risk even if protects itself by taking good collateral: If the entity to which the Fed lends fails with a Fed loan outstanding, Fed takes collateral at the expense of taxpayers exposed to losses from backstopping the deposit insurance fund or from other financial guarantees government has in place

Federal Reserve Emergency Credit Assistance

- Problem exacerbated after WW2 due to i) growing income tax access of Federal government to financial resources, ii) demise of gold standard constraint, and iii) increasing willingness of Federal government to run deficits and accumulate debt against future taxes
- Fiscal authorities are content to let <u>independent</u> Fed take the lead because its inclination to lend in incipient crisis usually matches their own, notwithstanding potential cost to future taxpayers
- Fiscal authorities have ex post option to criticize <u>independent</u> Fed
- Set-up facilitates lending laxity and moral hazard

Federal Reserve Emergency Credit Assistance

- For these reasons, Fed exhibited tendency to expand its lending beyond well-collateralized, temporary, liquidity assistance to solvent, supervised and regulated depositories long before FDICIA authorized lending to non-banks in 1991
- 1970 Fed lending to depositories supported the CP market after Penn Central bankruptcy
- 1974 Fed lending supported insolvent Franklin National Bank until it was purchased
- 1984-5 Fed lending supported undeclared insolvency of Continental Illinois Bank until resolved

Federal Reserve Emergency Credit Assistance

- Anna Schwartz (1992), p. 68 observed:

"…By the 1980s hundreds of banks rated by regulators as having a high probability of failure in the near term and which ultimately failed were receiving extended accommodation at the discount window…[t]he change in discount window practices, by delaying closure of failed institutions, increased the losses the FDIC and ultimately taxpayers bore."

Federal Reserve Emergency Credit Assistance

- Growing shadow banks and money markets could expect support from independent Fed credit policy (directly, or indirectly via depositories)
- In moment of crisis, Fed would be put in no win situation—deny credit and risk financial collapse or lend and feed expectations of more expansive lending in the future
- Fed exhibited tendency in credit turmoil of 2007-09 to expand its lending at low interest in i) scale, ii) maturity, iii) eligible collateral, and iv) reach beyond regulated and supervised depositories

Federal Reserve Emergency Credit Assistance

- The problem is this:

By analogy to independent monetary policy—Unbridled independent CB credit policy contributes to credit cycles even as it undermines the CB's independent legitimacy

- The nature of the problem is explored next

Government, Rule of Law, and Independent Central Banking

- Primary responsibilities of government: external and internal security, enforce contracts, resolve disputes with agreed political mechanism for taxation and spending
- Fiscal, regulatory, judicial procedures must be regarded as legitimate—conforming to recognized principles or accepted rules and standards—openly agreed, readily understandable, thoroughly and fairly enforced
- To encourage voluntary compliance
- Complexity, opacity give advantage to insiders, undermine legitimacy, confidence in government

Government, Rule of Law, and Independent Central Banking

- Independent central banking has veered between two public purposes
- Fiscal finance valued for occasional emergency financing of government
- Monetary stability valued for low inflation and financial stability to promote sustainable employment, economic growth

Government, Rule of Law, and Independent Central Banking

- Especially during and since the credit turmoil of 2007-09 independent CBs have been drawn into expansive credit policies for fiscal finance purposes beyond boundaries ordinarily regarded as legitimate
- Whether justified by the need to act in a timely manner or in lieu of paralyzed fiscal authorities, expansive credit initiatives call into question legitimacy of the independent central bank and the government

Securing the Promise of Independent Central Banking

- MONETARY POLICY:
- Congress should accept the Fed's 2% inflation objective and hold the Fed accountable for achieving it on average over time
- Congress should insist that the Fed manage its monetary liabilities with a "Treasuries only" asset acquisition policy (except for occasional lending to depositories) to avoid credit risk
- The Fed would recycle interest income on Treasuries (net of operating expenses and interest on reserves) directly back to the fiscal authorities
- Independent monetary policy would steer the central bank clear of the fiscal politics of credit allocation

Securing the Promise of Independent Central Banking

- CREDIT POLICY:
- Fed credit policy is debt-financed fiscal policy—the lending of public funds to private borrowers financed by selling Treasury securities from its portfolio (or by issuing interest-bearing bank reserves) against future taxes
- Emergency credit policy works by interposing government creditworthiness between private borrowers and lenders to facilitate credit flows
- The Fed returns interest on its credit assets to the Treasury, but all non-Treasury loans and securities carry credit risk and expose the central bank and ultimately taxpayers to losses and controversial disputes regarding credit allocation

Securing the Promise of Independent Central Banking

- The 2010 Dodd-Frank Act recognizes the problem and requires Fed lending extended beyond depositories to be approved by the Treasury Secretary and to be part of a broad program not directed to any particular borrower
- The Dodd-Frank delegation of such authority to the Treasury does not fix the problem
- The Treasury will likely take the recommendation of the independent Fed and both will remain exposed to the pressures of the moment to favor expansive emergency credit assistance rather than risk turmoil or collapse

Securing the Promise of Independent Central Banking

- To deal with expansive Fed credit policy, Congress should not delegate its responsibility: It should---

1) Authorize expansive Fed lending before the fact
2) Only as a “bridge loan” with a “take out”
3) Process should alert taxpayers to potential future cost
4) Taxpayer reluctance to bear the costs could credibly bend down expectations of expansive Fed lending
5) Markets would better self-insure against liquidity risk
6) Strengthened congressional oversight would preserve the legitimacy of the independent Fed and secure its promise for stabilization policy

Concluding Lessons

- Lesson 1: Wide operational and financial Federal Reserve independence to implement policy "in the public interest" initially subjected Fed to incentives detrimental for macro and financial stability
- Lesson 2: An independent CB needs the double discipline of a priority for price stability and bounds on expansive credit initiatives to secure its promise for macro and financial stability

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