

# **The Institutional Devolution of Government Financial Policy**

**(A peak at ideas related to future paper by  
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# Origins: Central Banks, Fiat Money, Commercial Banks

- Statecraft in finance is largely about chartering institutions to manage government debt, and to create money.
- These policies reflected the interests of the state or the parties that controlled the state, which wanted to lower the cost of funding the state, and facilitate merchant activities.
- Begins in 16<sup>th</sup> century Italy, 17<sup>th</sup> century Northern Europe (Wisselbank, Bank of England, later Hamilton's system, Fed).
- Initially debt distributing arms of government or banks of issue evolve into Treasuries, central banks, various kinds of chartered banks.

# Evolution Up To 2006 Was About...

- ***Dividing responsibilities*** efficiently to ensure accountability, proper focus on tasks. Fed holds bills; Treasury sets debt structure; Fed sets monetary policy while Treasury keeps bank accounts stable; having the Fed avoid subsidizing particular businesses or sectors through purchases; “State-owned banks” (SOBs) like EXIM or F&F are clearly separate and operating with a fiscal mandate.
- ***Establishing rules and procedures in the interest of fairness, rule of law, transparency*** (public auctions of debt, open market purchases by central bank, lending rules of Bank of England, Banque de France and others to ensure impartiality – Calomiris, Flandreau and Laeven JFI 2016)
- ***Using policy frameworks*** (implicitly or explicitly) to ground monetary policy in observables (e.g., policy that tracked the Taylor Rule well till 2002; debt management best practices developed by World Bank).
- ***Governance of Fed credibly balanced interests*** (regional Fed Presidents’ dissents, independent appointments).
- ***Progress was imperfect*** (and not a smooth upward path): As of 2006, there was no explicit monetary policy rule or LOLR rule (despite some legal limits), Fed regulatory (i.e., fiscal) policies (merger approvals and CRA-related extortionary policies), ***but all of these were actively being discussed*** (Bernanke and Mishkin as rule advocates!), Fed regulatory authority was subject to change as of 2007 (Treasury white paper).

# Now Where Are We?

- ***Fed operates as a state-owned bank***, funding mortgages (like F&F), Munis, etc., but with ***unclear authority separation*** during Covid – Treasury/Fed accountability game – Scott 2021)
- ***Fed pays above market interest*** to banks, and protects MMMFs in repo market.
- ***Fed holds all maturities*** of Treasuries (who is in charge of debt maturity?)
- ***Fed's regulatory and supervisory powers*** have exploded, implying further fiscal power.
- ***Monetary policy is adrift*** (inflation is accelerating, there is no recognizable policy framework, new crazy theories abound about inflation being unrelated to either government deficits or money creation;
- ***Fed tools are now very weak*** due to the combination of ***zero reserve requirement and interest on reserves*** – even without interest on reserves, policy impact would be very weak).
- ***Fed governance/appointments are a sham***. Board now dictates.
- ***Fed Board is now partisan*** and working closely with one side.
- ***Treasury balances in banks disruptive*** to monetary policy (“tightening” last year).
- ***Feels like the early 1970s***. Crazy theories, no credible commitment to fight inflation, politicized Fed Board.

# Long-run perspective: Shocks and opportunists

- *Shocks produce myopic decisions* that fail to protect institutional progress.
- *Administrative state opportunists* see crises as opportunities to enhance power even if that destroys accountability, efficiency, transparency.
- *Politicians in power don't see the importance of monetary and financial policy institution building*, or are myopic and so don't make them a policy priority (Trump predictably sold out the chance to make good Fed appointments or good financial regulatory policy to trade for things that he cared more about. Although rebuilding the Fed Board could have been his greatest legacy, he did not seem to care).
- *Good governance as a real political objective* only happens once we focus on solving a major problem (like Carter-Volcker example). Once inflation gets bad enough, perhaps we will decide to remember the evolution that happened and recreate it.
- *It has to get much worse before it can get better.* We are in for a very rough and long ride.