THE CHAIR'S SUCCESSION AND THE FED'S FUTURE

Marvin Goodfriend

Carnegie Mellon University
Tepper School of Business

and

National Bureau of Economic Research

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Introduction

The President of the United States has received an avalanche of advice in the media about how to select a successor to Ben Bernanke, whose term as Chair of the Federal Reserve Board expires in January. Some say experience in central banking, good judgment, temperament, and the respect of fellow central bankers are what count. Others insist that a dispassionate and pragmatic personality is essential. Elsewhere one reads what matters most is that a long and drawn out process not undermine the credibility of the nominee. Still others say we need continuity of policy and a Fed Chair to manage global cooperation based on mutual understanding. And others would make gender the primary consideration.

The unsolicited advice has been surprising, not only for its unprecedented volume, but also for the emphasis on personality, leadership style, or gender, and the absence of references to policy substance. The Fed Chair's power is recognized as hugely important by the public and by those positioned to influence the terms of the choice. Yet there is little public substantive discussion of the policies a good Fed Chair should be inclined to pursue. Extraordinary!

Perhaps the public is unable to grasp the economic issues. But consider this. The U.S. Constitution and legal precedent provide formal ground rules for discussion and debate about potential appointees to the U.S. Supreme Court. In large part, that debate involves how expansive the Supreme Court's jurisdiction should be and how much deference the Supreme Court should grant to federal or state political institutions. The constitutional and legal issues involving the Supreme Court are at least as complex as economic matters. Yet, the on-going debate has educated the public about the fundamental principles in a way that produces broad substantive public consideration of the issues at stake.

The public's interest in the Fed Chair's succession is now on par with or perhaps even more intense than its interest in the appointment of the Chief Justice of the U.S. Supreme Court! A public and Congress capable of consideration of broad constitutional and legal questions with regard to Supreme Court appointments should be capable of considering broad substantive questions regarding the governance of the independent Federal Reserve.

In my view, what we need are ground rules to frame the discussion of appointments to the Federal Reserve Board commensurate with those for Supreme Court appointments. My intention in this essay is to outline conceptual criteria to frame the discussion of Fed appointees analogous to the criteria that frame the discussion of Supreme Court appointees.

Unfortunately, the criteria in the Federal Reserve's case are not to be found in formal legislation. The Federal Reserve Act grants the Fed wide autonomy in the pursuit of broadly stated goals. The Act grants the Fed broad operational independence over bank reserves, currency, and asset acquisition to "maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." The Fed has financial independence to fund operations from interest earnings on its portfolio. And the Fed sends net interest income to the fiscal authorities and receives implicit taxpayer support for any losses that the Fed might incur.

Moreover, a number of external restraints that previously acted to limit the Fed's independent powers have fallen away. Most importantly, the gold standard was abandoned, restrictions on last resort lending were relaxed, and the Fed's supervisory and regulatory powers were expanded.

Given the general weakening of previously effective external restraints, the expansion of the Fed balance sheet in the recent credit turmoil, and the additional regulatory powers under Dodd-Frank, it is particularly important today to initiate a substantive political and public discussion about the Fed's independent operational policy reach, with ground rules analogous to those that frame the on-going debate about the jurisdiction of the U.S. Supreme Court.

The Fed Chair's Preeminence and the Senate Confirmation Hearings

The U.S. Senate's "advise and consent" role in the confirmation process for the Fed Chair affords an ideal opportunity to begin a political and public discussion about the Fed's independent policy reach. Even though the Fed Chair has only one vote on the Board of Governors and in the Federal Open Market Committee, the Chair is preeminent for a number of reasons. The Chair is appointed to lead the Federal Reserve System by the President of the United States. The Chair commands the large Federal Reserve Board staff. Most importantly, only the Chair is involved in every key operation (monetary policy, credit policy, bank supervision and regulation, financial services, foreign exchange operations, relations with Congress and the Treasury, public relations). Only the Chair is fully aware of all the potential interconnections of the Fed's activities. For all these reasons it is difficult to challenge the Chair's leadership.

The Chair's preeminence is central to the functioning of the Fed. The Chair must encourage diverse points of view and then mobilize the Fed to action. The Chair must use his/her preeminence to make the most of diversity while preserving the decisiveness needed to make policy.

The person of the Chair matters in addition because there are not clearly established boundaries of the Fed's operational policy powers. Given the Chair's preeminence, the Chair's inclination is decisive on whether to seek <u>broad</u> operational means, or <u>narrow</u> operational means to achieve the Fed's objectives. The Chair's judgment establishes operational boundaries between the Fed and markets on one hand, and the Fed and the fiscal authorities on the other. The Chair's succession matters hugely for how the Fed will act in the future.

In light of this reality, the Senate confirmation hearings should ascertain the nominated Fed Chair's inclination toward broad or narrow use of the Fed's operational independence. The following section outlines the conceptual criteria with which to consider the boundary between the independent Fed and the fiscal authorities, i.e., Congress and the Treasury. The subsequent section explains why failing to constrain the Fed's independent last resort lending reach, in particular, has been and remains counterproductive for financial stability. The concluding section recommends five questions to be asked of the designated Fed Chair to initiate a discussion at the Senate hearings of the proper boundary of the Fed's independent powers.

The Proper Boundary of the Fed's Independent Operations: Monetary Policy, Credit Policy, and Fiscal Policy

Any consideration of the proper boundary for the exercise of Fed policy independently of the fiscal authorities must distinguish conceptually between monetary policy (narrowly defined) and credit policy. The reason is that monetary policy and credit policy work through entirely different channels with very different fiscal policy features.

Monetary policy (narrowly defined) involves operations that expand or contract bank reserves by Fed purchases or sales of U.S. Treasury securities, respectively, from its portfolio. Monetary policy works via the provision of bank reserves and interest on reserves to influence the general level of market interest rates. Monetary policy does not favor one sector of the economy over another; and monetary policy does not involve taking credit risk onto the Fed's balance sheet. The Fed returns to the U.S. Treasury all the interest on its Treasury securities after expenses, for the fiscal authorities to allocate as they see fit. Therefore, monetary policy with a "Treasuries only" asset acquisition policy (followed by the Fed before the recent credit turmoil) is well-suited for delegation by Congress to the independent Fed. That said, Congress should accept the 2% inflation target announced by the FOMC in January 2012 and agree to hold the Fed accountable for achieving its inflation target to help anchor inflation expectations.

In contrast to monetary policy, Fed credit policy has little effect on the level of market interest rates and is not necessary or sufficient to maintain price stability. Credit policy works by interposing the government's creditworthiness—the power to borrow credibly against future taxes—between private borrowers and lenders to facilitate credit flows to distressed borrowers. Fed credit policy involves lending to private institutions (or acquiring non-Treasury securities) with freshly created bank reserves or proceeds from the sale of Treasuries from the Fed's portfolio. To prevent future inflation, the Fed must reverse the reserve creation eventually by selling Treasuries from its portfolio, or else the Fed will have to pay a market interest rate on the reserves. Either way, Fed credit policy involves the lending of public funds to favored borrowers financed by interest-bearing liabilities issued against future taxes.

In short, Fed credit policy is "debt-financed fiscal policy" carried out by the central bank. The Fed returns the interest on its credit assets to the Treasury, but all such assets carry credit risk and involve the Fed in potentially controversial disputes regarding credit allocation. So credit policy is a political, fiscal policy matter. Except for occasional short-term Fed lending to regulated, solvent depositories, on good collateral, the presumption should be that credit policy ought to respect the congressional appropriations process and be handled by the Congress and the Treasury and not the independent Fed.

Financial Instability and Independent Last Resort Lending

The boundary of the Fed's credit policy powers matters not only because the congressional appropriations process should be respected, but also because Fed last resort lending has expanded in reach and scope throughout the Fed's history with increasingly distortionary and destabilizing consequences.[1] For instance, in the 2007-8 credit turmoil the Fed was put in a no-win situation given its wide powers to lend—disappoint expectations of accommodation and risk financial collapse or take on expansive underpriced credit risk, as Paul Volcker put it "with the implied promise of similar actions in times of future turmoil." The Fed chose the latter course of action—even allowing two major investment banks (not previously regulated or supervised by the Fed) to quickly become bank holding companies so they could access the Fed discount window.

In the 19th century, the Bank of England followed Walter Bagehot's classic last resort lending advice "to lend freely at a high rate on good collateral" and did not take on credit risk because the Bank was a private, profit-maximizing institution whose shareholders earned the profit and bore the risk of loss.

The Fed, however, is inclined to take on underpriced credit risk when worried that not doing so threatens a systemic financial crisis. Why?—because the Fed's own funds are not at stake. As pointed out earlier, the fiscal authorities receive net Fed income after operating expenses and taxpayers bear any Fed losses. Moreover, even when the Fed protects itself by taking good collateral, the Fed harms taxpayers if the entity to which the Fed lends fails with a Fed loan outstanding. In that case, the Fed takes collateral at the expense of taxpayers exposed to losses from backstopping the deposit insurance fund or from other financial guarantees that the government may have put in place. The upshot is this: By protecting itself to minimize ex post lending losses, the Fed creates ex ante distortions by potentially delaying the closure of insolvent entities. So fully independent Fed last resort lending facilitates laxity and moral hazard.

Suggested Questions for the Fed Chair's Senate Confirmation Hearings

As emphasized above, the Fed Chair will play the preeminent role in deciding how expansively the Fed pursues its independent powers in the future. Therefore, the Senate should use the confirmation hearings to engage the Fed Chair designate on related matters. Five questions provided below should be addressed to the Chair nominee, if necessary with a request for the nominee to provide written answers for the record. The suggested questions are designed to stimulate discussion and debate in Congress and help to initiate a substantive public consideration of the issues at stake.

[1] See M. Goodfriend, "Lessons Learned from a Century of Federal Reserve Last Resort Lending," Testimony before the Committee on Financial Services, U.S. House of Representatives, September 11, 2013.

1) One hears two competing views on what Federal Reserve “independence” should mean:

   One view is that Congress should set the Fed’s goals broadly, allow the Fed wide operational powers to intervene in financial markets to achieve those goals, and give the Fed virtual free reign to use its operational powers as the Fed chooses.

   A second view is that the independent Fed needs the double discipline of an explicit mandated inflation target—to facilitate the conduct of monetary policy, and explicit limits on Fed credit policy—to limit the distortion and destabilization of financial markets due to the inclination of the Fed to provide underpriced credit assistance in times of credit turmoil.

   What most closely reflects your views? Explain.

2) Do you think it would be beneficial for the effectiveness of independent monetary policy for Congress to accept the 2% inflation target announced by the FOMC in January 2012 and hold the Fed accountable for achieving 2% inflation over time? Explain.

3) One can distinguish between Fed monetary policy (the management of bank reserves via open market operations in Treasuries) and Fed credit policy (lending to particular entities or purchasing non-Treasury securities with proceeds from the Fed sale of Treasuries or the fresh creation of bank reserves). Do you think the Fed should to utilize this distinction for purposes of transparency and accountability in explaining its policy initiatives? Explain.

4) Do you regard “flexibility” afforded by discretion (unconstrained by rules or boundaries) as a largely unalloyed benefit of Fed operational independence? Or do you worry that unconstrained discretion creates scope for destabilizing expectations of future inflation or future underpriced Fed credit assistance that create problems of their own? Explain.

5) Do you think the Fed should return to the “Treasuries only” asset acquisition policy it followed prior to the 2007-8 credit turmoil? Explain.