Why the Fed Should Issue a Policy Framework for Credit Policy

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The Federal Reserve is the single most independent of all of the federal agencies in the United States. Like its brethren, it nominally sits within the executive branch of our tripartite system of government: it helps to execute, or carry out, the laws made by Congress. But while the judiciary—the third branch, alongside the executive and legislative—has been pushing toward an increasingly unitary executive, there has been no effort to reign in the tremendous discretion exercised by the Federal Reserve, nor the degree to which it remains relatively free from efforts by the President to alter its course.

There are, of course, very good reasons for central bank independence, in the United States and elsewhere. The classic assumption, supported by empirical work finding that independence promotes price stability, is that elected officials cannot be trusted stewards of monetary policy.[1] They don't just lack the expertise, a common reason to delegate decision-making to technocrats, they also lack the right incentives. Leaders want to get re-elected or be replaced by their chosen successor. They understood that "it's the economy, stupid," long before James Carville coined the phrase, and they understand at least enough monetary policy to know that slashing interest rates can be great for the economy – in the short run. The problem, of course, is that there is a time consistency challenge. Overly accommodative monetary policy may boost productivity in the short run, but it can also set the stage for run-away inflation in the future. Freeing the central bank from direct executive accountability is key to enabling it to make the credible commitments needed to keep inflation in check. Concerns about central banks monetizing national debt are also relevant in efforts to explain why central banks should enjoy greater freedom from direct political accountability than other agencies.[2]

With all of this freedom, however, comes concerns about accountability. One of the core ways that the Federal Reserve has helped to address these concerns is by promulgating policy frameworks. These frameworks spell out what the Fed is seeking to achieve and how it plans to achieve it in its core roles, such as effectuating monetary policy and serving as a lender of last resort. It then uses those frameworks to guide and explain its subsequent decision-making.

Policy frameworks are not straitjackets. They are not legally binding obligations. They neither restrict what the Fed can do nor force it to take action. They cannot be enforced in court. Nonetheless, they can be used by others, from investors to Congress to academics, to understand how the Fed is likely to respond to given developments, and to hold the Fed's feet to the fire in the event its actions do not conform. As a result, they help promote transparency, accountability, and legitimacy—all values crucial to the Fed's ability to maintain its independence. A brief tour through the Fed's actions in two domains where it now has such policy frameworks—lender of last resort operations and monetary policy—and one where it doesn't—credit policy—brings to life just how important policy frameworks can be, and why the Fed should work toward producing one to govern its recent efforts to provide support directly to the real economy.

Lender of Last Resort. A classic function of central banks is to serve as the lender of last resort, which effectively means that the Fed and other central banks should provide liquidity—potentially in large amounts—during periods of systemic distress. Liquidity is the grease that financial systems need to function.

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[*] Harvey J. Goldschmid Professor of Law, Columbia Law School. Earlier iterations of some of the ideas conveyed here can be found in Kathryn Judge, The *Federal Reserve: A Study in Soft Constraints*, 78 Law and Contemporary Problems 65-96 (2015).

[1] Alberto Alesina & Lawrence H. Summers, *Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence,* 25 J. Money, Credit and Banking 151 (1993).

[2] Athanasios Orphanides, *Central Bank Policies and the Debt Trap*, 37 Cato J. 223, 240 (2017).

When they stop producing it internally, very bad things can happen. How best to provide liquidity depends on the mechanisms that a particular financial system relies on to create liquidity outside periods of distress.

Banks—ubiquitous creators of liquidity—illustrate the value of having a lender of last resort. Banks are unique businesses in many ways, but one of the most significant is that they provide valuable services on both sides of their balance sheet. They fund their activities with short-term debt, primarily demandable deposits, facilitating liquidity smoothing. A depositor can deposit a paycheck today and then use those funds to readily pay the rent and credit card bill when they come due. On the asset side, banks traditional held loans, loans that ideally they made to aspiring homeowners and entrepreneurs who—according to the bank's underwriting process—appeared well-positioned to pay off those loans when they came due. Most of the time, depositors' withdrawals are relatively uncorrelated, which is what makes deposits a relatively stable source of funding, enabling banks to use them to fund assets as long-term and illiquid as loans. The problem, of course, is that the structure is unstable if all depositors want their money bank at the same time—either because they don't trust the bank's health or because they are afraid that other depositors will withdraw, forcing the bank to sell illiquid loans at discounted, fire-sale prices, and potentially rendering even a healthy bank insolvent. Because only depositors who are early to withdraw get paid in full, everyone has an incentive to be toward the front of the line if mass exit is likely. Deposit insurance is one way to mitigate depositors' incentive to run; a lender of last resort is another.

A central bank willing to serve as the lender of last resort can stop this vicious cycle. It enables a solvent bank to avoid fire sales and instead use its loans as collateral to obtain fresh liquidity from the central bank. The bank has the liquidity it needs to satisfy depositors without suffering meaningful losses, as it retains ownership of the loans it posts as collateral. The trick, of course, is in ensuring that central banks remain the last resort—rather than the first resort—for liquidity. This is where Bagehot's dictum comes in.

Walther Bagehot was a 19th century British essayist and editor who wrote numerous influential books. He was one of the first to point out the value of having central banks serve as lenders of last resort, when he spelled out why the Bank of England ought to step up during periods of systemic distress. His guidance with respect to when and how central banks should use loans to contain dysfunction serves as the starting point for a now oft-cited set of principles, commonly known as Bagehot's dictum. The dictum explains to whom central banks should lend—any solvent institution with good collateral—and on what terms—a rate that imposes a penalty relative to normal market conditions.[3] Most importantly, it tells central banks that they should lend, that they have an affirmative duty to provide as much liquidity as the system needs to function, subject to the other conditions.

One way of understanding the Federal Reserve's failure during the Great Depression is that it failed to do this—it failed to lend freely to banks, even those that may have been able to survive. The result was that the financial system contracted, limiting its ability to support the real economy and exacerbating the magnitude of the recession that followed. Fed Chair Ben Bernanke, an expert in these matters, was determined not to repeat that mistake. He began invoking Bagehot in the fall of 2007, a year before most people realized that

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[3] Paul Tucker, *The Lender of Last Resort and Modern Central Banking Principles and Reconstruction*, 79 BANK FOR INT'L SETTLEMENTS PAPERS 10, 15 (2014); WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 56 (1873); *See also* Brian F. Madigan, Dir. Div. of Monetary Affairs, Bagehot's Dictum in Practice: Formulating and Implementing Policies to Combat the Financial Crisis, Speech at the Federal Reserve Bank of Kansas City's Annual Economic Symposium (August 21, 2009) (transcript available at https://www.federalreserve.gov/newsevents/speech/madigan20090821a.htm).

a financial crisis might be underway.[4] He continued to do so throughout the crisis, and then after the crisis. He used Bagehot to explain why the Fed was making so many loans to nonbanks. He used the Bagehot framework to explain that even though the Fed's operations looked quite different than just loaning money to banks via the longstanding discount window, its actions were following the same principles that had guided well-functioning central banks throughout the world for well over a century. He also used Bagehot to explain what may have been the Fed's most important decision not to intervene--its decision to allow Lehman Brothers to file for bankruptcy.

To be sure, there have been numerous challenges to both the Fed's decision to expand its support to reach "shadow banks," and the decision to allow Lehman to fail. There is room for debate on both fronts, and standards such as "solvency" are notoriously difficult to determine amidst a financial panic, particularly when being applied to institutions not directly overseen by the Fed. Significantly, however, even those attacking the Fed's decisions often do so by reference to whether it was in fact adhering to Bagehot.[5] The implicit assumption, thus shared both by many inside and outside of the Fed, is that adherence to Bagehot's dictum—or a principled basis for diverting from the path his dictum would dictate—was the relevant reference point. Bagehot's dictum provided the policy framework needed to navigate new territory, one that could be used to assess both whether the Fed was right to take the course it did and the legitimacy of those actions.

The Fed made numerous difficult and controversial decisions in its efforts to stabilize the financial system between 2007 and 2009. No simple set of principles can resolve all of those controversies. But the very fact that the Fed managed to avert a Great Depression coupled with the lack of any meaningful, long-term impairment of damage to the Fed's toolset or reputation are positive signs. They suggest that being able to invoke Bagehot's dictum helped the Fed in making and explaining its decision even as it was forced onto seemingly new terrain.

None of this is to elevate Bagehot's dictum into a policy framework that will always work, or work well. Policy frameworks, including Bagehot's dictum, can and should evolve as circumstances change and new insights are gained. There is also significant indeterminacy built into that framework. This helped it to prove useful despite the transformation in the structure of the financial system, but also required great judgment calls to be made in efforts to apply it. Some central bankers, such as Paul Tucker who had been the Deputy Governor of the Bank of England during the last crisis, have tried to expand on Bagehot's dictum to show how it can be used to provide more fine-tuned rules and hence greater accountability and transparency.[6] Others have called for a more fundamental reimagining of how central banks have contained and should seek to contain dysfunction during periods of systemic distress.[7] The point here is not to resolve these debates but to show the utility of having a policy framework such as Bagehot's dictum to ground these debates and shape expectation about when and how a central bank will intervene.

Monetary Policy. The Fed's authority over monetary policy may be the domain where it exercises the greatest discretion. It is also the domain where the Fed has invested the most effort in promulgating a clear

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[4] Ben S. Bernanke, Chair of the Board of Governors of the Federal Reserve System, The Recent Financial Turmoil and its Economic and Policy Consequences, Address at the Economic Club of New York (Oct. 15, 2007) (transcript available at https://www.federalreserve.gov/newsevents/speech/bernanke20071015a.htm).

[5] *See, e.g.*, LAURENCE M. BALL, THE FED AND LEHMAN BROTHERS: SETTING THE RECORD STRAIGHT ON A FINANCIAL DISASTER xiv (2018); Thomas L. Hogan et al., *Ben Bernanke and Bagehot's Rules*, 47 Journal of Money, Credit and Banking 333 (2015)

[6] Paul Tucker, *The Lender of Last Resort and Modern Central Banking Principles and Reconstruction*, 79 BANK FOR INT'L SETTLEMENTS PAPERS 10, 25 (2014).

[7] Perry Mehrling, *Why Central Banking Should be Re-Imagined*, 79 BANK FOR INT'L SETTLEMENTS PAPERS 108 (2014).

and detailed policy framework. In 2012, the Fed formalized its framework for monetary policy, in its Statement on Longer-Run Goals and Monetary Policy Strategy.[8] But broadly agreed upon frameworks, even if far less specific and not subject to the same rigorous processes, have long existed.[9] Even William McChesney Martin's famous 1955 quip—that central banks ought to serve as "the chaperone who has ordered the punch bowl removed just when the party was really warming up"—was such framework.[10] It explained what the Fed should do – tighten monetary policy—and when it should do it—when the economy is starting to overheat. This is part of what enabled others to criticize Fed Chair Arthur Burns for the Fed's failure to adequately tighten monetary policy in the face of troubling indicators in the early 1970s. Another basis for critique, and perhaps a more productive one, comes from Robert Hetzel:

> Economists use models to learn about the world and to explain how it works. A model imposes a discipline by forcing the economist to explain cause and effect relationships within a framework that yields testable implications. When experience falsifies those implications, the economist must return to the model… The evidence from Burns's own words shows that he did not use such a model to predict inflation and, consequently, failed to learn from the inflationary experience of the 1960s and 1970s.[11]

Although there are important differences between rigorous models of the type Hetzel references and policy frameworks, his description points to another value of policy frameworks—they can improve policy outcomes by ensuring the framework is revisited and updated in the event that outcomes fail to conform with expectations given relevant inputs.

Although clearly overdetermined by this point, the Burns example also helps to illustrate another way that policy frameworks can protect Fed independence—by making it more likely that any failure of the Fed Chair to remain resolute in the face of presidential pressure will be exposed in a timely way. Despite the Fed's nominal independence, Presidents continue to try to exert pressure when they think it will help them win an election. Perhaps the greatest rebuke against Burns is that many blame his failure to adequately tighten in a timely way as a sign that he succumbed to pressure from then-President Nixon.[12] In his autobiography, Chair Paul Volcker admitted that President Reagan tried to pressure him into adopting a more accommodative approach to monetary policy when Reagan was up for re-election.[13] And President Trump is famous for his pre-Covid efforts to pressure Chair Powell to lower rates with tweets such as "The Fed should get smart & lower the Rate", "would be sooo great if the Fed would further lower interest rates and quantitative ease" and "Fed Rate too high. They are their own worst enemies, they don't have a clue. Pathetic!"[14]

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[8] Federal Reserve System, *Statement on Longer-Run Goals and Monetary Policy Strategy* (January 24, 2012, amended August 27, 2020).

[9] *See* BEN S. BERNANKE, THE FEDERAL RESERVE AND THE FINANCIAL CRISIS: LECTURES BY BEN S. BERNANKE 7 (2013); NEIL IRWIN, THE ALCHEMISTS: THREE CENTRAL BANKERS AND A WORLD ON FIRE 10, 28 (2013).

[10] Wm. McC. Martin, Jr., Chair of the Board of Governors of the Federal Reserve System, Address before the New York Group of the Investment Bankers Association of America (Oct. 19, 1955) (transcript available at https://fraser.stlouisfed.org/title/statements-speeches-william-mcchesney-martin-jr-448/address-new-york-group-investment-bankers-association-america-7800).

[11] Robert L. Hetzel, *Arthur Burns and Inflation*, 84 FED. RESERVE BANK OF RICHMOND ECON. QUARTERLY, Winter 1998, at 21, 23.

[12] PETER CONTI-BROWN, THE POWER AND INDEPENDENCE OF THE FEDERAL RESERVE 194-195 (2016).

[13] PAUL A. VOLCKER & CHRISTINE HARPER, KEEPING AT IT: THE QUEST FOR SOUND MONEY AND GOOD GOVERNMENT 125-126 (2018).

[14] Christopher Condon, *Key Trump Quotes on Powell as Fed Remains in the Firing Line*, BLOOMBERG, https://www.bloomberg.com/news/articles/2019-12-17/key-trump-quotes-on-powell-as-fed-remains-in-the-firing-line (last visited October 5, 2020).

The possibility that outcomes that do not accord with expectations might force the Fed to revisit a policy framework was realized in late 2018, when the Fed decided to revisit its 2012 framework. There were a number of reasons behind the Fed's decision to undertake its "first-ever public review of how we make monetary policy," as Chair Powell described it.[15] The primary reason was that in the years after the Fed adopted its initial framework, it became clear that the economy wasn't quite working exactly as the models informing the initial framework would have predicted.[16] Among other things, unemployment kept falling, even below what many believed was the natural rate of unemployment, and yet inflation generally remained well below the Fed's 2% target. Recognizing that the Fed had entered a "new normal," led Chair Powell to the conclusion that the Fed could best face the uncertain and challenging terrain ahead by going back to revisit its framework.

As Vice Chair Richard Clarida further explained, the review was not a sign that the Fed had "been poorly served by the framework in place since 2012," but rather an indication that "the U.S. economy—and, equally importantly, [the Fed's] understanding of the economy—have clearly evolved along several crucial dimensions since 2012." This led the Fed to the conclude that "it made sense to step back and assess whether, and in what possible ways, we might refine and rethink our strategy, tools, and communication practices to achieve and sustain our goals as consistently and robustly as possible in the global economy in which we operate today and for the foreseeable future."[17] In sum, the processes of promulgating, revising, and using a policy framework brings rigor and discussion that can improve the capacity of a central bank to achieve its desired outcomes.

Chair Powell also chose to use the process as an opportunity to expand the voices that, at least in some way, might affect the Fed's thinking. In addition to learning from the best and brightest experts at its annual Jackson Hole gathering, focused specifically on monetary policy in 2019, the Fed used the process to engage with a wider swathe of other Americans, people who are affected by its policies but from whom Fed officials—particularly the Fed Governors and its staff inside the Beltway—rarely hear. A centerpiece of the process was a series of "Fed Listens" events across the country. Chair Powell and his colleagues on the Federal Open Market Committee listened to "representatives from a wide range of groups" about "how the economy is working for them and the people they represent and how the Federal Reserve might better promote the goals Congress has set for us."[18]

By the time the Fed finalized its revised framework, the Covid crisis had already caused the Fed to slash interest rates to near zero, commit to keeping them there for quite some time, and significantly expand the size of its balance sheet. Hence the biggest policy change—that the Fed will pursue 2% as an average inflation target, enabling inflation to sometimes rise above 2%, enabling further job creation and wage growth,--will not have any direct impact on policy for some time. Nonetheless, just the announcement of the change captured public attention, enabling the Fed to affirm its commitment to those who most struggle to

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[15] Jerome H. Powell, Chair of the Board of Governors of the Federal Reserve System, Building on the Gains from the Long Expansion, Address at the Annual Meeting of the Greater Providence Chamber of Commerce (Nov. 25, 2019) (transcript available at https://www.federalreserve.gov/newsevents/speech/powell20191125a.htm).
[16] Richard H. Clarida, Vice Chair of the Board of Governors of the Federal Reserve System, The Federal Reserve's New Monetary Policy Framework: A Robust Evolution, Remarks at the Peterson Institute for International Economics (Aug. 31, 2020).
[17] Richard H. Clarida, Vice Chair of the Board of Governors of the Federal Reserve System, The Federal Reserve's New Monetary Policy Framework: A Robust Evolution, Remarks at the Peterson Institute for International Economics (Aug. 31, 2020).
[18] Jerome H. Powell, Chair of the Board of Governors of the Federal Reserve System, Building on the Gains from the Long Expansion, Address at the Annual Meeting of the Greater Providence Chamber of Commerce (Nov. 25, 2019) (transcript available at https://www.federalreserve.gov/newsevents/speech/powell20191125a.htm).

find and retain jobs, even as its current policies were unaffected. More importantly, the process through which the guidelines have been created and revised, and presumably will be again in the future, illustrate how useful policy frameworks can be when the law necessarily provides central banks some discretion in how they fulfill the tasks before them.

Credit Policy. In stark contrast to its role as lender of last resort or as the authority over monetary policy, the Fed has no broadly agreed upon framework for credit policy. The term credit policy, which has had various meanings over the course of the last century, here refers to interventions by the Fed that facilitate the flow of credit to particular domains in the real economy. This may be companies, large or small, nonprofits, or even government actors, such as states or municipalities. For purposes of the discussion here, the only body explicitly excluded is the federal government (a topic addressed separately in the debate about the monetization of federal government debt).

The reason this topic is so pressing is that it remains at the core of the Fed's most controversial interventions in the Covid crisis. Some people believe the Fed should abandon these efforts completely while others believe the Fed has not done nearly enough.[19] To provide a little more context, the Fed acted quickly and aggressively to minimize the harms flowing from the pandemic. It quickly slashed interest rates and started buying up bonds and agency mortgage backed securities, both to ease monetary conditions and to restore healthier market functioning. It also encouraged banks to borrow through the discount window and it rolled out many of the facilities it had created in 2008 to support the market-based system of financial intermediation that remains important in the United States. All of these actions were swift and in aggregate, quite powerful. Because they all operated in accord with established frameworks, most were also not that controversial.

But the Fed did not stop there. On March 23, 2020, it also announced its unprecedented intention to create corporate credit facilities to buy corporate bonds for its own portfolio and its plan to create a complementary Main Street Facility for mid-sized companies not able to access public bond markets. Within the week, Congress embraced the idea that the Fed could and should play a central role providing much-needed support for businesses and entities of all kinds. In the Coronavirus Aid, Relief, and Economic Security Act, also known as the CARES Act, Congress gave the Fed and Treasury $454 billion, which they expected to be levered up with Fed support and then deployed to potentially provide trillions of dollars of new loans to help businesses and others weather the pandemic. The primary constraint was that the moneys had to be deployed via emergency lending facilities that the Fed created under its authority pursuant to Section 13(3) of the Federal Reserve Act to loan money to nonbanks in "unusual and exigent circumstances."[20] The core idea was for the Treasury to use the $454 billion to provide backstops to each of the facilities, enabling the facilities to make loans that posed credit risk while still making it unlikely that the Fed itself would incur any losses.

The implementation and ramifications of these efforts have been decidedly mixed. Large corporations able to access public debt markets have done great. As soon as the Fed announced its intention to create a corporate credit facility, spreads went down dramatically and issuance went up—in short, large companies could easily access debt on favorable terms.[21] The Fed subsequently did roll out these facilities, but its only purchases have been through the Secondary Market Corporate Credit Facility that buys ETFs and bonds

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[19] Compare David Beckworth, *George Selgin on the Fed-Treasury Relationship, New Lending Facilities, and the Fed's Evolving Role in Response to COVID-*19, MERCATUS CTR. (Apr. 27, 2020) with Mike Konczal, *A Federal Reserve Reform Agenda: Eight Recommendations*, ROOSEVELT INST. (Sept. 2020).
[20] 12 U.S.C. § 343(3)(A).
[21] J. Nellie Liang, *Corporate Bond Market Dysfunction During COVID-19 and Lessons from the Fed's Response*, (Hutchins Ctr. on Fiscal & Monetary Policy at Brookings, Working Paper No. 69, October 2020), at 2.

that are part of broad indices, most notably one that the Fed created just for this purpose. There is little sign that the actual purchases are having any effect on pricing or credit availability beyond demonstrating that the Fed meant what it said when it declared its intent to enter these markets. Not surprisingly given how much the markets have revived, there have been no takers for the Primary Market Corporate Credit Facility, which can buy bonds right from the issuer but which has additional requirements.

The Fed has also created numerous other facilities. It has five different facilities as part of its Main Street Lending Program, three for mid to large-sized companies and two for nonprofits. The structure here relies on banks as partners—a bank must underwrite and manage the loan, and retain 5% of each of the loans. The Main Street Lending Program was not actually launched until July, and even by the end of the September, the total value of loans extended remains quite small by just about any measure—$2,2 billion.[22] The Fed also created a Municipal Liquidity Facility, which also took many months to set up and has also extended only two loans worth $1,651,000,000 in the aggregate.[23] Of course, just looking at the amount of moneys loaned pursuant to a facility says little about its impact or significance. The impact of the Secondary Market Corporate Credit Facility on the ability of eligible companies to access credit appears quite significant despite the modest purchases by the Fed.[24] Unfortunately, there are few signs that small businesses and municipalities have had an easier time raising money because of the Fed's facilities, none of which create liquidity in the secondary market beyond that provided for corporate credit.

This state of affairs exposed Fed Chair Jerome Powell to sharp questions during his September visit before Congress. Members of both parties seemed frustrated that so much money remained unused while so many businesses, nonprofits and municipalities continue to struggle. The relevant question here isn't whether the Fed and Treasury ought to be offering more favorable terms or be willing to accept greater risks in any of the facilities. Rather, what is significant is that the testimony in and of itself revealed that the same Congress that gave this Fed Chair $454 billion didn't really understand what the Fed could or would do—much less what the Fed couldn't or wouldn't do—when they allocated the funds.

There are no easy answers to the question of the appropriate role of the Fed in extending credit to companies in the real economy. Some believe that avoiding any role in credit policy is the best way for the Fed to protect its independence, which is what enables it to respond so quickly with monetary policy and to support short-term markets. Others believe that the Fed should have a much greater role in this regard, and that the law governing emergency and other lending by the Fed and its institutional capabilities ought to be enhanced before the next shock so the Fed can provide support to a broader swathe of companies and other entities. Yet another alternative is to admit that the Fed can and will support bond markets, but it is not going to do much for smaller companies or municipalities, clearly putting the onus on Congress or another agency to do more for these entities.

These are not easy questions to resolve, which is precisely why it is so important to start the conversation. That means acknowledging that the Fed is currently involved in credit policy, acknowledging the contours of who it has helped and who its efforts have failed to reach, and figuring out where the Fed can and should go from here.

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[22] Fed. Reserve Sys., *Federal Reserve Statistical Release* (Oct. 1, 2020).

[23] Fed. Reserve Sys., *Federal Reserve Statistical Release* (Oct. 1, 2020); Fed. Reserve Sys., *Periodic Report: Update on Outstanding Lending Facilities Authorized by the Board under Section 13(3) of the Federal Reserve Act* (Sept. 7, 2020).

[24] J. Nellie Liang, *Corporate Bond Market Dysfunction During COVID-19 and Lessons from the Fed's Response*, (Hutchins Ctr. on Fiscal & Monetary Policy at Brookings, Working Paper No. 69, October 2020), at 9; Simon Gilchrist et al., *The Fed Takes on Corporate Credit Risk: An Analysis of the Efficacy of the SMCCF*, (Nat'l Bureau of Econ. Research, Working Paper 27809, 2020).