The Fed and the Coming Redefinition of Government Regulation

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Weathering the Storm: The Challenges and Opportunities of a Global Slowdown

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Any opinions expressed here are mine and do not necessarily reflect those of other Federal Open Market Committee members.

TOPICS

- The state of the economy.
- Proposals and priorities for regulatory reform.
- The Fed and financial stability.

THE FIRST PHASE OF ECONOMIC RECOVERY

- Real GDP growth has recently turned positive in the U.S.
- Global growth has surprised on the upside, especially in Asia.
- Household consumption expenditure has stabilized.
- Financial market stress has abated substantially since 2008 Q4.
- Unemployment is high, and labor markets are lagging.
- Bottom line: The U.S. is in the early stages of recovery from a very serious recession.

SMALLER BANKS ARE NOT THE PROBLEM

- Regulation works well for the thousands of smaller banks in the U.S.
- The system features deposit insurance plus prudential regulation.
- The system allows failure, but prevents bank runs and the associated panic.
- The FDIC has a robust resolution regime for these institutions.
- *Smaller banks did not cause the current crisis and do not need to be re-regulated.*

THE RISE OF THE SHADOW BANKING SECTOR

- The regulations in commercial banking gradually pushed activity into less regulated firms.
- Large, global non-bank financial institutions took on bank-like activities and a large fraction of all financial intermediation in the U.S.
- Some institutions borrowed short—on collateral—to fund longer-term investments.
- The crisis showed that runs on non-bank, non-deposit-taking financial institutions are possible as well as very destructive.
- This was not previously considered a problem.
- There is no analog of deposit insurance to solve this problem.

KEY PROBLEM: TOO BIG TO FAIL

- The crisis showed that large financial institutions worldwide were "too big to fail." (TBTF)
    - Really, "too big to fail quickly."
- If we let large financial firms fail suddenly, global panic ensues.
    - *Again, these firms are not necessarily banks.*
- Reform efforts must focus on getting this intolerable situation under control.
    - TBTF is very costly to the macroeconomy as well as unfair.
    - We need laser-like focus on this problem.

Actual proposals

- Proposals addressing TBTF:
  - Systemic risk regulation: A council with the Fed having implementation responsibility.
  - A resolution regime for large financial firms.
  - Split up large firms.
- There are important global coordination issues.
- Difficulties in design suggests a "go slow" approach.
  - The crisis will not soon be forgotten.

THE NATION'S THIRD ATTEMPT AT A CENTRAL BANK

- The first two central banks in the U.S. were discontinued.
- The nation had no central bank during much of the 19th century.
- The evidence from the 19th century is generally regarded as unfavorable.
  - There was far too much financial instability.
- This led to the founding of the Fed following the Panic of 1907.
- The regional structure was designed to keep some power out of Washington and New York.

Providing financial stability

- Despite the current crisis, the track record of the Fed and financial crises is reasonably good during the past 25 years.
- At least four major threats:
  - Latin American debt crisis in the 1980s.
  - The Thrift Crisis in the late 1980s and early 1990s.
  - The Asian Currency Crisis in the 1997-1998 period, leading to the collapse of Long Term Capital Management.
  - The collapse of Enron and WorldCom in the early part of this decade.
- Despite these threats, the period was one of the most tranquil on record for macroeconomic performance.

EARLY WARNINGS

- The Fed provided important warnings before this crisis began.
- William Poole (FRB-St. Louis) argued during the early 2000s that Fannie Mae and Freddie Mac were ticking time bombs that could badly damage the U.S. economy.
- Gary Stern and Ron Feldman (FRB-Minneapolis) published an entire book, "Too Big To Fail," in 2004.
- These types of warnings show that the Fed is well aware of systemic risk concerns in real time.
- The problem is what to do in terms of concrete policy action when times are good.
- Disrupting good times in the name of mitigating possible future problems is usually very unpopular.

THE FED AS LENDER OF LAST RESORT

- The Fed is the nation's lender of last resort.
- The role of Fed lending in mitigating the current crisis has been substantial.
- The Fed needs to have a role in regulating institutions to which it may lend.

The Fed as the nation's monetary authority

- To run an effective monetary policy, the Fed needs to know the condition of the financial system.
- The need to know the status of financial markets has been underscored by recent events.
- This also argues for a substantial Fed role in the regulation of these firms.
- The U.K. model, putting the FSA in charge of regulation and the Bank of England in charge of monetary policy, did not work well during this crisis.
  - The crisis in the U.K. has been even worse in some dimensions than in the U.S.

FED INDEPENDENCE

- Fed independence is vital in maintaining credible monetary policy.
- Non-independent central banks, historically, have been forced to finance large government budget deficits through money creation.
- This can be very inflationary.
- The U.S. has large government budget deficits right now.
- Talk of eroding Fed independence can be counterproductive for economic recovery.

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