FINANCIAL TIMES MONDAY AUGUST 10 2009

Fed needs better performance, not powers

John Taylor

The Obama administration's financial reform proposals would grant the Federal Reserve significant new powers. These powers – which fall under the rubric "systemic risk authority" – will have a negative impact on the conduct of monetary policy. The unintended consequence would be to increase not reduce systemic risk.

What are these new powers? The Fed would be given authority to determine whether any "individual financial firm poses a threat to financial stability". All such Fed-designated firms would then be placed in a special group called "Tier I Financial Holding Companies". The Fed would then have the power to supervise all companies in this group. They would also become subject to a new "resolution regime" through which the government could, at a moment's notice, take one over or order its sale. The Fed would also have the power to collect "periodic and other reports" from all US financial groups that meet certain minimum (as yet unspecified) size standards. And the power of the Fed to intervene in any private firm or market under the "unusual and exigent circumstances" clause of the Federal Reserve Act would not be circumscribed in any specific way, effectively ratifying the type of actions that some have argued test the limits or even go beyond existing law.

Why would these new powers be detrimental to monetary policy? First, they would dilute the key mission of the Fed, which is to maintain overall economic and price stability by controlling the growth of the money supply and thereby influencing the level of interest rates. Government institutions work best when they focus on a limited set of understandable goals and are held accountable for achieving them. Giving the Fed authority to determine which firms should be classified as Tier I FHCs and then giving it responsibility for their stability would greatly expand its mission.

Second, responsibility for Tier I FHCs would reduce the Fed's credibility as it became more involved in controversial decisions, as is already evident in the criticism of the Fed's actions in the Bank of America merger with Merrill Lynch.

Third, the new powers would create a conflict of interest. With firms in the Tier I FHC category being too big to fail, there will be a temptation to adjust monetary policy to protect these institutions. The Fed could postpone an appropriate interest rate hike to bolster the profits of such firms, or it could recommend an inappropriate resolution action for a Tier I FHC to make raising rates easier.

The plan threatens the Fed's independence, as sooner or later its expanded powers would lead to political checks

Fourth, giving more power to the Fed would threaten its independence over monetary policy. Sooner or later the expanded regulatory power will result in checks on it, perhaps through micro-managed political interference or legislative changes. It would be impossible to separate the new regulatory authority from the traditional monetary authority because both are housed in the same institution with the same chief.

Threats to the Fed's independence are a particular concern now because its recent unprecedented actions have led many in Congress to challenge its independence, with calls, for example, to audit all its monetary policy activities. Recalling the 1951 Accord that gave the Fed independence from the Treasury and observing the Fed's recent actions, George Shultz, former Treasury secretary, has warned that the Fed has already begun to lose independence, asking: "Has the Accord gone down the drain?"

There is an alternative that avoids these problems. The financial crisis was caused in large part by government actions, such as a monetary authority that aggravated the housing boom. Risky conduits linked to regulated banks were allowed by regulators. The Securities and Exchange Commission was supposed to regulate broker-dealers, but its skill lay in investor protection, not prudential regulation. The Office of Thrift Supervision was not up to the job of regulating AIG's complex financial products. Closing regulatory gaps and removing overlapping responsibilities would therefore reduce systemic risk. Monitoring the financial sector and issuing timely reports would also help. But such tasks do not require a new systemic risk regulator with broad powers, at the Fed or elsewhere.

A co-ordinating body similar to the President's Working Group on Financial Markets, but expanded to include all the regulatory agencies, could perform these tasks. The administration's proposed Financial Services Oversight Council could fulfil this role. The Fed could then take on a systemic risk monitoring role, which would not require new powers. Ironically, the Fed had such a role well before the crisis. "The Federal Reserve System: Purposes and Functions", published in 2005, states that its duties included "containing systemic risk that may arise in financial markets". As with regulatory and monetary policy, the task is to improve performance of existing authorities, not to create more power.

The writer, a professor of economics at Stanford and a senior fellow at the Hoover Institution, is co-editor of 'The Road Ahead for the Fed' and author of 'Getting Off Track'