

**Lessons from a Century of Fed Policy: Why Monetary and Credit Policies Need
Rules and Boundaries**

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INTRODUCTION

In 1913 the United States overcame a long-standing distrust of government intervention in the monetary system to establish a central bank. The Fed was to employ its independent monetary and credit policy powers to improve on the rules of the classical gold standard, rules that were seen as unduly restrictive². We now know that faith then placed in discretion over rules was misplaced. The independence given the Fed to pursue discretionary policy in the public interest proved counterproductive.

On the monetary policy side, in line with public and political pressures, the Fed's inclination to prioritize low unemployment over low inflation produced go-stop monetary policy after World War II that delivered neither, and instead produced the Great Inflation and rising unemployment. The Volcker Fed disinflation in the early 1980s eventually brought both inflation and unemployment down, and showed that effective monetary stabilization policy needs the discipline of an interest rate rule based on a credible commitment to low inflation.

On the credit policy side, there has been since World War II a gradual relaxation of the Fed's last resort lending discipline. Fed lending supported insolvent depositories in the 1970s and 1980s. And Congress in 1991 granted the Fed virtually unlimited power to lend beyond depositories in a crisis. Unbridled credit policy independence in conjunction with its financial independence drew the Fed into a massive expansion of credit in the 2007-09 credit turmoil with the "implied promise of similar actions in times of future turmoil."³ Just as an interest rate rule is needed to discipline independent monetary policy, tightly circumscribed boundaries are needed today to discipline independent credit policy.

The lesson from the Fed's first century is that wide operational and financial independence given to monetary and credit policy subjects the Fed to incentives detrimental for macroeconomic

² Bordo and Kydland (1995), and Goodfriend (1988).

³ Volcker (2008), page 2.

and financial stability. The paper tells the story. Section 1 distinguishes monetary policy from credit policy. Section 2 explains the incentives acting on the Fed that gave rise to “go-stop” monetary policy during the Great Inflation. Section 3 documents a century of expansive Fed credit policy. Sections 4 and 5, respectively, explain why Fed credit policy is a two-edged sword—how credit policy worked during the 2007-09 credit turmoil, and why unbounded credit policy exacerbated the Great Recession of 2007-09. Section 6 tells how the Fed’s governance differs from that of the 19th century Bank of England, and tells why the Fed lacks incentive to adhere to Walter Bagehot’s last resort lending rule followed by the Bank of England. Section 7 explains that the Fed’s credit policy powers must be tightly circumscribed to preserve a workable, sustainable division of responsibilities between the independent central bank and the fiscal authorities—Congress and the Treasury. Section 8 recommends a set of principles as the basis for a Fed-Treasury Credit Accord to circumscribe the Fed’s independent credit policy powers.

1) MONETARY POLICY vs CREDIT POLICY

Monetary policy refers to the expansion or contraction of currency or bank reserves via Fed purchases or sales of Treasury securities. We think of open market operations exclusively in Treasuries as monetary policy because then the Fed’s balance sheet would contribute only bank reserves and currency when consolidated with the Treasury’s balance sheet.

Monetary policy is suitable for delegation to an independent central bank because monetary policy is about managing aggregate bank reserves, currency, interest on reserves and the general level of interest rates for the whole economy. Assets are acquired only as a means of injecting bank reserves and currency into the economy. Hence, monetary policy can be implemented by confining asset purchases to Treasury securities. And “Treasuries only” insulates the independent central bank somewhat from politics because it avoids credit risk, and because the central bank simply returns

interest on its Treasuries to the Treasury (net of operating expenses) for the fiscal authorities to spend as they see fit.

Credit policy satisfies none of the conditions that make monetary policy suitable for delegation to an independent central bank. Credit policy involves lending to financial institutions (or the purchase of non-Treasury securities) financed by selling Treasury securities. When consolidated with the Treasury's balance sheet, Fed credit policy contributes loans and purchases of non-Treasury securities. Unlike monetary policy, Fed credit policy involves fiscal policy—lending to particular borrowers—financed by sales of Treasuries against future taxes. Credit policy has no effect on the general level of interest rates because it doesn't change aggregate bank reserves. In effect, credit policy effectively is debt-financed fiscal policy carried out by the central bank. The central bank returns to the Treasury interest earned on Treasuries that it holds; so when the central bank sells Treasuries to the public to finance credit policy initiatives, the result is as if the Treasury financed the credit policy by issuing new Treasury debt.

Fed 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 or otherwise favored borrowers. If the Fed funds credit policy with freshly created bank reserves, then to raise interest rates against future inflation the Fed must refinance by selling Treasuries from its portfolio, or pay a market interest rate on reserves created to fund the credit policy. Either way, credit policy involves the lending of public funds to particular borrowers financed by interest-bearing liabilities issued against future taxes. 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.

Even fully collateralized Fed credit policy exposes taxpayers to losses if the borrower fails subsequently. For instance, emergency “last resort lending” that finances the exit of uninsured

claimants of a financial institution that fails with a Fed loan outstanding strips that institution of collateral that would have been available otherwise to cover the cost of insured deposits if the institution had been closed more promptly.

2) DISCRETIONARY INCENTIVES PRODUCE GO-STOP MONETARY POLICY⁴

A central bank such as the Fed charged with conducting monetary policy in the public interest on a discretionary basis is naturally inclined to give considerable weight to the public's concerns. Go-stop monetary policy during the Great Inflation of the 1960s through the early 1980s was, in good part, a consequence of the Fed's inclination to be responsive to the shifting balance of public concerns for inflation and unemployment. For the most part, the public tolerated inflation as long as it was low, steady, and predictable. When labor markets were slack, the public was willing to tolerate higher inflation in order to stimulate additional economic activity. Only when economic activity was strong and inflation moved well above the prevailing trend did inflation become the top public's top concerns.

It is easy to understand why inflation need not greatly concern the public when it is steady and predictable. Individuals and firms are inconvenienced only slightly by low and steady inflation. As long as wages, prices, and asset values move up in tandem, there are no big financial consequences, especially when inflation is low. Likewise, a temporary and modest increase of inflation around a low, well-established trend need not immediately arouse concerns.

However, a persistent departure of inflation above trend causes anxieties because people wonder where a new trend might be established. Investors worry about how much of an inflation premium to demand in interest rates; businesses worry about how aggressively to price in order to

⁴ This section comes from Goodfriend (1997), pp. 6-8. Friedman (1964, 1972, and 1984) discusses go-stop policy. Romer and Romer (1989) document that since World War II the Fed tightened monetary policy decisively to fight inflation on six occasions beginning, respectively, in October 1947, September 1955, December 1968, April 1974, August 1978, and October 1979. The unemployment rate rose sharply after each policy shock. Only two significant increases in unemployment were not preceded by Fed action against inflation. One occurred in 1954 after the Korean War and the second occurred in 1961, after the Fed tightened monetary policy to improve the international balance of payments.

cover rising costs; and workers worry about how aggressively to price in order to cover rising wages.

In contrast to inflation, which affects the whole population, unemployment actually affects relatively few at a time. The unemployment rate in recent times has risen to only around 10 percent of the labor force. The public is concerned about unemployment not so much because of those who are currently unemployed but because people are afraid of becoming unemployed. It follows that the public is generally more concerned about unemployment when the unemployment rate is rising, even if it is still low, than when it is falling, even if it is already high.

The above-mentioned reasoning helps explain why the Fed produced go-stop monetary policy in the 1960s and '70s. In retrospect, one observes the following pattern:

First, because inflation became a major concern only after it clearly moved above its previous trend, the Fed did not tighten policy early enough to preempt inflationary outbursts before they became a problem.

Second, by the time the public became sufficiently concerned about inflation for the Fed to act, pricing decisions had already begun to embody higher inflation expectations. Thus delayed, a given degree of restraint on inflation required a more aggressive increase in short-term interest rates with greater risk of recession.

Third, in any cyclical episode there was a relatively narrow window of broad public support for the Fed to tighten monetary policy. The window opened after inflation was widely recognized as the major concern and closed when tighter monetary policy caused the unemployment rate to begin to rise. Often the Fed did not take full advantage of a window of opportunity to raise short rates, because it wanted more confirmation that higher short-term rates were required.

Fourth, it was probably easier for the Fed to maintain public support for fighting inflation with prolonged rather than preemptive tightening. A more gradual lowering of interest rates in the

later stage of a recession was a less visible means of fighting inflation than raising rates more sharply earlier. Once unemployment peaked and began to fall, the public's anxiety about it diminished. Prolonged tightening was attractive as an inflation-fighting measure in spite of the fact that it probably lengthened the "stop" phase of the policy cycle.

Over time, deliberately expansionary monetary policy in the "go" phase of the policy cycle came to be anticipated by workers and firms. Workers learned to take advantage of tight labor markets to make higher wage demands, and firms took advantage of tight product markets to pass along higher costs in higher prices. Increasingly aggressive wage- and price-setting behavior tended to neutralize the favorable employment effects of expansionary policy. And the Fed became evermore expansionary on average in its pursuit of low unemployment, causing correspondingly higher inflation and inflation expectations. Lenders demanded unprecedented inflation premia in long-term bond rates. And the absence of a long-run anchor for inflation caused inflation expectations and long bond rates to fluctuate widely.⁵

The breakdown in mutual understanding between the markets and the Fed greatly inhibited the conduct of monetary policy. The result of an interest rate policy action is largely determined by its effect on real interest rates, i.e., nominal rates minus expected inflation. And the Fed found it increasingly difficult to estimate the public's inflation expectations and to predict how its policy actions might influence those expectations. Compounding the problem, enormous increases in short-term rates were required by the early 1980s to stabilize the economy. Stabilization policy became more difficult because the public could not predict what a given policy action implied for the future, and consequently, the Fed could not predict how the economy would respond to its policy actions.

⁵ The monthly average 30-year bond rate rose from around 8 percent in early 1978 to peak above 14 percent in the fall of 1981. The long bond rate was near 13 percent as late as the summer of 1984.

Monetary policy became a source of instability and wound up worsening both unemployment and inflation. Taylor (1979) documents the inefficient variability of inflation and unemployment during the Great Inflation period marked by go-stop monetary policy relative to his econometrically estimated efficient policy frontier. Eventually, the Volcker Fed recognized that it would be better to reverse its priorities and justify its actions to stimulate employment against a commitment to low inflation. The reversal of priorities during the Volcker disinflation in the early 1980s enabled monetary policy subsequently to reduce the level and variability of both inflation and unemployment. The Greenspan Fed demonstrated that the benchmark Taylor (1993) interest rate policy rule could sustain price stability against inflation and deflation while sustaining low unemployment. And the public came to regard interest rate policy actions as acceptable and necessary to sustain low inflation and the lowest unemployment that monetary policy alone can deliver.

A milestone was reached in January 2012, when the Bernanke Fed formally adopted an explicit 2 percent inflation objective.⁶ In so doing, the Fed recognized explicitly that independent monetary policy needs the discipline of a priority for price stability to offset the tendency to drift otherwise into destabilizing inflationary go-stop policy cycles.

3) A CENTURY OF EXPANSIVE FED CREDIT POLICY

The constraints on the Federal Reserve's lending powers were loosened gradually over time.⁷ The original Federal Reserve Act of 1913 authorized the Fed to extend credit only to member banks of the Federal Reserve System. Lending to other entities was not permitted at all until 1932, when Section 13 (3) gave the Fed the authority to lend to "individuals, partnerships, and corporations" in "unusual and exigent circumstances" as determined by the vote of at least five

⁶ See "Statement on Longer-Run Goals and Monetary Policy Strategy" in Minutes of the FOMC Meeting of January 24, 2012, pp. 7-8.

⁷ Hackley (1973).

members of the Board of Governors. However, Fed credit extended to nonbanks in the 1930s was relatively insignificant because collateral requirements in 13 (3) were highly restrictive even after being relaxed by a 1935 amendment. Instead, Congress established the Reconstruction Finance Corporation to allocate credit widely to nonbank entities.⁸ Apparently, Congress was then uncomfortable expanding the credit policy powers of the independent central bank.

Nevertheless, the Fed exhibited a tendency on its own to expand the scope of last resort lending to depositories beyond short-term liquidity assistance, especially whenever the Fed worried that not doing so threatened a financial crisis. For instance, the Fed encouraged depositories in 1970 to borrow from the Fed discount window to support the commercial paper market in the wake of the Penn Central bankruptcy.⁹ In 1974, Fed lending supported the insolvent Franklin National Bank until it could be purchased by a group of investors. Similarly, Fed lending from May 1984 to February 1985 supported the undeclared insolvency of Continental Illinois Bank until it was resolved.¹⁰

The Federal Reserve's lending reach was expanded significantly when the Depository Institutions Deregulation and Monetary Control Act of 1980 gave all depositories access to the Fed discount window, whether or not they were members of the Federal Reserve System. By the end of the decade Schwartz (1992, p. 68) observed:

“...By the 1980s hundreds of banks rated by regulators as having a high probability of failure in the near term and which ultimately failed were receiving extended accommodation at the discount window...[t]he change in discount window practices, by delaying closure of failed institutions, increased the losses the FDIC and ultimately taxpayers bore.”

Motivated by the above record, in the aftermath of the Savings and Loan crisis the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) contained provisions intended to limit

⁸ See Jones and Angly (1951).

⁹ Calomiris (1993).

¹⁰ Schwartz (1992), pp. 62-4.

Fed lending to undercapitalized banks. Unfortunately, the effectiveness of the law would be compromised because capitalization was measured largely on book rather than market valuation.¹¹

The Fed made few loans to non-depositories under 13 (3) after the 1935 amendment took effect in 1936. But following the 1987 stock market crash policymakers were persuaded to relax restrictions on Fed lending to nonbank financial firms. And Section 473 of FDICIA amended the Federal Reserve Act so that the only collateral test remaining under 13 (3) was “satisfactory security,” the same test that applied to borrowings of depository institutions.¹² Alan Greenspan (2010, p. 17) has written that in 1991

“...at the urging of the Federal Reserve Board of Governors, Section 13 (3) of the Federal Reserve Act was considered, and amended by Congress. The section grant[ed] virtually unlimited authority to the Board to lend in “unusual and exigent circumstances.”

Ironically, although FDICIA is better known for a compromised attempt to restrict Fed lending to insolvent depositories, FDICIA actually expanded the Fed’s lending powers well beyond depositories.

Since then, financial innovation and regulatory arbitrage of minimum capital requirements have fueled a huge expansion of securitization and structured finance of longer-term illiquid cash flows for funding in money markets via shadow banking.¹³ By 2007, money markets accounted for a share of financial intermediation that rivaled depository intermediation in scale. Importantly, potential Fed lending in support of money markets was not accompanied by Fed supervision and regulation as it was for depositories with access to the Fed discount window. The fact that money markets could expect support from expansive Fed credit policy in a crisis directly, or indirectly via lending to depositories, probably encouraged the vast expansion of money market finance.

¹¹ The Fed’s lending to insolvent banks is discussed in Clouse (1994) and Schwartz (1992). Goodfriend (1994), p. 574 proposes a Fed-Treasury “Accord” so that Fed lending does not keep insolvent banks open at taxpayer expense.

¹² Todd (1993), p. 20.

¹³ Goodfriend (2011b).

In the 2007-8 credit turmoil the Fed was put in an untenable position given its wide powers to lend—disappoint expectations of accommodation and risk a systemic financial collapse, or lend expansively and feed expectations of even more expansive lending. Fed last resort lending again exhibited the tendency evident earlier to expand its lending reach in time of crisis, this time in an unprecedented enormous increase in reach, scale, maturity, and eligible collateral.¹⁴ Unbridled last resort lending drew the Fed into a massive expansion of credit “with the implied promise of similar actions in times of future turmoil.”¹⁵

The problem confronting independent Fed credit policy is this: last resort lending has the capacity to create ever-greater boom and bust cycles in banking and money markets while simultaneously undermining the Fed’s independent legitimacy within government.

4) HOW FED CREDIT POLICY WORKED IN THE 2007-09 TURMOIL

During the 2007-09 credit turmoil Fed credit policy worked initially and successfully on a massive scale to re-intermediate banking and money markets by selling Treasuries to entities no longer willing to lend in money markets (including in interbank markets) and lending the proceeds to depositories no longer able to borrow at reasonable rates in money markets, in part, so depositories could refinance their money market clients. By April 2009, the Fed had grown its balance sheet from around \$900 billion to over \$2 trillion, lending to depositories, to foreign central banks, to a variety of money market credit facilities, and to special purpose entities formed to rescue specific firms such as Bear Stearns and AIG. These Fed credit policy initiatives were then financed with around \$250 billion sales of Treasury securities, around \$300 billion of funds deposited in the Federal Reserve banks by the Treasury Department, and about \$800 billion of bank reserves created by the Fed. Amazingly, prior to the crisis the Fed had supplied only \$10 to \$20 billion of aggregate reserves to the banking system.

¹⁴ See Goodfriend (2011a), and Goodfriend and Lacker (1999), pp. 14-15.

¹⁵ The quote is from Volcker (2008), page 2.

The combination of Fed credit and monetary powers were well-suited to addressing the financial crisis in fall 2008. The Fed made the most of its independence to employ credit and monetary policies on an unimaginable scale. By spring 2009 financial markets were stabilized and the Fed balance sheet was stabilized as well. Unfortunately, there is another side of this story: the Fed's very independence, the ambiguous boundary of expansive Fed credit policy itself, would exacerbate the financial panic in September 2008 that would produce the Great Recession.

5) HOW FED CREDIT POLICY EXACERBATED THE GREAT RECESSION¹⁶

In March 2008 the Fed created and funded a special purpose entity, Maiden Lane LLC, for the purpose of acquiring risky mortgage obligations, derivatives, and hedging products from Bear Stearns to facilitate the acquisition of Bear by JPMC. Maiden Lane was funded by a \$29 billion Fed loan and a \$1 billion first-loss loan by JPMC. In effect, the Fed purchased the assets in Maiden Lane, with funds from the sale of Treasuries from the Fed portfolio. Since the Fed would have returned to the Treasury interest on the Treasuries it held, the Fed's credit policy support of Maiden Lane amounted to a "debt-financed fiscal policy purchase of pool of risky private financial assets." The Fed acknowledged the loan as fiscal policy by June 2008. Maiden Lane was brought on to the Fed's balance sheet, and the Treasury accepted responsibility for any loss.

Meanwhile, in an April speech to the Economics Club of New York Paul Volcker described the Fed as acting at the "very edge of its lawful and implied powers." In retrospect, Volcker's remarks can be seen as a "life preserver" to help the Fed persuade Congress to make resources available, if need be, to stabilize the financial markets. Instead the fiscal authorities were not then so involved. And the Fed remained exposed to having its balance sheet utilized as an "off budget" arm of fiscal policy without formal authorization from Congress.

¹⁶ This section comes from Goodfriend (2011a), pp. 5-7.

Fed credit policy cannot be the front line of fiscal support for the financial system. A Fed credit policy decision that commits substantial taxpayer resources in support of the financial system or one that denies taxpayer resources is inherently a highly-charged, political, fiscal policy matter. Initiatives that extend the Fed's credit reach in scale, maturity, and eligible collateral to unsupervised or potentially insolvent institutions inevitably carry credit risk, excite questions of fairness, and potentially threaten conflict between the Fed and the fiscal authorities—with the potential to destabilize financial markets and employment. Worse, an ambiguous boundary of expansive Fed credit policy creates expectations of Fed accommodation in financial crises, which blunt the incentive of private entities to take preventive measures beforehand to shrink their counterparty risk and reliance on short-term finance, and build up financial capital. Events surrounding the Fed's rescue of AIG in fall 2008 illustrate the problem.

On September 7th the GSEs failed and were taken into conservatorship by the U.S. government. On September 15th Lehman failed. On September 16th the Fed chose to lend \$85 billion on equity collateral to rescue AIG; this, in order to make AIG's counterparties whole rather than risk world-wide financial collapse. At that point the Fed had no good options left. The politics were such that even prominent members of Congress criticized the Fed's credit policy overreach as a questionable commitment of taxpayer funds. Chairman Bernanke replied on September 17th that the Fed was stretched to the limit and could do no more, and that the time had come for Congress to appropriate financial resources to stabilize the financial system or risk a severe contraction if not another Great Depression. The U.S. government appeared paralyzed. A run on money market funds on September 17th abated only after the U.S. Treasury made an extraordinary offer on September 19th to guarantee money market mutual fund assets for a year, apparently with backing from the Exchange Stabilization Fund which did not need a Congressional appropriation. The run on money market funds was contained. Congress rejected TARP on September 29th and the DOW dropped

7%. The \$700 billion TARP was passed and became law on October 3rd. Equity markets were down over 30% in month to October 10th. Most telling, high-yield spreads over Treasuries jumped to 16 percentage points and remained elevated for months well above the prior 6 percentage-point spread peak reached since the turmoil began in mid-2007.

The public was frightened by the tumult in financial markets, and by the political recriminations, government paralysis, the extraordinary rescue or demise of a variety of financial institutions, and talk of another Great Recession. The household saving rate jumped sharply by around 5 percentage points, and the collapse in aggregate demand pushed the unemployment rate up sharply to around 10 %. The chaos transformed the relatively mild recession that began in December 2007 into The Great Recession.

The lesson is that unalloyed flexibility of Fed credit policy, unconstrained by rules or boundaries is counterproductive for the stabilization of financial markets and employment. Congress in its oversight role should clarify the boundary of the Fed's responsibilities for taking expansive credit actions and correspondingly restrict its independence in doing so.

The 2010 Dodd-Frank Act recognizes the problem and requires Fed lending extended beyond depositories to be approved by the Treasury Secretary and to be part of a broad program not directed to any particular borrower. The Dodd-Frank requirements do not address the problem adequately, however, because the Administration is no more authorized to commit taxpayer resources than the independent central bank—only Congress can do so. And the Treasury is as likely as the Fed to favor expansive credit policy in a financial crisis rather than risk immediate financial collapse.

6) THE FED LACKS AN INCENTIVE TO FOLLOW BAGEHOT'S RULE¹⁷

Fed last resort lending is widely regarded as a natural extension of 19th century last resort lending rule for the Bank of England famously encouraged by Walter Bagehot (1873). However, the Fed and the 19th century Bank of England have pursued their last resort lending powers very differently as a result of their governance. When Bagehot urged the Bank of England to lend in a banking crisis against good collateral at a penalty rate, he needn't say more. Bagehot's problem was to encourage the Bank to pre-announce the lending policy that it would follow in a banking crisis once the U.K. Treasury temporarily suspended the gold reserve requirement against its paper banknotes. Bagehot could be sure that the Bank would lend at a profitable penalty rate, since the Bank was a private, profit-maximizing institution whose shareholders earned the profit and bore the risk of loss. Likewise, Bagehot could be sure that the Bank would lend against good collateral so as not to take on credit risk. Bagehot needn't be concerned that last resort lending could subsidize and distort credit flows. There was no need, since it was the monetary features of last resort lending (the elastic provision of banknotes) at a modestly elevated interest rate ceiling that mattered for stabilizing banking and financial markets.

The problem with regard to Fed last resort lending today is just the opposite—it is to limit the Fed's lending reach. The independent Fed is inclined to lend rather than risk a panic by not lending, even if forced to take relatively poor collateral at inordinately low interest, because its own funds are not at stake—the fiscal authorities receive net Fed income after operating expenses and taxpayers bear any Fed losses. Moreover, the Fed puts taxpayers at risk even if it protects itself by taking good collateral. As pointed out in Section 1, if the entity to which the Fed lends fails with a Fed loan outstanding, the Fed takes collateral at the expense of taxpayers exposed to losses from

¹⁷ This section follows Goodfriend (2012), page 48.

back-stopping the deposit insurance fund, or from other government financial guarantees. The set-up facilitates lending laxity and moral hazard.

Since the credit turmoil of 2007-8, the Fed has employed expansive credit policy initiatives for purposes beyond boundaries ordinarily regarded as legitimate for an independent central bank. Whether justified by the need to act in a timely manner, or by the need to act in lieu of paralyzed fiscal authorities, expansive credit policy initiatives that reach beyond such boundaries rightly draw scrutiny, in part because they necessarily favor one sector or another. Expansive credit initiatives undermine the Fed's legitimacy and potentially its capacity to pursue stabilization policy effectively. Moreover, expansive independent credit policy that bypasses the legislative process for whatever reason creates complexity and opacity that favors insiders and weakens the public's confidence in government and the rule of law.

7) FED CREDIT POLICY SHOULD BE CIRCUMSCRIBED TIGHTLY

Flexibility and decisiveness are essential for effective central banking. Independence enables a central bank to react promptly to macroeconomic or financial shocks without the approval of the Treasury or the legislature. Central bank initiatives must be regarded as legitimate by the legislature and the public, otherwise such initiatives will lack credibility essential for their effectiveness. The problem is to identify the limits of independence on monetary policy and credit policy to preserve a workable, sustainable division of responsibilities between the central bank and the fiscal authorities—the legislature and the Treasury.

The 1951 Accord between the Treasury and the Fed was one of the most dramatic events in U.S. financial history. The Accord ended an arrangement dating from World War II in which the Fed agreed to use its monetary policy powers to keep interest rates low to help finance the war effort. The Truman administration urged an extension of the agreement to keep interest rates low in order to hold down the cost of the huge Federal government debt accumulated during the war. Fed

officials argued that keeping interest rates low would require inflationary money growth that would destabilize the economy and ultimately fail.¹⁸ The Accord famously reasserted the principle of Fed independence so that monetary policy might serve exclusively to stabilize inflation and the macroeconomic activity.

Congress early on recognized that the Fed needed financial independence in order to conduct monetary policy effectively. The Fed is exempted from the congressional appropriations process in order to keep the political system from abusing its money-creating powers. The Fed finances its operations from interest earnings on its portfolio of securities. The Fed was given wide latitude regarding the size and composition of its balance sheet so it could react promptly, decisively, and independently to economic and financial conditions. In the early 1980s under the strong, independent leadership of Paul Volcker the Fed succeeded in establishing low inflation as the nominal anchor for monetary policy. Thus, Fed independence is today the institutional foundation for effective monetary policy.

The Fed has long executed credit policy in addition to monetary policy as “lender of last resort” to depository institutions. Credit policy is also subject to misuse for fiscal policy purposes. However, as long as Fed lending was relatively modest, temporary, and confined to depository institutions deemed solvent, and the Fed took good collateral against its loans, the potential for fiscal misuse was limited. Although the Fed has long needed an accord for credit policy, the lack of one was not a particularly pressing matter.¹⁹

The enormous expansion of Fed credit in the 2007-09 turmoil—lending beyond depository institutions and acquiring non-Treasury securities—demands an accord for Fed credit policy to supplement the accord on monetary policy. A credit accord should set guidelines for Fed credit policy so that pressure to misuse Fed credit policy for fiscal purposes does not undermine the Fed’s

¹⁸ See Hetzel (2001), Meltzer (2003), and Stein (1969).

¹⁹ Goodfriend (1994) and Schwartz (1992).

independence and impair the central bank's power to stabilize financial markets, inflation, and macroeconomic activity.

Congress bestowed independence on the Fed only because it is essential for the Fed to do its job effectively.²⁰ A healthy democracy requires full public disclosure and discussion of the expenditure of public funds. The congressional appropriations process enables Congress to evaluate competing budgetary programs and to establish priorities for the allocation of public resources. Hence, the Fed—precisely because it is exempted from the appropriations process—should avoid, to the fullest extent possible, taking actions that can properly be regarded as within the province of fiscal policy and the fiscal authorities.

As pointed out in Section 1, when the Fed purchases Treasury securities it transfers all the revenue from monetary policy to the fiscal authorities and hence does not infringe on their fiscal policy prerogatives. Monetary policy with the help of interest on reserves respects the integrity of fiscal policy fully.

Fed credit policy is another matter entirely, because all financial securities other than Treasuries or their equivalent carry some credit risk and all lending involves the Fed in potentially controversial disputes regarding credit allocation. It is important to appreciate the difficulties to which the Fed exposes itself in the pursuit of credit policy initiatives that go beyond ordinary last resort lending to solvent depository institutions. The Fed must decide how widely to expand its lending reach. Lending farther afield creates “an implied promise of similar actions in times of future turmoil,” as Volcker put it, which the Fed may then be inclined to accommodate.²¹ Fed presence in one credit market can drain lending from nearby credit channels and prompt calls for

²⁰ The following paragraphs draw on Broaddus and Goodfriend (2001).

²¹ See Volcker (2008), page 2, and the discussion of the “limited commitment” problem in Goodfriend and Lacker (1999).

support in neighboring credit classes. The Fed must determine the relative pricing of its loans based on risk and collateral. The Fed must be accountable for its credit allocations and the returns or losses on its loans or security purchases. The public deserves transparency on Fed credit extensions beyond ordinary lending to solvent depository institutions. Yet, congressional oversight opens the door to political interference in the Fed's lending or non-Treasury acquisitions. Broadly speaking, the Fed is exposed to pressure to exploit the central bank's off-budget status to circumvent the appropriations process.

Moreover, the Fed and the fiscal authorities must cooperate on banking, financial, and payments system policy matters. This interdependence exposes the Fed to political pressure to make undesirable concessions with respect to its credit policy initiatives in return for support on other matters. Worse, the Fed could be pressured to make concessions on monetary policy to deflect pressure regarding credit policy.

8) RECOMMENDED PRINCIPLES FOR A FED-TREASURY CREDIT ACCORD²²

By its very nature credit policy has the potential to create friction between the independent central bank and the fiscal authorities. That friction is evident in the tense relationship between the Fed and Congress in the aftermath of the credit turmoil. The problem is that credit policy undoes "Treasury only" so to speak, and uses some of the revenue from monetary policy to acquire non-Treasury assets without the authorization of the fiscal authorities. Unlike monetary policy, credit policy directs public funds to specific borrowers, and necessarily favors one class of creditors or one sector of the economy over another.

Even the Fed acquisition of government agency debt or securities packaged by government agencies is problematic. Except in rare cases when Congress has granted "full faith and credit"

²² On March 23, 2008 the Treasury and the Fed issued a joint statement on monetary and credit policy. The statement had much to recommend it: nevertheless, it did not provide a set of principles that could serve comprehensively to clarify the boundary of responsibilities between the Treasury and the Fed. Goodfriend (2011a), page 8.

backing to government agency debt or securities packaged by government agencies, acquisition of such securities by the Fed has allocative consequences because it steers credit in a particular direction and confers an implied preferential status enhancing that agency's creditworthiness.

Fed credit policy must be circumscribed with clear, coherent boundaries.²³ One could deny credit policy powers to the Fed altogether by requiring it to pursue a "Treasury only" asset acquisition policy. But Fed credit policy was useful in the recent turmoil and last resort lending to temporarily illiquid but solvent depositories has long been a valued part of independent central banking.²⁴ Moreover, conventional last resort lending is reasonably compatible with Fed independence. Last resort lending to supervised, solvent depositories, on a short-term basis, against good collateral provides multiple layers of protection against ex post losses and ex ante distortions. So the fiscal policy consequences of conventional last resort lending are likely to be minimal, and the scope for conflict with the fiscal authorities small.

On the other hand, expansive Fed credit initiatives—those that extend a central bank's credit reach in scale, maturity, and collateral to unsupervised non-depository institutions and the purchase of non-Treasury securities—inevitably carry substantial credit risk and have significant allocative consequences. Expansive Fed credit initiatives infringe significantly on the fiscal policy prerogatives of the Treasury and Congress and properly draw the scrutiny of the fiscal authorities. Hence, expansive credit initiatives jeopardize central bank independence and should be circumscribed by agreement between the fiscal authorities and the central bank.

Furthermore, an ambiguous boundary of expansive Fed credit policy creates expectations of accommodation in financial crises which blunt the incentive of private entities to take preventive measures beforehand to shrink their counterparty risk and their reliance on short-term finance.

²³ Friedman (1962), pp. 232-4.

²⁴ Goodfriend and King (1988) and Schwartz (1992) explain that the Fed can usually exercise its lender of last resort responsibilities solely through open market operations, against Treasury securities without the need to lend to individual institutions through the discount window.

Moreover, an ambiguous Fed credit reach blunts the incentive of the fiscal authorities to prepare procedures by which fiscal policy could act systematically and productively in times of financial turmoil. The chaotic, reluctant involvement of Congress in the fall 2008 crisis contributed enormously to the financial panic and intensified the Great Recession.

Such reasoning suggests the following three principles as the basis for a Fed-Treasury Credit Accord. To reiterate, Congress bestows Fed independence only because it is necessary for the Fed to do its job effectively. Hence, the Fed should perform only those functions that must be carried out by an independent central bank. The problem is to identify the limits of independence on credit policy to preserve a workable, sustainable division of responsibilities between the central bank and the fiscal authorities—the legislature and the Treasury.

Principle 1: As a long run matter, a significant, sustained departure from a “Treasuries only” asset acquisition policy is incompatible with Fed independence.

Principle 2: The Fed should adhere to “Treasuries only” except for occasional, temporary, well-collateralized ordinary last resort lending to solvent, supervised depository institutions.

Principle 3: Fed credit initiatives beyond ordinary last resort lending should be undertaken only with prior agreement of the fiscal authorities, and only as bridge loans accompanied by take-outs arranged and guaranteed in advance by the fiscal authorities.

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