Expansion of Federal Reserve Authority in the Recent Financial Crisis Raises Questions about Governance

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Several years before the onset of the recent financial crisis, ex-Board Member Lawrence Meyer wrote in his memoir, *A Term at the Fed*, that the Fed “is often called the most powerful institution in America.” Its “key decisions are made by nineteen people–whose names are known [by few] . . . meeting regularly behind closed doors.” The recent expansion of the Fed’s power and influence underscore the concerns Meyer’s words portend. In a Levy Economics Institute working paper, “The Impact of Financial Reform on Federal Reserve Autonomy,” I examine the origin and nature of Fed authority and independence. The paper reviews the impact of the Dodd-Frank Act of 2010 and concludes that the new constraints are modest at best. The Fed’s continued expansion inexorably raises questions about its governance.

In the 19th century, European central banks operated within the confines of the gold standard, managed interest rates to protect reserves, and, generally, conducted their affairs without concern for individuals or businesses (except their own). When needed, central banks acted as lenders of last resort. The founders of the Fed saw these central banks as an excessive concentration of private power. Thus, they organized the Fed as a decentralized banking – government joint venture, reined in by internal checks and balances. They crafted an institution that would largely be limited to preventing panics through monetary measures, and improving the supervision and regulation of banks, and the payments system.

The Fed began to exercise stabilization policies about a decade after it was established. Benjamin Strong, then governor of the New York Reserve Bank, immediately recognized the need to insulate the Fed from political pressure and gave voice to a perspective long embraced by Fed officials and others: in Strong’s view, the “natural inclination” of any administration is to “make business good.” Invariably, he wrote, the key to that is “the Federal Reserve . . . cheap money, abundant credit, [and] . . . rising prices.” General acceptance of Fed “independence” from political pressure in the monetary sphere has, over the years, been paralleled by the need for independence in the regulatory area.

Dodd-Frank both extended the Fed’s authority and imposed new constraints. The legislation retains the Fed as the sole supervisor of bank holding companies, a group that includes the largest and most “systemically important” financial companies in the country. It extends the Fed’s responsibilities to systemically important nonbank financial companies, and savings-and-loan holding companies. However, it also establishes a new Financial Stability Oversight Council (FSOC), chaired by the Treasury, to identify, monitor, and address systemic threats. The FSOC constitutes a check on Fed autonomy. The effectiveness of this check is, however, uncertain.

The Fed’s role as supervisor of systemically important financial institutions will, however, continue to provide it with unique access to “hands-on” information. Given its monetary authority, resources, and research facilities, the Fed remains in a position to dominate the process of assessing risk and formulating remedies.

Dodd-Frank also limits Fed credit extensions to nonbanks in exigent circumstances. It modifies the selection of Reserve Bank presidents and the standards for approving mergers. In extending credit to nonbanks, it does not permit the Fed to target specific companies, as it did with AIG in the recent crisis. It does permit the extension of credit within a “broad-based” program, albeit with Treasury approval. However, this is a weak constraint. The Fed could circumvent this limitation by organizing private consortiums, as it did for Long-Term Capital Management in 1998. “Circumvention” may be the wrong word, as the executive branch has been as least as determined as the Fed to extend credit to nonbanks in the face of a systemic threat.

From the beginning, Reserve Bank presidents have been selected by the nine directors at each Reserve Bank—three Class A directors (bankers elected and created by member banks), three Class B directors (nonbankers elected by member banks), and three Class C directors (appointed by the Board). Wary of bank influence, Dodd-Frank excludes Class A directors. The new voting scheme appears to shift power to the Board (which now selects half the directors choosing a president). However, since 1935 the appointment of presidents has been subject to Board approval; anecdotal information suggests that the Board has not been hesitant to exercise this authority in the past. Thus, the new voting restriction seems redundant.

Dodd-Frank establishes a new merger restriction aimed at limiting Board approvals of large bank combinations of the sort that augmented and created “too-big-to-fail” banks. In reviewing merger proposals, the Board must now consider the risk posed to the stability of the financial system. The addition of a “systemic risk” factor is, at best, a modest constraint, and one that does not substantially limit the Fed’s discretion. As Board Member Daniel K. Tarullo explains, the Board adds “systemic risk to the list of adverse effects” and then determines whether the benefits “outweigh these adverse effects.”

On the monetary side, the Fed’s power has expanded in recent years. Its new credit programs and innovations have enlarged its portfolio to unprecedented levels. Its new policy tools include interest payments on reserves and “forward guidance.” The magnification of Fed influence throughout the economy is obvious, revealed in its monetary and regulatory initiatives that unevenly impact savers, spenders, creditors, debtors, and financial institutions.

Continued growth and expanding influence raise anew the question of how this enormously powerful institution should be organized and governed. Should its key decisions be made by 19 appointed officials semi-insulated from political pressure and meeting regularly behind closed doors? Or is there a better way?

A more detailed discussion of these issues can be found at www.levyinstitute.org/publications/?docid=1615.

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