

# The Role of the U.S. Federal Reserve

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## Introduction

The role of the U.S. Federal Reserve has expanded and come under increasing scrutiny in the wake of the 2007-2009 global financial crisis. Its policy of keeping interest rates low during the early 2000s, which resulted in cheaper mortgages, is cited by many economists as a major factor that raised housing prices, although some dispute this. More recently, the Fed has been questioned for its large-scale intervention in the bond markets, including three rounds of quantitative easing that helped sustain the recovery but transformed the Fed into an investment vehicle with the power to create money. The Fed's assets have surged to more than \$3.5 trillion in August 2013 from \$869 billion in August 2007. Partisan gridlock in Washington, which has prevented further fiscal stimulus legislation, has forced the Fed to take on a greater policy role in maintaining a fragile economic recovery.

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### The Fed's Dual Mandate

Following a series of financial panics and banking runs, Congress passed—and President Woodrow Wilson signed into law—the 1913 Federal Reserve Act. The law created the Federal Reserve System, comprising twelve public-private regional federal reserve banks. Today, the Fed is tasked with managing U.S. monetary policy, regulating bank holding companies and other member banks, and monitoring systemic risk. The seat of power of the central bank is situated in the Washington, DC-based seven-member Board of Governors, currently headed by Chairman Ben Bernanke. Each member is appointed by the president and subject to confirmation by the Senate. The members of the Board of Governors are part of a larger board that includes five of the regional bank presidents, known as the Federal Open Market Committee (FOMC), which is responsible for determining interest rates and purchasing U.S. treasuries.

Historically, the Fed's monetary policy was governed by a "dual mandate" to maintain stable prices and full employment. The Fed's main method for achieving those goals has been to vary its federal funds target by altering its purchases and sales of U.S. treasuries and federal agency securities. The current benchmark by which many economists judge the aptness of Fed policy is the so-called Taylor's rule. Developed by Stanford economist John Taylor, the formula stipulates that interest rates should be raised when inflation or employment rates are high, and lowered under the opposite conditions.



The Federal Reserve building. (Photo: Larry Downing/Courtesy Reuters)

The Gramm-Leach-Bliley Act of 1999 legalized the merger of securities, insurance, and banking institutions—essentially allowing for the joining of retail and investment banking operations—that were formerly separated under the 1933 Glass-Steagall Banking Act. It also gave the Fed the authority to determine appropriate financial activities within bank holding companies and member banks. The law made the Fed responsible for ensuring banks' soundness by enforcing regulations such as minimum capital requirements, banking consumer protections, antitrust laws, and prevention of money laundering.

### **The Chairman**

Few officials in Washington enjoy the power and autonomy of the Fed's chairman. Analysts and investors hang on his every word, and markets instantly react to the faintest clues on interest rate policy. The unelected chairman is not directly accountable to voters, and the Fed, which sends tens of billions of dollars in profits to the Treasury each year, is largely free from the whims of Congress and is not subject to the appropriations process.

The Fed is effectively controlled by its chairman, who acts as a spokesman for the central bank, negotiates with Congress and the president of the United States, and controls the agenda of the board and FOMC meetings. This level of power makes the appointment of chairman or chairwoman one of the president's most important decisions.

In 2013, President Barack Obama was presented with the opportunity to name a new chair for the Fed, marking the first time since 1979 that a Democratic president will choose the overseer

of U.S. monetary policy. Candidates included the nation's top economists who previously served in government or the Fed's various boards and research units, and was whittled down to two choices: Janet Yellen, the Fed's current vice chair, and Lawrence Summers, a former Treasury secretary. Both Yellen and Summers have argued for the need of regulation to protect people from financial abuses and have backed interventions into the markets when needed. They are expected to make use of new Fed powers to rein in excessive risk in the financial services industry.

### **Dodd-Frank: A New Mandate**



Excessive risk-taking by an undercapitalized banking system triggered the global financial crisis in 2008, and it became clear in the aftermath that a new set of regulations was necessary. The Dodd-Frank Act grew out of a need to "address this increasing propensity of the financial sector to put the entire system at risk and eventually to be bailed out at taxpayer expense," said a 2011 report by New York University's Stern School of Business.

Dodd-Frank instituted a third official mandate for the Fed, empowering it to regulate systemic risk and preserve financial stability. The Fed is now required to present its findings on risky, non-bank financial firms to the Financial Stability Oversight Council, which instructs the Fed on how to sanction those institutions.

"The Fed has a great deal more responsibility," says Professor Thomas Cooley of New York University's Stern School of Business. "It is the primary watchdog for identifying systemically risky institutions of all types, including shadow banking institutions [such as hedge funds]," he explains.

Professor Darrell Duffie of Stanford University thinks that Dodd-Frank is a "step forward" for financial stability, but does not go far enough. Regulating authority, Duffie argues, should be more centralized in the Fed. "It should be the same agency writing the check [to bail out a given financial institution] that is responsible for oversight," Duffie says, referring to the central bank's role as a "lender of last resort."

### **Holes in the System: Origins of 'Systemic Risk'**

Experts have sought to identify the key drivers of so-called "systemic risk," or the financial interdependencies that allowed a seemingly limited subprime mortgage crisis to culminate in widespread panic in the United States and abroad, as well as the failure of some of the country's most prominent financial institutions. Some critics of Fed policy partially blame the institution, especially its decision to keep the federal funds rate at 1 percent from 2003 to early 2005, which allowed for significant credit expansion.

In the 2009 book *The Road Ahead for the Fed*, Carnegie Mellon's Allan Meltzer writes that, judging by the Taylor's rule guidelines on setting interest rates, former chairman Alan Greenspan's Fed policy was too expansive, considering that short-term interest rates remained negative as the economy continued to grow. Greenspan attributed this policy to his belief that the U.S. economy faced a risk of deflation (a decline in prices due to a tightening supply of credit) similar to Japan's experience in the 1990s.

Other experts point to the 1999 repeal of the Glass-Steagall Act—which led to an escalation in the number of non-bank institutions responsible for issuing credit—as a catalyst for increased systemic risk. The share of credit extended by banks in the United States dropped from 60 percent half a century ago to 20 percent in 2009. Mauro Guillén, professor of management at University of Pennsylvania's Wharton School of Business, says the repeal of Glass-Steagall was part of a regulatory "race to the bottom" between Britain and the United States in the 1980s and 1990s as they competed to woo financial firms.

Federal Reserve Chairman Ben Bernanke has also cited lax government regulation and gaps in oversight as causes of the crisis. In a March 2009 speech at the Council on Foreign Relations, Bernanke said, "The risk management systems of the private sector and government oversight of the financial sector in the United States and some other industrial countries failed to ensure that the inrush of capital was prudently invested, a failure that has led to a powerful reversal in investor sentiment and a seizing up of credit markets."

### **Competing Objectives**

Now that the Fed has been charged with overseeing systemic risk, experts question how it can best respond to systemic threats while fulfilling its original "dual mandate." Some argue that managing monetary policy and systemic risk presents the Fed with a conflict that could ultimately undermine price stability.

Professor Charles Calomiris of the Columbia University Graduate School of Business says to successfully implement these varying objectives, monetary policy (the "dual mandate") must be kept separate from macroprudential regulation (maintaining financial stability). Dodd-Frank, Calomiris argues, does not do enough to outline rules to this end. "It doesn't provide any guidelines for what macroprudential regulation is," he says. The law is "sympathetic" to the creation of a macroprudential authority, but not "specific."

Stanford's Duffie says the additional Fed mandate has made the central bank not just the "lender of last resort," but an "asset manager of last resort." In short, Duffie explains, the mandate of financial stability means the Fed wants to ensure that it does not lose a lot of money, no matter whether it is in the best interest of monetary stability. But, Duffie argues, this conflict of interest is "outweighed by the benefits of coordinated responsibility."

### **Quantitative Easing**

Some of the fiercest criticism of the Fed came after its November 2010 announcement that it would buy \$600 billion in long-term Treasury bonds to stimulate a struggling economy. The Fed hoped that this second round of so-called quantitative easing, or QE2—the first was implemented

at the end of 2008 during the height of the crisis—would lower long-term interest rates, increase investment, and boost job growth. Twenty-three conservative economists wrote a letter to the Fed criticizing the plan for potentially stoking inflationary pressures, weakening the dollar, and failing to alter the jobless rate. QE2 wrapped up in June 2011. But following the S&P downgrade of U.S. debt in early August 2011, subsequent global market volatility, and fears of another recession, many investors have looked to the Fed to implement a third round of bond buying in the absence of any coherent fiscal policy by legislators, and indeed, it launched a new, open-ended quantitative easing program in September 2012.

The concept behind quantitative easing is to create more resources for the financial system, making banks freer to lend and the public more apt to borrow, says NYU's Cooley. Traditional tools used by the Fed such as open market operations and changing the discount rate or reserve requirements were no longer effective when interest rates hovered around zero, so for the QE programs, the Fed creates money at no cost and uses the funding to buy Treasury bills and mortgage-backed securities.

Many economists are concerned that credit will remain tight as long as there isn't enough demand to borrow. The Fed should continue to hold interest rates down, Cooley says, but additional rounds of QE won't help the economy: "Monetary policy can't solve economic problems." Nor, he says, reflecting the view of a number of economists, can it facilitate innovation or generate growth.

Unconventional monetary policies, as quantitative easing and other central bank investments are called, were deemed "largely successful at achieving their domestic goals, and were especially effective at the time of greatest financial turmoil," according to an April 2013 report by the International Monetary Fund. Intervention stemmed the losses for volatile assets, such as mortgage securities, and provided maneuverability for central banks when they couldn't realistically enforce negative interest rates, the IMF report says. Moreover, the Fed's investment portfolio has contributed more than \$200 billion in profit to the Treasury over the past three years, which was largely generated from the interest payments it received from the Treasury for holding government bonds.

Despite the success of quantitative easing, most economists and Fed officials agree that the measure doesn't provide the fiscal, structural, and financial sector reform necessary for macroeconomic stability, and should therefore be rolled back once economic growth is sustainable. The Fed has signaled that it will "taper" its bond buying program in late 2013 if U.S. job growth continues, a move that will ultimately pare down the Fed's balance sheet to pre-recession levels. That process is also expected to be controversial because as interest rates rise, the value of the bonds owned by the Fed will fall, resulting in unrealized losses if the Fed sells those assets before maturity. The IMF predicts that losses from the exit of these bonds could be as high as 4 percent of GDP.

*--Caitlin O'Connell contributed to this report.*