

Monetary Policy and Systemic Risk Regulation

Testimony before the
Subcommittee on Domestic Monetary Policy and Technology
Committee on Financial Services
U.S. House of Representatives

John B. Taylor
Professor of Economics
Senior Fellow, Hoover Institution
Stanford University

July 9, 2009

Thank you Chairman Watt, Ranking Member Paul, and other members of the House Subcommittee on Monetary Policy and Technology for inviting me to testify on “Regulatory Restructuring: Balancing the Independence of the Federal Reserve Regarding Monetary Policy with Systemic Risk Regulation.”

The Administration’s plan for financial regulatory reform would grant the Federal Reserve significant new powers—more powers than ever before in American history. The Federal Reserve would have the power to determine “whether an individual financial firm poses a threat to financial stability” considering such issues as size or interconnectedness. All such Fed-designated firms would then be placed in a special group called “Tier I FHCs.” The Federal Reserve would then have the power to supervise and regulate all firms in this new group. Such Tier I FHCs would also become subject to a proposed “resolution regime” which would expand the existing resolution regime for insured deposit institutions under the Federal Deposit Insurance Act. The Federal Reserve would also have the power to collect “periodic and other reports” from all U.S. financial firms that meet certain minimum (as yet unspecified) size standards. The power of the Federal Reserve under Section 13(3) of the Federal Reserve Act—the unusual and exigent circumstances clause which has been used frequently to intervene during the past year—would not be circumscribed in any specific way, though it would “be subject to prior written approval of the Secretary of the Treasury”.¹

What Are the Main Concerns?

Taken as a whole these new powers proposed by the Administration are what constitute the Fed becoming a systemic risk regulator, though the term “systemic risk” is not defined operationally. The important question being examined by this Subcommittee is whether these

¹ Quoted passages in this paragraph are from “Financial Regulatory Reform: A New Foundation.” U.S. Treasury 2009

new powers—these systemic risk powers—will affect the Fed’s “traditional role as the independent authority on monetary policy.”² In my view, these new powers will have a significant negative impact on this role to the potential detriment of the conduct of good monetary policy. I have four main concerns.

First, the additional powers and responsibilities would *dilute the key mission* of the Federal Reserve to maintain overall economic and price stability by controlling the growth of the money supply and thereby influencing the overall level of interest rates. My experience in government and elsewhere is that institutions work best when they focus on a limited set of understandable goals and are held accountable to the public for achieving these goals.³ As the number of goals and the lack of clarity increases, the effectiveness and performance generally declines. By giving the Federal Reserve the responsibility for determining which firms should be classified as Tier I FHCs and then giving them broad responsibility for their stability and impact on the economy, the proposed plan would greatly expand the goals of the Federal Reserve and thereby have these negative consequences.

Second, responsibility for Tier I FHCs would *reduce credibility* of the Federal Reserve by involving it directly in potentially controversial decisions. We see this tendency already in the recent criticism of the Fed’s alleged involvement in the Bank of America merger with Merrill Lynch as well as in the backlash against the large bailouts of financial institutions and questions about the collateral. Academic research and practical experience show that the Fed’s credibility is an extraordinarily valuable asset which would be terrible to lose.

Third, the plan would *create a conflict of interest*. With firms in the Tier I FHC category being perceived as too big to fail, or perhaps even too big to resolve, there will be a temptation to adjust the instruments of monetary policy to protect these institutions, perhaps by not increasing short-term interest rates even though such an increase would be warranted under the price stability or overall economic stability goals. Or the Fed could mistakenly recommend an otherwise inappropriate start of the resolution regime for one or more Tier I FHCs because that would make it easier to raise interest rates in order to achieve its price stability goals.

Fourth, by giving so much power to the Federal Reserve, the plan would *threaten the Fed’s independence regarding monetary policy*. There is a good rationale for an independent monetary authority. It helps prevent the monetary authority from giving too great a focus to the short run at the expense of the long run, and international comparisons have shown that independent monetary authorities deliver better economic performance. Why would giving more power to the Fed in the area of regulation and supervision of Tier I FHCs or its choosing result in less independence in the monetary sphere? Because sooner or later the increased power will result in checks and limits on it, perhaps through micro-managed political interference or even through legislative changes. It would be impossible in practice to prevent such interference from spreading from the new regulatory and supervisory function to the traditional monetary function,

² This question and related issues are discussed in *The Road Ahead for the Fed*, John C. Ciorciari and John B. Taylor (Eds.) Hoover Press, Stanford University, 2009. See in particular the essay by Andrew Crockett, “Should the Federal Reserve Be a Systemic Risk Stability Regulator?” in that volume.

³ John B. Taylor, *Global Financial Warriors*, W.W. Norton, New York, 2007.

because they are in the same institution with the same CEO. The loss of independence can occur via the executive branch or the legislative branch of government.

Loss of Federal Reserve independence is a serious issue, especially at this time of rapidly increasing Federal debt and a greatly expanded Federal Reserve balance sheet. Indeed, after reviewing recent events, George Shultz writes: “Observing this process, the question comes forcefully at you: Has the Accord gone down the drain? And remember how difficult it was for the Fed to disentangle itself from the Treasury in the post-World War II period.”⁴ Secretary Shultz is of course referring to the 1951 Accord where the Federal Reserve regained its independence following the World War II peg of Treasury borrowing rates. Requiring the Secretary of the Treasury approve using Section (13)3 raises additional independence concerns. Better to carve out specific Section 13(3) actions in specific ways in legislation and perhaps assign those to the Treasury.

What Are the Alternatives?

Given these disadvantages, what are the alternatives for systemic risk regulation? In general, I would define systemic risk in the financial sector as a risk that impacts the entire financial system and real economy, through cascading, contagion, and chain-reaction effects.⁵ The triggering event for such a macro impact can come from the public sector—as when the central bank suddenly contracts liquidity, or from the financial markets—as when a large private firm fails, or externally—as when a natural disaster or terrorist attack shuts down the payments system.

Examples of systemic events prior to the current crisis were the default by the Russian government in 1998 which affected markets around the world leading the Federal Reserve to cut interest rates, and the 9/11 terrorist attacks which spread through the payments system in the United States by severely damaging financial firms intimately engaged in the system. It is important to emphasize that contagion or chain reactions are not automatic; they can be altered by changes in the rules of the game established by public policy. When Argentina defaulted on its debt in 2001, three years after the Russian default, there was no global contagion, even though the world economy was in worse shape, primarily because the rules of International Monetary Fund (IMF) support were better explained and anticipated.

What were the systemic events in the current crisis? Fortunately, there was no terrorist attack or natural disaster, so was it government forces or market forces? In my view, government actions—from monetary policy being too easy to government sponsored agencies encouraging too much risk—were the primary causes. The failure to regulate adequately entities that were supposed to be, and thought to be, regulated encouraged the excesses. Risky conduits

⁴ George P. Shultz “Think Long” in John D. Ciorciari and John B Taylor (Eds.) *The Road Ahead for the Fed*, Hoover Press, Stanford University, 2009.

⁵ See John B. Taylor “Systemic Risk and the Role of Government,” Dinner Keynote Speech, Conference on Financial Innovation and Crises, Federal Reserve Bank of Atlanta, Jekyll Island, Georgia, May 12, 2009 from which the material in this section is drawn.

connected to regulated banks were allowed by regulators. The SEC was to regulate broker-dealers, but its skill base was in investor protection rather than prudential regulation. Similarly, the Office of Thrift Supervision (OTS) was not up to the job of regulating the complex financial products division of AIG. These regulatory gaps and overlapping responsibilities added to the problem and they need to be addressed in regulatory reform.

So efforts to reform the regulatory system are in order. What are reasonable objectives and tasks for systemic risk regulation? Based on recent experience, closing present and future regulatory gaps and de-conflicting overlapping and ambiguous responsibilities would help reduce systemic risk, especially as new instruments and institutions evolve. In addition, systemic risk might be reduced if disaggregated information were aggregated and passed back to the private sector as Myron Scholes suggests.⁶

But none of these tasks and objectives requires a new systemic risk regulator whether at the Fed or elsewhere. Indeed, such a regulator might serve as an excuse for existing regulatory agencies to pass off responsibilities for past and future regulatory failures.

I have suggested that these tasks be done within the existing President's Working Group on Financial Markets suitably expanded with the additional regulatory agencies and with funding to support sufficient staff at the Treasury to take on the tasks. This recommendation is very close to replacing the President's Working Group with the Financial Services Oversight Council as proposed by the Administration. In my view this would be a sufficient reform in the systemic risk area, and it would not require giving the additional powers to the Federal Reserve.

⁶ Myron Scholes, "Market-Based Mechanisms to Reduce Systemic Risk" in *The Road Ahead for the Fed*, John D. Ciorciari and John B. Taylor (Eds.), Hoover Press, Stanford, California, 2009