

INTRODUCTION

THE FEDERAL RESERVE is the single most important economic policy institution in the United States. This spring the two of us and the ten other authors of this book came together to present and to discuss our views about the future of the Fed. The catalyst for our meeting was the series of unprecedented actions and interventions taken by the Fed relating to the financial crisis. The Fed created new lending facilities for banks and primary dealers, bought part of the Bear Stearns portfolio, infused funds into AIG, purchased assets backed by mortgages, student loans, and credit cards, loaned to foreign central banks, intervened in the commercial paper market, and bought long-term government bonds. By taking these actions the Fed exploded its balance sheet and raised serious concerns in many quarters about inflation, as well as the independence and effectiveness of the Fed.

In this book we and our coauthors address these concerns. We differ in our assessments and our proposals, but we have a

common purpose: to understand how the Fed arrived at this unusual juncture, how it can best navigate the road ahead, and how the road itself can be designed to reduce the likelihood of crisis-driven interventions in the future. Moreover, although each author wrote individually, the chapters were put together following our meeting to reflect other views and to integrate them in a logical exposition.

The book is divided into three parts. Part I provides principles and directions for the Fed going forward by drawing on political, historical, and market experiences. Part II presents the central debate over the rationale for the Fed's actions, the seriousness of the dangers, and the exit strategy, with contrasting views from inside and outside the Fed. Part III proposes and examines new market-based mechanisms and regulatory reforms that can help the Fed exit from its exceptional programs and keep it on the road to good monetary policy in the future.

PART I. DIRECTIONS FROM POLITICS, HISTORY, AND THE MARKET

George Shultz opens by urging policy analysts both inside and outside the Fed to “think long” as they address today's challenges facing the U.S. and global economies. Drawing from decades of policy experience, including the years when he was Secretary of the Treasury, he shows how short-term responses to economic challenges can generate unintended and undesirable longer-term consequences.

Allan Meltzer then puts the Fed's response to the current crisis in historical perspective, drawing from his recently-completed history of the Fed. He shows why only a return to proven

economic policy principles can restore discipline and stability to the system.

Peter Fisher explains how easy money, unbounded government sponsored enterprises, and excessive leverage led us into the crisis by misaligning incentives. Drawing from his market experience, he urges that the Fed explain clearly its objectives—including which fire it is trying to put out and why—as it charts its future course.

PART II. THE FED'S ENTRY AND EXIT STRATEGIES

Essential to mapping and designing the road ahead is knowing where you are and how got there, which is the objective of this central part of the book. As will be most apparent from the chapters that constitute this part, there is a raging debate about these issues.

Federal Reserve Board Vice-Chairman Donald Kohn opens this part with the view from inside the Fed. He explains the Fed's rationale for its extraordinary actions and draws attention to a number of potential risks that the Fed is attempting to address. He also responds to concerns raised about inflation and Fed independence.

James Hamilton shows, with a dramatic series of charts, the impact of the Fed's actions on the size and composition of the Fed's balance sheet. He explains the hazards, raising concerns about the Fed's role in credit allocation, inflation threats, and the loss of central bank independence. John Taylor follows up on Hamilton's concerns with recommendations on how to execute a clear and credible exit strategy from the exceptional

measures taken to date and return to the type of monetary policy that worked well before the crisis began.

PART III. PAVING THE WAY WITH MARKET AND REGULATORY REFORMS

One reason the Fed has taken such unprecedented interventions in this crisis was its worry that the failure of a financial institution which was “too big or too interconnected to fail” would have harmful cascading effects on the economy. If the Fed is to stay on the road of good monetary policy in the future, it will have to say no to requests for bailouts. It will be easier for the Fed to do so if systemic risks are successfully managed through a combination of market-based mechanisms and regulatory reforms.

Myron Scholes leads off with a look at market-based mechanisms. He shows how moving risks from institutions to markets can reduce overall risks in the financial sector and improve its resilience to shocks. He proposes new ways to reduce vulnerabilities stemming from volatility, leverage, and government guarantees. One key to enhancing stability in the financial system will be to strengthen the market for derivatives. Darrell Duffie delves into this important topic. He recommends more market transparency and examines the ways in which a central clearing counterparty can help reduce risk in the markets for credit default swaps and other derivatives.

Can regulatory policy be improved to deal better with risks of a systemic nature given the interconnectedness of the financial system? Andrew Crockett examines the possible usefulness of a systemic stability regulator for this purpose. He reviews the

functions that such a regulator could usefully perform and considers the pros and cons of assigning that role to the Fed. Drawing from experience at the SEC during the Bear Stearns crisis, Michael Halloran shows deficiencies in the existing framework for risk regulation and argues that a systemic regulator is needed. Crockett and Halloran agree that the Fed ought not be given this additional responsibility.

Can a new resolution authority for non-bank financial institutions help reduce the need for Fed interventions? Richard Herring argues that it would and examines in detail how such a resolution policy might work in practice. He raises difficult international coordination issues that must be addressed because of the global structure of large financial institutions. To deal with this problem, he recommends that financial firms develop detailed wind-down contingency strategies and submit them for review to their regulatory authorities.

COMMON THEMES WITH REVEALING DEBATES

Common threads connect all the chapters even as differences emerge. All raise concerns about the implications of the Fed's extraordinary actions. There is a strong consensus that there must be an exit, but debate about how difficult such an exit will be. There is agreement about the risks of future inflation, though differences about how and whether the Fed will be able to contain them. There are general concerns about the independence of the Fed in the future, but debate about how difficult it will be to address them. There is agreement that market-based mechanisms and regulatory reforms will help the Fed focus on basic principles of monetary policy in the future,

yet a range of views about whether to emphasize markets or government regulatory reform.

In the concluding chapter, John Ciorciari observes that three principles raised in the opening part are repeated throughout the book. We must: (1) consider the long term consequences of short term interventions, (2) put incentive effects front and center in every action and reform, and (3) marry market-based mechanisms with enhanced regulation to achieve optimal outcomes. We believe that these three principles—and the constructive analysis contained in these pages—can serve as guideposts on the road ahead for the Fed.

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