Key Principles and Recommendations

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As the authors of this book demonstrate, Federal Reserve actions and interventions associated with the financial crisis carry vital economic and policy implications, both in the short and in the longer terms. Major new programs and facilities raise fundamental questions about the future of the Fed. Will these actions compromise the Fed's independence or lead to inflation? Do recent interventions point toward increased problems of moral hazard down the line? What types of market and regulatory reforms can help pave the way to effective central banking policy in the future? The importance of addressing these questions can hardly be overstated. Independent and effective central banking has provided a foundation for the success of the modern U.S. and global economies, and it must continue to do so.

The authors of this volume present a range of views on the merits and implications of the Fed's recent policy approach. They share, however, the goal of providing constructive analysis that helps the Fed focus on its core mission and exit smoothly from its extraordinary programs. In this chapter, I briefly review some of the major arguments and debates contained in the preceding chapters and draw out key principles and recommendations.

Broad Principles for Fed Policy

A major purpose of this book—and the meetings and discussions leading up to its publication—is to identify core principles that should govern the Fed's policy decisions going forward. Some of these principles are specific to the Fed, such as the importance of central bank independence and a credible long-term commitment to monetary policy that promotes a strong economy and price stability. Others are more general in application, such as the need to foresee future ramifications of present policies, to align market players' incentives with socially desired outcomes, and to identify market-based mechanisms to complement regulatory regimes. These principles can serve as guideposts for the Fed and other participants in the process of designing and implementing economic policy.

Weighing Future Consequences

One key principle is the importance of considering the future implications of policy measures taken today. As Donald Kohn explains, the Fed has justified its new programs as necessary responses to a severe crisis and sharp recession. He argues that when the Fed's usual policy tools—the Fed funds rate and ordinary discount window lending—proved inadequate, it had to identify other ways to carry out its mandate. The Fed has thus sought to intervene in broad markets, such as those for commercial paper and asset-backed securities, where it believes interventions will have broad economic effects.

The authors of this book disagree on the merits of the Fed's argument that it must prioritize "putting out the fire" of current market turmoil, but there is general agreement that the Fed's crisis response has the potential to produce important undesired consequences. Large new lending programs and asset purchases have been financed in large part by creating money in the form of reserve balances at the Fed. This could lead to inflation and compromise the credibility of monetary policy. In addition, the Fed's greatly expanded role in providing credit could lead to inefficient credit allocation and undermine the independence that the Fed has historically fought hard to protect, as political pressure is brought to bear on its lending decisions. George Shultz rightly stresses the political and economic dangers of relying on central banks to finance large government activities during periods of fiscal strain.

Opinions vary on the magnitude of risks presented by the Fed's new activities, which relate to the Fed's capacity and willingness to exit from exceptional current practices, reduce inflation risk, and preserve independence from congressional pressure. Kohn asserts that the Fed is focused on those challenges and has the necessary tools to meet them. James Hamilton and several others express skepticism. Given the dramatic rise in the Fed's reserve balances and unprecedented scope of its activities, their concerns are compelling. It is imperative to keep the intertemporal hazards of current Fed policies in focus.

Putting Incentives First

A second core principle emerging from our discussion is the need to focus on incentives when crafting policies. Misaligned incentives certainly contributed to the current crisis—a point aptly driven home by Allan Meltzer and others in this volume. Government policies promoting home ownership, particularly via off-budget subsidies through Fannie and Freddie, encouraged the overgrowth of the mortgage market and deterioration of loan quality. At the same time, a long period of easy monetary policy gave market players an incentive to "reach for yield" by dealing in assets of dubious quality.

The Fed and other government agencies also contributed to incentive misalignment by allowing banks and financial firms to become "too big (or too interconnected) to fail" without articulating a "lender of last resort" policy. Indeed, the existence of such entities, combined with the absence of a lender of last resort policy, fueled market expectations of a bailout if a major bank or firm were to implode. The result was moral hazard, as anticipation of a government backstop reduced the incentives of market players to manage their risks responsibly.

Marrying Market-Based Mechanisms with Improved Regulation

Responding to the challenges above requires both market-based mechanisms and a stronger regulatory regime involving the Fed and other agencies, at home and abroad. Depending on the central bank for massive bailouts and credit lifelines to vital industries is a perilous way to run an economy. Much stronger support structures are needed to address systemic risks, obviate crises, and reduce the need for costly government intervention. The answer is neither to "leave it all to markets" nor to simply pile on additional regulations, which are often difficult to enforce and relatively easy for market players to end-run. Private and public forces need to work synergistically to achieve optimal growth and stability. This is a third broad principle arising from our discussions.

Translating Principles into Policy Recommendations

In addition to presenting broad principles to help guide the Fed and other relevant actors, the authors of this book attempt to translate those principles into specific policy recommendations. They suggest steps that the Fed can take going forward, as well as ideas on how other aspects of financial markets and regulations can be strengthened to improve stability in the system and make the Fed's job easier.

Steps That the Fed Can Take

The authors of this book present a number of recommendations on steps the Fed can take to maintain price stability, exit from its extraordinary programs, help prevent future crises, and promote market confidence.

Managing Price Stability and Exiting from the Extraordinary Programs

A first set of policy suggestions relates to concerns about inflation and the need for price stability. Kohn argues that the Fed has not found a single monetary policy rule that enables it to address the financial crisis and carry out its dual mandates of price stability and high employment and growth. He also argues that the Fed has the necessary tools to withdraw liquidity and head off inflation. Taylor and others recommend taking a different, rule-based approach to monetary policy. Meltzer argues that guidelines such as the Taylor rule will enhance the Fed's credibility and generate confidence in the markets. During the period of 0 percent interest rates, Taylor recommends that the Fed focus on levels or growth rates in the quantity of a monetary aggregate so as to avoid basing those aggregates on selective credit decisions. To this end, the Federal Open Markets Committee could provide target ranges for the growth of reserve balances, base money, or other aggregates.

To reduce inflationary pressures and avoid inefficient or overly politicized credit allocation, the Fed needs a sound strategy for winding down the exceptional facilities. Some authors have suggested ways of doing so, namely by beginning to terminate programs that are not functioning well or are no longer needed. Withdrawing credit will not be easy. As Peter Fisher argues, the Fed has effectively positioned itself at the center of a new "plumbing system" for credit in the economy. Its new role in credit allocation exposes it to added political pressure, and winding down special Fed facilities will be politically unpopular, especially during a period of relatively high unemployment.

Kohn notes that many of the Fed's new lending programs will need to be terminated once the crisis period ends because the Fed has invoked them as part of its statutory authority to address "unusual and exigent" circumstances. That will naturally reduce the size of the balance sheet. Kohn also notes that the Fed is paying interest on excess reserves and can use transactions such as reverse repurchase agreements to reduce balances. To make it easier to raise rates when necessary, the Fed is also seeking other authority to enable it to absorb reserves.

Other authors of this book express concern about the Fed's ability to unload assets, especially "toxic" ones and securities backed by consumer credit, mortgages, and student and auto loans. Hamilton recommends that the Fed shift toward purchases of quality assets such as long-term Treasury Inflation-

Protected Securities. This, he argues, will help the Fed exit more easily in the future and avoid asset purchases that promote a return to problematic securitization practices.

Taylor likewise advocates focusing on a reduction in reserve balances but challenges the Fed's plans on how to do so. He argues that paying interest on reserves has been ineffective and that other options—such as issuing debt to the public—would jeopardize the Fed's independence and expose it to the credit risks inherent in selective credit allocation. He recommends instead that the Fed undertake a rigorous assessment of the effectiveness of existing facilities and shut down those that are ineffective or no longer necessary. He cites the Term Auction Facility and Fed facility for buying medium-term Treasuries as possible candidates. As this volume suggests, analysts differ on how effective the new facilities have been. Those disagreements suggest the need for urgent further analysis and policy evaluation, both inside and outside the Fed.

Addressing Moral Hazard and "Too Big to Fail"

A third group of recommendations concerns the Fed's ability to help prevent future crises by addressing moral hazard that arises from government guarantees and bailout expectations. Myron Scholes recommends a number of measures the Fed could use to reduce the expected value of central bank guarantees and thereby encourage market participants to manage their risks more effectively. These include using credit default swap (CDS) rates or LIBOR spreads over the Fed funds rate to estimate the premiums the Fed would charge on guarantees; providing guarantees only to investments backed by government debt; and requiring enhanced disclosure of any such guarantees.

The problem of moral hazard is particularly acute for the largest, most systemically vital banks and firms. Several authors of this volume contend that an entity that is "too big to fail" is simply too big and that regulators need to take active measures to prevent banks and firms from overgrowing, such as increasing capital requirements. Not everyone agrees. Michael Halloran argues that large banks and financial firms are sometimes needed to provide functions that smaller institutions cannot. Regardless of how that debate is decided, large and highly interconnected financial entities exist today and are not likely to disappear soon. The Fed and other policy actors need better ways to deal with big, complex financial institutions and the risks to the system that they present.

Meltzer argues forcefully that the Fed must articulate a clear and credible "lender of last resort" policy to avoid the moral hazard that accompanies expectations of a bailout. A clear policy would also help reduce the occurrence of seemingly inconsistent policies, such as the Fed's varying responses to Bear Stearns and Lehman Brothers. Underlying recommendations for clear rules and policies to guide Fed decisions is a key debate evident in this book. To what extent can the Fed be trusted to resist unwarranted intervention and uphold its traditional principles of monetary policy when storms hit? Kohn expresses confidence in the Fed's commitment to sound monetary policy and its capacity to intervene only when appropriate. Other authors of this book are more doubtful and believe that rules can stiffen the resolve of central bankers and help them stick to core principles.

Improving Transparency

Finally, a number of authors point to the need for greater transparency at the Fed. Many of the Fed's recent programs have been designed and implemented with little opportunity for public input and analysis. As Fisher recommends, the Fed needs to articulate clearly what problems it is attempting to address and the means by which it is pursuing its goals. The scale and unprecedented nature of the Fed's recent activities have the potential to generate significant uncertainty in the markets, both about inflation and the Fed's broader role.

Kohn notes that it will be difficult to respond to congressional and public pressure to increase transparency on collateral and counterparties because such disclosure would increase stigma and discourage use of the Fed's new facilities. Nevertheless, there is broad agreement on the merits of improving information flow, toward which the Fed has taken significant steps. It has developed a new website to explain its exceptional programs and balance sheet and has issued public statements with the Treasury about their respective roles. Taylor recommends a series of further steps, including daily dissemination of data on the balance sheet, more detailed minutes of relevant Fed meetings, public release of policy evaluation findings, and clearer statements of key operating policy principles, such as the avoidance of monetization. Transparency and the development of clear, credible exit strategies can help the Fed deal with the intertemporal hazards of its crisis response measures.

Market-Based and Regulatory Reforms

The Fed should not take on too much. Central banks work best when they are able to carry out a limited range of functions within a sound market and regulatory setting. Another priority of this book is to offer recommendations on how market-based mechanisms and regulatory reforms can contribute to a more favorable environment for central banking policy. Better overall management of risk and stability in the financial system can reduce the need for crisis-driven government intervention and enable the Federal Reserve to focus on its core monetary policy mandates. A number of authors draw attention to the need for market and regulatory reform.

Reforming Housing Finance

As noted above, housing policy and practices in the United States misaligned incentives and contributed directly to the financial crisis and recession. Meltzer recommends looking for ways to eliminate the off-budget housing subsidy provided through Fannie and Freddie by subjecting the subsidy to the congressional appropriations process. He also advocates liquidating Fannie and Freddie if politically possible. Fisher recommends consolidating the mortgage guarantee functions at Fannie and Freddie into a single federal mortgage insurer that guarantees only fixed-rate mortgages. These sensible reforms will not be easy to achieve given the powerful political appeal of off-budget subsidies. At a minimum, however, the future stability of U.S. financial markets requires taking a more accountable and responsible approach to housing finance.

Enforcing Sensible Capital Standards

In addition to overinflated housing markets, inadequate risk management in banks and investment banks was another key cause of the crisis. To reduce future vulnerabilities, the capital adequacy framework requires reform. Scholes recommends increasing capital requirements uniformly for financial entities by requiring equity capital sufficient to absorb shocks to each class of that entity's assets. He argues that mark-to-market accounting is sensible but that regulators should be empowered to evaluate capital adequacy using other accounting measures when appropriate. He also suggests a slightly more radical measure: requiring banks to leverage their operations only through convertible debt, which would turn into a predetermined fraction of equity on the occurrence of a shock or at the direction of the relevant regulator. This, he argues, would help reduce the demand for government bailouts, because banks would not need to engage in fire sales of assets to raise capital in a crisis.

Other authors of this book suggest further areas for improvement. Halloran recommends revising the Basel II framework to take better account of short-term secured funding, which lay at the heart of the Bear Stearns crisis. Fisher recommends refocusing attention on the quality of underwriting of assets, rather than focusing only on crude capital ratios. Meltzer adds that regulators have been lax in applying their legal authority under the Federal Deposit Insurance Improvement Act (FDICIA) to intervene in troubled banks when capital falls below required limits. He recommends extending the provisions of FDICIA to all financial firms. Taken together, the suggestions in this book can be reduced to a simple and sensible formula: capital adequacy standards need to be higher, and regulators need both the will and authority to take actions when deficiencies arise.

Strengthening Rating Agencies

Part of the problem with capital adequacy rules was their reliance on rating agencies, which have been the target of intense criticism during the financial crisis. Improving the accuracy of their assessments is essential. Meltzer recommends adopting a proposal whereby the accuracy of rating agencies' past assessments is reported to the public and influences fees. Halloran recommends implementing a proposal by Joe Grundfest to establish buyer-owned credit rating agencies (BOCRAs) owned by buyers of bonds and requiring all ratings to include at least one by such a BOCRA. He also advocates removing regulatory rules that rely on credit rating agencies and suggests requiring firms to disclose after-rating performance of particular assets. A common theme underlying these proposals is the need to use market-based disclosure mechanisms to give rating agencies the incentive to do a better job.

Improving the Derivatives Markets

Derivatives markets, which figured prominently in the AIG crisis and contributed to recent market turmoil, also require reform. One issue to address is transparency. Myron Scholes recommends "moving risks to markets" and away from financial institutions, because in transparent and liquid markets (such as those for equity or government bonds), shocks can be more easily absorbed via the changing prices of assets. Conversely, when financial institutions accumulate large volumes of relatively illiquid leveraged assets, they become more vulnerable to shocks and paralysis.

One way to improve price discovery mechanisms and increase resilience to shocks would be to require some credit derivative contracts to migrate from over-the-counter markets onto exchanges. Fisher recommends that any names that can trade both credit default swaps and underlying bonds on an exchange should do so. Duffie advocates a slightly more cautionary approach, arguing that the tremendous diversity of credit derivatives products would make it difficult to decide which ones to move onto exchanges and citing the need to avoid stifling innovation by reducing some of the profitability of new products. He recommends improving price transparency by requiring dealers to report trade prices as they do via the TRACE system for corporate and municipal bonds, though noting certain challenges to implementing such a system.

Highly customized credit derivative contracts raise other issues, because they lack sufficient demand to be traded on exchanges. Fisher recommends regulating such products as insurance contracts and subjecting holders to a requirement of adequate reserves against potential future exposure. Duffie argues that the patchwork nature of state-level insurance regulation would make that inadvisable. He also recommends that parties should be able to use credit derivatives to hedge even if they do not hold the underlying debt, because allowing them to do so adds price transparency and liquidity to the market.

Despite those differences in view, there is general agreement on the importance of managing risk in customized derivatives. Even a more transparent market would not have prevented the AIG crisis, which stemmed from highly exotic, "bespoke" contracts. Scholes and others provide a useful cautionary note: it will be difficult to devise a regulatory office or agency with the sophistication to keep up with the most exotic new derivatives products. Dealers in those contracts must be given powerful incentives to manage their own risks.

A further set of reforms in the derivatives markets relate to reducing counterparty risks. Scholes recommends requiring all dealers and market participants to post initial margin on derivative contracts. He and Duffie also recommend using central clearing counterparties (CCPs) to reduce counterparty risk in derivative markets. However, Duffie warns that CCPs can only be effective if they are few in number, extremely well capitalized, follow high standards for collateral, and designed to net assets across different classes, such as credit default swaps and interest rate swaps. He thus provides an important cautionary note as new CCPs begin to proliferate in the United States, Europe, and elsewhere. Regulators need to avoid "too much of a good thing;" competition among CCPs could lead some to relax their standards for collateral and thus raise risks to the system.

Reforming the Bankruptcy Laws

To reduce counterparty risk problems, the bankruptcy regime needs improvement. Under current law, when a firm declares bankruptcy, many of its existing contracts are essentially frozen, protecting the troubled firm from counterparty claims. Derivatives, swaps, and repurchase agreements are exempted from that treatment, however. That exemption presents a serious problem when a firm (such as Bear Stearns) gets into trouble because counterparties can foreclose on their collateral immediately, possibly wiping out the troubled entity and causing market calamity. To address that problem—and to provide firms with incentives to take market-based measures to reduce counterparty risks—Fisher recommends subordinating the rights of counterparties with net trading exposures to the rights of other creditors. Again, the key to reform is to align market participants' incentives with desired policy outcomes.

Resolving Firms That Fail

Even if the Fed and other regulators do their jobs well, some firms are bound to fail. Better structures need to be in place to manage that contingency. Richard Herring recommends that the relevant financial regulators be given stronger examination powers and more data to perform diagnosis and triage on systemically important institutions. He also advocates developing more credible "preinsolvency triggers" that would enable regulators to address problems before they metastasize and generate large creditor losses and systemic risk. Such triggers would also have the important effect of giving entities incentives to keep their houses in order. Rather than simply assisting larger institutions in buying troubled smaller ones—which contributes to the "too big to fail" problem—he advocates using bridge financial institutions to resolve entities in danger. Further, he suggests simplifying tax and financial regulations to remove incentives for large financial institutions to spawn subsidiaries (which complicate resolution). Lastly, he recommends requiring big banks and firms to file "winding-down plans" for regulators' review and imposing remedial measures on those with insufficient plans. When firms do fail or when a crisis occurs, Scholes suggests convening a group of relevant experts, regulators, and market participants to review lessons learned.

Possible Roles for a Systemic Stability Regulator

Many of the issues discussed above have given rise to proposals for a new systemic stability regulator (SSR). Andrew Crockett lays out a number of reasons why an SSR is needed. He argues that instability can emerge from a variety of institutions, including both regulated and unregulated market players, making it important to have a holistic view of emerging vulnerabilities. Regulation or supervision of individual firms often fails to address risks of a systemic nature. Halloran's experience at the Securities and Exchange Commission during the Bear Stearns crisis leads him to a similar conclusion: that an SSR is needed to address systemically important risks that existing agencies are not well equipped to regulate. Not all analysts are as enthusiastic. Meltzer casts doubt on the ability of regulators to assess risks as effectively as managers who are given proper incentives. This critique notwithstanding, the idea of an SRR is being widely debated and receives due attention in this book.

The first question is what form an SSR (if any) should take. The Fed has been advanced as one possible option given its institutional competence, its existing regulation of bank holding companies, and its experience in liquidity provision. The authors of this volume cast doubt on the wisdom of turning the Fed into an SSR. Crockett, Halloran, and others recommend keeping monetary policy and systemic regulation separate to avoid a dilution of focus and reduce the opportunities for politicization of central banking policy. Halloran recommends establishing a council that includes long-term members and some heads of relevant regulatory agencies.

The powers and functions of an SSR would also need to be delineated. Crockett recommends entrusting an SSR with supervising systemically significant institutions; overseeing trends in financial products or practices with possible systemic risk implications; establishing new rules of prudential behavior; monitoring systemic vulnerabilities; intervening to provide financial support; and cooperating with counterpart agencies abroad. Halloran favors granting an SSR the necessary powers to set rules on products or practices that generate systemic instability, enforce leverage limits, police ratings agencies, and take certain enforcement actions. The interagency group would determine coverage of particular banks and financial firms by reference to their size, leverage, short-term borrowing, and other factors. Scholes suggests that an SSR should aggregate information from financial firms, play an information-sharing role, and lead efforts to bring more risk measures onto income statements and balance sheets.

There are numerous other issues to consider designing an SSR, such as how to define systemically significant institutions, when to publicize or act on vulnerabilities, and how to function alongside other regulators, especially across national borders. An SSR will be no panacea—it will face some of the same challenges that existing agencies face in identifying risks in complex and evolving markets and taking decisive (and often unpopular) action to deal with them. There are also potential hazards to establishing a new systemic regulator. A poorly designed SSR could exacerbate risk by providing a false sense of security or contributing to expectations that the government will not allow large enterprises to fail. Despite the urgency of resolving the present crisis, discussions on whether and how to create an SSR should not be rushed. Careful deliberation and dialogue is required to reform the existing regulatory regime and align incentives properly.

Looking Ahead

This book has addressed some of the most contentious issues facing the Fed and has presented diverse opinions on the appropriateness of the Fed's recent interventions, the impact of those actions to date, and the risks that they pose. The authors of this volume have also debated the best steps to take going forward. Nevertheless, a few broad principles have emerged that represent the most important shared conclusions of the book. Policymakers inside and outside the Fed need to weigh the future consequences of their actions today, focus on incentives, and pursue broader market and regulatory reforms to pave the way toward financial stability and effective monetary policy as they traverse the road ahead.