Central Bank Accountability For Financial Stability and Economic Reconstruction

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Demands for Transparency and Accountability

FT.com
FINANCIAL TIMES

Geithner sparks banks rally

Independent Central Banks failed in the current crisis

- ***Failed to stop massive imbalances and bubbles from building up***

- ***Were slow to respond to crisis when it broke out***

- ***Although they have taken dramatic actions since the Lehman Bankruptcy, they have still been hesitant to confront the prerogatives of the big financial institutions in terms of bank restructuring and bank operations. Hence, the financial system remains hobbled and ineffective while the real economy continues to decline.***

Key Questions

- ***Would more central bank accountability have prevented or reduced the severity of the crisis?***

- ***Moving forward, is more central bank accountability desirable to help resolve the crisis and contribute to financial and economic reconstruction of the US and other economies?***

Failures are multi-faceted and broad based

- ***Failure of monetary theory and analysis:***

Mainstream monetary analysis based on efficient markets, full employment reduced macroeconomic analysis to an analysis of time-inconsistency, inflation targeting and central bank "credibility" and independence.

Partly Based on these theories

IMF and others pushed central bank independence and (commodity) inflation targeting to many countries.

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Many institutions in Executive Branches and Parliaments failed

- ***Supported light touch Financial Regulation***
- ***Failed to deal with causes of imbalances and bubble build ups through other policies (fiscal policies)***
- ***Failed to over-see financial regulators to prevent fraud and abuse***

So: in this world of multi-faceted blame:

Would one change, more central bank accountability have made a difference?

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Must see central bank independence as part of a system of poor theory and poor practice.

This norm of central bank independence and the theory that supported it scared off politicians who wanted to exert more control over the system and gave political cover to those who did not.

Who provides the political muscle to keep central bank independence intact:

Milton Friedman: "Politically Independent Central Banks give undue influence to the interests of commercial bankers", 1962.

Central Bank Independence

Helps to explain the bias in Central Bank Policy to protect the prerogatives of private finance over the interests of the public in some of the decisions about financial bail-outs and restructuring as well as inflation obsession that delayed initial response.

Reducing the norm of central bank independence would have

- ***Empowered those who had a keener interest in more enforcement of regulations***

- ***Empowered interests to push for a quicker and more effective response to the crisis by central banks***

- ***Made more transparent, more direct and more effective many of the financial interventions that have taken place since the outbreak of the crisis.***

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Moving Forward:

The case for more Federal Reserve Accountability is overwhelming:

- ***Need for more coordination with Treasury on supporting fiscal policy***

- ***Massive amounts of public money at risk in Fed credit operations***

- ***Very intensive interventions with individual financial institutions***

Challenge in structuring more Fed accountability:

Challenges for creating more Fed Accountability

- ***How to make the Fed's monetary and credit policy more responsive to the needs of the public at large***
- ***Create checks and balances between Executive Branch and Congress***
- ***While preserving expertise and longer-term perspective along with appropriate shorter term responsiveness***

Need reforms to:

Make the Fed simultaneously more accountable to public at large, the Congress and the Executive Branch.

Outline of talk:

1. ***Why the LOLR interventions failed***

2. ***Discuss how more central bank accountability could have helped***

3. ***Discuss why more Fed accountability is important now as we move forward.***

4. ***Present some structural reforms for making the Fed more accountable.***

Why did the LOLR Fail?

The Authorities were late to react sufficiently to the crisis because they had allowed the financial system to become so complex that the central banks and other authorities did not understand what would happen as the financial bubble burst; and therefore did not understand how difficult it would become to fix.

In other words:

They had allowed financial institutions to become too big too fail, but too complex and opaque to save.

But other, very important problems:

1. ***"Inflation and credibility obsession" delayed and hobbled effective monetary responses early on.***
2. ***Hard fought lessons on the importance of fiscal policy were lost in the US and even more so in Europe. Led to complete reliance on monetary policy early on.***
3. ***Did not understand how property value collapses would desroy the finanical system***
4. ***Gave undo influence to the prerogatives of bankers so did not demand quid pro quos in their bail-out actions to insure credit would keep flowing and debts would be reduced in an orderly fashion.***

Evolution of the Lender of Last Resort (LOLR) in the Crisis

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- Initially Central Banks focused on liquidity and credit all the time worrying about inflation; did not see the collapse of aggregate demand and insolvency and coordination problems

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But as aggregate demand declined, asset bubble burst, increasingly the problem became solvency problems. With them become profound coordination issues, especially as the complex interactions are increasingly cross - border

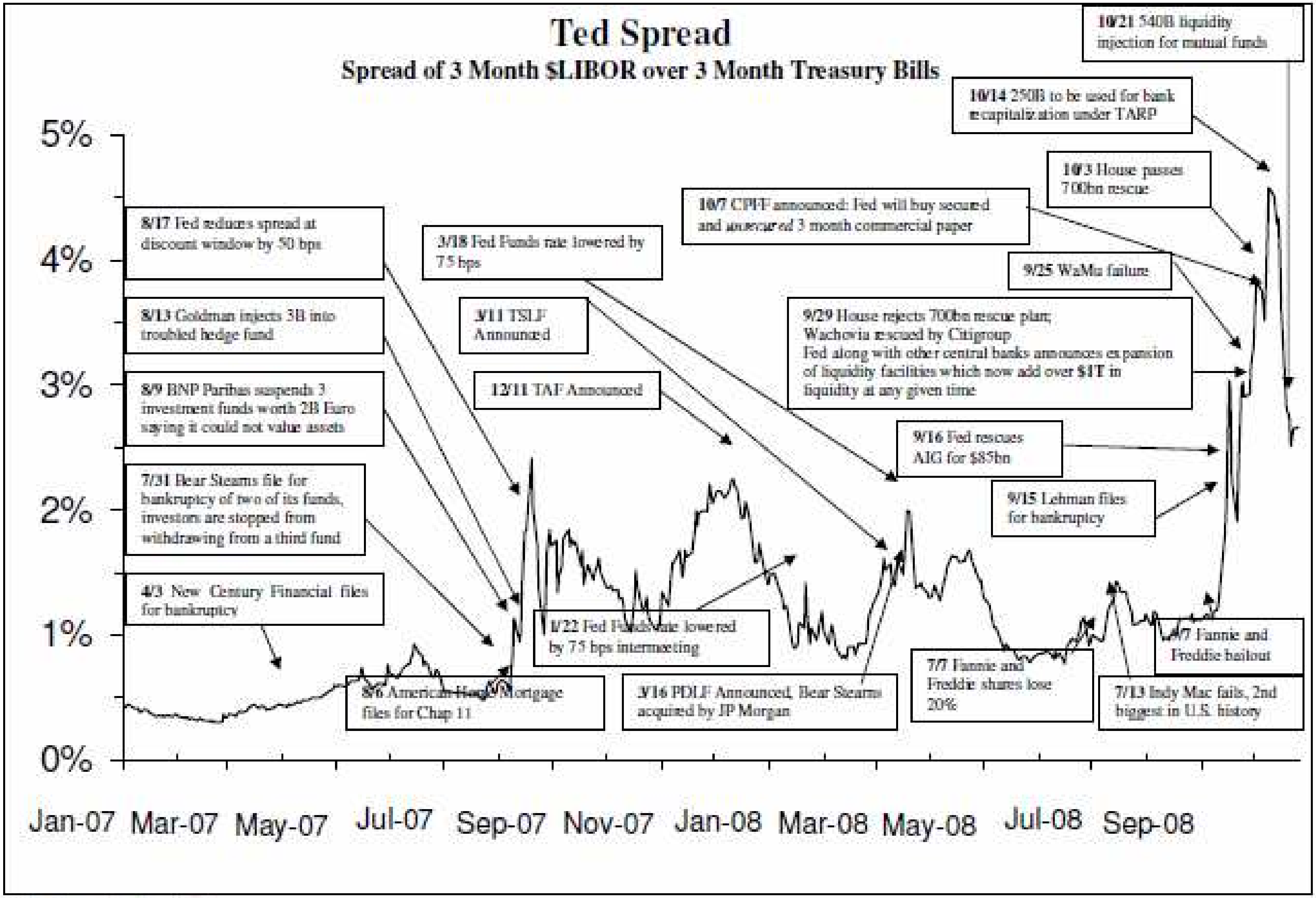
Phases of Crisis

1. ***Winter – Spring 2007: Complacency***
2. ***Summer, 2007, interest rate reductions and swaps***

3. ***Winter - Spring, 2008: Liquidity Actions, LLOR innovation to avoid harming inflation targets and protect financial markets***

4. ***Spring-Summer of 2008: Fear of Inflation, and complacency***

5. ***September, 2008 – Current Period: greater and greater "LOLR" innovation, increasing use of guarantees and ownership. Shift of involvement to government and away from Central Banks***



TAF: Term Auction Facility
TSLF: Term Securities Lending Facility
PDLF: Primary Dealers Lending Facility
CPFF: Commercial Paper Funding Facility
TARP: Temporary Asset Relief Program

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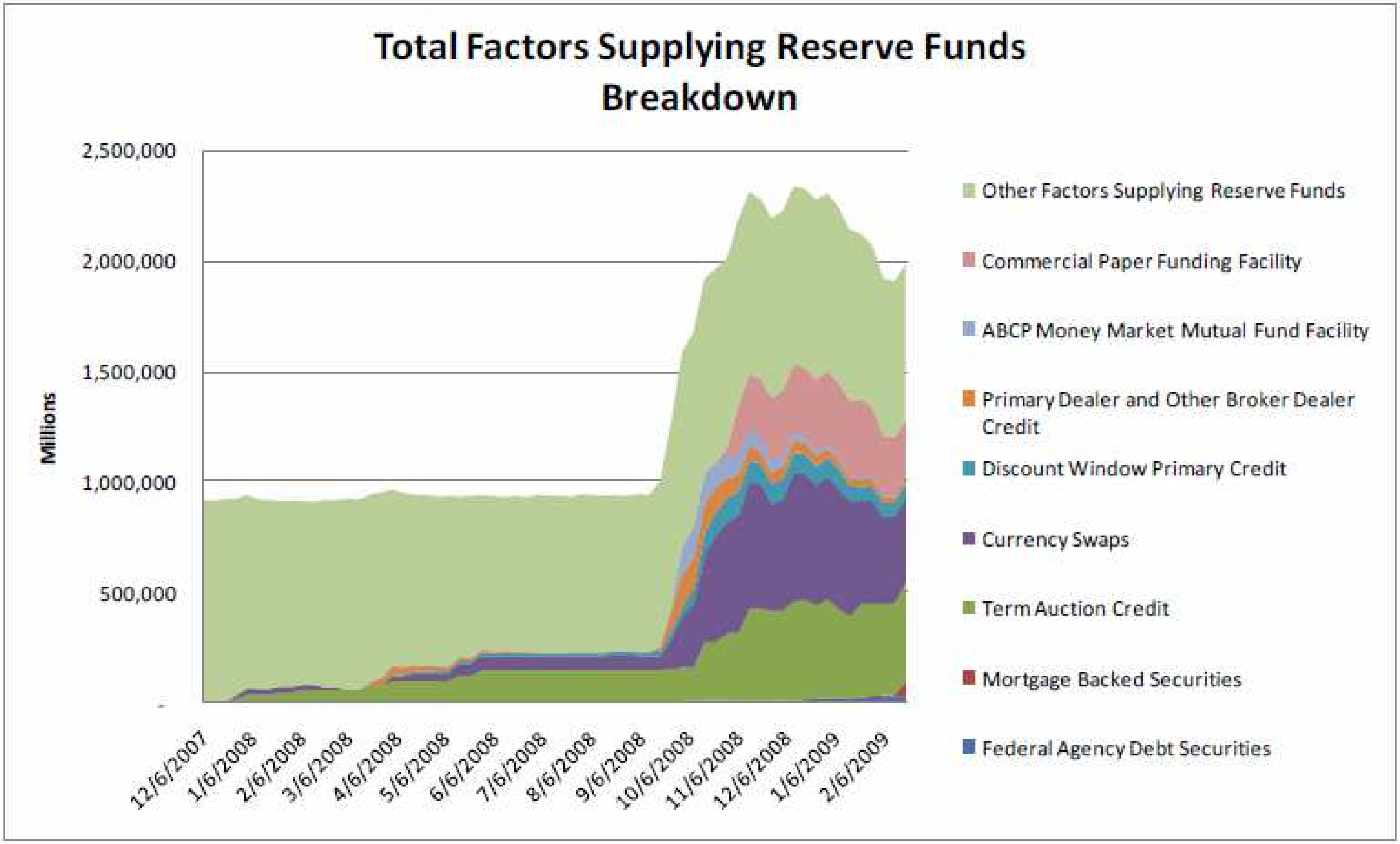

Federal Reserve

Financial Regulatory Complacency and lack of enforcement of financial regulations

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Regulatory Authority to Restrict Sub-Prime Lending

The Federal Reserve Had Broad Authority to Restrict deceptive lending practices under the 1994 "Home Owners Equity Protection Act"

But it did not do anything to enforce this law.

According to *Wall Street Journal*

"Mr. Greenspan says he didn't get heavily involved in regulatory matters in part because his laissez-faire philosophy was often at odds with the goals of the laws Congress had tasked the Fed with enforcing"

Fast Forward to October, 2008

Greenspan Concedes Error on Regulation

Doug Mills/The New York Times

But Greenspan blames the securitization process

"Pressures on lenders to supply more "paper" collapsed subprime underwriting standards from 2005 forward. Uncritical acceptance of credit ratings by purchasers of these toxic assets has led to huge losses.

It was the failure to properly price such risky assets that precipitated the crisis."

Problems with Bank Bail-outs and restructuring Plans well known:

1. ***Secrecy with respect to AIG and counter-parties***

2. ***Attempts to use Fed (and FDIC) as cover in the PPIP bank restrcuturing plans, etc.***

3. ***Did not use powers gained from bail-outs to force reforms on banks and force them to keep credit flowing.***

Would more Fed Accountability Have Helped?

1. ***More pressure to stop bubble? Seems unlikely***

2. ***More pressure to take more expansionary action earlier on.***

3. ***More accountability and transparency in initial bail-outs and perhaps stronger pressure for more influence over bank actions to support economic recovery would have helped.***

More accountability necessary in current phase

1) ***The Fed will continue to be extensively involved with bank restructuring operations, placing at risk billions of taxpayers dollars***
2) ***Credit easing operations affect particular institutions, markets in broad swaths of the economy, and come quite close to credit allocation***
3) ***Must coordinate with fiscal policy to support fiscal policy actions, eg. As it buys long-dated securities***

Two Dangers:

1. ***Fed will be insufficiently cooperative with Treasury***

2. ***That the Treasury will use the Fed as a cover for some of its operations and more resources to use without proper congressional oversight.***

New Treasury-Fed Accord, March 3, 2009

1. ***As long as unusual and exigent circumstances persist, Fed will continue to cooperate with Treasury and other agencies to help prevent failures that will cause systemic damage***
2. ***Fed Credit operations will try to avoid credit allocation which is the province of the fiscal authorities***
3. ***Fed retains independent control over monetary policy***

Agreement is designed to:

1. ***Signal Feds willingness to cooperate now***
2. ***To preserve authority over monetary policy as much as possible and certainly for the future ot avoid "trap" of the 1930's and 1940's***
3. ***Avoid any real structural changes in Fed Reserve Governance so that once the crisis is over, they can return to business as usual.***

Reforming the Fed to Enhance Accountability: Fed Anomalies

1. ***Fed Owned by commercial bank members. Insulates Regional Bank Presidents, some of whom sit on the FOMC, from Congressional Confirmation, and other oversight. (This includes President of the New York Fed)***

2. ***The Fed is not subject to GAO Audits***
3. ***Fed has some exemptions from FOIA and Sunshine Laws***
4. ***Inspector General Appointed by Fed Chair not President***

Fed Anomolies

5. Fed Budget not subject to Congressional Appropriations

Numerous Proposals over the years to reform the Fed

1961 Commission on Money and Credit sponsored by the business organization Committee on Economic Development: Proposed "expanding the degree of of independence of the Federal Reserve from the banking community which it both serves and regulates".

Some Sensible Proposals to:

1. ***Enhance public oversight***
2. ***Congressional branch accountability***
3. ***Executive branch accountability***

While preserving expertise and longer term perspective of fed.

Reforms:
Make Fed more accountable to public

1. ***Nationalize the Federal Reserve: retire commercial bank stock and replace it with stock owned by the people living in the fed reserve districts.***
2. ***Public members of Boards of directors of Fed Regional Banks chosen by voters in Fed Districts***
3. ***Presidents of Reserve Banks have congressional confirmation hearings.***

Make Fed More Accountable to Congress

1. ***Place Federal Reserve Budget under normal Congressional Appropriations Process***

2. ***The General Accountability Office should have the same powers to audit the Fed as other institutions***

3. ***Sunshine laws and FOIA laws should be revisited to see which ones should be applied to Fed***

Make Fed more accountable to the Executive Branch

1. ***Terms of the appointments of top Fed officials should be more coterminous with that of the President.***

2. ***The details of the new accord should be fleshed out and made more explicit and allow more public discussion.***

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Conclusion:

1. ***More Fed accountability would have likely substantially helped in avoiding some of the build-up to the Congress, creating a swifter and more effective response.***
2. ***More accountability is essential moving forward.***

3. ***But these by themselves are not sufficient:***

-Need to reform macroeconomic theory and practice

-- Dramatically reduce the role of money in politics that can corrupt all these oversight processes.