



# Restoring Monetary Policy Independence: The Risks of Regulatory Reform

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## Introduction

Monetary policy independence is often discussed, but almost never defined. What does it mean for a central bank like the Fed to be independent in the context of American political institutions? What is the point of its being independent? What threatens beneficial independence, and how should current reformers of financial regulation think about the likely consequences of increasing or decreasing the Fed's regulatory powers or mandates on the Fed's monetary independence?

This article addresses those questions by (1) defining the meaning of central bank independence, (2) considering the extent to which central bank independence, including Fed independence, has varied over time; (3) describing how the reshaping of the substance and structure of financial regulation could affect the future of Fed independence; and (4) suggesting guiding principles for the role the Fed should and should not play in financial regulation in light of potential consequences for the Fed's independence.

## Defining Central Bank Independence: "Structural" and "Contextual" Independence

A high degree of central bank independence does not mean that the central bank does whatever it pleases. In a democracy, the central bank, like all government creatures, ultimately must answer to the people via their elected representatives. In a Constitutional democracy, the will of the people with

respect to central banking policy is and should be expressed either in the Constitution itself (which some countries have used to define their central banks' functions and powers) or in legislation, subject to periodic amendment, that defines the goals and institutional structure of the central bank.

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**In a Constitutional democracy, the will of the people with respect to central banking policy is and should be expressed either in the Constitution itself or in legislation**

Economists advocate central bank independence – that is, delegation of day-to-day decision making over monetary policy to an institution that is as removed as possible from short-term political pressures – because such delegation permits the central bank to operate outside the short-term mandates of the election cycle and take a longer-term perspective on economic policy. That is not to say that central banks should behave in ways that are independent of the public's long-term desires. Ultimately, therefore, central bankers must be accountable to the societies that delegate authority to them.

Central bank independence, therefore, properly relates to two different phenomena: **(1) the *degree to which, and the time horizon over which, a Constitution or legislation delegates authority*** to central bankers (e.g., the length of central bankers' terms of office, the extent to which central bankers' discretion is permitted to determine policy, etc.), and **(2) the *degree to which the central bank is***



**able to operate independently from short-term pressures by government officials that exert power through political threats** rather than through legislative changes in the charter of the central bank.

These two aspects of independence – which I will refer to as “**structural**” and “**contextual**” independence – are distinct, are subject to change over time, and can evolve in opposite directions. The first aspect refers to the formal powers and structure of the central banking institution, while the second refers to the contextual reality in which central bankers operate. To see how these two concepts of independence can differ, consider the mid-1930s, when Treasury Secretary Morgenthau believed that he controlled Fed decision making through his ability to credibly threaten use of the Exchange Stabilization Fund and other levers of control over the money supply to reverse Fed actions, if necessary:

...the way the Federal Reserve Board is set up now they can suggest but have very little power to enforce their will...[The Treasury's] power has been the Stabilization Fund plus the many other funds that I have at my disposal and this power has kept the open market committee in line and afraid of me (Blum, 1959, p. 352).

This loss in Fed independence in the mid-1930s (due to pressures exerted outside of the formal procedures governing Fed policy making) occurred in spite of new legislative powers that had been given to the Fed in the Banking Act of 1935 (which consolidated power within the Board of Governors and gave the Board new authorities, including the control of reserve requirements). Indeed, Morgenthau intimated in his diary that he supported the 1935 Act partly because it gave the appearance of enlarged power within the Fed, which would insulate him from responsibility “if the financial situation should go sour,” but he did not believe that the new powers of the Fed made a substantive difference to their power, given his ability to pressure the Fed to do his bidding. Morgenthau was prescient; he cajoled the Fed successfully

in March 1937, when he pressured the Fed into supporting bond prices, after threatening to intervene in the market if they did not. That threat was credible because the Treasury had more resources available under the law to increase the money supply than the Fed (with its limited balance sheet size) had to shrink it. The Fed capitulated to Morgenthau’s demands (Calomiris and Wheelock 1998, p. 40). That sort of political threatening is not an isolated incident. Members of Congress, Secretaries of the Treasury, and Presidents have often used threats of action, rather than actual legislation, to influence the decision making of Fed officials and those of other semi-autonomous regulatory agencies. In measuring independence, the broader context in which the Fed operates matters as much, and sometimes more, than the specific powers that are delegated to the Fed to perform monetary policy. For example, during a protracted and costly war, the central bank’s autonomy is constrained by the practical needs of war finance, and by the implicit threat of potential legislative action against any central bank that would stand in the way of the national war effort. Similar inflationary war financing policies occurred in the US during its major wars, whether in the absence or the presence of a central bank<sup>1</sup>. It would be folly to imagine that the formal statutory authority of the central bank could empower it to execute independence in the context of a wartime economy.

## Politics and Central Banking Prior to the Fed’s Founding

There is much to be learned about the factors affecting central bank independence from the Bank of England’s history, and that of the two proto-central banks that operated in the US during its early history (the Bank of the United States and the Second Bank of the United States). Before reviewing the record of Fed independence, I briefly review their histories.

1. The Revolution, the War of 1812, the Civil War saw the creation of extraordinary monetary instruments. In the case of the Civil War, two wartime measures (legal tender currency and nationally chartered banks that backed their note issues with government bonds). During World Wars I and II, the pressures for inflation to support the war effort were similarly visible.



## Restoring Monetary Policy Independence: The Risks of Regulatory Reform

### *The Bank of England: Successful Co-Evolution of Politics and Central Banking*

Until 1946, the Bank of England (the Bank) was a privately-owned organization. Before that date, the Bank of England was a for-profit government-sponsored enterprise (GSEs) that combined monopoly privileges with public purposes.

**[The Bank] did not act as a monetary authority or even as a clearing house for the banking system; goldsmith bankers regarded the Bank as too politicized and risky to be trusted for that purpose.**

Although the Bank of England was privately owned prior to 1946, its structural and contextual independence varied greatly over its history. As a creature of Parliament, it was dependent on Parliament for its charter, which was subject to change or revocation. The Bank was chartered in 1694, at which time its primary purpose was to make loans to the government, whose finances were in a desperate state. During its early history, the Bank primarily served as a source of credit to the government. It did not act as a monetary authority or even as a clearing house for the banking system; goldsmith bankers regarded the Bank as too politicized and risky to be trusted for that purpose. In that respect, the Bank was quite different from its famous Dutch predecessor, the Wisselbank, which acted as a highly efficient clearing house for bill of exchange and did not lend to government during its early history).

Many Parliamentary policy changes altered the “deal” between the Bank of England and the British government during its existence, and those changes had important consequences for monetary policy. In 1797, despite the strong financial condition of the Bank and of the banking system in general,

weakness in public finances led the government to force suspension of convertibility by the Bank, which ushered in inflationary finance of Britain’s War effort against Napoleon, with the assistance of the Bank.

The Bank’s notes were given legal tender status in 1833, which was motivated (and explicitly justified at the time) as a means to increase the Bank’s capacity to bail out bills brokers during banking crises (effectively, giving the Bank access implicitly to taxpayer resources). An essential part of the service to be performed by the Bank in exchange for its monopoly privileges was the funding of bailouts of bill brokers, which happened during the financial crises that England experienced roughly every ten years from the mid-18th century through the mid-19th century.

The Bank was required to maintain a 100% specie backing for its notes in 1844, but this limit was always relaxed during a financial crisis, so that the Bank could issue notes as needed to bail out the financial system. The Bank was permitted to substantially curtail its bailouts of financial institutions in 1858, as the result of high-profile public and Parliamentary debates over bailout policies and moral hazard, which culminated in the elimination of the (implicit) burden on the Bank. This policy change was tested by the Overend Gurney crisis of 1866, at which time the Bank refused to bail out Overend Gurney, despite its too-big-to-fail bid for protection.

By the late 19th century, the relationship between the Bank of England and the British government had stabilized. Having achieved substantial independence from the deficit financing needs and bailout mandates of the government, the Bank of England came to play the role of the banker’s bank of Great Britain, as the manager of monetary policy and the lender of last resort, sometimes providing



discipline, and sometimes accommodation. The Bank is widely viewed as having played a constructive role in maintaining the gold standard and avoiding severe financial crises in Great Britain for nearly a century and a half. A key feature of its policy approach was to provide liquidity support to the financial system without absorbing significant risk of loss when doing so (“Bagehot’s Rule” of lending only on good collateral at a high rate is one example of this policy; providing backstop protection to the London clearing banks, who absorbed almost all of the risk from their support of Barings in 1890, is another example).

The Bank of England is an example of a successful co-evolution of a central bank and its government. Early in its history, the Bank was not independent – structurally or contextually. Its charter changed frequently and was subject to revocation without notice (a provision that accompanied the granting of legal tender authority to the Bank in 1833). The volatility of its legal position both reflected and invited “contextual pressures” that operated in the highly unstable political equilibrium of its early history, and effectively forced the Bank to participate in bailouts that it found objectionable and strongly opposed<sup>2</sup>. Over time, however, that equilibrium changed. The powers of the Bank, and the social consensus about the desirability of those powers, converged on a stable definition, which gave considerable legal autonomy to the Bank, and also protected the Bank from threats to its autonomy by powerful government officials.

It is noteworthy that **a key contributor to that constructive change was the loss of some of the Bank’s power**. During and after the 1830s, entry

barriers on bank chartering and branching were relaxed, which eroded the Bank’s monopoly position in London, but also reduced public pressures on the Bank to provide “payment” for its privileges. In other words, as the rents attached to the Bank’s charter declined, so did the ad hoc demands from Parliament that the Bank share those rents. Demands to bail out the inland bills market were reduced in large part because the presence of banks providing substitute sources of credit for bills brokers reduced the political support for propping up the bills brokers (bills brokers had been a second-best source of credit supply necessitated by the limitations placed on bank chartering, which had been won by the Bank in its early political lobbying).

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### *Central Bank Extinction under Political Disequilibrium: The History of the BUS and SBUS*

In contrast to the case of the Bank of England, America’s attempts to create a central bank twice led to extinction of those banks rather than evolution toward a stable set of structural and contextual norms that protected central bank independence. That difference is important, and has important lessons for the political risks that the Fed faces today. Alexander Hamilton modeled the Bank of the United States (BUS) on the Bank of England, although its operations and ownership structure were somewhat different. The BUS’s primary role was as a fiscal agent of the government, but it also acted as

2. The Revolution, the War of 1812, the Civil War saw the creation of extraordinary monetary instruments. In the case of the Civil War, two wartime measures (legal tender currency and nationally chartered banks that backed their note issues with government bonds). During World Wars I and II, the pressures for inflation to support the war effort were similarly visible. King (1936, 71-72) recounts how London’s merchants organized protests to pressure the Bank not to constrain its discounting policies as early as 1793 and 1795. The protesting merchants issued a joint statement threatening that if the Bank were unwilling to maintain sufficient discounting, “it will be requisite that some other Public Establishment should be created to supply the Deficiency; at the same time wishing that this assistance may be derived through the old and customary Channel, the Bank of England.” In other words, if the Bank of England refuses to obey the needs of the public, the public should charter a new bank to meet those needs. Later, attempts by the Bank to establish a classification system for bills, and price bills of different quality accordingly, also met with merchant opposition and was abandoned (King 1936, 53). The Bank objected to playing the role of benefactor to the inland bills market during financial crises. In both 1847 and 1857, the Board of the Bank of England advised the government against suspending the 1844 Bank Act’s provisions (Hughes 1960, 320-21. Bagehot 1873, 65-66), but to no avail. In principle, the Bank could have refused to increase its note issuing beyond the amount of its specie reserve in 1847 and 1857, and the Bank could have refused to accommodate bills, both before and during banking crises. But that would not have been possible in practice. At the heart of the matter was the simple fact that the Bank relied on the government, and on public opinion, to maintain its special privileges, and “an institution so dependent on the Government of the day for the continuance of valuable rights was little able, as Mr. Ricardo observed, to withstand the cajoling of Ministers” (Schuster 1923, 11).



a competitor to state-chartered banks. Its liabilities did not enjoy legal tender status. The charter of the BUS lapsed in 1811 and it was not renewed by the Jeffersonians, who opposed the BUS as an unhealthy concentration of national financial power.

The absence of the BUS during the War of 1812 was associated with severe problems of managing the fiscal affairs of the government, and a bank suspension during the War. Those problems galvanized public opinion in favor of the chartering of the Second Bank of the United States (SBUS), which was founded in 1816. Like the BUS and the Bank of England, the SBUS was a for-profit institution that was expected to balance private and public interests.

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**In other words, the extinction of the BUS and SBUS resulted from their poor political fit with the political context of their times, not from their poor economic fit with the financial system.**

The SBUS was expected to be a source of discipline on other banks; it was envisioned that it would use its privileged position as the only branching bank operating throughout the country to prevent over-issuance of banks' notes by sending notes back to issuers as needed, and thus inhibit excessive risk taking. It was also expected to be a source of accommodation (liquidity support) to other banks during crises. And its stockholders expected it to earn a profit. Needless to say, striking the right balance between serving the public interest via the right mix of accommodation and discipline, while fulfilling its obligations to stockholders, was a challenging triple mandate. With these conflicting mandates it is no wonder that the SBUS became a lightning rod for criticism. When it limited its accommodation during crises it was accused of self-serving, anti-competitive behavior intended to harm its competitors. It was also blamed for insufficiently disciplining banks and

preventing their excessive risk taking in advance of financial crises. And, like its predecessor, the SBUS was despised as an improper concentration of national financial power. All of this contributed to the veto of its new charter by President Andrew Jackson in 1832.

In contrast to Jacksonian contemporaries, financial historians have had a very favorable appraisal of the SBUS (see Calomiris 2009 for a review), finding that it balanced discipline during normal times and accommodation during crises, within the limits permitted by its finite financial resources (unlike the Bank of England's notes, SBUS notes were not a legal tender). Furthermore, financial historians have found that the existence of the SBUS was associated with moderation in seasonal volatility of liquidity (and in this respect, it was clearly a precursor of the Federal Reserve System).

In other words, the extinction of the BUS and SBUS resulted from their poor political fit with the political context of their times, not from their poor economic fit with the financial system. The Bank of England was able to evolve beyond its early years of political and economic disequilibrium toward a stable social consensus that fostered its structural and contextual independence. In contrast, the BUS and SBUS never managed to satisfy the political constraints necessary to form a social consensus about their role and structure, which was necessary to ensure their survival, much less their independence.

### The Founding of the Fed

Since the extinction of the SBUS, the US operated without a central bank until the creation of the Federal Reserve System in 1913. The Fed, like the BUS and SBUS, was a creature of legislation. It has no Constitutional status. Indeed, it is uniquely vulnerable to Congressional interference, since it



is not part of the Executive Branch of government, and therefore, does not enjoy the Constitutional protections that apply to the Executive branch. The Fed could disappear tomorrow, if the Congress and the Administration decided to repeal the Federal Reserve Act. Or, it could be instructed to change its policy goals, targets, or instruments in accordance with new amendments to the Federal Reserve Act.

Not surprisingly, from its inception to the present, the Fed's history has reflected the politics of the nation. But that does not mean that the Fed has always been equally "independent."

The Fed's founding was a grand political compromise. After the Panic of 1907, the National Monetary Commission (NMC) was established to recommend reforms to the American financial system in light of the peculiar US propensity for banking panics. The NMC published voluminous studies of other countries' banking systems, drawing attention in particular to the destabilizing role of America's unit banking system, in contrast, in particular to Canada's nationwide branching system, which avoided banking panics despite the absence of a central bank (the Bank of Canada was founded in 1935).

The unit banking system in the US was responsible for many problems. First, the barriers to entry implied by unit banking prevented productive competition among banks. Second, unit banking produced lack of diversification of loan risk within banks, as each bank's portfolio risk reflected the operations of its local economy. Third, unit banking inhibited financial integration across regions, which resulted in large differences in interest rates between the East and the West, and high seasonal volatility in liquidity risk. Seasonal liquidity risk – reflected in seasonal cycles in interest rates and stock returns – reflected primarily the harvesting cycle of the cotton crop

(and, to a lesser extent, other crops) which drove large seasonal swings in the demand for credit in agricultural areas in the fall and the spring, which required seasonal transfers of funds, back and forth, twice a year, between New York and the periphery. Fourth, the lack of financial integration and the pyramiding of reserves in New York also made the whole system excessively vulnerable to financial system shocks affecting securities markets. Fifth, when financial shocks occurred, it was virtually impossible for banks to coordinate their responses to those shocks via collective action, because of the thousands of geographically separate banks that made up the banking system. Although there was not a consensus on what weights to attach to each of these five aspects of unit banking for explaining the peculiar history of US banking panics, all problems pointed to unit banking as their ultimate source. The obvious simple solution, however – to imitate Canada's nationwide branch banking system – was a political nonstarter.

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In that sense, the founding of the Fed (like the creation of the BUS and SBUS before it) was a second-best economic solution to the deeper political problem of unit banking. The Fed smoothed the effects of seasonal and cyclical liquidity demands by making the supply of reserves more elastic via its new sources of reserves supply (the discount windows of the twelve Federal Reserve Banks). Importantly, the Federal Reserve Banks issued legal tender currency, which meant that the supply of riskless reserves was not limited by the inelastic stock of specie and other forms of currency. The Fed operated throughout the nation to smooth seasonal and cyclical demands for



liquidity. The early history of the Fed indicates that it was quite successful in improving the elasticity of liquidity supply seasonally and cyclically.

The Federal Reserve System was an acceptable political solution to banking instability precisely because of the combination of structure, powers, and rules that it embodied. It was decentralized in structure, and thus did not run afoul of opponents of national consolidation of control. Even more important, it was an institutional embodiment of political balance. The Fed was not “above it all” politically; rather, it combined in one organization the opposing interests that held sway over its existence. The political balancing act of the founding of the Fed gave important new powers and opportunities to agrarian interests (e.g., by permitting member banks to make real estate loans – an activity prohibited for national banks in the first fifty years of their existence), gave new opportunities for borrowing to member banks, and shared power over its rules and governance with the Executive and Legislative branches of the federal government, ensuring that all these parties had an interest in preserving the institution, and that none of them had much of a chance to hijack it for their own purposes. The Fed’s charter was a credible commitment to the balanced interests that negotiated it because it would be difficult to change.

The bargain that was struck over the founding of the Fed was a **stable bargain**. It gave the institution more than two decades to absorb its new economic powers before having to engage in a political “re-chartering” battle in 1933-1935, and the restructuring that occurred in the 1930s, and subsequently, has always occurred within the context of institutional stability – small changes within a stable institutional structure.

That institutional stability was especially helpful during the Fed’s formative years, as the first two decades of the Fed’s existence was an economically tumultuous period, and one in which the Fed was grappling with a wide range of issues. How would the Fed implement the “real bills doctrine” as a monetary policy strategy? What principles should guide the supply of reserves over the business cycle? What were the best instruments to execute monetary policy? How could member banks be attracted while still enforcing meaningful prudential regulatory standards? How could the Fed’s interbank clearing and deposit network replace the stubborn pyramiding of reserves? The Fed responded to these and other challenges flexibly. During World War I, for example, the Fed adapted to the government’s financing needs by instituting a major and lasting change not envisioned by its architects, namely permitting the use of government securities for discounting and open market operations.

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The 1930s saw a major restructuring of the banking system in 1933 (Glass-Steagall, Regulation Q, FDIC insurance) along with significant changes in powers of the Fed and the allocation of Fed decision making in 1935. As noted before, although the changes in Fed powers in 1935 seemed to increase Fed independence (and ultimately did increase Fed independence after World War II), the Treasury Secretary actually increased his power at the expense of Fed independence during the mid-1930s. That trend accelerated during World War II, as monetary policy took a back seat to the war effort.

As the Fed emerged from World War II however, the wartime growth that had occurred in its balance sheet gave the Fed a new power – namely, the power



to shrink its now massive balance sheet. In the mid-1930s, the Fed's balance sheet was no match for Secretary Morgenthau, who had more than enough resources to offset with expansion any attempt at contraction by the Fed. After World War II, that was not the case. This simple arithmetic of a credible threat to shrink underlay the 1951 Accord, whereby the Fed once again obtained effective autonomy over monetary policy. Although the Fed had the tools and the power to pursue independent monetary policy in the 1960s and 1970s, creeping inflation resulted from the political risks of contraction. The Fed avoided implementing the contraction necessary to wring inflation from the system, despite its recognition of the problem, and of the obvious solution. In part, that reluctance underlay concerns about the political repercussions of a severe recession for the Fed. The triumph of the Fed as an institution in defeating inflation in the early 1980s was arguably the Fed's finest hour – a moment in which the Fed made unabashed use of its authority and tools to end high rates of inflation.

## The Future Independence of the Fed

We are now, as during the early 1830s, the early 1930s, the late 1940s, and the late 1970s, in the midst of a highly volatile time from the standpoint of potential changes in the structure of our central bank. Should the Fed expand beyond its dual mandate of targeting unemployment and inflation to also target financial stability (aka “systemic risk”)? Should new tools be added to its arsenal to do so, and if so which ones? Should additional rules relating to the new tools to manage “systemic risk” be adopted, and if so, which rules? Which combination of time-varying capital requirements, liquidity requirements, and provisioning requirements would work best, and what indicators would best capture systemic risk (leverage, asset price growth, credit growth)?

Should these changes be accompanied with more or less discretionary authority by the Fed? Especially in light of the loose monetary policy of 2002-2005, and the disastrous consequences of departing so aggressively from the Taylor Rule during those years, some are arguing that the Fed should be charged with adhering more to a Taylor Rule?

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In other words, there is great uncertainty about how the Fed's monetary policy authority, and other authority, will evolve. Regardless of the ultimate outcomes, the **unpredictability of this current state of affairs matters now**, because it weakens Fed independence immediately, “contextually,” even before any legislative actions are taken.

Fed officials are constantly engaged in political dealing in Washington. The Fed seems to be at the mercy of the Treasury to help it develop an exit strategy that would allow it to disgorge its toxic securities. The Fed worries over its potential loss of power, especially in supervision and regulation. The Fed is positioning itself on many issues, forming alliances with members of Congress and the Administration, often cow-towing to them in public. At the moment, Fed independence is not at risk; it is gone. The question is whether it will someday be restored.

How did this happen? Part of the story, of course, is that the financial crisis encouraged the Fed to undertake unprecedented actions – which have undermined its independence from the Administration and Congress. Another part of the story is that the financial crisis has inspired many new ideas for reforms.



But another part of the story about the Fed's lost independence, and the volatility of the currency policy environment, relates to the Fed's own actions as a player in the Washington drama. The Fed has aggressively sought to expand its authority over the financial system over the past several decades, and has sought increasing power to determine the structure of the financial system, culminating in the creation of its "umbrella" authority under the Gramm-Leach-Bliley Act of 1999. Over the past half century, the Fed has aggressively pursued an expansion of its regulatory powers – to decide which banks should merge with whom and which should not, to determine whether banks are properly serving the interests of their communities, to decide whether real estate brokerage is a financial activity, to protect consumers from unfair practices, to supervise the broad range of activities undertaken by bank holding companies, and to enforce violations of banking regulations. None of those activities is at the core of the Fed's mission as a monetary policy authority.

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While it is necessary and proper for the Fed to act as an unfettered examiner of member banks, and of all other institutions that are given access to its discount window, examination is separate from the activities listed above. Examination authority (for purposes of deciding whether to lend) need not entail supervisory authority, enforcement authority, or authority to set merger standards or to decide on the range of permissible financial activities. Neither is it necessary for the Fed to establish the basic prudential regulatory standards for banks or other financial institutions. The Fed's regulatory power

grab is not just a distraction from its core mission. The Fed's involvement in regulatory and supervisory matters – not to mention the financing of bail outs or the management of distressed financial institutions – reduces Fed independence by embroiling the Fed in a constant and unpredictable array of political struggles that destabilize the political equilibrium that has traditionally supported its independence as a central bank. The Fed has sought increased powers and greater political involvement on the theory that these activities enhance its power, and that enhanced power increases independence. That is a faulty analysis, as the preceding historical discussion shows. The Bank of England's time of greatest independence followed substantial ceding of its monopoly privileges, which encouraged it to focus on its core mission. As the history of the SBUS shows, multiple mandates expose a central bank to risk of political attack. The more involved the Fed is in the political struggles over dividing regulatory rents, the more exposed it is to "contextual" threats to monetary policy independence.

## Guiding Principles

The central implication of this analysis – that it is counterproductive for central banks to also play the role of financial regulator and supervisor – seems to be widely accepted outside of the United States. The expanding role of the Fed as a financial regulator in recent years is out of step with the global trend to separate monetary policy from regulatory policy. Virtually all developed economies have separated their monetary authority from their financial regulatory authority. Such a separation is understood to be desirable because it limits the politicization of monetary and regulatory policy. Indeed, the US is one of the clearest examples of these risks; pressures from special interests in the regulatory arena have led to poor regulatory decision making by the Fed,



most obviously in the areas of bank merger approval and the limitation of permissible financial activities, precisely because the Fed fears repercussions from Congress. Those pressures and fears reduce the Fed's independence in managing monetary policy (Calomiris 2006).

That said, the Fed does have a legitimate role to play in one new area. To the extent that reforms of financial regulation will seek to manage cyclical changes in credit growth and financial system risk, and impose time-varying capital and liquidity requirements on banks as part of an augmented approach to cyclical stabilization policy, the determination of these new policies (but not their enforcement) is an area in which the Fed should play a key role. The main argument in favor of a Fed role in determining the framework for macro prudential regulatory policy is the desirability of concentrating accountability for countercyclical policy within one institution.

Accountability, however, would not be served by a policy approach that would target an amorphous multiplicity of goals with a diverse set of instruments. Whoever takes on the role of macro prudential regulator (whether the Fed or a council of regulators) should develop a formal modeling framework for measuring the extent of systemic financial risk, which it would have to defend publicly. That model would describe how time-varying system-wide financial risk is measured, and how moments of high systemic risk are identified. The macro prudential framework would delineate how minimum capital requirements, provisioning requirements, and reserve requirements – not the fed funds rate – would respond to significant perceived increases in system-wide risk.

Monetary policy – variation in the fed funds rate – should be rules-based, and should not be

complicated by attempts to use monetary policy as an instrument to control financial system risk. The Fed should formally adopt as a benchmark some specific announced inflation target and a Taylor Rule associated with that target. That would permit the public to predict monetary policy better and better hold the Fed accountable for monetary policy. The Fed would still be free to deviate from its announced targeting policy, but it would be forced to explain such deviations immediately because both the rule and policy actions would be observable.

It may also make sense to create some new rules for the resolution of large financial institutions, although this idea is also fraught with risks. In any case, it would be highly inappropriate to place such resolution authority over bank or nonbank financial institutions in the hands of the Fed. Doing so would further politicize the Fed, and likely would encourage rather than avoid too-big-to-fail bailouts.



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