THE CHAIR'S SUCCESSION AND THE FED'S FUTURE

SOMC STATEMENT

Shadow Open Market Committee

"Exiting, Succession, and the Future of the Fed"

Sponsored by the
Manhattan Institute for Policy Research
New York City

September 20, 2013

The public's interest in the Fed Chair's succession is now on par with or perhaps even more intense than its interest in the appointment of the Chief Justice of the U.S. Supreme Court! A public and Congress capable of consideration of broad constitutional and legal questions with regard to Supreme Court appointments is certainly capable of the same with regard to the governance of the independent Federal Reserve. Yet the wealth of commentary in the media has focused on personality, style, and gender and has been sorely lacking in substantive content.

It would be far more helpful to view the forthcoming Senate confirmation process for Fed Chair as an opportunity to reconsider the appropriate boundaries for the Federal Reserve's operational policies. The Chair has the decisive say in whether the Fed will utilize broad operational means, or narrow operational means to achieve its objectives. The Chair's judgment establishes operational boundaries between the Fed and markets on one hand, and between the Fed and the fiscal authorities (Congress and the Treasury) on the other. The Chair's succession matters hugely for how the Fed will act in the future.

The primary consideration in appraising the appropriate boundary for the Federal Reserve's independent operational policies is the distinction between monetary policy (narrowly defined) and credit policy.

Monetary policy (narrowly defined) involves Fed operations that expand or contract bank reserves by the purchase or sale of Treasury securities from the Fed's portfolio. Monetary policy works via the management of bank reserves and interest on reserves to influence the general level of market interest rates. Monetary policy does not favor one sector of the economy over another; and monetary policy does not involve taking credit risk onto the Fed's balance sheet. Therefore, monetary policy with a "Treasuries only" asset acquisition policy (followed by the Fed before the recent credit turmoil) is well-suited for delegation by Congress to the independent Fed.

In contrast to monetary policy, Fed credit policy has little effect on the general level of interest rates and inflation. Credit policy involves Fed lending to private entities financed by the sale of Treasuries from the Fed's portfolio or by freshly created bank reserves. Fed credit policy exploits the government's creditworthiness—via the sale of Treasury debt from the Fed's portfolio against future taxes—to finance loans to distressed borrowers.

Fed credit policy is really debt-financed fiscal policy carried out by the central bank. Except for occasional short-term Fed lending to regulated, solvent depositories, on good collateral, the presumption should be that credit policy ought to respect the congressional appropriations process and be handled by Congress and the Treasury and not the independent Fed. The lack of clarity in the boundary of Fed credit policies, especially evident in the 2007-8 credit turmoil and its aftermath, threatens the legitimacy of both the independent Fed and the fiscal authorities.

The absence of clear limits on Fed credit policy creates another problem, too, due to the tendency for Fed last resort lending to expand in reach and scope, with increasingly distortionary and destabilizing consequences. For instance, in the 2007-8 credit turmoil the Fed was put in a no-win situation given its wide powers to lend—disappoint expectations of accommodation and risk financial collapse or take on expansive underpriced credit risk, as Paul Volcker put it "with the implied promise of similar actions in times of future turmoil." The Fed chose the latter course of action—even allowing two major investment banks (not previously regulated or supervised by the Fed) to quickly become bank holding companies in order to access the Fed discount window.

In light of the abovementioned realities, the Senate confirmation process should ascertain the nominated Fed Chair's inclination toward broad or narrow use of the Fed's operational credit policy independence. Senators could then choose to confirm or not, in part, based on their comfort with the nominee's inclinations in this regard.

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