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# Lessons from a century of FED policy: Why monetary and credit policies need rules and boundaries☆

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ABSTRACT

Wide operational and financial independence given to monetary and credit policies subjects the Federal Reserve to incentives detrimental for macroeconomic and financial stability. The absence of a monetary policy rule created go-stop incentives that produced inefficient volatility of both inflation and unemployment during the Great Inflation. Fed credit policy has undergone massive "mission creep" since the Fed was established. Being debt-financed fiscal policy, Fed credit policy beyond ordinary temporary lending to solvent depositories creates friction with the fiscal authorities and jeopardizes the Fed's independence. An ambiguous boundary of expansive Fed credit policy creates expectations of Fed accommodation in financial crisis—that blunts the incentive of private entities to take protective measures beforehand (to shrink counter-party risk and reliance on short-term finance, and build up equity capital) and blunts the incentive of the fiscal authorities to prepare procedures in advance to act systematically in times of credit turmoil. These points are illustrated with reference to the 2007–09 financial crisis. Part of the problem is that the independent Fed does not have the same incentive as the 19th century Bank of England to follow Bagehot's Rule. The paper concludes with a set of principles to preserve a workable, sustainable division of responsibilities between the independent central bank and the fiscal authorities.



## 1. Introduction

In 1913 the United States overcame a long-standing distrust of government intervention in the monetary system to establish a central bank. The Fed was to employ its independent monetary and credit policy powers to improve on the rules of the classical gold standard, rules that were seen as unduly restrictive.[2] We now know that faith then placed in discretion over rules was misplaced. The independence given the Fed to pursue discretionary policy in the public interest proved counterproductive.

On the monetary policy side, in line with public and political pressures, the Fed's inclination to prioritize low unemployment over low inflation produced go-stop monetary policy after World War II that delivered neither, and instead produced the Great Inflation and rising unemployment. The Volcker Fed disinflation in the early 1980s eventually brought

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[2] Bordo and Kydland (1995) and Goodfriend (1988).

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both inflation and unemployment down, and showed that effective monetary stabilization policy needs the discipline of an interest rate rule based on a credible commitment to low inflation.

On the credit policy side, there has been since World War II a gradual relaxation of the Fed's last resort lending discipline. Fed lending supported insolvent depositories in the 1970s and 1980s. And Congress in 1991 granted the Fed virtually unlimited power to lend beyond depositories in a crisis. Unbridled credit policy independence in conjunction with its financial independence drew the Fed into a massive expansion of credit in the 2007–09 credit turmoil with the “implied promise of similar actions in times of future turmoil.”[3] Just as an interest rate rule is needed to discipline independent monetary policy, tightly circumscribed boundaries are needed today to discipline independent credit policy.

The lesson from the Fed's first century is that wide operational and financial independence given to monetary and credit policy subjects the Fed to incentives detrimental for macroeconomic and financial stability. The paper tells the story. Section 1 distinguishes monetary policy from credit policy. Section 2 explains the incentives acting on the Fed that gave rise to “go-stop” monetary policy during the Great Inflation. Section 3 documents a century of expansive Fed credit policy. Sections 4 and 5, respectively, explain why Fed credit policy is a two-edged sword—how credit policy worked during the 2007–09 credit turmoil, and why unbounded credit policy exacerbated the Great Recession of 2007–09. Section 6 tells how the Fed's governance differs from that of the 19th century Bank of England, and tells why the Fed lacks incentive to adhere to Walter Bagehot's last resort lending rule followed by the Bank of England. Section 7 explains that the Fed's credit policy powers must be tightly circumscribed to preserve a workable, sustainable division of responsibilities between the independent central bank and the fiscal authorities—Congress and the Treasury. Section 8 recommends a set of principles as the basis for a Fed–Treasury Credit Accord to circumscribe the Fed's independent credit policy powers.

## 2. Monetary policy vs credit policy

Monetary policy refers to the expansion or contraction of currency or bank reserves via Fed purchases or sales of Treasury securities. Open market operations exclusively in Treasuries are monetary policy because when consolidated with the Treasury's balance sheet, the Fed's balance sheet would then contribute only bank reserves and currency.

Monetary policy is suitable for delegation to an independent central bank because monetary policy is about managing aggregate bank reserves, currency, interest on reserves and the general level of interest rates for the whole economy. Assets are acquired only as a means of injecting bank reserves and currency into the economy. Hence, monetary policy can be implemented by confining asset purchases to Treasury securities. And “Treasuries only” insulates the independent central bank somewhat from politics because it avoids credit risk, and because the central bank simply returns interest on its Treasuries to the Treasury (net of operating expenses) for the fiscal authorities to spend as they see fit.

Credit policy satisfies none of the conditions that make monetary policy suitable for delegation to an independent central bank. Credit policy involves lending to financial institutions or the purchase of non-Treasury securities financed by selling Treasury securities. When consolidated with the Treasury's balance sheet, Fed credit policy contributes loans and purchases of non-Treasury securities. Unlike monetary policy, Fed credit policy involves fiscal policy—lending to particular borrowers—financed by sales of Treasuries against future taxes. Credit policy has no effect on the general level of interest rates because it doesn't change aggregate bank reserves. In effect, credit policy effectively is debt-financed fiscal policy carried out by the central bank. The central bank returns to the Treasury interest earned on Treasuries that it holds; so when the central bank sells Treasuries to the public to finance credit policy initiatives, the result is as if the Treasury financed the credit policy by issuing new Treasury debt.

Fed credit policy works by interposing the government's creditworthiness—the power to borrow credibly against future taxes—between private borrowers and lenders to facilitate credit flows to distressed or otherwise favored borrowers. If the Fed funds credit policy with freshly created bank reserves, then to raise interest rates against future inflation the Fed must refinance by selling Treasuries from its portfolio, or pay a market interest rate on reserves created to fund the credit policy. Either way, credit policy involves the lending of public funds to particular borrowers financed by interest-bearing liabilities issued against future taxes. The Fed returns the interest on its credit assets to the Treasury, but all such assets carry credit risk and involve the Fed in potentially controversial disputes regarding credit allocation.

Even fully collateralized Fed credit policy exposes taxpayers to losses if the borrower fails subsequently. For instance, emergency “last resort lending” that finances the exit of uninsured claimants of a financial institution that fails with a Fed loan outstanding strips that institution of collateral that would have been available otherwise to cover the cost of insured deposits if the institution had been closed more promptly.

## 3. Discretionary incentives produce go-stop monetary policy[4]

A central bank such as the Fed charged with conducting monetary policy in the public interest on a discretionary basis is naturally inclined to give considerable weight to the public's concerns. Go-stop monetary policy during the Great Inflation of

[3] Volcker (2008), page 2.

[4] This section comes from Goodfriend (1997), pp. 6–8. Friedman (1964, 1972) discuss go-stop policy. Romer and Romer (1989) document that since World War II the Fed tightened monetary policy decisively to fight inflation on six occasions beginning, respectively, in October 1947, September 1955, December 1968, April 1974, August 1978, and October 1979. The unemployment rate rose sharply after each policy shock. Only two significant increases in