William C Dudley: The role of the Federal Reserve – lessons from financial crises

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Annual Meeting of the Virginia Association of Economists, Virginia Military Institute, Lexington, Virginia, 31 March 2016.

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It is a great pleasure to have the opportunity to speak here today as part of the Virginia Association of Economists annual meeting at Virginia Military Institute and Washington and Lee University. This is an appropriate setting for the topic I will be addressing – the role of the Federal Reserve as the central bank of the United States. When the Federal Reserve Act was enacted in 1913, H. Parker Willis, who had been a professor at Washington and Lee University, played a critical role. He worked closely with Representative Carter Glass of Virginia in crafting the legislative proposal that established the Federal Reserve, and Willis became the first Secretary of the Federal Reserve Board in 1914.

Of course, I'm tackling this subject today not just because H. Parker Willis was a professor here in Lexington. Instead, I'm addressing this issue because of the ongoing debate about the role of the Federal Reserve and its structure and governance. My purpose is to demystify the nation's central bank and to respond to some of the critiques that we continue to face. I see this as necessary because there is a risk that the Federal Reserve could be changed in ways that might impair our ability to achieve our primary objectives – namely, full employment and price stability. As always, what I have to say today reflects my own views and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.

The current debate surrounding this nation's central bank is not new, but rather dates back to our nation's independence from Great Britain. The notion of a central bank in the United States has nearly always been controversial – in concept, design and practice. So much so that the charters of the first two U.S. central banks, the First and Second Banks of the United States, were allowed to lapse.

The United States, in contrast to many of our European counterparts, had no central bank from 1836 to 1913. During this period, the economy was prone to financial panics. The rapid development of the 19th century American economy, including the westward expansion made possible by railroads, outstripped the ability of the private banking system to satisfy the nation's needs for an elastic currency and a stable supply of credit. Ultimately, the Panic of 1907 – in which J.P. Morgan, the leading financier of the day, played an outsized role in responding to the crisis – was the catalyst that turned the tide back in favor of establishing a central bank.

The debate preceding the passage of the Federal Reserve Act in 1913 was protracted and intense. Early drafts of reform proposals were careful not to even mention a "central bank" – the 75-year-old scars from the Second Bank's failed reauthorization battle had still not fully healed. Although there was a strong recognition that the country needed a central bank to forestall and mitigate financial panics, there was considerable disagreement about how it should be structured. Important considerations included what role should be played by private bankers versus government officials, how centralized the new bank should be and the extent of its powers.[1]

During this period, the U.S. economy was susceptible to financial panics. Lacking a central bank, the country had no reliable lender of last resort that could provide currency and credit on demand against high-quality assets. Banks had to self-insure against bank runs by holding a high fraction of deposits as cash, and by entering into private liquidity agreements with other banks. Self-insurance was not only expensive relative to the cost of a public backstop provided by a central bank, but it was also limited in its effectiveness. When the business cycle turned down and financial stress intensified, bank runs often ensued as bank customers rushed to convert their deposits into cash. Without a true lender of last resort, cash that banks individually and collectively kept in reserve often proved inadequate to meet demand. At that point, a bank under duress had to either close its doors or quickly sell assets. Of course, either action worked to intensify the panic and to increase the stress on the economy.

The Federal Reserve was established so that there would be a lender of last resort that could lend against high-quality collateral and provide a reliable and elastic currency.[2] The knowledge that such a lender of last resort existed reduced considerably the incentives for depositors to race to their banks to make withdrawals at the first sign of trouble.[3] At that time, the provision of an elastic currency was especially important because the agricultural sector represented a significant proportion of the U.S. economy. As a result, the demand for credit increased significantly each fall when farmers incurred the costs associated with harvesting their crops. Prior to the establishment of the Federal Reserve, accommodating this seasonal demand necessitated a flow of currency and credit from the major financial markets such as New York and Chicago that put upward pressure on interest rates. With its ability to provide an elastic currency, the Federal Reserve would be able to dampen such seasonal swings in interest rates.

At its inception, the Federal Reserve differed from central banks in Europe in that it was decentralized. The design reflected long-standing concerns in our country about the concentration of power in a single authority. These concerns are reflected in the federated system established by the Constitution in 1787. Similarly, the design adopted for the central bank in 1913 was also federated, with twelve independent Reserve Banks, each with its own capital and board of directors, overseen by a seven member Federal Reserve Board in Washington, with the Secretary of the Treasury serving as chair of the Board. This decentralized structure allayed the prevailing fear of concentrating power in either New York or Washington and, especially within the banking community, of ceding too much power to the federal government.

Paul Warburg was an American banker who had emigrated to the United States from Europe. He was deeply involved in the debate about the appropriate structure of the central bank and described the concern as follows:

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1 See *America's Bank: The Epic Struggle to Create the Federal Reserve*, Roger Lowenstein, 2015.

2 President Wilson, who signed the Federal Reserve Act, described this new feature for the currency. "Suffice it here to say that it provides a currency which expands as it is needed and contracts when it is not needed: a currency which comes into existence in response to the call of every man who can show a going business and a concrete basis for extending credit to him, however obscure or prominent he may be, however big or little his business transactions." Letter to Congressman Oscar Underwood, October 17, 1914, *Wilson Papers*, vol. 31.

3 In addition, the Federal Reserve was given the authority to clear checks on a nationwide basis. This helped knit the country's commerce together better and ensured that checks would be payable at par rather than discounted by differing amounts depending on how far one was from the bank of issue and how little one knew about a particular bank's financial condition and viability.

The view was generally held that centralization of banking would inevitably result in one of two alternatives: either complete governmental control, which meant politics in banking, or control by "Wall Street," which meant banking in politics.[4]

Importantly, the Federal Reserve was designed to have budgetary independence from the federal government. The System funds itself through its business operations, and not through Congressional appropriations.[5] This formed an important foundation in ensuring that the conduct of monetary policy would be independent from political influence. A wide range of research has shown that central banks achieve better outcomes with respect to employment and inflation when they are insulated from short-term political pressures in their conduct of monetary policy.[6]

The Federal Reserve System was soon tested, first by the Depression of 1920–21, and then by the Great Depression. The searing experience of the Great Depression, including the 1933 Banking Holiday and thousands of bank failures, revealed significant shortcomings. This led to the Banking Act of 1935, which made two important changes – establishing a federal deposit insurance system and making the Federal Reserve System more centralized. The Great Depression made it clear that having a lender of last resort was not sufficient for preventing bank runs. Deposit insurance, which had been debated but not adopted during the drafting of the Federal Reserve Act, was instituted with the creation of the Federal Deposit Insurance Corporation.

A second lesson was that monetary policy would be more effective if it were coordinated at the national level, rather than conducted individually by the Reserve Banks.[7] To accomplish this, the Banking Act replaced the Federal Reserve Board with the Board of Governors of the Federal Reserve System, and established the Federal Open Market Committee (FOMC) to oversee the conduct of monetary policy. The governors in Washington were made dominant because they were given the majority of votes on the FOMC.[8] Over time, the role of the executive branch and the U.S. Treasury was reduced. Beginning in 1936, the Secretary of the Treasury no longer served on the FOMC. The Federal Reserve Board moved to its own building in 1937, and the Federal Reserve gained independence in the setting of monetary policy with the Treasury-Federal Reserve Accord in 1951.

A century following the Panic of 1907, another financial crisis led to the Great Recession. As was the case following the Great Depression, weaknesses exposed by the crisis led to further changes to the Federal Reserve System. Some of these changes were legislated while others were initiated by the Federal Reserve itself.

Before discussing the lessons learned from the financial crisis and the changes that ensued, I think it is important to recount the Fed's efforts to support the U.S. economy during this recent period of severe economic and financial distress. As you may recall, the Federal

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4 Paul Warburg, *The Federal Reserve System: Its Origins and Growth*, vol. 1, 1930.

5 The Federal Reserve Banks are funded through their respective operations. The Federal Reserve Board – and later, the Board of Governors – is funded through semiannual assessments on the Banks [Section 10(3) of the Federal Reserve Act]. The Board's financial independence was strengthened in the 1933 Banking Act [Section 6(b)] which stipulated that these semiannual assessments "[…] shall not be construed to be Government funds or appropriated moneys."

6 For example, see Alesina and Summers, "Central Bank Independence and Macroeconomic Performance." *Journal of Money, Credit and Banking*, vol. 25, no. 2 pg. 157–62, 1993.

7 H. Parker Willis described this independence given to the Reserve Banks in the conduct of policy. "There is nothing, either in the Federal Reserve Act or in the regulations of the Federal Reserve Board, to indicate that the reserve banks are to be operated in groups or through communications with one another, resulting in the establishment of a single policy as to detail." H. Parker Willis, *The Federal Reserve*, pg. 128, 1915.

8 This assumes no vacancies on the seven-member Board of Governors. Currently, with five members of the Board of Governors and five votes among the Reserve Banks, the balance is split equally.

Reserve responded to the financial crisis in two ways. First, it intervened to prevent the failure of several systemically important institutions, including firms that it did not supervise – namely Bear Stearns and AIG.[9] Second, it established a number of special liquidity facilities to ensure that domestic banks, securities dealers, commercial paper issuers, money market mutual funds and foreign banks had sufficient access to dollar liquidity so they could sustain their lending and investment activities, and thereby continue to supply credit to households and businesses.

I strongly believe that these interventions were necessary to prevent a systemic collapse of the global financial system. If such a collapse had occurred, I am convinced that the consequences would have been a global depression. If the Federal Reserve hadn't done everything in its authority to prevent a collapse, we would have been derelict in our duty to the country.

Let me be clear: The interventions by the Federal Reserve during the crisis were designed to safeguard the economy, for the benefit of all Americans, while protecting the taxpayer. I am proud of our record on both accounts. In the end, the Federal Reserve's extraordinary interventions achieved their intended purposes to support economic activity and, incidentally, taxpayers were compensated for the risks undertaken in these interventions. Total profits from these interventions were more than $30 billion.[10] One important condition for lending in these programs was that the loan needed to be secured to the satisfaction of the Federal Reserve Bank extending the loan. Despite the degree of dislocation in the financial system at the time and the severity of the Great Recession, there were no losses for ***any*** of the Fed's programs.

At the same time, I agree with those critics who argue that there was something fundamentally unfair about the disparity in treatment between the few large financial institutions that were saved versus the millions of individuals who lost their homes or their jobs. My response is not particularly satisfying. Recessions inflict considerable pain on innocent bystanders in the economy. Depressions greatly compound this pain. Given the Federal Reserve's role and authority, what we knew at the time and the powers and tools that were available to us, I think we made good choices. If the large systemic banking organizations had failed, the hardships inflicted on households and small business would have been far worse.[11]

From my perspective, I believe that any critique of the Fed or other agencies should be focused more on the regulatory and supervisory shortcomings – some of which, I admit, were ours – that created the economic and financial market circumstances in which the Fed's extraordinary interventions proved necessary. This leads me back to some of those lessons learned and the changes that have resulted.

The crisis showed that the regulatory community did not fully grasp the vulnerability of the financial system. In particular, critical financial institutions were not resilient enough to cope with large scale disruptions without assistance, and problems in one institution quickly spread to others. In response, the Federal Reserve has made significant changes in how we regulate and supervise financial institutions. We have raised capital and liquidity requirements, put banks through annual stress tests, established the Large Institution Supervision Coordination Committee (LISCC) to enable us to evaluate the largest firms collectively and relative to one another, and set up the Office of Financial Stability to enable

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9 The Federal Reserve was unable to prevent the bankruptcy of Lehman Brothers.

10 For example, see "Federal Reserve: Emergency Lending," Marc Labonte, Congressional Research Service, January 6, 2016.

11 In retrospect, I believe more government support could have been provided to homeowners. Although the Federal Reserve did not have the authority to implement a mortgage modification loan program, we did implement a mortgage-backed securities purchase program to lower mortgage interest rates.

us to look at the financial system more holistically. Financial stability now receives the attention it deserves. For example, there are now regular briefings and discussions on financial stability at FOMC meetings.

As discussed earlier, the Federal Reserve has the responsibility to be the lender of last resort. In normal times, this occurs through discount window lending to depository institutions. During the financial crisis, Section 13(3) of the Federal Reserve Act enabled extensions of credit in "unusual and exigent" circumstances to individuals, partnerships and corporations.[12] The extraordinary interventions that were undertaken using our emergency powers under Section 13(3) of the Federal Reserve Act were warranted and within our authority. However, I suspect that the scale and scope of these interventions went considerably further than envisioned by the public and Congress prior to the crisis.

In response, Congress narrowed the scope of Section 13(3) with the Dodd-Frank Act. In particular, Dodd-Frank limits the Federal Reserve's authority to extend credit through facilities with broad-based eligibility, and constrains the Federal Reserve's authority to extend credit to a single company. The Dodd-Frank Act also modified the governance that would apply to any future intervention in an effort to increase public accountability.

In addition, the Dodd-Frank Act addressed the broader issue exposed by the crisis – that some large financial institutions had become "too-big-to-fail" (TBTF). To end TBTF, Title II of the Dodd-Frank Act established a process to ensure that any financial firm could be resolved without threatening the viability of the financial system and without putting taxpayer funds at risk.[13] In addition, financial intermediaries designated as systemically important by the Financial Stability Oversight Council are subject to tougher prudential standards and enhanced supervision by the Federal Reserve. The intent behind these measures is to reduce the likelihood of a failure of a large financial firm, and the consequence of such a failure for the financial system, should one occur.

The Dodd-Frank Act left intact the decentralized structure of the original federated Federal Reserve System – the twelve Reserve Banks and the Board of Governors in Washington. Each Reserve Bank continues to operate as a separately capitalized corporation with its own Board of Directors.[14] But, to limit the role of bankers on the Federal Reserve Bank boards, the Dodd-Frank Act prohibited the bankers on each board from participating in the selection of its Reserve Bank president.[15]

Even prior to the Dodd-Frank Act, it is important to emphasize that the directors played no significant role in setting policy.[16] Instead, their role has been to advise the Reserve Bank

[12] Several other conditions had to be satisfied as well.

[13] Although considerable progress has been made in ending TBTF, I think it is premature to declare victory. Some banks still have work to do to make their resolution plans credible, and there needs to be more work on cross-border issues to ensure that such a resolution would proceed smoothly.

[14] Each Board is made up of nine members divided evenly into Class A, B, and C directors. The Class A directors represent the banks of the District that are Federal Reserve member banks, the Class B and C directors represent the broader public interest. Only eligible Class B and Class C directors can participate in the process for selecting Reserve Bank presidents.

[15] The selection of the President consists of two steps: Appointment of the Reserve Bank president by the Board of Directors, and approval of the appointment by the Board of Governors. For details see: http://www.federalreserve.gov/faqs/how-is-a-federal-reserve-bank-president-selected.htm.

[16] There is one exception, but it has little actual significance. Boards of Directors do make recommendations concerning changes in the primary credit (discount) rate. However, these recommendations only go into effect by an affirmative vote by the Board of Governors. Also, if the Board of Governors wanted to change the primary credit rate and no recommendations were available to act upon, the Board legally could move unilaterally. In fact, what would likely happen in this unlikely circumstance would be a phone call to one or more Reserve Banks to ask for the desired recommendation and rapid compliance with the Board of Governors' request.

president about economic, community and business developments in the District, and to ensure that the Bank is a well-governed and well-managed institution.[17] And, although member banks hold capital in the Federal Reserve and receive a dividend set by law against this capital, member banks do not influence the Fed's monetary and regulatory policy decisions, how policy is implemented or the supervisory oversight of banks.

The Dodd-Frank Act also addressed the need for enhanced transparency by establishing disclosure requirements for participation in Federal Reserve facilities. In terms of transparency, I do think it is a fair critique that, in the past, the Federal Reserve has not always been sufficiently transparent. For example, prior to 1994, we typically didn't even announce changes that were being implemented in monetary policy. Market participants had to infer what we were doing from our daily open market operations and where the federal funds rate was trading. During the crisis, I also believe we could have done more to explain the motivations for our extraordinary interventions. At times, while the motivations and objectives might have been obvious to us, they weren't always as readily apparent to Congress or to the public. I think this created uncertainty about what we were trying to accomplish, and made it more difficult for outside observers to assess the appropriateness of our actions and our motives.

Today the situation is quite different. We have made significant enhancements with respect to transparency. After each meeting, the FOMC issues a statement that sets the current target range for the federal funds rate and explains its monetary policy decision. Four times a year, the chair holds a press conference explaining the decision and the FOMC releases its Summary of Economic Projections (SEP). The SEP provides the FOMC participants' forecasts for key economic variables and the federal funds rate over the next few years. In addition, the FOMC participants give numerous speeches explaining their views on monetary policy and other issues, and the chair regularly testifies about monetary policy and the Federal Reserve's other activities before Congress. Overall, I have found that this move towards greater transparency has held us in good stead.

Nearly six years since the enactment of the Dodd-Frank Act, there still remains considerable debate about whether further changes to the role and structure of the Federal Reserve System are warranted. Some of the issues being debated include how much discretion the Federal Reserve should have in the conduct of monetary policy, whether the Federal Reserve is sufficiently transparent in how it operates, and the role of the New York Fed. I would caution that any further changes to the Federal Reserve System should be grounded on what we learned from the crisis and based on the needs of our evolving economy. Changes should be undertaken if they would make the Federal Reserve more effective in its mission. In contrast, changes based on an emotional, unreasoned response in reaction to the pain associated with the financial crisis and the Great Recession would likely be counter-productive.

Some argue that the Federal Reserve has too much discretion in its implementation of monetary policy and, consequently, would have the Fed stick to a formal rule in its conduct of monetary policy. This is a poor idea because adherence to a simple rule would undoubtedly lead to significant policy errors. The world is simply too complex to put monetary policy on autopilot.[18]

Concerns over the FOMC's degree of discretion in monetary policy likely reflect, in part, innovations in monetary policy enacted in recent years that added accommodation at a time

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[17] The Board of Governors plays an important role in the oversight of the Reserve Banks. The Board of Governors regularly evaluates Reserve Bank operations and each Bank's budget The Reserve Banks conduct supervision under delegated authority from the Board of Governors. Reserve Bank directors continue to have no role in bank supervision.

[18] See The Fed at a crossroads, Where to go next? Brookings Institution panel remarks, October 15, 2015.

when short-term interest rates were stuck very close to the zero lower bound. In particular, the Federal Reserve's balance sheet grew substantially as the Federal Reserve enacted a series of large-scale asset purchase programs designed to support economic activity. With respect to the argument that these programs have distorted financial markets, I would simply respond that monetary policy always affects financial markets and financial asset valuations. The expected path of the federal funds rate is an important factor influencing the level of bond yields, and the level of bond yields and bond term premia have implications for the valuations of other financial assets, such as equities, and influence the foreign exchange value of the dollar.

Of course, the impact of monetary policy may have been greater this time. But this is mainly because more monetary policy stimulus has been required during the current economic cycle in order to push the U.S. economy towards the Fed's dual mandate objectives. I believe that if we had not responded as forcefully, the recovery would have been slower, the unemployment rate would have been higher and there would have been a greater risk of deflation.

While it is much too soon to claim success, the U.S. economy today is in a relatively good place compared to most other countries. The economic expansion is in its seventh year and we have made considerable progress relative to our employment and inflation objectives. Also, the tools that we designed to control monetary policy even with a very large balance sheet have been shown to be effective. In December, when we raised our target range for the federal funds rate to 25 to 50 basis points, we also raised the interest rate we pay on bank reserves to 50 basis points and the rate we pay on our overnight reverse repo facility to 25 basis points. Not only have these new tools been effective in moving the federal funds rate up into the middle of its new target range, but the entire complex of money market rates has moved up as well.

Also, the fears expressed by some that the Federal Reserve's very large balance sheet would lead to runaway inflation have proven to be unwarranted. Now that we have demonstrated that we have monetary control even with a very large balance sheet, I would hope that this issue has been put to rest.

As I noted earlier, I am a committed advocate for enhanced transparency and we are always looking for ways to improve. But, of course, there are limits. One could argue, for example, that a live broadcast of a Federal Open Market Committee meeting would be more transparent. But, such a broadcast would do considerable harm by constraining candor and debate over the appropriate monetary policy decision. I believe it would likely lead to less informed decisions and, consequently, poorer execution of our monetary policy responsibilities. Similarly, disclosing in real time who was borrowing from the Federal Reserve's Discount Window would likely undercut the efficacy of the window. Banks might be reluctant to borrow if it were immediately made public because such borrowing might be construed in the market as a sign of weakness.[19] Stigmatizing Discount Window use by banks would make this tool less effective as a lender of last resort backstop for bank liquidity needs. While there obviously is a point of diminishing returns in terms of increased transparency, I think it's reasonable to evaluate what further steps the Federal Reserve could make in this direction, judging whether additional steps would enhance versus diminish the effectiveness of our tools and policies, and our ability to achieve our objectives.

With regard to the Federal Reserve Bank of New York, which I have the responsibility of leading, I'd observe that the New York Fed, like the other eleven reserve banks, serves to

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[19] A historical example was the disclosure of Reconstruction Finance Corporation loans to banks in the Great Depression. This disclosure often created runs at the respective banks. See James Butkiewicz, "The Reconstruction Finance Corporation, the Gold Standard, and the Banking Panic of 1933," *Southern Economic Journal*, vol. 66, no. 2, October 1999, pg. 271.

support the overall mission of the Federal Reserve System. But, by virtue of its location, the New York Fed has a unique responsibility on behalf of the System – namely to serve as the operational arm of the Federal Open Market Committee with respect to the implementation of monetary policy. This separation of the policy arm and the operational arm of monetary policy in two distinct institutions is a very unusual setup among central banks.[20]

There are good reasons why these important functions are assigned to the New York Fed. Monetary policy works by affecting financial market conditions in order to promote the economic outcomes consistent with the Fed's dual mandate. As such, effective and efficient monetary policy execution requires a practical and thorough understanding of the broad range of the financial markets through which monetary policy operates.

New York City is the nation's principal financial center. By locating the duties related to the execution of monetary policy at the New York Fed, the System gains a number of benefits. These include the New York Fed's ability to develop expertise in and understanding of the broad spectrum of financial markets and institutions, and its access to a deep pool of specialized financial talent in the place where it is most concentrated.

The New York Fed's institutional knowledge and experience in financial markets and its related disciplines are a critical input at all times, but never more so than during periods of duress. This was evidenced during the financial crisis, when the New York Fed's unique insights and expertise helped the Federal Reserve respond quickly and effectively to unfolding events.

The authors who crafted the Federal Reserve Act such as Carter Glass – assisted by H. Parker Willis – deliberately created a central bank structure that fits the U.S. political system, with a series of important checks and balances – between Washington and the rest of the country, between Washington and New York, and with respect to the role of the federal government versus the private sector. These checks and balances exist to ensure that the central bank acts in the broadest interests of the nation, and is appropriately insulated from short-term political pressures and considerations. In this construction, New York does have a special role, but one that stems from where it sits, in New York City, the nation's most important financial center.

The Federal Reserve exists to serve Main Street, not Wall Street. The dual mandate objectives established by Congress – full employment and price stability – are clear on this point. There is no mention of Wall Street. At the same time, it is broadly recognized that without a well-functioning financial system it would be difficult, if not impossible, for the Federal Reserve to achieve those objectives.

The Federal Reserve has evolved considerably since its inception in 1913. This evolution has been informed by lessons from past financial crises. The goal has been to make the Federal Reserve even more effective in carrying out its mission. This process of learning from experience is as critical for institutions as it as individuals. To paraphrase Winston Churchill: People always make mistakes, but only wise ones learn from their mistakes.

Thank you for your kind attention. I would be happy to take a few questions.

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[20] In the case of the European Central Bank, the member national central banks are involved in policy implementation.