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Economics After the Crisis: Reflections on a Return to Madison

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I am very grateful to the Economics Student Association for their invitation to return to the University of Wisconsin, Madison campus. I literally have not been back since receiving my degree in 1985, but that is no reflection on my time here. On the contrary, my time in graduate school represents the most important and formative years of my professional life. When I left in 1985, I envisioned pursuing a career in academia, not in central banking, and certainly not as a president of a Federal Reserve Bank. But it was because of the people I met here and what I learned from them that this career path was even a possibility for me. To these economists, some of whom are in the audience, I owe my eternal gratitude.

I consider myself fortunate to have been afforded a role in economic policymaking at a U.S. institution that has been at the center of the most critical and contentious economic policy decisions of the last few years. In our time together this afternoon, I would like to share some reflections on the implications of the events of these tumultuous years for the science of economics. But, before I begin, I must note that the views I express are my own and are not necessarily shared by any of my colleagues on the Federal Open Market Committee.

There is a popular narrative of late according to which the financial crisis and Great Contraction have eroded the credibility of economics. While there is still important research to be done that deserves the attention and energy of young economists like you, I believe many critics have gone overboard. So my message for young economics students is that economics as a discipline continues to be relevant and well worth your time and effort.

One popular criticism is that economists did not foresee or predict the financial crisis that began in 2007 and culminated in the dramatic events in late 2008. In one sense, this charge is quite true. But, it's like criticizing seismologists for failing to predict the time and place of the earthquake that recently struck in Mineral, Va., just 40 miles northwest of my Richmond office. As this analogy suggests, I think that criticism is unfair. Just as seismology provides a rich understanding of the forces that led to the quake, the economics literature provides a rich understanding of the forces at work in the recent financial crisis.

For example, Douglas Diamond and Philip Dybvig in 1983 published a celebrated paper[1] showing how financial intermediaries that engage in "maturity transformation" — that is, borrowing via short term, demandable liabilities to fund longer term or less liquid assets — could be vulnerable to "runs." That paper has provided the basic framework within which economists continue to study the logic of financial fragility.[2] That vulnerability has motivated deposit

insurance and other forms of government-provided financial safety net protection, but such protection for creditors can seriously distort incentives. A 1978 article by John Kareken and Neil Wallace pointed out that deposit insurance gives insured banks and thrifts an incentive to take on socially excessive amounts of risk and dampens their creditors' incentive to monitor and constrain such risk-taking.[3] Several years later, Kareken wrote about the critical role of regulation and supervision in constraining the excessive risk-taking incentives that result from deposit insurance.[4] He cited the dangers of deregulating such institutions before commensurately strengthening the supervisory regime to be able to contain the expanded bank and thrift risk-taking capabilities. More recently, former Minneapolis Fed President Gary Stern and his then-colleague Ron Feldman warned in a 2004 book about the distorted risk-taking incentives of large financial institutions that were viewed as "Too Big to Fail," the title of their book. Without corrective policies, they argued, excessive risk-taking was likely to cause problems and result in further instances of financial distress and bailouts, which is exactly what we have experienced.

Several popular narratives regarding the Federal Reserve System also have emerged from the crisis. Some of these are patently counterfactual, such as the notion that the Fed is not audited. The regional Reserve Banks, just like private companies, are audited by an external audit firm, as well as by internal audit staff. In addition, our operations are regularly examined by staff from the Board of Governors and the Government Accountability Office.[5]

Some conventional narratives are less hostile to the Fed. For example, some view the Federal Reserve's extensive emergency lending as a vital palliative that was essential to overcoming the crisis. In this view, such lending was consistent with the Fed's historic Lender of Last Resort function and reflects the founding mission of the Federal Reserve Act to handle financial crises, along the lines advocated by Walter Bagehot in 19th century England.[6]

This conventional wisdom can be seriously misleading, in my view. Walter Bagehot wrote before the advent of open market operations, when lending was the most expeditious way for the Bank of England to increase the money supply to accommodate an increase in the demand for money during financial panics. His famous dictum to "lend freely at a penalty rate" was a sensible prescription, given the institutional arrangements of his day, for varying the money supply during financial panics in a way that preserved monetary stability. This is quite different from the sterilized lending that central banks typically engage in. Indeed, the first large increases in Fed lending during the financial crisis were sterilized by offsetting sales from the System's holdings of U.S. Treasury securities, and it wasn't until the Fall of 2008 that Fed lending became arguably Bagehotian. And even for those and subsequent expansions of Fed credit, appeals to Bagehot fail to justify central bank credit allocation.

At the founding of the Federal Reserve in 1913, the American banking system was highly fragmented. The need to clear and settle interbank payments efficiently gave rise to a network of interregional "correspondent" banking relationships to settle via debits and credits to interbank deposits. In addition, clearinghouses in the major cities economized on bilateral transactions costs via multilateral netting. During financial panics clearinghouses met the increased demand for currency by issuing clearinghouse certificates. Country banks often had difficulty converting bank balances into currency to meet their local demands.

Banking reform debates in the years leading up to the establishment of the Fed were essentially about the governance of financial crisis resolution, not about taxpayer-financed lending. They reflected dissatisfaction among banks outside New York at not being able to withdraw their reserve deposits in a crisis. A method of expanding note issue nationwide in a crisis was sought. But, a single centralized institution, modeled on the central banks of Europe, was a nonstarter politically because of the risk it would be dominated by the large New York banks. The Federal Reserve System, with its twelve regional Reserve Banks, represented a network of government-sponsored clearinghouses with potentially universal membership. Like other clearinghouses, they would be owned and governed by member banks, but would be coordinated by a government agency in Washington. The preamble to the Federal Reserve Act spells out their central purpose: "to furnish an elastic currency" — that is, to expand the supply of notes in response to shifts in demand. This is just what the clearinghouses did; the difference was in who would be calling the shots. The Federal Reserve was founded not to resolve financial crises, but to give those outside New York or Washington a greater voice in *how* they were resolved. This governance issue is still with us today — as is the need for the Reserve Bank system.

When the Federal Reserve was founded, the operation of the gold standard pinned down inflation trends. The departure from the gold standard forty years ago resulted in a fiat money regime in which inflation is driven by current and expected central bank policy. Without the nominal anchor provided by the gold standard, central banks around the world struggled in the 1970s to resist political pressure to inflate in order to (temporarily) reduce unemployment or finance government deficits. Governance arrangements that were workable when central banks were founded a century or more ago — namely, ministerial control to assure politically desirable management of public sector clearinghouses — became a liability under a fiat money regime, when the short-term focus of political leaders made them willing to sacrifice inflation control for the immediate gains associated with stimulus. Independence from political pressures ultimately became critical to central banks' ability to reduce inflation and sustain credible commitments to price stability.

Many central banks outside the U.S. received new charters in the 1980s and 1990s, making them more independent of, though still strongly accountable to, governments and legislatures. In the U.S., the participation on the FOMC of Reserve Bank presidents, who are appointed by their board of directors, along with the 14-year tenure of Federal Reserve Board governors, helps protect policymaking from short-run political pressures. This hybrid public-private governance structure builds in an ability to insulate policymaking from election-induced swings and to make policy choices based on long-run considerations. At the same time, the Fed is strongly accountable at the level of macroeconomic results. Through the semi-annual Monetary Policy Report to Congress, as well as testimony and speeches, Federal Reserve officials discuss and assess macroeconomic conditions and provide the public with the opportunity to scrutinize the results of past policy actions.

Political pressures have again been targeted at Fed policymaking in recent weeks. Attempts at intimidation should perhaps not be surprising, given the severe economic stress facing our nation, and the fierce partisan debate that has enveloped economic policy. But these are precisely the times when the governance structure that shields the Fed from such short-term pressures is critically important.

Central bank independence is a double-edged sword, however. While independence has helped enhance the credibility of central banks' commitment to price stability in many countries, it also provides central banks with the capability to circumvent the constitutional checks and balances surrounding conventional fiscal policy. When a large financial institution is hit by financial distress, policymakers face an inevitable temptation to insulate creditors from the consequences of default or failure. Such events often unfold rapidly, and a central bank's independent balance sheet gives it the ability to provide assistance without the delays associated with legislative deliberations. As an off-budget vehicle for transferring private risks to taxpayers, central bank lending is often sought out by governments and the private sector alike. This may be the single most important factor explaining the secular rise of "too big to fail," the observed propensity of policymakers to prevent large financial institutions from utilizing established bankruptcy procedures.

This narrative may differ from the conventional wisdom. But for me, it provides a persuasive understanding of the events of the last hundred years of Fed history. The founders of the Fed certainly did not envision all of the challenges of the past century. The Fed has had to learn how to use its unique political status in the best interest of the nation's economy — how to ensure long term monetary stability in a fiat money regime, for instance. The pressing challenge now is to learn how to constrain the Fed's ability to allocate credit in a way that preserves the independence of its balance sheet management from political pressures. The next hundred years will no doubt present the Federal Reserve with new challenges and new lessons to learn as well. But the Fed's federated structure has also made it a capable learner over time, and this gives me confidence that we will continue to find ways to improve our performance as the nation's central bank. Given the continued strength and vitality of the Wisconsin economics tradition, I hope that the Fed will have the benefit of talented Badger alum over the next hundred years as well.

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[1] Douglas Diamond and Philip Dybvig, "Bank Runs, Deposit Insurance and Liquidity," *Journal of Political Economy*, June 1983, vol. 91 no. 3, pp. 401-19.
[2] Federal Reserve Bank of Richmond Economic Quarterly, First Quarter 2010, A Special Issue on the Diamond-Dybvig Model and Its Implications for Banking and Monetary Policy.
[3] John H. Kareken and Neil Wallace, "Deposit Insurance and Bank Regulation: A Partial Equilibrium Exposition," *Journal of Business*, July 1978, vol. 51, pp. 413-38.
[4] John H. Kareken, "Deposit Insurance Reform or Deregulation Is the Cart, Not the Horse," Federal Reserve Bank of Minneapolis *Quarterly Review*, Spring 1983, vol. 7, no. 2.
[5] Finding out more about these audits is quite easy. Just go to "www.federalreserve.gov" and click on the button in the upper right corner that says "Does the Fed get audited?" There you will find links to a trove of information and data.
[6] Walter Bagehot, "Lombard Street." (London: Harry S. King and Co., 1873.)