TESTIMONY TO

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AND TECHNOLOGY

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by

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It is a pleasure to testify today to the House Subcommittee on Domestic Monetary Policy and Technology on the important issue of what role the Federal Reserve should have as a systemic regulator of the financial system. The subcommittee posed four questions, but I would like to respond to them by providing answers to three questions which deal with the same issues as the questions the Subcommittee posed. Let me comment on each of these in turn.[1]

Should the Federal Reserve Be the Systemic Regulator?

There are four reasons why I believe that the Federal Reserve should be made the systemic regulator of financial markets in the United States.

First, the Federal Reserve has daily trading relationships with market participants as part of its core function of implementing monetary policy and is well placed to monitor market events and to flag looming problems in the financial system. No other public institution in the United States has comparable insight and access to the broad flows in the financial system.

Second, the Federal Reserve's mandate to preserve macroeconomic stability is well matched to the role of ensuring the stability of the financial system. Macroeconomic downturns are often tightly connected to the financial system, and similar analyses, drawing on the disciplines of macroeconomics and financial economics, can provide guidance for both types of oversight. As a result, macroeconomic policy and systemic regulation are tailor made for each other.

Third, the Federal Reserve is among the most independent of government agencies. Successful systemic regulation requires a focus on the long run. Because they face relatively short re-election cycles, politicians tend to focus on the short run. Insulating the systemic regulator from day-to-day interference by politicians will help ensure a systemic regulator's success. The respect and independence that the Federal Reserve enjoys therefore makes it the natural candidates to be the systemic regulator.

[1] This testimony draws heavily on a working paper published by the Squam Lake Working Group on Financial Regulation, "A Systemic Regulator for Financial Markets," which can be found at http://www.cfr.org/publication/19256/systemic_regulator_for_financial_markets.html.

Fourth, the Federal Reserve is the lender of last resort. It has a balance sheet that it can use as a tool to meet systemic financial crises. As the lender of last resort, it will be called on to provide emergency funding in times of crisis. Too often during the current crisis, the Federal Reserve has been drawn in at the last minute to provide funding to institutions about whom they had no firsthand knowledge because they were not supervised by the Federal Reserve.. Bear Stearns, for example, was supervised directly by the SEC and not by the Federal Reserve. No amount of information sharing can substitute for the firsthand information gathered in direct on-site examinations. If the Federal Reserve will be asked to lend money to save an institution, it needs to have firsthand supervisory information.

Should the Federal Reserve Relinquish Any Roles?

I believe that the Federal Reserve should give up its role as a consumer protection regulator. My reasoning for this conclusion is as follows.

The skills and mindset required to operate as a consumer protection regulator is fundamentally different from those required by a systemic regulator. Protecting consumers involve setting and then enforcing the appropriate rules under a transparent legal framework. The orientation of an effective systemic regulator must be different from that of a rule-enforcing consumer protection or conduct of business regulator. A regulator charged with both enforcing rules and managing systemic risk may end up devoting too much of its attention to rule enforcement.

A second, and more important, problem with the combination of systemic and consumer regulation is that consumer regulation is highly charged politically. Because consumer regulation affects so many constituents, politicians sometimes put tremendous pressure on regulators to take actions to protect consumers without worrying about unintended consequences. Political pressure on a systemic regulator because politicians are unhappy with its role as a consumer regulator may interfere with the regulator's independence and ability to perform systemic regulation.

The arguments above imply that the role of systemic regulator should be separate from a consumer protection regulator and so if the Federal Reserve is asked to be a systemic regulator it should relinquish its role as a consumer protection regulator.

Are There Dangers From Having the Federal Reserve Become the Systemic Regulator?

There are three dangers from handing this new responsibility to the Fed.

The Congress has appropriately given the Federal Reserve a dual mandate, achieving price stability and maximum sustainable employment. One danger is that the clear focus on achieving output and price stability might become blurred once the Federal Reserve has to focus on financial stability objectives.

Second, there is a danger of increased political pressure on the Fed that could subject it to attacks on its independence when it takes action to reign in risk-taking by systemically important institutions. Not only could this compromise the ability of the Federal Reserve to do its job as a systemic regulator, but attacks on the Federal Reserve's independence because of its actions as a systemic regulator could spill over to compromise its independence in the conduct of monetary policy. Both theoretical work in economics and past experience has shown that central bank independence is crucial to achieving good monetary policy outcomes.

Third, right now the Fed does not have sufficient resources to take on this new role. Without sufficient resources, the systemic regulator will not be able to identify systemic risks and craft the needed regulations. As I learned when I was a governor of the Fed during the current crisis, its staff has been stretched to the limit. Asking it to become a systemic regulator will stretch already thin resources, perhaps even compromising its ability to conduct monetary policy.

The Bottom Line

Despite these dangers, given the importance of the financial stability goal and the fact that some institution must play the role of the systemic regulator, I strongly believe that the Fed should take on this new task in spite of the difficulties this will pose. Some safeguards can mitigate the difficulties. For example, some central banks have used explicit, numerical long-run inflation objectives to keep the price stability goal firmly in view. As I have argued in speeches when I was a member of the Board of Governors of the Federal Reserve System, the Fed should head in this direction. It is also imperative that Congress reaffirm its support for Federal Reserve independence, which is a serious concern right now. It also needs to be supportive of the Federal Reserve’s need for additional resources to perform both its monetary policy and systemic regulator roles.

An important lesson from the current crisis is that we desperately need a systemic regulator, and I am convinced that the Federal Reserve is the only logical choice.