THE CASE FOR A TREASURY-FEDERAL RESERVE ACCORD FOR CREDIT POLICY

Testimony before the

Subcommittee on Monetary Policy and Trade

Of the

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Marvin Goodfriend[1]

Friends of Allan Meltzer Professor of Economics

Tepper School of Business

Carnegie Mellon University

and

Research Associate

National Bureau of Economic Research

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[1] Former Senior Vice President and Policy Advisor, Federal Reserve Bank of Richmond, 1993-2005.

Introduction

I am pleased to be invited to testify before the Subcommittee on Monetary Policy and Trade of the House Committee on Financial Services on "Federal Reserve Oversight: Examining the Central Bank's Role in Credit Allocation." My testimony, "The Case for a Treasury—Federal Reserve Accord for Credit Policy," argues that the 1951 Treasury-Fed Accord on monetary policy should be supplemented with a Treasury-Fed Accord on credit policy.

Flexibility and decisiveness are essential for effective central banking. Independence enables a central bank to react promptly to macroeconomic or financial shocks without the approval of the Treasury or the legislature. Central bank initiatives must be regarded as legitimate by the legislature and the public, otherwise such initiatives will lack credibility essential for their effectiveness. The problem is to identify the limits of independence on monetary policy and credit policy to preserve a workable, sustainable division of responsibilities between the central bank and the fiscal authorities—the legislature and the Treasury.

The Suitability of Monetary Policy for Delegation to an Independent Central Bank

Monetary policy can be conducted independently by a central bank because the objectives of monetary policy—price stability and full employment—are reasonably clear and coherent. Moreover, monetary policy is about managing aggregate bank reserves, interest on reserves, and currency to influence 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" keeps the independent central bank free of 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.

The Unsuitability of Credit Policy for Implementation by an Independent Central Bank

Credit policy satisfies none of the conditions that make monetary policy suitable for management by an independent central bank. Credit policy involves selling Treasury securities from the central bank portfolio and lending the proceeds to a private financial institution, or using the proceeds to acquire non-Treasury debt such as mortgage backed securities. Credit policy has no effect on the general level of interest rates because it doesn't change aggregate bank reserves or interest paid on reserves. Credit policy is debt-financed fiscal policy. 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.

Credit policy works by exploiting the government's creditworthiness—the power to borrow credibly against future taxes—to facilitate flows to distressed or favored borrowers. Doing so involves a fiscal policy decision to put taxpayer funds at risk in the interest of particular borrowers. All central bank credit initiatives carry some credit risk and expose the central bank and ultimately, taxpayers to losses and controversial disputes involving credit allocation.

Even fully risk-free collateralized central bank 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 the loan outstanding, strips that institution of collateral that would have been available to cover the cost of insured deposits if the institution had been closed more promptly.

Clarifying the Boundary of Independent Central Bank Credit Policy

The 1951 Accord between the Treasury and the Fed was one of the most dramatic events in U.S. financial history. The Accord ended an arrangement dating from World War II in which the

Fed agreed to use its monetary policy powers to keep interest rates low to help finance the war effort. The Truman administration urged an extension of the agreement to keep interest rates low in order to hold down the cost of the huge Federal government debt accumulated during the war. Fed officials argued that keeping interest rates low would require inflationary money growth that would destabilize the economy and ultimately fail.[2] The Accord famously reasserted the principle of Fed independence so that monetary policy might serve exclusively to stabilize inflation and the macroeconomic activity.

Congress early on recognized that the Fed needed financial independence in order to conduct monetary policy effectively. The Fed is exempted from the congressional appropriations process in order to keep the political system from abusing its money-creating powers. The Fed finances its operations from interest earnings on its portfolio of securities. The Fed was given wide latitude regarding the size and composition of its balance sheet so it could react promptly, decisively, and independently to economic and financial conditions. In the early 1980s under the strong, independent leadership of Paul Volcker the Fed succeeded in establishing low inflation as the nominal anchor for monetary policy. Thus, Fed independence is today the institutional foundation for effective monetary policy.

The Fed has long executed credit policy in addition to monetary policy as "lender of last resort" to depository institutions. Credit policy is also subject to misuse for fiscal policy purposes. However, as long as Fed lending was relatively modest, temporary, and confined to depository institutions deemed solvent, and the Fed took good collateral against its loans, the potential for fiscal misuse was limited. Although the Fed has long needed an accord for credit policy, the lack of one was not a particularly pressing matter.[3]

[2] See Hetzel (2001), and Stein (1969).
[3] Goodfriend (1994) and Schwartz (1992).

The enormous expansion of Fed credit in the 2007-09 turmoil—lending beyond depository institutions and acquiring non-Treasury securities—demands an accord for Fed credit policy to supplement the accord on monetary policy. A credit accord should set guidelines for Fed credit policy so that pressure to misuse Fed credit policy for fiscal purposes does not undermine the Fed's independence and impair the central bank's power to stabilize financial markets, inflation, and macroeconomic activity.

Congress bestowed independence on the Fed only because it is essential for the Fed to do its job effectively.[4] A healthy democracy requires full public disclosure and discussion of the expenditure of public funds. The congressional appropriations process enables Congress to evaluate competing budgetary programs and to establish priorities for the allocation of public resources. Hence, the Fed—precisely because it is exempted from the appropriations process—should avoid, to the fullest extent possible, taking actions that can properly be regarded as within the province of fiscal policy and the fiscal authorities.

When the Fed purchases Treasury securities it transfers all the revenue from monetary policy to the fiscal authorities and hence does not infringe on their fiscal policy prerogatives. Monetary policy, perhaps with the help of interest on reserves, respects the integrity of fiscal policy fully.

Fed credit policy is another matter entirely, because all financial securities other than Treasuries or their equivalent carry some credit risk and all lending involves the Fed in potentially controversial disputes regarding credit allocation. When the Fed extends credit to private or other public entities lacking the "full faith and credit" backing of the US government, the Fed is allocating credit to particular borrowers, and therefore taking a fiscal action and invading the territory of the fiscal authorities.

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[4] The following paragraphs are from Broaddus and Goodfriend (2001).

As emphasized above, even fully collateralized lending that is riskless for the Fed exposes taxpayers to losses if the borrower fails subsequently. Fed credit that finances the exit of uninsured or unsecured lenders to a financial institution that fails while the loan is outstanding will have stripped the bank of collateral that could otherwise be available to cover the cost of insured deposits or other government guarantees.

It is important to appreciate the difficulties to which the Fed exposes itself in the pursuit of credit policy initiatives that go beyond ordinary last resort lending to solvent depository institutions. The Fed must decide how widely to expand its lending reach. Lending farther afield creates "an implied promise of similar actions in times of future turmoil," as Volcker put it, which the Fed may then be inclined to accommodate.[5] Fed presence in one credit market can drain lending from nearby credit channels and prompt calls for support in neighboring credit classes. The Fed must determine the relative pricing of its loans based on risk and collateral. The Fed must be accountable for its credit allocations and the returns or losses on its loans or security purchases. The public deserves transparency on Fed credit extensions beyond ordinary lending to solvent depository institutions. Yet, congressional oversight opens the door to political interference in the Fed's lending or non-Treasury acquisitions. Broadly speaking, the Fed is exposed to pressure to exploit the central bank's off-budget status to circumvent the appropriations process.

Moreover, the Fed and the fiscal authorities must cooperate on banking, financial, and payments system policy matters. This interdependence exposes the Fed to political pressure to make undesirable concessions with respect to its credit policy initiatives in return for support on other

[5] See Volcker (2008), page 2, and the discussion of the "limited commitment" problem in Goodfriend and Lacker (1999).

matters. Worse, the Fed could be pressured to make concessions on monetary policy to deflect pressure regarding credit policy.

"Accord" Principles for Central Bank Credit Policy

By its very nature then, credit policy has the potential to create friction between the independent central bank and the fiscal authorities. That friction is evident in the tense relationship between the Fed and Congress in the aftermath of the credit turmoil. The problem is that credit policy undoes "Treasuries only" so to speak, and uses some of the revenue from monetary policy to acquire non-Treasury assets without the authorization of the fiscal authorities. Unlike monetary policy, credit policy directs public funds to specific borrowers, and necessarily favors one class of creditors or one sector of the economy over another.

Even the central bank acquisition of government agency debt or securities packaged by government agencies is problematic. Except in rare cases when Congress has granted "full faith and credit" backing to government agency debt or securities packaged by government agencies, acquisition of such securities by the central bank has allocative consequences because it steers credit in a particular direction and confers an implied preferential status enhancing that agency's creditworthiness.

Central bank credit policy must be circumscribed with clear, coherent boundaries.[6] One could deny credit policy powers to the central bank altogether by requiring the central bank to pursue a "Treasuries only" asset acquisition policy. But credit policy has been useful in the recent turmoil and last resort lending to temporarily illiquid but solvent depositories has long been a valued part of independent central banking. Moreover, conventional last resort lending is reasonably compatible with central bank independence. Last resort lending to supervised, solvent depositories,

[6] Friedman (1962), pp. 232-4.

on a short-term basis, against good collateral provides multiple layers of protection against ex post losses and ex ante distortions. So the fiscal policy consequences of conventional last resort lending are likely to be minimal, and the scope for conflict with the fiscal authorities small.

On the other hand, expansive credit initiatives—those that extend a central bank's credit reach in scale, maturity, and collateral to unsupervised non-depository institutions and the purchase of non-Treasury securities—inevitably carry substantial credit risk and have significant allocative consequences. Expansive credit initiatives infringe significantly on the fiscal policy prerogatives of the Treasury and Congress and properly draw the scrutiny of the fiscal authorities. Hence, expansive credit initiatives jeopardize central bank independence and should be circumscribed by agreement between the fiscal authorities and the central bank.

Furthermore, an ambiguous boundary of expansive central bank credit policy creates expectations of accommodation in financial crises which blunt the incentive of private entities to take preventive measures beforehand to shrink their counterparty risk and their reliance on short-term finance. Moreover, an ambiguous central bank credit reach also blunts the incentive of the fiscal authorities to prepare procedures by which fiscal policy could act systematically and productively in times of financial turmoil. The chaotic, reluctant involvement of Congress in the fall 2008 crisis contributed enormously to the financial panic and greatly worsened the Great Recession.

Such reasoning suggests the following three principles as the basis for a Treasury-Fed "Accord" for credit policy. To reiterate, Congress bestows Fed independence only because it is necessary for the Fed to do its job effectively. Hence, the Fed should perform only those functions that must be carried out by an independent central bank. The problem is to identify the limits of independence on credit policy to preserve a workable, sustainable division of responsibilities between the central bank and the fiscal authorities—the legislature and the Treasury.

Principle 1: As a long run matter, a significant, sustained departure from a "Treasuries only" asset acquisition policy is incompatible with Fed independence.

Principle 2: The Fed should adhere to "Treasuries only" except for occasional, temporary, well-collateralized ordinary last resort lending to solvent, supervised depository institutions.

Principle 3: Fed credit initiatives beyond ordinary last resort lending should be undertaken only with prior agreement of the fiscal authorities, and only as bridge loans accompanied by take-outs arranged and guaranteed in advance by the fiscal authorities.

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