Democratizing the Federal Reserve

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The Federal Reserve Board (or "Fed") bears substantial responsibility for the current crisis. Among other failures, it allowed an $8 trillion housing bubble to expand unchecked even though the collapse of this bubble inevitably would lead to a serious recession. To ensure better policy outcomes in the future, the Fed must be made accountable and transparent. In short, it must become a true public agency.

Designed-in Conflicts of Interest

By design, the Federal Reserve in its current form is largely under the control of the financial industry. The presidents of the twelve regional Federal Reserve Banks are chosen through a process that is dominated by the banks. Under the current system, each regional bank has nine directors. Three of the directors are chosen directly by the member banks within the district. Three directors, who are supposed to represent the larger community, are selected by the first three directors. The final three, who are also supposed to represent the larger community, are appointed by the Board of Governors. These nine directors select the regional bank president who is the chief executive officer for the bank.

All of these bank presidents sit on the Open Market Committee that determines monetary policy, with the seven members of the Board of Governors appointed by the president. Five of these governors actually vote on monetary policy (four spots rotate among the banks, with the president of the New York Federal Reserve Bank being a permanent voting member).

In addition to their large role in determining monetary policy, the district banks also have substantial regulatory powers, especially the New York bank. In effect, the current structure of the Fed is a system in which the banks largely decide who regulates them.

There is no reason why the banks should have a special role in determining the country's monetary policy, nor why they should pick their own regulators. Insofar as the Fed has policy responsibilities (it also engages in check-clearing operations and provides other bank services), all of its key officials should be appointed by the president and directly answerable to the Congress, not the banks.

If Fed officials were accountable to Congress then monetary policy might be designed to address the concerns of ordinary workers instead of banks. This would mean more emphasis on maintaining high levels of employment and less concern about modest rates of inflation.

The Fed also has largely ignored its responsibility to oversee the Community Reinvestment Act and other laws that ensure equal access to credit. To the extent it retains jurisdiction in these areas, it would benefit from oversight by consumers.

Non-Transparency

The Fed's proceedings are excessively opaque. As it stands now, the Fed provides summary minutes of the meetings of the Open Market Committee, with a six-week lag. Full transcripts are made available after five years. There is no reason that these lags cannot be reduced. In principle, the meetings could be televised live so that the public could immediately understand the factors underlying the Fed's decisions on monetary policy.

This type of transparency could have helped stem the growth of the stock and housing bubbles. Transcripts from the late 1990s, in contrast to their public statements, show that the Fed members were fully aware of the stock bubble and were waiting for it to burst. Investors might have been more reluctant to buy stock had they known that the country's top economic officials believed the market was seriously inflated. Similarly, if the Fed had recognized the housing bubble, and the public had become aware of this fact, then many potential homebuyers might have been more reluctant to buy homes in severely over-valued markets.

Reforms on Bailout Authority, Regulatory Authority, and Monetary Policy

Bailout or Resolution Authority. The bailout function should not reside with the Fed. This responsibility belongs with the Federal Deposit Insurance Corporation (FDIC), which has long experience in dealing with failed financial institutions and is much more transparent in its operations. The FDIC knows how to perform bailouts, while the Fed does not. Moreover, it is improper for an agency operating outside of the budgetary framework to use public funds in dealing with failed institutions as the Fed has done. If the Fed is to continue conducting bailouts with public funds, it must be transparent and publicly accountable.

Regulatory Authority. In light of the Fed's longstanding regulatory failures, its regulatory authority should be limited and clearly defined. In most instances, other agencies will be better situated to regulate effectively. Insofar as the Fed retains or is given new regulatory authority, it must be fully accountable to Congress and the public.

Monetary Policy. On monetary policy, the Fed should be accountable primarily to the public, not the banking industry. All Fed officials with policymaking responsibility should be appointed by the President and approved by Congress. In the current structure, this would mean that the district bank presidents would be appointed by the president. Alternatively, it would be reasonable for the Board of Governors to perform the Open Market Committee's functions without the involvement of regional bank presidents. Also, within the current structure, the Consumer Advisory Council should have an increased role.

While the Fed should have a substantial degree of independence in its conduct of monetary policy (the current practice of giving governors long terms that overlap presidents is desirable), it must be accountable to Congress. Toward this end, Congress should establish a Monetary Policy Committee with the explicit purpose of overseeing the Fed's policy.

The Fed should also be more transparent in its conduct of monetary policy. It is not clear that Open Market Committee meetings should be conducted in secret. However, even if the meetings are not open to the public, the lag time on the release of transcripts certainly should be shortened from the current five-year period.

It is also essential that the Fed recognize that containing asset bubbles is an explicit responsibility. It was incredibly reckless for the Fed to ignore the stock market and housing bubbles. In addition to the goals of 4.0 percent unemployment and price stability, the Fed's operating guidelines should direct it to act to prevent asset bubbles from growing large enough to pose a threat to the real economy.

Answering Critics of Fed Reform

Critics of Fed reform have argued that the Fed must retain the authority to deal with failed institutions like Bear Stearns and AIG because it is the only agency with a clear view of the macroeconomy—and therefore the only agency that can assess the potential impact of these firms' failures.

This argument is unpersuasive because the Fed lacks expertise on the primary function under discussion—how to resolve failed institutions. The FDIC has the most experience in this area, and it could simply consult with the Fed when dealing with the failure of a major institution. We should take advantage of the FDIC's experience rather than have the Fed immerse itself in a new set of responsibilities for which it is ill-suited.

Critics also have argued that proposals to make the Fed more publicly accountable contradict a worldwide trend of making central banks more independent. They argue that reforms could render the Fed vulnerable to political influence and possibly even result in pressure to permit a higher rate of inflation.

This argument fails foremost because the Fed is far from independent. Private banks have a direct voice in choosing its leadership and setting monetary policy. The Fed is an outlier in these respects.

Furthermore, the virtue of political independence for central banks has been overstated. The single-minded focus on inflation among independent central banks around the world led them to ignore housing bubbles and other imbalances that laid the basis for the current financial crisis. For example, Iceland celebrated the fact that it held assiduously to its 2.0 percent inflation target even as its current account deficit rose to an incredible 15 percent of GDP. This single-minded focus on inflation was deeply foolhardy and reckless. People around the world are paying an enormous price for the incompetence of economists in believing that inflation targets were the only important consideration for central bankers.

Lower inflation is generally more desirable than higher rates of inflation, but the world is paying an enormous price for the period of moderate inflation that it enjoyed over the last decade. Most people probably would preferred to have lived with a slightly higher inflation rate and avoided the current downturn.