St. Louis Fed's Bullard Discusses "The Fed at a Crossroads"

ST. CLOUD, Minn. — Fallout from the financial turmoil of 2008 and 2009 has placed the Fed at a crossroads on three dimensions, St. Louis Fed President James Bullard said in remarks today at St. Cloud State University's 48th annual Winter Institute. "First, the political independence of the Fed is at risk. Second, regulatory reform legislation threatens to hamstring the Fed's ability to respond to a future crisis. Third, the Fed adopted a near-zero interest rate policy and successfully carried out its stabilization policy through quantitative easing," he said.

Fed Independence at Risk

In his presentation, " [The Fed at a Crossroads](https://www.stlouisfed.org/-/media/project/frbstl/stlouisfed/files/pdfs/bullard/remarks/bullardwinterinstitutefinal.pdf) ," Bullard gave a brief history of the founding of the Federal Reserve System and how its decentralized structure has provided a strong checks-and-balances system against power being too concentrated on Wall Street or in Washington, D.C.," Bullard gave a brief history of the founding of the Federal Reserve System and how its decentralized structure has provided a strong checks-and-balances system against power being too concentrated on Wall Street or in Washington, D.C.

In keeping with the fundamental principle that monetary policy should be at arm's length from the political process, the Federal Reserve System was designed with three distinct but complementary parts: the Board of Governors in Washington, D.C.; a Federal Reserve Bank in New York City, long regarded as the nation's financial capital; and 11 regional Reserve banks to represent the voice of Main Street across the rest of the country.

"This regional structure was designed to keep some power out of New York and Washington," Bullard said. "It allows for input on key policy questions from around the U.S.A. As a result, this system has been very successful."

"The current crisis has created a loud protest from the nation," he added. "However, it would be ironic indeed if the response to that protest were to further centralize power in New York and Washington."

The importance of maintaining the Fed's independence from political influence is crucial to a stable economy, Bullard said, noting, "Politics ebbs and flows. If political shifts get translated into monetary policy, the result is more and unnecessary volatility in the U.S. economy."

He warned, "In the U.S., erosion of Fed independence could result in a 1970s-style period of volatility. The consequences for the U.S. and the global economy would be large. No one would be served well by this outcome."

Regulatory Reform Threatens To Hamstring the Fed

In the aftermath of the financial crisis, some proposals have called for diminished Fed regulatory authority. Instead, Bullard said, "The reform response should be to provide the Fed with an appropriately broad regulatory authority so that the central bank is well-informed about the entire financial landscape."

"A future Fed, with an appropriately broad regulatory responsibility, provides the U.S. with the best chance to head off a future crisis," he added.

Prior to the crisis of 2007, the Fed had primary regulatory authority for only about 12 percent of total U.S. banks, he said. In addition, banks and thrifts represented only a fraction of the entire financial landscape. "As the crisis began, 20 firms accounted for about 80 percent of S&P 500 financial sector assets in the U.S. About one-third of this total was in banks. About two-thirds of this total was non-bank financial firms such as government-sponsored enterprises (Fannie Mae and Freddie Mac), investment banks, insurance companies, and thrifts."

"Non-bank financial firms turned out to be the most troublesome entities in this crisis, and the Fed had no supervisory authority over these entities," he said. "The bottom line: The Fed had a severely limited view of the financial landscape as the crisis began."

"The Fed had primary regulatory authority for only some of the banks, and none of the troublesome non-bank financials," he added. Yet, as the crisis unfolded, "All eyes turned to the Fed as the lender of last resort. This always happens in a crisis – only the central bank can play the lender-of-last-resort role."

More recently, some suggestions for reform seek to remove the Fed from the supervision of smaller banks, Bullard noted. "Existing regulation works well for the thousands of smaller banks in the U.S. Smaller banks did not cause the crisis and do not need to be re-regulated."

"The Fed should remain involved with smaller bank regulation so that it has a view of the entire financial landscape and does not become biased toward the large, mostly New York-based institutions," he added. "One critical role of regulation is to provide a level, competitive playing field for institutions of all sizes. Smaller banks tend to fund smaller businesses, an important source of job growth for the economy. Understanding this process helps the Fed make sound monetary policy decisions."

Monetary Policy by Different Means: Successful Quantitative Easing

Bullard summarized the three components to the Fed's current U.S. monetary policy that have been used to alleviate the impact of the financial crisis: the liquidity programs (now mostly ended), a near-zero interest rate policy, and a quantitative easing policy.

"Policy rates were reduced to near zero across the Group of Seven in late 2008 and early 2009," he said, reiterating that the FOMC has said it will keep the federal funds target rate near zero for an extended period. "Any movement on the funds rate target is contingent on both inflation and real economic developments."

Calling it "the new face of stabilization policy," Bullard discussed the Fed's successful implementation of its more than $1.7 trillion asset purchase program, which is set to be completed by the end of this month. "The program has been regarded as successful in further easing monetary conditions after the zero bound was encountered," he said.

He added, “The Fed is very capable of conducting stabilization policy when policy rates are near zero. The quantitative policy should be conducted in a manner analogous to interest rate policy. This means adjusting the policy according to incoming information on the economy.”

He further explained, “The asset purchases are being financed by reserve creation, or ‘printing money.’ The monetary base has expanded rapidly,” he said. “In contrast to the liquidity programs, the expansion of the monetary base associated with the asset purchase program is likely to be very persistent. This has created a medium-term inflation risk.”

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- **February 23, 2010**. Speech. "Will Regulatory Reform Prevent Future Crises?" (cfavirginia23february2010final5pmpdf) delivered at the *CFA Virginia Society*, Richmond, Virginia.
  Press Release | Related news articles | Slides with Audio (20100223-bullard-richmondpdf) (requires Adobe Reader 9 or later).
  Similar remarks were also given at Texas A&M University in Texarkana on February 25, 2010.
  Related news articles.

  St. Louis Fed's Bullard: Fed is the Nation's "Best Chance" for Avoiding Future Financial Crises

  RICHMOND, Va.—In remarks today to the CFA Virginia Society in Richmond, Va., St. Louis Fed President James Bullard provided an overview of the origins of the financial crisis and explained why most of the regulatory reform proposals under debate in Washington will not be adequate for preventing future crises.