

## Constitutional Principles and Federal Reserve Practice

By: Allan H. Meltzer

Article 1, Section 8 of the U.S. constitution gives Congress the power to “create money and regulate the value thereof.” In 1913, Congress assigned its monetary power to the newly created Federal Reserve. Earlier, Congress had adopted the gold standard, so Federal Reserve actions were restricted by gold standard rules.

The restriction did not last. Once the gold standard ended, the Federal Reserve generally did not follow any rule or principle to guide its actions. It is wedded to discretion, the belief that it knows the right thing to do and should be allowed to remain unconstrained. Political pressures have an important influence Meltzer (2010). Frequent assertions of independence notwithstanding, the Federal Reserve in recent years has carried out administration fiscal policy and allocated credit to support administration housing policies and to give membership to GMAC to prevent its failure. In the 1970s, it created inflation to support public policies that gave primary attention to unemployment while allowing inflation to rise to double digits. In almost 100 years, it can point to only a few periods that combined low inflation with relatively stable growth. Unlimited discretion has not worked to benefit the public.

Just as there is no rule guiding monetary policy actions, there is no rule governing the Federal Reserve’s role as lender of last resort. Starting in the 1970s, the Federal Reserve has yielded to pressures to bailout large banks and financial institutions. This became the too-big-to-fail policy, in practice a policy of unrestrained discretion that protects bank managements and stockholders at taxpayer expense. This policy encourages banks to become large, and it induces

lenders to consider large banks to be safer than others. This permits the favored banks to borrow at lower interest rates.

The recent financial crisis revealed three major flaws in U.S. financial supervision and regulation. First, the Federal Reserve has unlimited discretion to increase or reduce the stocks of money and credit, thereby encouraging excessive or insufficient expansion. Second, housing policy is supported by housing finance that includes subsidies for low income borrowers that are not part of the government's budget. This practice invites corruption and violates the constitutional principle that all government expenditure should be in a budget approved by Congress. Third, regulators are captured by the regulated and much regulation is circumvented. One of many examples is the Securities and Exchange Commission, long the captive of the industry and firms it is supposed to regulate. Another is the Basel Committee on Bank Supervision's agreement on bank risk. The central banks announced regulations to limit the risk on bank balance sheets. Banks circumvented the agreement by putting their risky mortgage loans off their balance sheets.

The fundamental issue underlying proposals for reform is whether command and control regulation can reduce risk and costs to taxpayers more efficiently than incentives that steer bankers to control risk. Failure of regulators everywhere to identify financial problems and reduce risk before the crisis suggests that command and control is ineffective. It was not just banking. Regulators did not act against Madoff, Stanford, or AIG.

The massive Dodd-Frank bill did nothing to improve the three major problems and made some of them worse. The more than 2000 pages of legislation propose hundreds of new regulations, more command and control, to be written by regulators. The new law invites more capture and circumvention of costly regulation.

Lawyers and bureaucrats write regulations, but markets learn to circumvent costly edicts. Often the same lawyers who write the regulations go to work for the regulated firms to show them how to circumvent the rule without violating it. In contrast successful regulation changes the incentives of the regulated in favor

of enforcement. They introduce means of enforcement instead of circumvention. The Dodd-Frank bill generally ignores incentives and it ignores recent research at the World Bank showing that there is no evidence of increased bank stability in countries that follow the “core principles” of regulation proposed by the Basel committee of regulators (Demirguc-Kunt and Detragiache, 2009). I suggest likely reasons are widespread capture and circumvention and few supportive incentives. Almost daily the press reports examples of circumvention and capture from many regulated industries.

The Federal Reserve will soon be 100 years old. It has discussed internally the practices that it should follow when acting as a lender of last resort, but it has never announced principles or a policy rule. A proper rule would recognize that a central bank is responsible for protecting the payments system so that transactions can continue in the marketplace. It should not protect the failing firm. Failing firms should be allowed to fail. The central bank is not the country’s bailout agency. Its responsibility is to lend to counterparties of the failing firm and others to whom it lends against marketable collateral. This was well known and widely understood in the 19<sup>th</sup> century. Walter Bagehot (1873), who insisted on these principles, pointed out that, when failures occurred they did not spread or cause a panic once the Bank of England protected the payments system, not the failing bank.

The time-honored way to prevent bank failures was to require banks to hold adequate capital. In testimony to Congress I proposed several times that capital requirements should increase with asset size. Congress preferred regulation to incentives. I welcome the Basel committee’s emerging proposal to increase bank capital. If stockholders are at risk, they will encourage managements to be prudent, thereby creating incentives to enforce capital requirements. This will limit risks and crises. It will not prevent all bank failures.

Instead of closing the government mortgage lenders and putting housing subsidies on the budget, the Dodd-Frank bill ignored the housing subsidy and opened a large, new off-budget agency. The Federal Reserve holds hundreds of billions of government debt and other assets, so it has large portfolio earnings

every year. For many years, it has paid 90 percent of its earnings to the Treasury. The Dodd-Frank bill assigns some of Federal Reserve earnings to a new banking regulator, so the financing by the Federal Reserve comes as a direct draw against revenues that would accrue to the Treasury. Payments are not subject to Congressional oversight or approval. Further, the new agency is inside the Federal Reserve but not subject to oversight by the Federal Reserve and very little from Congress. This violates constitutional strictures and proper procedures.

As long as it claims to protect the public, the new agency can regulate as it chooses. Thus the agency not only violates constitutional principles about budgets, it subverts the rule of law. Congress is supposed to make laws or at least to oversee the rules that agencies adopt. The new banking agency appears to be largely exempt from such oversight.

Increasingly, the country has strayed from the constitutional principles and the rule of law which gave the nation a government of laws. It is past time to reverse course.

Much recent financial regulation looked backward to restrict the real and imagined flaws in regulation. No one in authority asked whether risk would be reduced or simply moved to a new, unregulated lender. Economic progress requires that lenders accept risk and use diversification and capital to reduce the social cost of risk-bearing. Who will bear the risks in the heavily regulated financial system? Will risk-bearing move offshore or to a less regulated intermediary? What will that do to opportunities to finance new innovations?

Successful capitalism requires risk-bearing. Capitalism without failure is like religion without sin. It doesn't work. The new regulations are not well-designed to reduce risk while promoting growth.

Let me say a word about the European Central Bank. It is more independent than the Federal Reserve because it is not formally part of any existing government. Like any institution it is subject to political and public pressure. Two weaknesses in its design were recognized when it began: Fiscal restrictions are weak, so there is pressure to monetize government debt. It lacks authority and responsibility for

lender of last resort functions. In the current crisis, these design failures caused the ECB to violate its principles by lending to Greece and purchasing large amounts of sovereign debt. Germany's commitment to principles weakened. It was unwilling to insist on protecting the market and the payments system, not the failing institutions. I do not see why more loans to Greece at concessional rates can help Greece adjust its wage rates to become competitive.

The ECB was created following Robert Mundell's claim that Europe was an optimal currency area. Count me as one of the skeptics who believes that doubts have been resolved against the claim.

*A main lesson, again, is that regulation w/o enforcement or incentives doesn't work. There were no binding incentives on the 3% fiscal rules*

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Meltzer, Allan H. (2010). *Politics and the Fed*. *Journal of Monetary Economics* (forthcoming),