

**Clarifying Central Bank Responsibilities for Monetary Policy,  
Credit Policy, and Financial Stability**

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## Introduction

Independence has long been recognized as an essential element of effective central banking. The extraordinary central bank interventions in the recent credit turmoil precipitated a reconsideration of the nature of that independence. On one side, the Federal Reserve has been commended for its willingness to provide generous support for the financial system in lieu of congressional support that was not always forthcoming. On the other side, the Federal Reserve has been condemned for its generous financial support for particular financial institutions, its critics calling for more scrutiny and oversight of Fed policy actions, and enhanced auditing of the Fed balance sheet. The Fed's expansive initiatives put the central bank in a cross-fire and created a pressing need to clarify its independent responsibilities.

The extraordinary scale and scope of central bank initiatives in the credit turmoil exposed the weakness of insufficiently constrained central bank independence. Ambiguity about the boundary of independent responsibilities of the central bank has been shown to be counterproductive. Not only has the Fed put its own independence in jeopardy, but the lack of clarity on the boundary of its responsibilities helps to explain the failure of Congress to act sooner to provide fiscal support for the financial system. The boundary of the Fed's independent

powers should be clarified to protect the central bank from being drawn into circumstances that compromise its independence in the future.

A central bank's primary responsibility is to employ monetary policy independently to maintain macroeconomic and financial stability. The lesson from the recent credit turmoil is that to preserve independence on monetary policy, the fiscal policy powers of both monetary policy and credit policy must be clarified. This essay reviews the rationale for monetary policy independence. Then, it outlines the fiscal policy aspects of monetary policy and credit policy, and suggests a clarification of the boundary of responsibilities for each that can sustain central bank independence. The essay concludes by explaining why an independent central bank cannot serve as a "pinnacle financial stability oversight authority."

### Why Independent Monetary Policy

The 1951 Accord between the Federal Reserve and the US Treasury affirmed the independence of the central bank for the purpose of employing monetary policy to stabilize employment and inflation. The Fed has been given wide latitude regarding the size and composition of its balance sheet to enable it to react flexibly to unanticipated developments in the economy. And the Fed has been allowed to fund its operations from interest earnings on its portfolio of securities to strengthen its financial independence. 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. And Fed independence is today the institutional foundation of effective monetary policy.

There are two operational reasons why independence is essential for monetary policy to succeed. First, in order to stabilize employment and inflation, monetary policy must raise interest rates preemptively and allow interest rates to vary over the business cycle. The very success of stabilization policy makes raising interest rates seem unnecessary; yet, failing to raise interest rates during expansions destabilizes the economy. Independence is needed to distance central banks from the politics of the moment. Second, on occasion the central bank will be too slow to raise interest rates against inflation. Such situations require aggressive interest rate actions subsequently to anchor inflation and inflation expectations, with great risk of recession. Again, and even more so, central banks need independence to distance themselves from the politics of the moment.

#### Clarifying the Fiscal Boundary of Monetary Policy

Independent monetary policy need not infringe at all on the fiscal policy prerogatives of the Treasury and Congress. Monetary policy works by varying the aggregate quantity of bank reserves to influence interest rates. The central bank buys or sells securities to add or drain reserves depending on whether it wants to lower or increase interest rates. In principle, open market operations can be conducted in any class of securities. One can think of pure monetary policy as

consisting of central bank open market operations that expand or contract high-powered money (aggregate bank reserves plus currency) by buying or selling US Treasury securities.

In fact, until the recent credit turmoil the Federal Reserve satisfied virtually all its asset acquisition needs in support of monetary policy by purchasing US Treasury securities. The Fed followed that asset acquisition policy, long known as “Treasuries only,” to avoid carrying credit risk on its balance sheet. The main exception to US Treasuries in the Fed’s assets was occasional, temporary, discount window lending to solvent depository institutions; discount window loans never accounted for more than a relatively small fraction of Fed assets until recently. Importantly, the Fed returns to the Treasury all the interest (net of operating expenses) on the Treasuries that it holds. Hence, by adhering to “Treasuries only” the Fed passes all the revenue from monetary policy back to the Treasury and leaves all the decisions regarding the use of that revenue to the fiscal authorities, the Treasury and Congress. Therefore, “Treasuries only” clarifies fully the fiscal policy boundary between independent monetary policy and the fiscal authorities.

The Fed should return to “Treasuries only.” Doing so would make it unnecessary for Congress to audit the Fed balance sheet or to scrutinize Fed monetary policy actions beyond the regular oversight hearings undertaken to hold

the Fed accountable for the dual mandate—the maintenance of stable employment and low inflation.

### The Fiscal Nature of Credit Policy

Unlike monetary policy, credit policy does not involve changing aggregate bank reserves or high-powered money. Instead, credit policy involves using funds from the sale of Treasury securities to acquire non-Treasury securities or to finance loans to private institutions. In other words, credit policy involves changing the composition of a central bank's assets, holding high-powered money fixed.

Central bank credit policy works by interposing the government between private borrowers and lenders to exploit the government's creditworthiness to lower private borrowing costs and facilitate credit flows. Hence, credit policy involves the assumption of credit risk by the central bank. And credit policy exposes the central bank, and ultimately taxpayers, to potentially costly and controversial disputes regarding credit allocation. This is true even if a central bank protects itself with good collateral. This so because if a central bank finances the exit of uninsured creditors of a borrower that fails subsequently, then the central bank would strip that failed entity of collateral that would be available otherwise to cover the cost of deposit insurance or government guarantees.

Credit policy pursued by the Fed is really debt-financed fiscal policy. The reason is that the Fed uses only a small fraction of the interest earned on the

Treasury securities that it holds to pay its operating expenses, and returns the rest to the Treasury. So when the Fed sells Treasury securities to finance the acquisition of non-Treasury assets such as discount window loans to depositories, or mortgage-backed securities, it is as if the Treasury financed the asset purchase by borrowing from the public.

By its very nature, then, central bank credit policy has the potential to create friction between the independent central bank and the fiscal authorities. Credit policy undoes “Treasuries only,” so to speak, and uses some of the revenue from money creation to acquire non-Treasury assets without the authorization of the fiscal authorities. Moreover, credit policy directs public funds to specific borrowers. Whenever a central bank takes a credit policy action, it favors one sector over another.

Even the acquisition of government agency securities has allocative effects because it steers credit in a particular direction and confers a preferential status enhancing that agency’s creditworthiness. Hence, even when a central bank buys agency securities it makes a potentially controversial choice to favor one use of credit over another.

### Clarifying the Boundary of Credit Policy

Given its inherent fiscal nature, expansive central bank credit policy has the potential to create enormous friction between the independent central bank and the

fiscal authorities. That friction is evident today in the tense relationship between the Fed and the Congress.

One way to reduce the scope for such friction is to deny credit policy powers to the central bank altogether by requiring the central bank to pursue a “Treasury only” asset acquisition policy. But that would take away a policy option that has proven to be invaluable in the recent credit turmoil. And last resort lending to temporarily illiquid but solvent depositories has long been a valued feature of independent central banking.

Moreover, last resort lending is compatible with central bank independence. Conventional last resort lending to supervised, solvent depositories, on a short-term basis, against good collateral provides multiple layers of protection against losses. 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, 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.

In order to secure its independence, a central bank's credit policy reach should be confined to last resort lending as described above, lending beyond that should be clearly authorized by the fiscal authorities.

### A Central Bank Cannot Be the Pinnacle Financial Stability Oversight Authority

At the core of financial reform legislation working its way through Congress is the proposal to establish a "pinnacle financial stability authority" with responsibility for oversight of the whole financial system. The structure, scope, membership, and location of such an oversight body are matters of intense debate. Whatever other powers are given to the "pinnacle authority," in order to be the decisive "one stop shop" systemic regulator that reformers have in mind, the "pinnacle authority" must be empowered to either grant or deny taxpayer fiscal support for particular firms or sectors in financial distress.

We saw recently that the decision to grant or deny public fiscal support to individual firms or sectors in times of financial turmoil is inevitably political, highly charged, and among the most contentious fiscal policy choices imaginable. And we saw that the Fed's expansive credit initiatives put its independence in jeopardy. Whatever one thinks of establishing a "pinnacle authority," clearly it cannot be lodged in an independent central bank. To grant or deny taxpayer support for firms in financial distress is fiscal policy. To force a central bank to

make fiscal policy, especially such contentious fiscal policy decisions, would surely politicize the central bank and destroy its independence.