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The Centennial Monetary Commission Act of 2013: A Second Look at the Fed and the 2008 Financial Crisis

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Abstract
There is still a great deal of debate over the Federal Reserve's role in the 2008 financial crisis. Critics have blamed the Fed's policies for everything from causing the crisis to worsening it, as well as prolonging the economic recovery after the financial markets stabilized. This debate has not been settled, but Congress has already expanded the Fed's authority, providing yet another avenue for criticism. Congress should set up a formal monetary commission, such as the one proposed in the Centennial Monetary Commission Act of 2013. This type of commission would provide a public venue for both critics and supporters to discuss the Fed's past operations and the appropriate role for the central bank going forward.

Key Points

- Critics have denounced the Fed for everything from causing the 2008 financial crisis to worsening it, as well as prolonging the economic recovery after the markets stabilized.
- Nevertheless, Congress expanded the Fed's authority through the Dodd–Frank Act of 2010.
- Congress should set up a formal monetary commission, such as the one proposed in the Centennial Monetary Commission Act of 2013.
- This type of commission would provide the appropriate venue for both critics and supporters to discuss the Fed's operations and its proper role going forward.

More than five years after the 2008 financial crisis, the Federal Reserve's role is still the subject of much debate. Some critics feel that the Fed's efforts to stem the financial panic were misguided because they allocated credit directly to insolvent institutions. They believe that the Fed should have allowed insolvent firms to restructure through bankruptcy and should have provided credit only to sound banks on a short-term basis. Instead, the Fed facilitated bailouts to insolvent banks and even non-banks by invoking its so-called emergency lending authority. The government even forced some banks to take the money against their objections.[1] These operations were based on the premise that failing to undertake them would have caused a calamity on the scale of the Great Depression.

Even after financial markets stabilized, the Fed expanded its activities because the recovery was slow to materialize. These ongoing monetary policies have come under fire for being ineffec-

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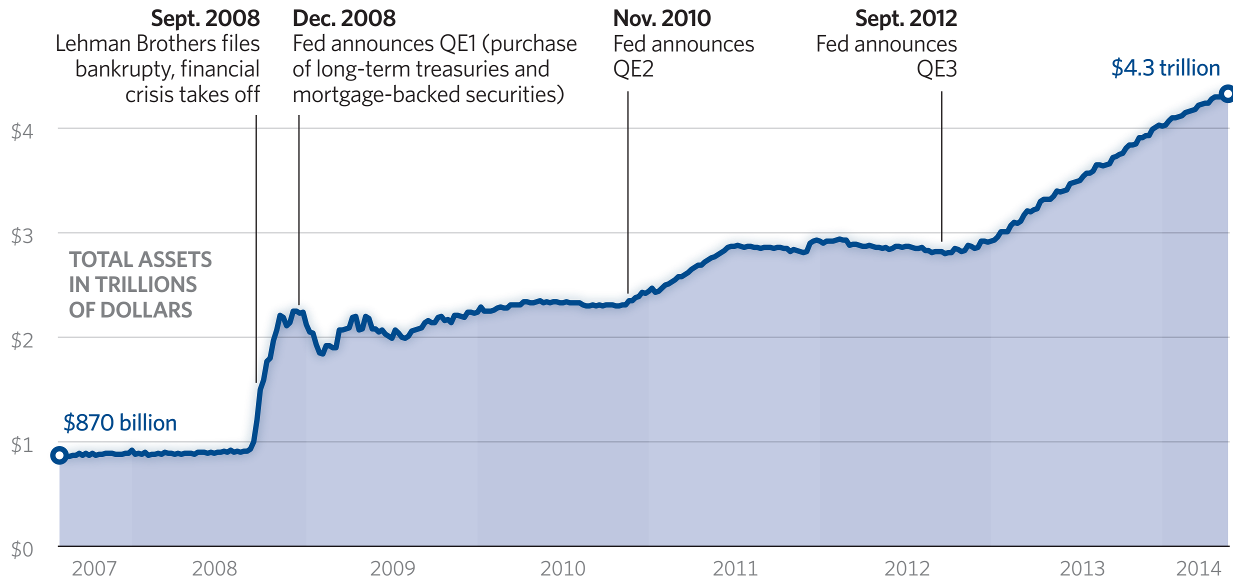
CHART 1

Federal Reserve Assets: Key Dates



Source: Board of Governors of the Federal Reserve System, "Credit and Liquidity Programs and the Balance Sheet: Total Assets of the Federal Reserve," http://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm (accessed June 5, 2014).

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tive and for increasing the likelihood of future inflation because they were so aggressive. The Fed now holds more than five times the amount of debt it had prior to these operations. (See Chart 1.) The policies have also been criticized for preventing proper valuation of certain financial assets, thus prohibiting the natural market processes that ultimately strengthen an economy.

The central bank's detractors have even argued that the Fed's pre-2007 expansionary policies contributed to the meltdown. Yet Congress expanded the Fed's authority in the wake of the crisis, providing yet another avenue for criticism. In particular, the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act expanded the Fed's lending powers and its overall reach as a regulator. At the very least, Congress should provide a public venue for both critics and supporters to discuss the Fed's past operations and the appropriate role for the central bank going forward.

Centennial Monetary Commission Act

The Centennial Monetary Commission Act (CMCA) (H.R. 1176) would "establish a commission to examine the United States monetary policy, evaluate alternative monetary regimes, and recommend a course for monetary policy going forward." This bill, originally introduced by Representative Kevin Brady (R–TX), and a companion bill introduced by Senator John Cornyn (R–TX), would provide a much needed public forum for experts to evaluate the Fed's overall performance and mission. The commission's recommendations would not bind Congress to make any particular changes, but it would provide Members of Congress with information they need to fulfil their constitutional responsibilities for monetary policy.

Since the 1970s the Fed has acted under a "dual mandate," a controversial provision that requires the central bank to focus on both price stability and full employment.[2] The commission would allow a public

1. See Nina Easton, "How the Bailout Bashed the Banks," CNN Money, June 22, 2009, http://money.cnn.com/2009/06/19/news/economy/trouble_with_tarp_bailout.fortune/index.htm?postversion=2009062107 (accessed June 11, 2014), and John A. Allison, *The Financial Crisis and the Free Market Cure: Why Pure Capitalism is the World Economy's Only Hope* (New York: McGraw Hill, 2013), pp. 170–171.

debate over whether such a mandate is workable, the Fed should focus only on price stability, or if the central bank should be so heavily involved in the economy in the first place. The commission would fully examine how the Fed has affected the U.S. economy and then recommend which operational regimes might achieve the best long-term monetary policy. The CMCA is flexible, but it requires the commission to evaluate a number of specific policy regimes. The following list briefly describes the alternative regimes that the commission should evaluate.

Discretionary Monetary Policy. The Federal Reserve currently employs discretionary policy without any rigid operational framework. Thus, the Federal Open Market Committee (FOMC) implements monetary policy as it sees fit. Under the dual mandate, FOMC members attempt to conduct monetary policy to promote both price stability and low unemployment.[3] The FOMC has no binding requirements to hit any specific economic goals, so it is free to implement its policies (within the law) however it chooses.

In general, if the FOMC believes that unemployment is too high and/or that there is a danger of deflation (a falling price level), it pursues expansionary policy by targeting lower interest rates and purchasing government securities. On the other hand, if the FOMC believes unemployment is too low and/or that there is a danger of inflation, it follows a contractionary policy by targeting higher interest rates and selling securities.[4] In either case, FOMC members are completely free to judge both the direction of the economy and the appropriate response. FOMC members often disagree on these policy judgments because there is no set of purely objective economic measures.

The FOMC is not bound to implement expansionary or contractionary policies at any particular time using any particular method. The FOMC also has the discretion to deal with large, unexpected swings in the economy via "emergency" measures, even though its operations are supposed to prevent such swings from occurring in the first place.[5] Opponents of pure discretionary policy claim that this lack of any real policy constraints leads to uncertainty and distorts the value of money, making it more difficult for families and business owners to properly plan for the future. While critics argue that a group of technocrats cannot actually stabilize the economy, the Fed's supporters believe that the FOMC needs broad discretion to deal with unforeseen economic changes. Partly to prevent too much bureaucratic meddling in the economy, many believe the Fed should implement rules-based policies.

Monetary Policy Rules. In general, rules-based policies differ from a discretionary framework because they require the Fed to state specific policy goals and responses *before* engaging in policy actions. For instance, the Fed may state a goal of keeping inflation below 2 percent. The Fed could then commit to a rule of increasing the money supply by a given percentage each year, based on the growth rate of gross domestic product (GDP). This commitment would ostensibly bind the Fed to a specific course of action based on clearly defined economic outcomes.

One possible advantage of policy by rule rather than policy by discretion is that rules-based policies can prevent short-term considerations from interfering with the Fed's long-term goals. Nonetheless, a central bank could choose to implement one of many different monetary policy rules, and it is doubtful a central bank could be strictly bound by any policy rule for very long. Aside from targeting the GDP growth rate, economists have developed monetary policy rules that would focus on variables such as the rate of inflation, the aggregate price level, and the money supply. Three such rules are:

2. This provision is controversial because many economists believe that monetary policy can do very little to influence employment. For example, former Federal Reserve Chairman Ben Bernanke publicly stated that "the maximum level of employment in a given economy is largely determined by nonmonetary factors." Chairman Bernanke, press conference, Federal Reserve, January 25, 2012, http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20120125.pdf (accessed May 20, 2014).
3. See Norbert J. Michel, "The Fed at 100: A Primer on Monetary Policy," Heritage Foundation *Backgrounder* No. 2876, January 29, 2014, http://www.heritage.org/research/reports/2014/01/the-fed-at-100-a-primer-on-monetary-policy.
4. Expansionary (contractionary) monetary policies are those designed to expand (contract) credit, thus leading to more (less) economic activity. See ibid.
5. The Federal Reserve Act allows the Fed to provide emergency financial assistance in certain "unusual and exigent circumstances." 12 U.S. Code § 248(r)(2)(A)(ii).

- *Inflation rate targeting rule.* Inflation rate targeting rules require the central bank to try to keep the rate of inflation within a certain range. For example, the Fed may endeavor to ensure that the rate of inflation in the U.S. is always between 1.5 percent and 2.5 percent, as measured by the rate of change in the consumer price index (CPI). Proponents of inflation rate targeting argue that highly variable rates of inflation—rather than just inflation itself—can lead to dangerous fluctuations in the economy's output.

  Using the target range of 1.5 percent to 2.5 percent, if the rate of inflation rose to 3 percent, the Fed would conduct contractionary monetary policies. On the other hand, if the inflation rate fell to less than 1.5 percent, the Fed would implement expansionary policies to raise the rate of inflation to the target range. In theory, successfully targeting inflation in this manner would allow people to plan better for the future with less risk of inflation eating into their income.[6]

- *Price level targeting rule.* Price level targeting is very similar to inflation rate targeting, but a price level rule requires the Fed to target the level of the price index itself as opposed to the rate of change in the index. For instance, the Fed may aim to keep the CPI between 220 and 230. In this case, if the CPI ever falls below 220, the Fed would undertake expansionary monetary policy, whereas a CPI of more than 230 would require contractionary policy.

  Successfully targeting the price level in this manner ensures that inflation fluctuates around a base level of the CPI, whereas inflation rate targeting is not concerned with the CPI level. This difference matters because targeting only the rate of change in the CPI is likely, over time, to lead to a substantially higher price level, even if the target is consistently reached. In other words, if the inflation target is 1.5 percent to 2.5 percent, the Fed will always try to hit this range regardless of the level of the CPI.[7]

- *Nominal gross domestic product (NGDP) targeting.* A policy rule based on a nominal gross domestic product (NGDP) target can take several forms. For example, the central bank could set a target range for either the level or the growth rate of NGDP. Scott Sumner, one noted advocate of an NGDP target, has proposed that the Fed target a specific growth rate for NGDP and then commit to compensating for any misses.[8]

  The general idea under this rule is that the Fed should be as expansionary or contractionary as necessary to ensure that the economy's aggregate nominal spending stays on target. For instance, using this rule, the Fed may set a target annual growth path of 4 percent for NGDP. If actual NGDP growth is only 3 percent, the Fed would then engage in expansionary policy to try to increase NGDP growth to 5 percent. If successful, the average growth rate would return to 4 percent. Sumner has also proposed a version of NGDP targeting that would limit the Fed's role to setting the target.

  Under this approach, investors would buy and sell NGDP futures contracts until the money supply

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6. See Federal Reserve Bank of San Francisco, "What Are the Costs and Benefits of Inflation Targeting? Should the Fed Adopt an Inflation Targeting Monetary Policy Regime?" March 2007, http://www.frbsf.org/education/publications/doctor-econ/2007/march/inflation-targeting-monetary-policy-costs-benefits (accessed May 22, 2014). The Federal Reserve set a formal inflation target, though not a rule, in 2012. See Jonathan Spicer, "In Historic Shift, Fed Sets Inflation Target," Reuters, January 25, 2012, http://www.reuters.com/article/2012/01/25/us-usa-fed-inflation-target-idUSTRE80O25C20120125 (accessed May 22, 2014).
7. Another way of describing this issue is that adhering to an inflation rate target can lead to a "path" for inflation that is substantially above or below the original path. Those who favor inflation targeting argue that one way to avoid this problem is to focus on average inflation rates over a given time period. See Greg Mankiw, "Taylor on Inflation Targeting," Greg Mankiw's Blog, July 13, 2006, http://gregmankiw.blogspot.com/2006/07/taylor-on-inflation-targeting.html (accessed May 22, 2014).
8. See Scott Sumner, "The Case for Nominal GDP Targeting," George Mason University, Mercatus Center, October 23, 2012, http://mercatus.org/sites/default/files/NGDP_Sumner_v-10%20copy.pdf (accessed May 22, 2014).

adjusted enough to get expected NGDP back to the Fed's target.[9] For example, if investors expected NGDP growth above the target, they would buy contracts from the Fed, thus tightening the money supply and contracting NGDP. Conversely, if investors expected NGDP growth below the target, they would sell contracts to the Fed, expanding the money supply and NGDP. Thus, markets would ultimately determine the money supply and interest rates after the Fed sets the target. The overall goal of this plan would be to stabilize expected NGDP growth based on what "markets" believe.

The Gold Standard. The gold standard, although it has many historical variations, is essentially another type of monetary rule. The gold standard requires paper currency in this regime to be convertible to a fixed amount of gold. From roughly 1870 to 1914 (commonly referred to as the classical gold standard period), all major nations adhered to this sort of gold standard. The U.S. dollar, for instance, was defined as 0.048 troy ounces of gold, which meant that an ounce of pure gold was equivalent to $20.67. People exchanged gold for currency and vice versa.

Under such a system, gold defines the monetary unit and serves as the ultimate medium of redemption. Both private banks and the central bank can issue paper currency (notes) under the gold standard, but their notes are redeemable in gold. Historically, banks held gold coins and/or bullion in reserve to meet customers' redemption needs. The economy's money supply and price level were ultimately tied to the supply and demand of gold because banks were contractually obligated to redeem currency in gold.

Similarly, the total amount of government borrowing was limited to what could credibly be repaid in gold. Proponents of a gold standard like this feature because national governments and/or central banks can only inflate the currency if they break the rule imposed by the gold standard. Of course, Great Britain, Germany, and France broke this constraint to finance World War I. Thus, gold provided a nominal anchor for the currency, but highlighted the difficulty in enforcing any sort of monetary rule. Critics of the gold standard argue that it subjects the value of money to the variations in a commodity market and that it prevents the government from lessening the impact of business cycles as economic conditions change.[10]

Competitive Currencies. Although none of the currently pending legislation requires it, any formal commission should also evaluate a competitive currency regime. Prior to the creation of the Federal Reserve, no single currency was in use throughout the United States. Banks typically issued their own currencies, which were redeemable for either gold or silver.[11] The Federal Reserve Act of 1913 gave the federal government a monopoly on the nation's currency, and many people now take for granted that a single government-provided currency is desirable.

Starting in the 1970s, reliance on government currency has steadily declined in favor of alternative monetary assets, such as money-market funds, commercial paper, and even gold.[12] During the past two decades, more direct alternatives to government-produced money have appeared, such as bitcoin. These types of innovations have sparked a debate over whether the government should have a monopoly on money.[13]

9. See Scott Sumner, "Re-Targeting the Fed," *National Affairs*, No. 9 (Fall 2011), http://www.nationalaffairs.com/publications/detail/re-targeting-the-fed (accessed February 18, 2014).
10. See Sumner, "The Case for Nominal GDP Targeting," and Matthew O'Brien, "Why the Gold Standard Is the World's Worst Economic Idea, in 2 Charts," *The Atlantic*, August 26, 2012, http://www.theatlantic.com/business/archive/2012/08/why-the-gold-standard-is-the-worlds-worst-economic-idea-in-2-charts/261552/ (accessed May 22, 2014).
11. For a discussion of the theory and history of these issues, see Lawrence H. White, "Free Banking in History and Theory," George Mason University *Working Paper in Economics* No. 14-07, May 12, 2014, http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=2435536 (accessed May 21, 2014).
12. See David Glasner, *Free Banking and Monetary Reform* (Cambridge, U.K.: Cambridge University Press, 1989), pp. 155–180.
13. See Lawrence H. White, "The Troubling Suppression of Competition from Alternative Monies: The Cases of the Liberty Dollar and E-gold," *Cato Journal*, Vol. 34, No. 2 (Spring/Summer 2014), pp. 281–301, http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2014/5/cato-journal-v34n2-5.pdf (accessed June 24, 2014), and Kevin Dowd, "Contemporary Private Monetary Systems," *Working Paper*, August 1, 2013, http://www.kevindowd.org/working-papers/ (accessed May 27, 2014).

Critics of competing currency argue that having the money supply under a central bank's control improves economic stability and that competing currencies would make business cycles more volatile. Some opponents of a competitive currency framework also claim that it may not be compatible with other policy regimes that the Fed might operate, while supporters maintain that it is compatible with any of the frameworks discussed above. A competitive structure could serve as a source of competition to the Fed, perhaps enabling market forces to better limit the impact of Fed policies on the economy.

What Congress Should Do

The Federal Reserve's original purpose was to stem seasonal currency shortages at member banks, and its operations were constrained by the gold standard. The Fed began as a decentralized system in which most of the decision-making authority was left to the respective district banks. By the end of the 1930s, the constraints of the gold standard were gone, and the role of the district banks had been greatly diminished. The Fed's reach into the economy has greatly expanded, and whether this is good for the economy is far from a settled question. The central bank's 100th anniversary is the perfect time to settle this debate with a formal monetary commission.

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