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ON THE CONNECTION BETWEEN MONETARY POLICY AND REGULATION OF BANKING AND FINANCIAL MARKETS

By

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The extremely dangerous 2007-09 credit crisis in the United States and its lingering aftermath of slow unsatisfactory growth, as well as the more recent financial crisis in the EU and related weak economic performance, have brought bank and financial regulatory issues, among other things, into greater focus along with their implications for monetary policy.

In assessing the causes of the crisis in the U.S., much blame has been placed on regulatory policies and neglect, but monetary policy has not been able to escape its share of blame, having been rather passive in face of the evolution of asset bubbles in the equity market late in the preceding century and in the housing market during the first decade of the current century. At least in the economic culture of the times, asset bubbles and associated financial market instability had come to replace inflation in the price of goods and services as a principal threat to sustained economic well-being.

Of course, the crucial underlying connection between regulatory and monetary policies for overall economic stability should have been no surprise to anyone with responsibilities in the financial policy area. Rather, it was the extreme seriousness of the crises and also the regime threatening aspects that emerged – such as the viability of the Euro, confidence in the political system, attitudes toward central bank independence and their role in the regulatory process – that had clearly been underestimated.

In the U.S, the full extent of the danger under foot was evidently unanticipated both by the Fed and the Treasury. In the event, as is well known, resolution of the crisis required a huge expansion in the Fed's balance sheet that was unique in its history, and also raised questions and complications about the central bank's ability to return to normalcy in an orderly fashion. The whole situation, essentially a human policy-made mess, has prompted extensive re-examination of issues in the connections between the market regulatory process and monetary policy.

The more recent ongoing crisis affecting the Euro zone and the EU, with the ECB also expanding its balance sheet by an unusual amount, involves similar questions about market events and regulations and their implications for monetary policy, though with added difficulties raised by the union's unique political structure. This structure not only has tolerated the recent well-publicized market problems occasioned by unsustainable sovereign fiscal and regulatory policies of some member countries on Euro area and EU banking and market conditions generally, but also has entailed excessive complications in efforts to coordinate market regulation throughout the union.

In both the U.S. and EU, regulatory power centers are quite diversified and subject to differing influences and incentives than is the case for monetary policy. But in the U.S. (where the Fed itself, in contrast to the ECB, has a major regulatory role), it seems clear that Federal regulatory agencies are considerably more dominant than those in the states (which have certain regulatory authority but which are far from independent sovereign countries). Still, the regulatory powers of the Federal government are diversified among various banking and securities regulators all with their own interests and constituency. The Fed is potentially the most influential regulator, but it is fair to say that, certainly at crunch time, the U.S. Treasury dominates. That is more clearly evident in the regulatory coordination structure set up by the Dodd-Frank Act (DFA) enacted in 2010 in response to the crisis.

In light of the country's baleful recent experience, this note briefly discusses whether and how regulatory and monetary policies can be more closely connected or integrated, and the limitations in doing so. While it will stress U.S. experience and background, the general points at issue are also relevant, I believe, to the ongoing efforts being made in the EU better to coordinate prudential standards among its countries and bring them more into concordance with combined credit and liquidity influences of ECB policy operations in the Euro zone and the operations of other central banks in the EU. In evaluation of the U.S., the note draws on views about the coordination of monetary and regulatory issues presented in the author's recently published book, *The Federal Reserve: What Everyone Needs to Know*, (Oxford University Press, 2013).

The connection between banking/financial regulation and the implementation of monetary policy is essentially complementary. But the two policies are distinct. On an ongoing basis, they seldom directly interact. That is, they have different objectives, pursue them on different paths, and do not usually adjust their actions in light of one another's activities or take actions to help support any particular short-term policy action of the other.

Coordination or integration of the two policies has to take account of the differing principal objectives of the two – a safe and sound, and also equitable, banking and financial system for regulatory policies and, in the U.S., the dual economic objectives of price stability and maximum employment for monetary policy. At the same time the close longer run mutually beneficial connection between monetary and regulatory policies has to be recognized.

A financial system that is fundamentally stable, predictable, and adaptable makes it easier for monetary policy to evaluate the practical implications of its policy options and to operate effectively in accord with its basic economic objectives. At the same time, a modern central bank's role as the lender of last resort provides the financial system with assurance that liquidity will be available to abet the continued overall functioning of the market even as temporarily overextended sectors of the market make their necessary readjustments.

But when a financial system as a whole destabilizes and threatens to break down almost entirely, monetary policy is forced to devote its full attention to stabilizing the system through which its policies affect the economy rather than focusing on its principal economic goals. In such circumstances, the extent to which the central bank will have to employ its broad balance sheet powers to support the market, and in effect become a sizeable continuing provider of credit to the market, will depend in good part on the degree to which the government steps in, through one measure or another, and participates in efforts to resolve both the crisis and its adverse economic impact.

As was apparent in the course of the recent crises, a government can step in through a number of routes, such as itself taking on or guaranteeing some of the market's bad debt, injecting capital to needy institutions, or helping the private markets regenerate themselves by pursuing an active fiscal policy that stimulates the economy. In the U.S., the government was constructively involved in the first two routes, but fiscal policy was a sadder story. In Europe, the proper role of fiscal policy seems, as of this writing, to remain an ongoing argument.

Turning to issues in evaluating how monetary and regulatory policies might be better attuned to each other, the regulatory and supervisory functions of the Fed are aimed, as already noted, at keeping the banking system safe and sound through good and bad economic times. As is well known, it does so via various tools of the regulatory trade, especially through regulations adjusted as needed in reflection of ongoing changes in financial technology and of varying business and consumer preferences as the economy evolves, and also through supervision to ensure adherence to the regulations. In a micro sense, it sees to the proper functioning of individual banks. In a macro sense, it sees to the stability of the financial system as a whole through such policies as capital and liquidity standards. But in practice micro and macro surely interact in influencing the general healthiness of the financial system.

The Fed's authority also reaches beyond member banks through its oversight over bank and financial holding companies (involving banks). Thus, its regulatory authority is quite broad and can be considered crucial to the underlying health of the financial system. Especially since the recent U.S. credit crisis, the Fed's fundamental credibility with the public and the Congress appears to depend as much on its regulatory performance in relation to financial markets as on its success in controlling inflation.

However, while the Fed as a central bank has a unique control over inflation, it is only one among many regulators in the U.S. It shares responsibilities with many other banking agencies such as the Office of the Comptroller of the Currency (which charters national banks), the Federal Deposit Insurance Corporation, and state banking regulators. Moreover, in evaluating the condition of the nonbank components of bank and financial holding companies, it relies mostly on the primary supervisor of securities firms or insurance companies that are part of the holding company. In practice, the Fed appears to have exercised potential supervisory authority outside the member banking system with considerable and probably even too much restraint.

While reducing the Fed's regulatory authority in some minor respects, the recently enacted DFA notably enhanced it by granting special authority over very large bank and financial holding companies and also very large nonbank financial institutions whose failure would risk destabilizing the financial system. This provides the central bank with a strong anti-crisis tool but whether, given the complicated overarching regulatory structure set up by the DFA, it in practice can and will be used on a timely basis to forestall a threatening crisis is of course unknown.

In any event, the international competition for business among large banks and financial institutions, overall implications for domestic markets, and the existing domestic political situation at a particular time greatly complicate the decision. In today's and tomorrow's world, there is and will be a clear need for a well defined and well ordered politically agreed pattern of responsibilities if timely action to avert crises and their spread is to have a better chance.

Because of its basic focus on continuing safety and soundness of the financial system, as well as because of the advantage to continuity in regulatory attitudes and prudential standards for sound business planning purposes, the regulatory process normally unfolds gradually over time. It differs from monetary policy formulation at, say, the Federal Open Market Committee (FOMC), where decisions are made and announced about every six weeks that affect the nation's overall credit availability and interest rates. Rather, regulatory policy decisions, with the Fed as one among a number of regulators, can be viewed as emerging, metaphorically, out of something like a never-ending nationwide or even worldwide meeting with large numbers of official participants coming and going while markets continue on their innovative ways. The regulators are dealing with complex business, customer, and inter-institutional relationships, both domestic and international. They stop along their way and make an announcement as changing conditions may require and when agreement can be reached.

In that context, it remains difficult for regulatory adjustments and monetary policy actions to be well tuned together in adapting to, for instance, cyclical variations in economic activity or more threatening circumstances, such as the potential for a severe credit or financial crisis. Rarely, if at all, have regulatory actions served as substitutes for or in conjunction with a particular monetary policy action.

The Fed, for instance, has not altered its margin requirement affecting stocks for forty years or more. I am unaware of adjustments in capital requirements on banks (either in the aggregate or for a particular line of business) taken deliberately in place of a tightening or easing of monetary policy that might otherwise have too severe a repercussion on markets and the economy as a whole. I would note in that regard (with the great benefit of hindsight) that an increase in capital requirements on mortgage loans early on in the housing boom that preceded the recent credit crisis might have helped to mute housing market excesses and reduced the crisis potential in the U.S. Of course, with money so fungible a commodity, even such an action might not have been effective unless also accompanied by at least some tightening of monetary policy overall.

A coordination of monetary and regulatory policies for cyclical purposes or to work against a build-up of speculative pressures would be easiest to carry out if the central bank had the same unique control of both monetary and regulatory instruments. Even if it did (as might be the case at the Fed in a limited way), the control of, for instance, capital requirements cannot be readily exercised in practice without taking account of impacts on other institutions and the viewpoint of other regulators. And some issues would require international considerations and consultations. The timing may or may not work right.

Under existing circumstances, the possibility of bringing regulatory decisions into a closer connection with monetary policy operations over time would be enhanced if the Fed, and also the ECB for its area, issued on a regular basis (semi-annually or at least annually) a well-publicized report on the systemic health of the financial system. That would become an important guidepost for evaluating the potential for significant weak points in the system, and might help serve as a goad to regulatory actions that could forestall the potential for a debilitating crisis that might otherwise face monetary policy.

In an apparent effort to force the Fed to focus more on its regulatory responsibilities and their overall implications, the DFA authorized the appointment to its Board of Governors of a vice chairman for supervision (who is required to report to

Congress twice a year on the institution's regulatory and supervisory activities). But at this point, some three years after the law was enacted, no one has been proposed for job and the position has not yet been filled. It is difficult to determine whether that reflects purely political difficulties in getting appointments through the congressional process because of the very wide and often unbridgeable divisions between the two major political parties over the past several years, or whether it reflects a less than vigorously felt need to pursue regulatory reform on the part of the administration and perhaps even the Fed.

While a sitting governor can be designated to perform the same tasks as would a vice-chairman for supervision, the vice-chair position would very likely evoke more authority and raise the profile of regulation within the Fed (where regulatory officials and staff have traditionally possessed less status than monetary policy officials) since the prestige of the holder would be fortified by approval of both the President and the Senate. Perhaps there would also be positive demonstration effects on other regulatory agencies.

The great difficulties in making progress on regulatory reforms under current circumstances, following decades of emphasis on deregulation, are evident from the contentiousness in implementing the reforms already enacted by the DFA. For instance, implementation of the Volcker rule that would limit banks' use of their own funds for purely speculative purposes has been bogged down in seemingly endless disputes designed to reduce reform's bite (such as about what constitutes hedging and what is not).

At any rate, when the time comes for the Fed and the ECB to begin the trip back from their continuing enlarged balance sheet role as market-makers supporting a weakened financial system to their normal role (which seems increasingly foreseeable as of this writing, the summer of 2013), the issue of how regulatory policies should be better integrated with monetary policy needs and operations will probably still be a work in progress. This author tends to believe that in practice regulatory policies may remain for the most part better suited (but not without exceptions as noted below) to a longer-run structural role of keeping markets safe and sound through good and bad economic times rather than a short-term policy role that helps supplement monetary policy actions to control inflation and moderate short-term economic disturbances.

In that respect, recent experience suggests that, in setting prudential standards for the banking and financial system, regulators should show much more care and caution about such matters as leverage, available liquidity, off balance sheet shenanigans, and customer suitability. Moreover, more skepticism about whether markets themselves are capable of solving a tendency toward systemic instability should be exhibited in both regulation and the supervision of individual institutions, bank and nonbank, especially the larger ones.

All that being said, perfection in a continuing financial world is something like a dream from a historical perspective. Major crises, unpredicted, have always been with us. As a result, circumstances are likely to arise in practice when it will turn out to be desirable to undertake regulatory adjustments in a flexible, timely way – such as for capital or liquidity measures – in support of a particular current monetary policy. In the U.S. the regulatory part would fall under the authority of the Board of Governors of the Fed, rather than the FOMC, but together they act as one institution (or should in practice do so).

In the Euro area, an operating integration on a current basis of monetary and regulatory policies appears more problematic, given its decentralized political and regulatory structure. A more effective long run structural role for regulation seems the more real possibility, but that assumes the political possibility of effective coordination among the sovereign regulatory authorities. That possibility would be aided, I believe, from clear recognition by the political authorities of the crucial interest of, and some role for, the ECB in the regulatory process.

In any event, whether considering the U.S. or the EU, a closer and more fruitful connection between monetary and regulatory policies affecting dollar and Euro markets in response to the recent crises remains, to repeat, a work in progress. It may well ever be so, though in the form, one hopes, of constructive progress. But it should be noted that if progress evolves toward giving a central bank more and more power and control of regulation on a par with its control over monetary policy, the difficult question of how much independence should a central bank continue to be given would probably in practice arise.

From the perspective of the public and politicians, regulatory issues would seem to involve decisions that are inherently more political than anti-inflation control because of how they more clearly appear to affect equity and fairness in the public's access to credit and the necessities of life. The recent crisis in the U.S. clearly showed the high political dudgeon aroused by both regulatory deeds and misdeeds.