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Let's Break up the Fed

The Federal Reserve has done a terrible job at financial regulation. Why give it more power?

By AMAR BHIDÉ

The Obama administration's plan to increase the powers of the Federal Reserve, says one critic, is like giving a teenager "a bigger, faster car right after he crashed the family station wagon." Treasury Secretary Timothy Geithner disagrees. He argues that the Fed is "best positioned" to oversee key financial companies, and that the Obama plan would give the Fed only "modest additional authority."

Mr. Geithner is right about one thing: The Fed's power is already vast.But it wasn't even well-positioned to supervise the likes of Citicorp. Broadening the Fed's responsibilities won't help. Instead, we should think of how best to dismantle an overextended Fed.

Though advanced economies like ours require organizations capable of taking on a wide range of activities, there are limits. As Frank Knight, the great Chicago economist, pointed out in his 1921 classic "Risk, Uncertainty, and Profit," individuals who control large organizations have to delegate many decisions to subordinates. Entities like hedge funds, where individuals such as George Soros make most of the consequential choices, are exceptions.

Therefore, good judgments about people—picking the right subordinates, refereeing staff conflicts, evaluating performance, and so on—are crucial.

Good judgment requires experience, not just exceptional intelligence or raw ability. Although many lessons about managing people can be applied to different fields, good judgment also requires some specific expertise. You can't manage plumbers without knowing something about plumbing.

Unfortunately no one can learn everything about everything. Yes, Lou Gerstner turned around IBM without any prior experience in the computer business. But he had decades of general management experience, was an exceptionally quick study, and had to come up to speed in just one industry. Individuals who can learn how to effectively lead conglomerates, especially during periods of transition, are exceedingly rare.

This mismatch between what even the most talented minds can learn and the challenges of controlling widely disparate businesses has helped bring our financial system to the brink of collapse. The great names in finance once had distinctive identities and capabilities: Salomon Brothers was the champion in bond trading; Merrill Lynch's thundering herd was tops in retail brokerage; Morgan Stanley and J.P. Morgan's white-shoe bankers built formidable blue-chip client lists; and Bear Stearns's PSDs—poor, smart and driven staff—cultivated scrappy entrepreneurs. Willy-nilly diversification turned these focused outfits into highly leveraged, unwieldy agglomerations of unrelated fiefdoms.

Likewise, the Fed has been incapacitated by its transformation into an omnibus enterprise with responsibilities ranging from boots-on-the-ground regulation to high-level monetary policy. The Federal Reserve Act of 1913, which created the Federal Reserve System, did so to forestall financial panics rather than pursue macroeconomic policies. The gold standard defined monetary policy. The Fed was merely meant to "provide an elastic currency" by serving as lender of last resort in times of crisis. The Act also assigned the Fed routine responsibilities for maintaining and improving the financial system—examining banks, issuing currency notes, and helping clear checks.

The adoption of Keynesian and monetarist ideas by central bankers and elected officials subsequently cast the Fed in a proactive macroeconomic role. William McChesney Martin, who served as chairman from 1951 to 1970, said that the job of the Fed was "to take away the punch bowl just as the party gets going." This might have been wise in theory, but it wasn't mandated by the law. In 1977, an amendment to the 1913 Act explicitly charged the Fed with promoting "maximum" employment and "stable" prices. The Humphrey-Hawkins Full Employment Act that followed in 1978 mandated the Fed to promote "full" employment and while maintaining "reasonable" price stability.

Legislation also has increased the Fed's responsibilities for overseeing the mechanics of the financial system. The Bank Holding Company Act of 1956 gave the Fed responsibility over holding companies designed to circumvent restrictions placed on individual banks. It was tasked with regulating the formation and acquisition of such companies.

Congress further tasked the Fed with enforcing consumer-protection and fair-lending rules. The Fed was made the primary regulator of the 1968 Truth in Lending Act that required proper disclosure of interest rates and terms. Similarly, the Community Reinvestment Act of 1977 forced the Fed to address discrimination against borrowers from poor neighborhoods.

The expansion of bank holding companies into activities such as investment banking and off-balance-sheet exposures to complex instruments such as credit-default swaps also required the Fed to increase the scope of its supervisory capabilities.

In principle, an exceptionally talented theorist might capably run a Fed focused just on monetary policy. Setting the discount rate and regulating the money supply are centralized, top-down activities that do not require much administrative capacity. But without deep managerial experience and considerable industry knowledge, effective chairmanship of a Fed that relies on far-flung staff to regulate financial institutions and practices is almost unimaginable. The vast territory the Fed covers would challenge the most exceptional and experienced executives.

As it happens, the Fed has been led for more than 20 years by chairmen who had no senior management experience. Prior to running the Fed, Alan Greenspan started a small consulting firm and Ben Bernanke was head of Princeton's economics department. Given their understandable preoccupation with monetary and macroeconomic matters, how much attention could they be expected to devote to mastering and managing the plumbing side of the Fed? While the record of the Fed's monetary policy has been mixed, its supervision of financial institutions has been a predictable and comprehensive failure.

The Fed's excessively broad mandate also has thwarted accountability. The CEOs of Citibank, AIG, Bear Stearns, Lehman and Countrywide are all gone—albeit with too much delay and with no clawback of unmerited compensation. At the Fed, no high-level heads have rolled. Mr. Geithner was promoted to treasury secretary. Mr. Bernanke is treated with great deference as he solemnly testifies that if it weren't for the Fed, the crisis would have been much worse. But then, how can anyone be held responsible for failing at a job no human could do?

At the very least we should split the monetary policy and regulatory functions of the Fed, as was done through the Maastricht Treaty that established the European Central Bank. What we need now is a debate about how to break up the Fed—and some of the sprawling financial institutions it supervises—in order to make both the regulator and the regulated more manageable and accountable.

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