

## **A Fed Scorecard for the Last Decade, and Its Implications for the Future**

**Charles W. Calomiris**

**April 20, 2012**

Have the Fed's policy decisions been good, bad, or mediocre over the past decade? The debate over the Fed is ongoing, but is often qualitative and undisciplined by the articulation of any framework within which the Fed's actions can be judged. This article will attempt to score the Fed's performance in a somewhat disciplined, but still admittedly subjective, fashion. I begin by articulating four broad criteria by which Fed policy actions should be judged. I then consider, from the perspective of these criteria, the most important decisions made by the Fed over the past decade. I then grade the Fed's decisions in light of the four criteria. I attach weights to those decisions based on their importance (again based on my subjective assessment, and attempting to take into account that some of these decisions are related).

The four criteria on which my scoring of Fed actions is based are as follows:

- i. The articulation in advance of proper rules and procedures (not necessarily rigid rules) that guide Fed actions, and the subsequent Fed adherence to those rules and procedures.
- ii. The appropriateness of the responses to the subprime crisis, judged as standalone actions (that is, apart from faulting the Fed for its lack of any articulation of rules or procedures in advance of the crisis). Appropriate actions should take into account the need to courageously address problems in a timely fashion, but also being mindful of the consequences of actions for future incentives of market participants.
- iii. The extent to which the Fed acted in accordance with its role as a central bank rather than as a fiscal authority.
- iv. The quality of the Fed's oversight of financial institutions under its authority, and more broadly, its monitoring of financial markets and the economy from both a regulatory and a monetary policy perspective.

I apply these four criteria as indicated below, focusing on nine actions by the Fed, which I regard as the most important ones during the past decade.

1. During 2002-2005 the Fed persistently departed from any plausible Taylor Rule. The Fed maintained a negative real fed funds rate for four consecutive years, setting the fed funds rate about 2% below its warranted level (using a Taylor rule with the assumption of a long-run 2% inflation target). The Taylor Rule had been only vaguely articulated, but the departure from it was nevertheless contrary to expectations that the Fed itself had encouraged in the markets. The departure was extreme, poorly defended, and unwise. **Grade: F. Weight: 10%.**

2. Regardless of whether the 2002-2005 policy should be judged an “error,” the Fed should have anticipated its potential implications for risk pricing and should have been on the alert for market underpricing of risk. The tendency for loose monetary policy to lead to underpricing of risk has been documented for many countries over many periods. **Grade: D. Weight: 10%.**

3. The Fed missed (or ignored) mounting subprime risks in 2004-2007 because it was not paying close enough attention to GSEs’ changes in behavior, or to changes in mortgage leverage, no-docs lending, or other important facts, including the banks it was supposed to be monitoring, like Citibank. Fed leaders seem to have been largely ignorant of events in the securitization markets over this crucial period and were caught flatfooted. The Fed maintains a large staff at Citibank, and yet was not able to see the huge risk exposures and poor risk management practices that should have been apparent. **Grade: F. Weight: 10%.**

4. The Fed missed the housing price flattening in mid-2006 and its implications for subprime risks, which were not missed by Josef Ackerman of Deutsche Bank or many other savvy observers who were watching the mortgage market. The Fed had regulatory authority to raise capital ratio requirements or liquidity requirements; it was not constrained to only use monetary policy, which would have been a weak tool to employ in dealing with the housing finance problems. Other central banks, in fact, did use such tools, beginning in 2007. If the Fed had responded in 2006 to signs of trouble on the horizon, banks would have raised substantial equity capital in advance of the 2007 crisis. The failure to respond also allowed peak originations of subprime to continue until first quarter of 2007. **Grade: D. Weight: 10%.**

5. The Fed’s response to the ABCP panic in 2007 and to the Bear Stearns failure in March 2008 were too complacent, especially after Bear Stearns’ failure; the Fed and Treasury should have

pushed banks and investment banks to recapitalize. The equity markets were open to banks from September 2007 to September 2008, but banks were permitted to allow their true (market) capital ratios to decline dramatically. Citibank's market capital ratio fell gradually from 13% in April 2006 to about 2% by the end of 2008, at a time when its mythological risk-based capital ratio still stood at 11.8%. This created a veritable tinder box of counterparty risk throughout the financial system, and Lehman was the match. The Fed was specifically informed in the summer of 2008 that Met Life (despite its desire to buy Lehman) was unwilling to do so because of Lehman's deep insolvency. The Fed and the Treasury did nothing for several months about that fact. Furthermore, after providing assistance to Bear in March 2008, the Fed did nothing to articulate what would guide assistance of the same kind in the future. This created unnecessary confusion and severe moral hazard, thereby encouraging managements' delays in dealing with problems at Merrill and Lehman. **Grade: F. Weight: 10%.**

6. The confusion was worsened by the inconsistent policy approach to Lehman and AIG in September 2008, and the failure of the Fed to provide intellectual leadership on what sorts of policy mechanisms were needed. Chairman Bernanke pretended to agree about the Paulson auction mechanism, although this made no sense as a policy response. He just nodded at whatever Paulson said during Congressional hearings. This caused an unproductive wasting of precious time, and substantially damaged the Fed's credibility and independence. **Grade: D. Weight: 10%.**

7. The Fed was creative, quick and clear about its desire to respond to the crisis after September 2008, but it assumed fiscal obligations that it should not have assumed as part of the assistance package that did emerge; instead, the Fed should have insisted on placing the burden on the Treasury and Congress to pursue fiscal policy. This put the Fed's institutional independence further in jeopardy and led to the politicization of Fed policy. The Fed still has not explained what principles guide its lender-of-last-resort authority, or how it will decide in ways and under what circumstances to intervene. **Grade: B** which combines an A grade for creative and quick responses, but C for the rest. **Weight: 20%.**

8. QE1 made sense as a means of continuing to expand the supply of money and credit at the zero interest rate bound, but QE2 and operation twist did not make sense. They were unlikely to have a discernible effect, and they exposed the Fed to significant inflation risk (because of political constraints that could limit the contraction of money and credit in the future). Furthermore, recent policies (including forward guidance) continue a highly accommodative policy stance in spite of the fact that the inflation rate is above its stated target level. Given the absence of any clear rule that the Fed is following, it is unclear whether the Fed's actions are driven by (a) political considerations, (b) an over-weighting of the unemployment objective at the expense of targeting inflation, or (c) a belief that the natural rate of unemployment is very low. **Grade: B-**, which combines A for QE1, and C- for QE2 and op. twist. **Weight: 15%.**

9. The Fed's new forward guidance statements are an ambiguous attempt to commit without really committing. It is possible to justify commitment using theoretical models of the value of commitment, but the Fed's forward guidance is not structured properly as a commitment, and has mainly added to the politicization of the Fed, to inflation risk, and to the uncertainties and confusion about what it is saying and what that will turn out to mean. Evans' proposed 7/3 commitment, while not advisable under current circumstances, at least would clarify things and be a real commitment. **Grade: C-** reflecting that a commitment arguably makes sense at the zero bound, since a Taylor Rule is not feasible at the zero bound, but that the creation of inflation risk and the lack of clarity are negatives. **Weight: 5%.**

Grade for the past decade of the Fed's actions: **C-**

Grade for Fed since 2007: **C**

### *Counterfactual Questions and Policy Implications*

If the Fed had maintained explicitly articulated principles consistent with the four criteria I have employed to score the Fed's actions, it would have been much more likely to follow those principles, and it would have been more successful at (1) mitigating the severity of

the subprime crisis, (2) responding to the subprime crisis better (and much sooner) without having to exceed its proper boundaries or sacrificing its independence, (3) signaling to markets its monetary policy intentions (which enhances the potency of monetary policy), and (4) avoiding long-term inflation risks, which are now a major threat.

If the Fed were to adopt a clear commitment to price stability as its overarching goal for monetary policy, as proposed in recent legislation, that would likely make the Fed's monetary policy actions more predictable under most circumstances, and would also result in greater stabilization of output. The main benefit, counterfactually, likely would have been a less expansionary monetary policy during 2002-2005, but it is unclear how that objective would have affected Fed policy during the recent crisis.

Importantly, the Fed does much more than monetary policy, and that implies the need to go further – to articulate clearly the macro-prudential, lender of last resort, and regulatory intervention principles that will guide policy, which will make the Fed more responsive, more predictable, and more accountable in these key areas.