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The New Federal Reserve and America's Financial Future—Summary

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Perry Mehrling, professor of economics at Barnard College and author of *The New Lombard Street: How the Fed Became the Dealer of Last Resort* (Princeton 2010) places the current financial crisis in the context of the evolving role of the Federal Reserve since its founding in 1913. Mehrling describes the extension of the Fed's role as it dealt with the recent financial crisis, and defends its actions as necessary and appropriate. The active role of the Fed, however, has yet to be accepted politically, in part because the public does not have a good understanding of how the real world of finance works.

Key observations include:

- The Federal Reserve was founded in the aftermath of the financial crisis of 1907. The lender of last resort for the U.S. economy during that crisis was, in effect, J.P. Morgan. The Federal Reserve Act of 1913 created a national, central bank under democratic control.

- The Federal Reserve Act incorporated the British "Real Bills Doctrine" and as such focused on the Fed's role in financing commerce, agriculture and industry. The Act was framed as anti-speculation and anti-Wall Street measure; the Fed was expected to have no role in financing Treasury Bills or discounting Wall Street paper.

- Once the Fed was created, the role it played in the real world was quite different than that outlined in 1913. Almost immediately, it was called upon to finance World War I by discounting massive amounts of Treasury Bills, and then later did the same to finance WWII.

∞ The ideology of the Real Bills Doctrine also conflicted with the long-term capital financing needs of industry, farming, and housing. Inevitably, the Fed has played a larger role in this realm than originally envisioned.

∞ When the Fed was founded, it was never anticipated that the gold standard would be dropped and the dollar would become the world's reserve currency. Here again, the Fed has wound up playing a larger role than originally envisioned.

∞ The real world of banking bears little resemblance to the popular notion of traditional banking. The shadow banking system existed before the Fed was founded and continues to exist today.

∞ Initially, the Fed's response to the financial crisis was to lower interest rates. After Bear Stearns, the Fed became the financial system's lender of last resort. And then, after Lehman Brothers, it went even further, becoming the financial system's dealer of last resort.

∞ Indeed, because the shadow banking system is international, the Fed served as the lender of last resort to the international money market — at one point lending $600 billion to foreign central banks.

∞ The political challenge the Fed faces now stems from the disconnect between the real world of finance and the simpler world of traditional banking. The Fed's expanded role has not yet been accepted politically, as it was, for example, when the Fed was called upon to fund the nation's involvement in the world wars.

∞ The Fed did the right thing during the crisis, regardless of how much it extended its initial mandate. We learned during the crisis that no other entity was capable of managing the crisis, and the Fed stepped in and did what had to be done.