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US Federal Reserve System and the Global Financial Crisis

4.1 Introduction

As stated in Chapter 1, the market or government orientation of a central bank can be approached from its legal framework, which deals with its two-tier relationship; these were, however, challenged by the GFC. This chapter will demonstrate that the US Fed was a market-oriented central bank with consolidated prudential regulation, until the GFC changed its commitment to market principles.

The GFC originated from the US subprime mortgage crisis, and the US Fed changed its monetary policy responses to deal with the resulting recession. Also, the US attracts significant attention from China. This chapter will thus provide a leading case study for further comparison. With these goals in mind, this chapter proceeds as follows. First, the US Fed had gradually developed its functions as the LOLR, and had also developed indirect policy instruments to affect financial markets. Its legal framework assumed it to be a market-oriented central bank and consolidated regulator. During the GFC, it became a target for public criticism related to its sacrificing independence, directly intervening in the financial markets, and neglecting systemic financial stability. In response to these problems, subsequent legal reforms sought to reaffirm it as a market-oriented central bank and macro-prudential regulator. Accordingly, under pressure from the GFC, the US Fed changed its two-tier relationship, and then its proposition. This chapter will conclude with a comparative summary regarding the way in which the GFC challenged the approach of the US Fed towards financial stability.

4.2 The overriding legal framework of the US Fed before the GFC

This section will first focus upon the ruling legal framework of the US Fed before the GFC. The US Fed was arguably born of market panics, and had
been challenged by recurring financial crises. It was intended to work as the LOLR, with financial regulation and supervision modified accordingly. However, it was also founded with the express purpose of being independent, and its relationship with the government developed following limited statutory changes. These characteristics constitute the distinct two-tier relationship governing the US Fed; the legal framework assumed its independence within the government and emergent lending to the markets.

4.2.1 Establishment of the US Fed

The American banks were initially built up in the 17th and 18th-century British colonies in the New World, following the model of the BOE. Then between 1835 and 1856, the ‘free banking’ model placed the flourishing financial activities under an increasing number of laws and rules, especially in New York.\(^1\) After the National Banking Act 1863, a dual system of state-registered and nation-registered banks came into being, with certain rudimentary central banking functions (Summer, 1971). This Act required national supervision by the newly established Comptroller of the Currency (COC), covering capital and reserve requirements, interbank payment and holdings of gold (Peretz and Schroedel, 2009). New York gradually developed into the central reserve city, and clearing houses also emerged (Moen and Tallman, 2003). Then the clearing houses, which had initially dealt with increasing cheque transactions, began to issue their own loan certificates (similar to the LOLR lending), and to take on both a public role in money creation and selected regulatory duties (Gorton, 1984).

Reluctance to develop central banking delayed the establishment of the US Fed until just before World War I.\(^2\) In 1907, a run on the Knickerbockers Trust Company caused payments to depositors to be suspended, triggering intensive debates over uneven regulation among financial institutions, and working as a catalyst for the creation of a central bank (Tallman and Moen, 1990). Responding directly to this crisis, the Aldrich Vreeland Act was enacted in 1908 with provisions of note issues in an emergency (Laughlin, 1908), and a National Monetary Commission was established to explore long-term solutions to related banking and financial problems, as well as temporary mechanisms to offer emergent lending, moving further towards central banking (Dewald, 1972). From an international perspective, pre-war

\(^1\) The New York law was viewed to have contributed to successful banking and the wider economy growth in the US. See Rockoff (1974).