



Excerpts from
The Federal Reserve After the Crisis
By Frederic S. Mishkin*

The full chapter will be released in a forthcoming AEI volume on the financial crisis to be edited by AEI Resident Scholar Vincent R. Reinhart

The U.S. Treasury has proposed that the Federal Reserve be given the responsibility to act as the systemic prudential regulator and supervisor of the financial system. This proposal has, however, met a lot of resistance in the U.S. Congress. I would argue that there are four strong arguments for having the Federal Reserve be the systemic regulator.

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Given the Fed's actions to prop up the financial system and recent criticism of its regulatory activity – particularly over financial products for consumers, who often found that they were given loans that they did not have the ability to repay – the Federal Reserve is in a very difficult position. Preserving its independence therefore needs to be a high priority, and one way to do this is to exit the large balance sheet positions that leave the Fed politically exposed.

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Although I think that the view expressed in the press that macroeconomic research has become irrelevant is just plain silly and ill informed, there are serious criticisms that need to be addressed. The problem that central bank researchers and the macroeconomics profession now faces is that although we have research that indicates the importance of financial crises to business cycle fluctuations, this research has not been incorporated into general equilibrium models. Neither DSGE models used at central banks, nor older more traditional econometric models such as the FRB/US model, the primary econometric model used for policy analysis and forecasting at the Federal Reserve, have financial frictions built into them as a key factor that can affect economic activity. This is a major failing and this is the bad news.

The good news is that the current crisis is likely to reinvigorate general equilibrium, macroeconomic research. We are just at the beginning of this process. Researchers at central banks are now focusing on financial frictions, as are many macroeconomists in academia.

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