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Summary

Throughout its history, the U.S. Federal Reserve has engaged in international diplomacy, outside the bounds of (and sometimes in conflict with) the priorities of the White House and U.S. State Department. In directing monetary policy, the Fed's primary concern is to benefit the U.S. economy. In the process, the Fed at times acts in concert with foreign central banks, as was the case in setting new bank regulations after the 2008 financial crisis. At other times, the Fed acts in ways that other countries view as detrimental to their economic interests. Either way, the Fed operates with little public accountability and can wind up complicating the work of U.S. diplomats. This issue brief focuses on the questions of whether and how greater oversight of the Fed's international activities should be pursued. It recommends not an overhaul of the Fed's structure or the elimination of its role in international affairs but instead calls for greater disclosure of its international activities. The Fed should provide testimony to Congress twice per year on its foreign policies, just as it does for monetary and regulatory policy. This kind of disclosure permits broader discussion of the Fed's activities without eliminating the benefits of its institutional independence for monetary policy.

Disciplines

Banking and Finance Law | Economic Policy | International Law | International Trade Law | Public Policy

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Shining a Light on the Federal Reserve's Foreign Affairs

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ISSUE BRIEF

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The Federal Reserve is more than the U.S. central bank; it is also a kind of financial State Department, playing a key role in the nation's foreign affairs. This is not new: the Fed has functioned as a kind of diplomatic corps since its founding in 1913.

Throughout this history, it has forged relationships, traditions, legal commitments, and even built formal organizational institutions with counterparties abroad. While important to the Fed's identity, these connections are also not unique in government. Most independent regulatory agencies engage in some kind of international diplomacy, separate from the U.S. State Department.¹ We call this practice of pursuing foreign affairs outside the usual channels of Congress and the State Department "regulatory diplomacy."²

Pursuing policy of any kind—social or economic, foreign or domestic—outside the direct control of the people's representatives in the White House and Congress strikes some as evidence of a "deep state" bent on undermining popular will.³ We disagree, and see the complexity of our nation's institutions not as an invitation for conspiracy theorists but an invitation to reflect on the appropriate balance between technocratic policymaking and democratic accountability. In this Issue Brief, we focus solely on the Federal Reserve, with its extraordinary power to disrupt foreign economies, respond to cross-border financial contagion, and favor or disfavor allies with financial interventions in

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- In directing monetary policy, the Fed's primary concern is to benefit the U.S. economy. In the process, the Fed at times acts in concert with foreign central banks, as was the case in setting new bank regulations after the 2008 financial crisis. At other times, the Fed acts in ways that other countries view as detrimental to their economic interests. Either way, the Fed operates with little public accountability, and can wind up complicating the work of U.S. diplomats.
- This issue brief focuses on the questions of whether and how greater oversight of the Fed's international activities should be pursued. It recommends not an overhaul of the Fed's structure or the elimination of its role in international affairs, but instead calls for greater disclosure of its international activities.
- The Fed should provide testimony to Congress twice per year on its foreign policies, just as it does for monetary and regulatory policy. This kind of disclosure permits broader discussion of the Fed's activities without eliminating the benefits of its institutional independence for monetary policy.

their countries. If these functions were placed inside an institution with more direct public accountability—such as the State Department—there would be less cause for concern. But the idea that the Fed might have an independent diplomatic policy poses a threat to “the traditionally executive role in foreign policy,” given the Fed’s unique independence as a government agency. The Fed has longer traditions of independence, controls its own funding to an extent unmatched elsewhere in the administrative state, and is almost completely sealed off from judicial review.^{4,5,6} These institutional barriers against oversight by the executive, Congress, and the judiciary give added urgency to the need for more oversight over the Fed’s “regulatory diplomacy.”

Such oversight, however, can go too far. It may be impossible to demand central bank subservience in diplomacy while preserving central bank independence for monetary policy, especially as the trends toward globally integrated monetary and financial systems increase. Adding oversight to the Fed’s diplomatic role may undermine the Fed’s efficacy as a monetary policymaker. The task for democratic accountability of technocratic institutions is therefore a

delicate balancing act.

We recommend, then, not an overhaul of the Fed’s structure or the elimination of its role in international affairs, but the more surgical mandate of greater disclosure of its international activities. The Fed should provide testimony to Congress twice per year on its foreign policies, just as it does for monetary and regulatory policy. This kind of disclosure permits broader discussion of the Fed’s activities without eliminating the benefits of its institutional independence for monetary policy.⁷

Lest this seem like modest reform, the Fed has fiercely fought even this level of formalized oversight in other contexts.⁸ We therefore take a moderate position against both the Fed’s historical positions, which would exempt most kinds of disclosures of its diplomacy, and the more searching congressional interventions that have been mooted in proposed legislation, such as requiring congressional pre-approval of the Fed’s regulatory diplomacy, or prohibiting the central bank from participating in the forums where it concludes its international arrangements without going through notice and comment rulemaking before doing so.⁹

THE FED’S AGENDA IS ALL ITS OWN

Almost throughout its history, the Fed has taken domestic factors—not international ones—into primary account when conducting monetary policy. The tendency to allow domestic interests to direct monetary policy and indirectly shape the Fed’s interactions with foreign counterparts runs deep, back to its founding, where it was created not only to mimic the Bank of England, but also to beat it at its own game of housing the international reserve currency for global trade and finance. The idea of becoming an international playmaker for U.S. interests thus was baked into the Fed’s institutional DNA.¹⁰

This domestic focus becomes a source of grave frustration both of central bankers elsewhere, who would like the Fed to take a more global perspective, and other U.S. diplomats, whose jobs become more difficult when domestic economic interests spill over into foreign policy.

Take, for instance, the successive rounds of quantitative easing, introduced in late 2008 in response to the 2008 financial crisis and consequent recession. Through a series of policy moves, the Fed began a long-term

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¹ Today, 13 of the 18 agencies designated as independent by Congress have international affairs offices.
² This Issue Brief is based on Peter Conti-Brown and David Zaring, “The Foreign Affairs of the Federal Reserve,” Working Paper.
³ On the “deep state” as a fundamentally anti-democratic institutionalized bureaucracy, see Mark Tushnet, “Introduction: Reflections on the First Amendment and the Information Economy,” 127 HARV. L. REV. 2234, 2246 (2014).
⁴ David Zaring, “Financial Reform’s Internationalism,” 65 EMORY L.J. 1256, 1302 (2016).

⁵ For more discussion of the Fed’s budgetary autonomy, see Peter Conti-Brown, “The Institutions of Federal Reserve Independence,” 32 YALE J. REG. 257, 273-285 (2015).

⁶ In *Raichle v. Federal Reserve Bank*, 34 F.2d 910, 915 (2d Cir. 1929), the court concluded that “the correction of discount rates by judicial decree seems almost grotesque.” The Fed has enjoyed very limited judicial review for most of its activities ever since. See David Zaring, “Law and Custom on the Federal Open Market Committee,” 78 L. & CONTEMP. PROBS. 158 (2015).

⁷ See 12 U.S.C. § 225b (setting forth the semi-annual re-

quirement of congressional testimony).

⁸ We mean “Audit the Fed” and rules-based monetary policy, although each in its way departs from a pure disclosure by testimony approach that we advocate here. For more, see Peter Conti-Brown, *The Power and Independence of the Federal Reserve* (2016).

⁹ These proposals have been included in the Financial Choice Act, which has passed the House. The statute would, among other things, “[c]reate greater transparency for financial regulators by requiring them to release for notice and comment a public disclosure of any positions they

set of experiments to combat high unemployment and the potential devastation of deflation. International critics—in China, Brazil, India, and elsewhere—claimed that the Fed was engaged in “currency wars,” since these unconventional policies had the consequence of depreciating the U.S. dollar at the expense of export-oriented economies.¹¹ Former Fed Chairman Ben Bernanke denied that the intent was to harm emerging-market countries, but he also disclaimed any responsibility for considering the economic interests of allies.¹² “Financial regulation and supervision are areas in which the Fed and other central banks should cooperate (and to an important extent already do) to reduce financial risks,” he said. But on monetary policy the response was different. As “economic conditions in our respective countries” differed, Bernanke noted, “our perceived interests began to diverge.”

As Bernanke noted above, the Fed has at times acted in a more “cosmopolitan” fashion, with a commitment to international cooperation, especially in the areas of bank regulation—which it oversees in conjunction with several foreign central banks—and ensuring global financial stability. What is remarkable is how much the

Fed controls its foreign policy agenda, whether it is seeking U.S. domestic economic priorities or seeking international cooperation.

FINANCIAL STABILITY ABROAD

During the Mexican peso crisis in the mid-1990s, called by some the “first crisis of the 21st century,” many feared that Mexico’s default on its government debt would not only wreak havoc on its own economy, but also affect its major trading partners—including the United States. The Clinton Administration wanted to help Mexico avoid default, and needed \$40 billion to rescue the peso, but the Administration feared congressional backlash to using funds Congress had authorized for arguably different contexts. The Fed then intervened. Specifically, the Fed’s Division of International Finance engineered a way for Mexico to exchange pesos for dollars through an “international swap facility” between the Fed and the Bank of Mexico.¹³ Through the swap facility, Mexico could get access to dollars exclusively from the Federal Reserve that it could not secure in the private markets.

The peso intervention provided a blueprint for the Fed’s actions during the 2008 global financial crisis.

Although the Fed is most remembered for its “bailouts” of U.S.-based banks and other financial institutions, the Fed also stretched its legal authority to provide favored foreign central banks with the dollar liquidity they needed to survive. As one scholar observed, “at the height of the financial crisis, the biggest beneficiaries of the Federal Reserve’s emergency loans were not American banks but European ones.”¹⁴ The so-called Eurodollar market was also, during the crisis, faced with a high demand and a small supply for U.S. dollars, putting all financial institutions participating in Eurodollar trades—and there were many of them—at risk.

In 2008-2010, the Fed became the world’s banker by supplying U.S. dollars in exchange for currencies from over a dozen countries, reflecting the Fed’s belief that crisis response required internationalism. These transactions are known as currency swaps, and agreements in place to commit to a number of currency swaps in advance are called swap lines.¹⁵ Swap lines both exemplify the Fed’s power, given the size and importance of these swaps, and the Fed’s autonomy in deploying that power. Although Congress has never formally enshrined these swaps into the language of the

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plan to take as part of international regulatory negotiations, and provide a public report to Congress on the negotiations at their conclusion.” Staff of H. Comm. on Financial Services, 114th Cong. Memo on the full committee markup of the Financial Choice Act of 2016.

¹⁰ Congress’s instructions to the Fed do not mention an international mission, though the setting of American monetary policy has global implications. 12 U.S.C. § 225a (instructing the Fed to set rates “to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.”). An

exception to this domestic-first approach was the Fed’s sometimes unthinking devotion to the gold standard in the interwar era, where the Fed’s interest-rate decisions seemed more tailored to protecting the UK’s ability to sustain the international gold standard than it did to protecting domestic U.S. economic interests.

¹¹ James Rickards, *Currency Wars: The Making of the Next Global Crisis* (2012).

¹² Bernanke pointed to the empirical evidence suggesting that such devaluation is offset by the increase in domestic income, “which in turn raises home demand for foreign

goods and services.” Ben S. Bernanke, Brookings Institution, Mundell-Fleming Lecture at the IMF: Federal Reserve Policy in an International Context (Dec. 2015).

¹³ See Edwin Truman, *The Mexican Peso Crisis: Implications for International Finance*, <https://www.federalreserve.gov/pubs/bulletin/1996/396lead.pdf>.

¹⁴ For an overview, see Stephen A. Fowler, Note, “The Monetary Fifth Column: The Eurodollar Threat to Financial Stability and Economic Sovereignty,” 47 *VAND. J. TRANSNAT’L L.* 825, 827 (2014).

¹⁵ These swaps are not permanent. Part of the agreement is

Federal Reserve Act, today the swap lines between the Fed and six foreign central banks have become fully formalized.

It is worth underscoring how selective the Fed was, even among the U.S.'s diplomatic allies. The Fed entered swaps with Brazil but not Argentina, Japan but not China, and Singapore but not Malaysia. This kind of selective policy was no doubt motivated in large part by the Fed's assessment of counterparty risk and where dollar liquidity would do the most good. But the appearance (and likely substance) of the decision also reflects the irreducibly political and diplomatic nature of the Fed's foreign relations. Normally, the President, subject to parameters established in law by Congress, is in charge of determining which allies get which benefits, whether in trade, military support, direct aid, or other kinds of benefits. Here, supporting U.S. allies' financial systems—hardly a niche interest from the perspective of foreign relations—was left to the Fed alone to determine.

It was not only the fact of these alliances that draws interesting attention, but the size as well. At one point the Fed had swapped currencies worth \$583 billion, or one-fourth of the assets on its books, to its foreign part-

ners.¹⁶ By way of contrast, the entire foreign development assistance budget for USAID in 2017 was \$22 billion.¹⁷

INTERNATIONAL BANK SUPERVISION AND REGULATION

After World War I, central banks seeking financial cooperation organized what they called the Bank for International Settlements (BIS), located in neutral Switzerland, as a kind of bank for central banks, a private organization with a public purpose owned by the central banks and not their governments.¹⁸ Although the BIS lurched through a controversial turn during World War II—the BIS probably laundered gold stolen by Nazis from the regime's Jewish victims—the BIS continued to find its footing as a support institution even after the establishment of the World Bank and International Monetary Fund, sister organizations with overlapping responsibilities. Eventually, prompted by two medium-sized, but broadly consequential, international bank failures in 1974, the Fed, the other central bank governors of the G-10, Luxembourg, and Switzerland established the Basel Committee on Bank Supervision. This committee asserted that central banks could best perform the regulatory parts of their

jobs in concert. To this day, the BIS acts as the committee's secretariat.¹⁹

As with the BIS, the Fed created Basel without congressional authorization to do so (though that eventually came later.)²⁰ There is little evidence that in its secretive early years the executive branch had much information at all about the policy formulation process in Basel. The U.S. Treasury Secretary still has not had an opportunity to join the committee or to participate in its meetings. It was strictly a central bank affair.²¹

Bank supervision is not now and has almost never been the exclusive purview of central banks, whether in the United States or abroad.²² But through the Basel Committee, central banks negotiated an international regulatory framework of enormous, decisive importance to the way that national governments think about this basic feature of government-market interactions.²³ Participation in these international efforts to coordinate bank supervision also exemplify the Fed at its most cosmopolitan, as it has agreed to conduct the rules it uses to supervise the most important American banks, including their capital rules, in the manner set by an international process that it influences, but does not control. There are few

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the foreign central bank's commitment to repurchase its currency at a set future date for a set price, which means that it receives back the exact nominal amount of dollars that it originally swapped. The foreign central bank also pays an additional fee based on a preset interest rate.

¹⁶ See Colleen Baker, "The Federal Reserve's Use of International Swap Lines," 55 ARIZ. L. REV. 603, 607 (2013).

¹⁷ McKenna, Long & Aldridge, "History and Mission of USAID," INTERNATIONAL GOVERNMENT CONTRACT LAW § 4:2 (Aug. 2017).

¹⁸ See Bank for Int'l Settlements, The Bank for International

Settlements: A Profile of an International Organization 2 (June 1995) (describing the BIS ownership structure).

¹⁹ The Basel Committee itself does not have a staff, and barely has a budget. It is, at best, a kind of institutionalized meeting that makes ample use of the resources of the home central banks and the coordination function of the BIS.

²⁰ International Lending Supervision Act of 1983, 12 U.S.C. § 3901(b).

²¹ The Fed has since been joined by the Federal Reserve Bank of New York, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

²² See Elizabeth F. Brown, "Consolidated Financial Regulation: Six National Case Studies and the Experience of the European Union," Volcker Alliance Working Paper.

²³ Why Basel became so important has been the subject of much debate. For an overview, see Pierre-Hugues Verdier, "The Political Economy of International Financial Regulation," 88 IND. L.J. 1405, 1422 (2013).

²⁴ Victoria McGrane & Ryan Tracy, "Sen. Shelby to Unveil Legislation Heightening Fed Security," Wall Street Journal (May 11, 2015).

²⁵ Huw Jones, "Fed's Quarles to chair Financial Stability

regulatory questions of more interest to banks than how much capital they must maintain, and the Fed's decision to delegate the answer to that question to an international process reflects a foreign policy decision as much as a financial regulatory one.

Basel's requirements have been blamed in some quarters as a contributor to the 2008 financial crisis, particularly because of its overly generous treatment of the stability of housing assets, but the Fed has made this framework the focus of its crisis response, even empowering a new and more politically responsive overseer for the committee, the Financial Stability Board (FSB). The FSB comprises all of the principal financial regulatory networks, chiefly the Basel Committee, along with the securities market and insurance company regulators, the World Bank, and the IMF.

Participation in these international forums are not unanimously popular among U.S. politicians, in part because of a sense in some corners that these bodies impose international cooperation at the expense of U.S. domestic interests. In the interest of making sure that the U.S. can see after its own economic needs first, members of both the House and Senate have intro-

duced legislation that would forbid American financial regulators from setting regulatory standards through an international process.²⁴ Despite this, the Fed has continued to rely on Basel and the FSB to set the standards for safety and soundness that it applies to American banks. This reality was reinforced with the recent appointment of Fed Governor Randal Quarles—the Fed's first ever Vice Chair for Supervision appointed by President Trump in 2017—as the new chair of the FSB.²⁵ Post-crisis financial regulation thus has continued to be outsourced to an international process.

REFORMING THE FED'S REGULATORY DIPLOMACY

What to do about this unusual, even unique, set of institutional arrangements at the intersection of central banking and foreign affairs? Opening the Federal Reserve Act for a complete overhaul, as some have proposed in response to perceived abuses of authority, is unappealing.²⁶ There is no guarantee that the resulting central bank would be an improvement to the existing one, and a great risk that it would be inferior.

If its independence is one of the Fed's most valuable, if frequently misunderstood, political assets, it is difficult to find ways to obligate it to coordinate its foreign relations policies with the legislature or executive without damaging that asset with respect to monetary policy. Reforming the Fed—to improve its accountability in foreign affairs or in any other aspect of its institutional design—confronts this same challenge: how to protect what is worthwhile about the Fed as an independent central bank while also increasing the extent of democratic accountability that its other activities require.

Three proposals with historical precedent can be dismissed outright:

1. Making the Fed's chief diplomat a Senate-confirmed Presidential appointee (removable at the President's will);
2. Increasing the formal, institutionalized congressional oversight of the Fed, through the Government Accountability Office (GAO); and
3. Doing nothing.

The first proposal would destroy the Fed's independence; there is nothing inherent in the second that

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Board," Reuters, November 26, 2018.

²⁶ Thomas F. Cargill. "The Myth of Central Bank Independence, Mercatus Working Paper," Mercatus Center at George Mason University, Arlington, VA, October 2016.

²⁷ Section 211 of the Economic Growth, Regulatory Relief, and Consumer Protection Act directs the Fed Chairman and the Treasury Secretary, or their designees, to report to Congress on the efforts of both entities to increase transparency at meetings of the International Association of Insurance Supervisors (IAIS).

²⁸ In fact, there may be occasion for a Congressional Hear-

ings On Regulatory Diplomacy Act (the "CHORD Act") that would institutionalize regular testimony for all agencies engaged in regulatory diplomacy.

²⁹ Board of Governors, Financial Stability Report, November 28, 2018, available at <https://www.federalreserve.gov/publications/financial-stability-report.htm>.

³⁰ Board of Governors, Federal Reserve Supervision and Regulation Report, November 9, 2018, available at <https://www.federalreserve.gov/supervisionreg/supervision-and-regulation-report.htm>.

³¹ Jerome H. Powell, "The Federal Reserve's Framework

for Monitoring Financial Stability," Speech at The Economic Club of New York, November 28, 2018, available at <https://www.federalreserve.gov/newsevents/speech/powell20181128a.htm>.

suggests GAO-oversight would lead to better policy outcomes; and the third is unappealing on its face. Not only is the general lack of accountability troubling, but also the consistency of the Fed's approach to foreign relations is, as we have shown, by no means clear. And while a consistent foreign policy is not a be-all and end-all, the Fed might serve its own interests as well as the public interest if it provided more information about its international plans than it does today. Also, in a time of concern about the deep state, doing nothing about the Fed's increasingly controversial regulatory diplomacy risks furthering a political backlash against any degree of agency discretion. These decisions are inescapably political. Regulatory diplomacy, with all of its virtues, needs some kind of external political check to guide its internal political logic.

For this reason, we endorse a fourth proposal to address the problem of the Fed's independent foreign relations policy: a modest legislative fix whereby the Fed goes to Congress twice annually, separate from its twice annual monetary policy testimony,

to discuss specifically its vision of international affairs and the Fed's role within it. The scope of these hearings would go beyond the new reporting requirements mandated by the May 2018 bipartisan banking law.²⁷ For the most part, these hearings would be uneventful, even boring. But these hearings can serve a useful purpose for democratic accountability by educating members of Congress—and the public—about exactly how international an institution the Federal Reserve actually is. And if, as in today's climate, the Fed's internationalism is out-of-step with the political zeitgeist, a bit of democratic humility might counsel toward an adjustment in orientation.

In this way, the Fed's foreign relations would be subject to enhanced disclosure, but not other more intrusive forms of legislative action (such as political audits). It would be a publicly beneficial exercise for the Fed to clarify where it sees its international relationships. It also would give the executive and legislative branches an opportunity to adjust their own thinking about international economic

affairs. More testimony and hearings amount to low-key reform, but in this case the more exciting solutions seem to come with uniquely detrimental drawbacks. Our disclosure-oriented approach could, more generally, inform the way the political branches treat the other independent agencies.²⁸

The Fed will likely resist such a proposal, but its recent forays into greater transparency have nevertheless been encouraging. In November 2018, the Fed released the first installments of two new reports that it intends to publish regularly: the Financial Stability Report²⁹ and the Supervision and Regulation Report.³⁰ Current Fed Chairman Jerome Powell referred to these documents as “important tools” for “sharing Federal Reserve views and stimulating public dialogue regarding the stability of the financial system.”³¹ On the subject of the Fed's foreign relations, it would be beneficial to the public for the Fed to continue this trend toward transparency—with or without a nudge from Congress.

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David Zaring's scholarship addresses administrative and regulatory law from an international perspective. He previously served as Acting Assistant Professor in the Lawyering Program at New York University School of Law from 2002 to 2005, and as a visiting professor at Vanderbilt Law School in the fall of 2007. After graduating from Harvard Law School, Professor Zaring clerked for Chief Judge William Matthew Byrne Jr. of the U.S. District Court for the Central District of California and then for Judge Judith Rogers on the U.S. Court of Appeals for the D.C. Circuit. He served as a trial attorney for the U.S. Department of Justice in the Federal Programs Branch of the Civil Division and as a special assistant to the General Counsel in the U.S. Department of Housing and Urban Development before entering the academy.

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