

Betting the Fed

The Federal Reserve can do what democratic institutions can't. But its days as a shadow government may be numbered.

BY ROBERT KUTTNER

In the banking panic of 1907, J. Pierpont Morgan personally organized a syndicate of financiers to provide \$25 million to collapsing banks. It was this panic that finally persuaded Congress in 1913 to create the Federal Reserve System—not a single central bank but 12 regional reserve banks and a weak board of governors in Washington. The New York Federal Reserve Bank, with its intimate links to Wall Street, quickly became the reserve system's most influential player. Congress hoped that with this new system in place, financial crises would be rare, and relief would no longer depend on individual bankers like Morgan.

A century later, the Federal Reserve itself turned to JPMorgan Chase, the successor to the original House of Morgan. In the March 2008 midnight rescue of Bear Stearns, an insolvent \$600 billion investment bank with anxious creditors throughout the banking system, the Fed put up \$29 billion to guarantee Morgan's emergency takeover of Bear. In a century we have come full circle, from Morgan serving as central banker to the nation, to the Federal Reserve serving as investment banker to Morgan, Citigroup, Bank of America, and numerous others.

The Federal Reserve is unique among America's governing institutions. Its combination of outsized power and lack of democratic accountability exceeds even that of the CIA, which at least reports directly to the president. The Fed's powerful regional banks are accountable to private boards made up mostly of bankers. When current Treasury Secretary Timothy Geithner was named president of the New York Fed in 2003, the search committee was chaired by private-equity mogul Peter G. Peterson and dominated by private financiers. The campaign to get Geithner the job was led by Robert Rubin of Citigroup.

All of this clubbiness was by design. In creating the Fed, Congress appropriated a radical idea from the populists for a more stable and resilient banking and currency system—but put it in the safely conservative hands of private bankers. This insularity is troubling enough in ordinary times. It is downright scandalous in the aftermath of an economic crisis brought on by banking excesses that in turn were enabled and indulged by the Fed.

The economy was crashed by the activities of a shadow banking system—mortgage companies, hedge funds, private-equity

firms, buyers and sellers of credit-default swaps, and corrupted credit-rating agencies—none of which were regulated by anyone and none of which troubled the Fed. The system's financiers were often bank holding companies whose activities were supposed to be supervised by the Fed but in practice were not.

As a shadow government, the Fed has mirrored the shadow banking system. Now the Fed has put its own balance sheet at risk, courting inflation down the road—and inviting a long-overdue backlash.

Arguably, there is some justification for the Fed's insulation from short-run political pressure when it comes to monetary policy. But critics across the spectrum are asking why the Federal Reserve should not be subject to the same kind of scrutiny as other agencies in its roles as regulator and emergency lender. Instead, these functions have become entangled in a fashion that defies accountability.

By creating massive liquidity that will eventually either find its way onto the national debt or be monetized as inflation, the Fed is now conducting fiscal as well as monetary policy. It is picking winners and losers, with no stated criteria. The Fed continues to waive regulatory scrutiny in the hopes of coaxing a wounded financial system back to life. It bails out institutions deemed “too big to fail,” but in preventing the collapse of several banks, from Merrill Lynch to Bear Stearns to Wachovia to National City, its preferred strategy has been to orchestrate mergers to create even bigger banks, thus redoubling the too-big-to-fail problem.

The Fed has all but taken over the banking system, stretching its emergency powers beyond their limits, flooding in trillions of dollars using its power to create money, orchestrating shotgun mergers, contriving jerry-built schemes to inflate the value of dead financial assets, while largely ducking public accountability. Treasury Secretary Geithner, a far less self-assured public figure than Fed Chair Ben Bernanke, has been the political lightning rod for congressional frustration and withering media coverage. But these schemes depend entirely on the deep pockets of the Fed. And of course before Geithner moved to Treasury, he was point man for the Fed.

There is plenty to criticize in Geithner's stewardship, but the all-powerful institutional role of the Fed is the more

important story. Until recently, the Fed, despite its missteps, retained something of its aura of neutral servant of the public good, above politics and beyond reproach. But this may be changing, and fast.

IN 2006, BEFORE THE SUB-PRIME crisis, then-Treasury Secretary Henry Paulson floated the idea, with few details, of making the Fed a “systemic risk regulator,” usurping powers from other bank regulators and the Securities and Exchange Commission (SEC). At the time, the Bush administration was promoting further deregulation, and the idea of a systemic risk regulator was a useful fig leaf; the Fed is the most ideologically tame and Wall Street-friendly of the regulatory bodies.

Paulson’s plan was the antithesis of sound regulation. If bank regulators did their day-to-day jobs and there were no holes in the regulatory structure, no financial institution would ever reach the point where it posed systemic risks. Conversely, if the Fed gained power at the expense of tougher regulators, there would be more systemic crises requiring costly bailouts.

In late April, startling testimony by former Bank of America CEO Ken Lewis revealed that the Fed and Treasury had strong-armed him into purchasing Merrill Lynch even after it came to light that Merrill’s losses were far larger than had been revealed. Legally, when there is a “material change” in the condition of a merger partner, the acquiring party may back out of the deal. But according to Lewis’ testimony, confirmed both by Paulson and by official minutes of meetings, Paulson and Bernanke pressured Lewis into violating his own legal fiduciary duty to his shareholders, who had to approve the deal based on accurate information. Relying on no legal authority whatsoever, the Fed and Treasury threatened to remove the board and management of Bank of America if they refused to go forward and demanded that Lewis not divulge the conversation. Based on these revelations, Attorney General Andrew Cuomo of New York wrote a five-page letter to the SEC and key Congressional committee chairs, suggesting that the Fed and Treasury may have improperly interfered with Bank of America’s legal duty to its shareholders.

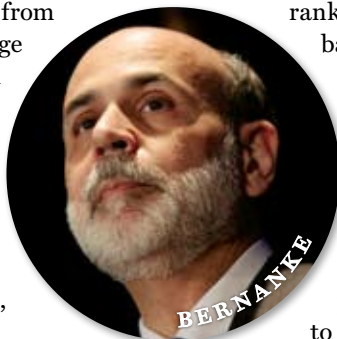
The idea of a systemic risk regulator has now morphed into something potentially more robust—but there is little Congressional appetite to entrust the function to the Fed. As understood in the current policy debate, a systemic risk regulator would monitor unregulated institutions such as private-equity firms and hedge funds, it would conduct more stringent examinations of any very large institution, and it would look at the potentially risky interconnections *among* institutions. As one senior congressional staffer explains it, “You could have 15 banks that all look fine when you examine them separately, but if it turns out that they all made the same bets and the bets go bad, it could take down they system. Nobody cur-

rently has the authority to explore these interconnections.”

However, the idea of giving the job to the Fed is now all but dead because of its overreaching. As recently as mid-April, Barney Frank was favorable to lodging systemic risk regulation in the Fed, but a majority of his own House Financial Services Committee has turned against the plan. So have Chris Dodd,

chair of the Senate Banking Committee, and the ranking Republican, Richard Shelby of Alabama. “Some of the biggest failures in the world occurred on their watch,” Shelby recently said of the Fed. The backlash is bipartisan.

The consensus candidate for systemic risk regulator is now a panel of the several regulatory agencies, while regulation of hedge funds and private-equity firms is more likely to go to a strengthened SEC. Other indications of backlash against the Fed’s role as shadow government include a provision attached to the budget resolution in the Senate that requires the Fed to identify the financial institutions that have received \$2.2 trillion in taxpayer-backed loans, something the Fed has refused to do voluntarily. Advocates for the provision in the House range from left-liberal Congressman Alan Grayson of Florida to arch libertarian Ron Paul of Texas. A very senior regulatory official told me, “People are now waking up to all the dubious stuff the Fed has taken onto its own balance sheet and all of the things it has done with absolutely no accountability. It is totally turning people off to the idea of giving the Fed even more power.”



THE FEDERAL RESERVE'S COMBINATION OF OUTSIZED POWER AND LACK OF DEMOCRATIC ACCOUNTABILITY EXCEEDS EVEN THAT OF THE CIA, WHICH AT LEAST REPORTS DIRECTLY TO THE PRESIDENT.

THE FINANCIAL COLLAPSE turned critical in a frantic week last September, which began with the Fed and Treasury’s joint decision not to save Lehman Brothers. Barely a day later, the trio of Paulson, Geithner, and Bernanke reversed course and decided to bail out the insurance conglomerate American International Group. This was also the week that the Treasury and the Fed orchestrated the shotgun acquisition of Merrill Lynch by Bank of America.

The events set off a belated stock market crash, and the week ended with Paulson coming before Congress to warn of an imminent financial collapse and to request emergency funding of \$700 billion for the banks. This should have been the moment for policy to shift gears, into a more systemic and transparent long-term strategy for the recapitalization and regulation of the banking system.

In every systemic financial crisis of the past century, Congress had stepped in to legislate remedies rather than allow the Federal Reserve to spend un-appropriated or un-accounted funds. But far from representing a return to the normally transparent process of government aid to industry, Congress’ reluctant approval of \$700 billion for Paulson’s Troubled Asset

Relief Program (TARP) program on Oct. 3 was a momentary departure from a process that continues to be orchestrated behind closed doors by the Treasury and the Federal Reserve, largely shrouded in secrecy. According to *The Washington Post*, the latest Geithner-Bernanke plans were conceived and drafted by such leading investment houses as Goldman Sachs and Pimco, which of course stand to gain or lose many billions depending on what the government does.

Treasury's role in the plan is at least subject to review by the Congressional Oversight Panel and the special inspector general, provisions that were added by Congress as conditions for legislating the money. Both agencies have the right to demand documents, and both have been scathing in their criticism of the Treasury. But neither the panel nor the inspector general has any authority over the Fed.

The cycle of nontransparent financial rescues has fed upon itself. As a surly Congress has resisted additional direct appropriations, the Fed and Treasury have invented ad-hoc programs with names like the Term Auction Facility, the Commercial Paper Funding Facility, TARP, TALF, CAP, P-PIP—about 15 in all—relying mostly on Fed funding. The details are mind-numbing, but the basic idea is to pump money into banks and non-banks alike, in exchange for the dubious collateral that financial institutions want to unload—securities backed by used-car loans, credit cards, commercial paper, credit-default swaps, and sub-prime loans.

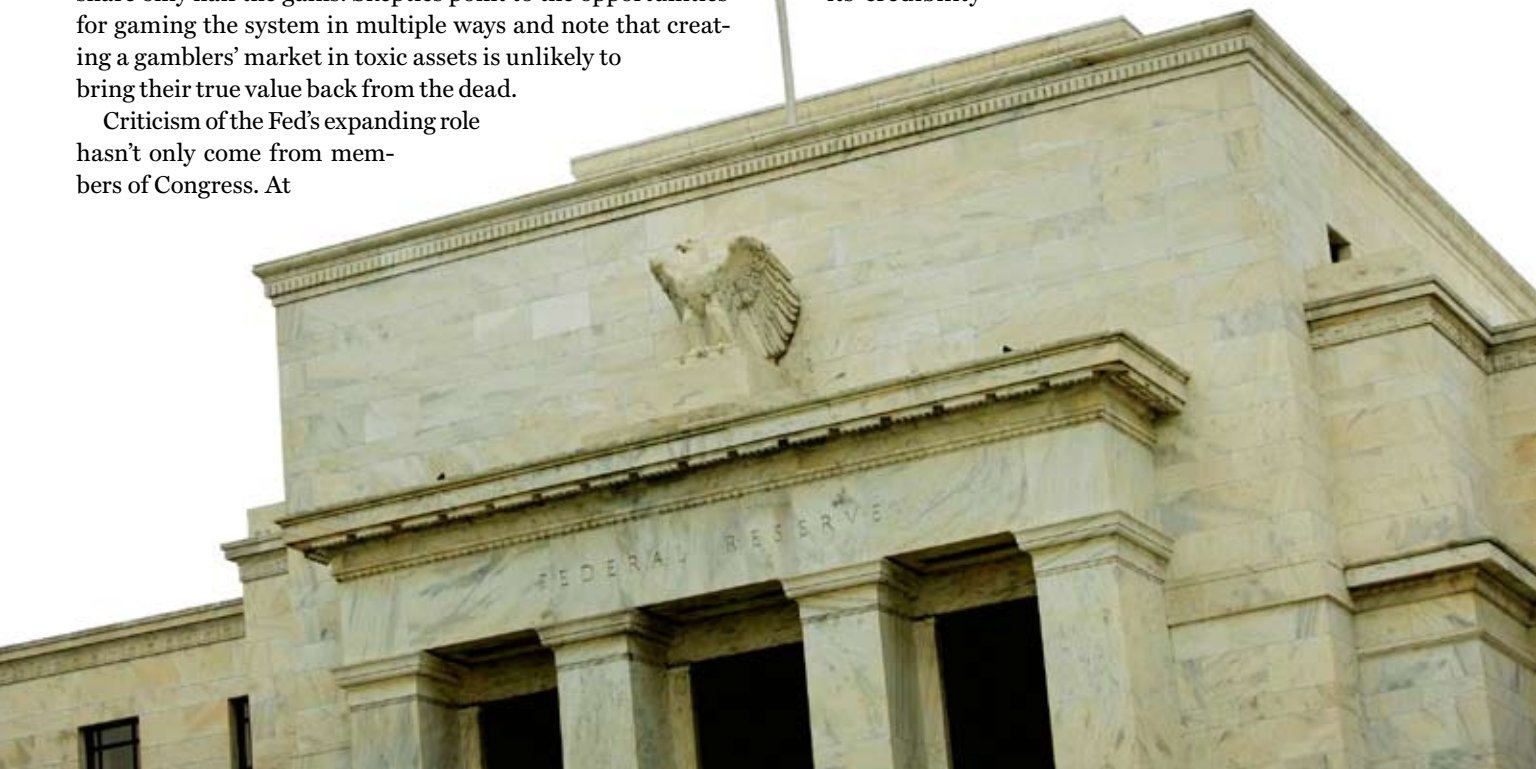
P-PIP, which stands for Public-Private Investment Program, is an especially dubious policy. The Treasury will leverage its last \$100 billion of TARP money against a trillion dollars of credits and loan guarantees mostly from the Fed. This money will ostensibly be used to attract private capital, but the private capital from hedge funds and private-equity companies will be as little as 6 percent of the total. The government will guarantee the losses, but share only half the gains. Skeptics point to the opportunities for gaming the system in multiple ways and note that creating a gamblers' market in toxic assets is unlikely to bring their true value back from the dead.

Criticism of the Fed's expanding role hasn't only come from members of Congress. At

least three presidents of regional reserve banks have not been shy about questioning the rescue plan. Thomas Hoenig, president of the Kansas City Federal Reserve Bank, warned that unless the Fed gets its money back from these dubious new loans, "I think we risk a very serious inflationary problem with new bubbles." William Poole, president of the St. Louis Federal Reserve Bank until March 2008, declared that the Fed was risking "massive inflation." In February, Jeffrey Lacker, president of the Richmond Federal Reserve Bank, refused to go along with the Fed-Treasury plan until the Treasury signed an unprecedented accord promising to absorb any losses incurred by the Fed.

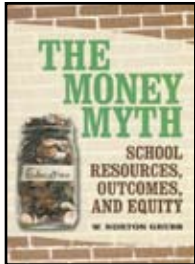
Where will the Treasury get the money? It will issue bonds, adding to the national debt. You could say that the Fed is essentially serving as a money laundry for eventual Treasury borrowing. Alternatively, the Fed could just create more credit, a process that risks inflation—increasing unease among many of its senior officials.

The dissent expressed by the Fed bank presidents reflects a classic axis of the heartland versus New York. This tension has always existed, but in the current crisis there is deep resentment on the part of the regional banks that Wall Street is getting gentler treatment than community banks that were far less implicated in the financial engineering that caused the crisis but which are now suffering as demand for good credit dries up and are paying higher fees to cover the Federal Deposit Insurance Corporation's (FDIC) losses from less careful banks. Bank examiners are being far tougher on the loan portfolios of ordinary commercial banks than on the securitized junk clogging the balance sheets of the big, money-center banks. Hoenig reflected this feeling of a double standard when he recently testified before Congress that the 12 regional reserve banks were established by Congress "specifically to address the populist outcry against Wall Street." The Fed suffered a further setback to its credibility





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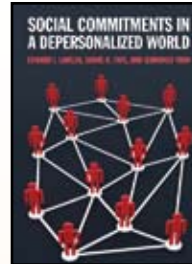
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when it was revealed that Stephen Friedman, a Goldman Sachs board member who is also chair of the New York Fed, bought up distressed Goldman shares for a tidy profit after the Fed had expedited conversion of Goldman to a bank holding company that could get government benefits.

THE FED BECAME AN all-purpose piggy bank by default. Even in normal times, the Fed and its decision-making should be rendered more accountable. In this financial emergency, we need to create a transparent, democratic alternative to the secret bank rescues, one that would rely on explicit legislation, direct appropriations, and temporary receivership for insolvent banks. A government corporation or expanded FDIC would be given explicit authority to take a large failed bank into receivership, audit its losses, replace existing management, decide how much of the financial hole should be made up by bondholders versus taxpayers, and then return a restructured bank to health. This process is known as resolution, and it gets the bank and banking system back to health fast.

This alternative has been fiercely resisted by Wall Street, since it would likely end in the breakup of at least two large banks, with management displaced and stockholders wiped out. Both Geithner and White House economic chief Larry Summers disparage this approach as “nationalization.” However, this is almost exactly the approach used in the bailout of automakers. It is the approach used by the FDIC when it shuts down and reopens failed smaller banks. And the same strategy was followed in the late 1980s and early 1990s when Congress created the Resolution Trust Corporation to revive a collapsed savings and loan industry. The Reconstruction Finance Corporation of the 1930s—invented by Herbert Hoover, expanded by Franklin Roosevelt—did much the same thing.

This alternative has the support of some conservatives, such as Alex Pollock of the American Enterprise Institute and Walker Todd, a former senior official of the Federal Reserve banks of Cleveland and New York, who is a leading historian of Roosevelt’s Reconstruction Finance Corporation. Hoenig has called for a new RFC, with the enthusiastic backing of Kansas’ very conservative Republican senator, Sam Brownback. Why do many on the right prefer something seemingly socialistic? As Todd explains, “It’s far better to do this transparently through a public agency than to pervert the mission of the Federal Reserve.”

As evidence of the emerging left-right consensus on this proposition, *The Wall Street Journal* recently ran an editorial that reads as if it could have been written by Joseph Stiglitz or Paul Krugman. “The sounder strategy,” the *Journal* argues, “is to address systemic financial problems the old-fashioned way: bank by bank, through the Federal Deposit Insurance Corp. and a resolution agency with the capacity to hold troubled assets and

work them off over time. If the stress tests reveal that some of our largest institutions are insolvent or nearly so, it’s then time to seize the bank, sell off assets and recapitalize the remainder. (Meanwhile, the healthier institutions would get a vote of confidence and could attract new private capital.)”

The administration insists that it has to use the Fed because Treasury can’t get any more money out of Congress. But if the Treasury and Fed were more forthcoming with Congress, and were willing to shut down zombie banks and force shareholders to take losses, the plan would be more credible, and Congress would be more likely to provide funds. So-called “stress tests”—not comprehensive examinations but projections of how much capital different banks would need under different economic scenarios—are another awkward policy ploy by Geithner and Bernanke, mainly to buy time. However, few observers think that Citigroup or Bank of America can raise the capital it needs within the mandated six months. While Geithner and Summers have insisted that they oppose “nationalization,” the administration is supporting legislation for standby resolution authority—which amounts to the same thing. So by next fall, Geithner and Bernanke may well find themselves back before Congress with a plea for funding to finally do the job of recapitalizing banks properly.

WHEN I WAS A YOUNG congressional assistant in the 1970s, the banking committees were often in the hands of old-fashioned progressives who had an abiding wariness of the Fed. In the House, Wright Patman, a Texan populist, had the radical idea that the Fed should be a fully accountable public institution. One of Patman’s successors was another Texan progressive, Henry Gonzalez, who regularly badgered the Fed to let in more sunlight. Both men were treated by the press as kooky relics of the William Jennings Bryan era, while Fed chairs such as Arthur Burns, William McChesney Martin, Paul Volcker, and Alan Greenspan were deified as apolitical stewards of the public interest. In the Senate, more mannered progressives who chaired the banking committee, such as my former boss William Proxmire of Wisconsin and later Paul Sarbanes of Maryland, also sought to bring the Fed under greater public scrutiny, with only limited success. In retrospect, Patman looks less like a kook than a seer.

Greenspan has already fallen from grace, and Bernanke could be next. And though the Fed continues to play an outsized role in containing the crisis, its influence as a largely unaccountable shadow government has already peaked. The only question is how much further damage we will have to endure before both the financial system and its all-too-friendly central bank are rendered more accountable to a broad public interest. **TAP**



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