Center for American Progress

What Monetary Policy?

Conservatives' Blind Eye to Fed Bailouts

Scott Lilly
April 2008

www.americanprogress.org
Progressive Ideas for a Strong, Just, and Free America

WHAT MONETARY POLICY?

Conservatives' Blind Eye to Fed Bailouts

Scott Lilly
Center for American Progress

April 2008

What Monetary Policy?

Since the time of the American Revolution, monetary policy has been a central issue in many of the nation's hardest fought political confrontations. Alexander Hamilton's attempt to establish a national bank was seen by Thomas Jefferson, James Madison, and others as a plot to further urban and Northern interests at the expense of farmers and the South. That fight contributed significantly to the evolution of a two-party political system.

Three decades later Andrew Jackson's efforts to defund the Second National Bank before its charter expired resulted in his censure by the Senate. Jackson also believed that a national bank would be used as a tool by economic elites at the expense of ordinary citizens. Ultimately Jackson blocked the renewal of the banks charter with his veto and the nation was without a central bank for the next 75 years.

That did not, however, stop the intense fights over credit, banking, and the nation's money supply. In the presidential election of 1896, William Jennings Bryan promised to expand the money supply by backing the dollar with silver rather than gold. He told the Democratic Convention in Chicago:

> *Having behind us the commercial interests and the laboring interests and all the toiling masses, we shall answer their demands for a gold standard by saying to them, you shall not press down upon the brow of labor this crown of thorns. You shall not crucify mankind upon a cross of gold.*

Eleven years later, the issue of a central bank reemerged during the panic of 1907. In the aftermath a commission was created to examine that possibility, which led in 1913 to President Woodrow Wilson signing legislation creating the current Federal Reserve System.

Whether or not failures in Federal Reserve policy contributed to the U.S economy's descent into the Great Depression was a matter of intense debate throughout the 1930s, as were the efforts of then Federal Reserve chairman Paul Volker in the 1980s to "wring inflation out of the economy" by tightening the money supply until more than 10 percent of the workforce were jobless. In the 95 years since the Federal Reserve was created, Congress has amended the Act more than 100 times.

This long history of passionate public conflict over the nation's monetary policy makes it even more extraordinary that many of the nation's political leaders who most vigorously associate themselves with the philosophy of free markets and laissez faire capitalism have almost nothing to say about the policies of a Federal Reserve that has injected itself into the day-to-day decisions of the marketplace as never before in the nation's history.

John McCain

Take a recent speech by Sen. John McCain (R-AZ), the presumptive presidential nominee of the Republican Party. On March 25 he told Hispanic business leaders in California:

> *A bubble occurs when prices are driven up too quickly, speculators move into markets, and these players begin to suspend the normal rules of risk and assume that prices can only move up—but never down…Between 2001 and 2006, housing prices rose by nearly 15 percent every year. The normal market forces of people buying and selling their homes were overwhelmed by rampant speculation. Our system of market checks and balances did not correct this until the bubble burst.*

Perhaps the Senator could have provided a more complete accounting of events had he listened to his Republican Senate colleague, Jim Bunning of Kentucky, who said at the time of current Federal Reserve Chairman Ben Bernanke's confirmation in 2005: "I oppose Dr. Bernanke because he says he will continue the policies of Chairman Greenspan." By the fall of 2005, Bunning was already blaming Greenspan for the "housing bubble." He stated that Fed policy had:

> *Led to an unbalanced economic recovery fueled by cash raised from soaring home prices. This resulted in record household debt and negative consumer savings rates… Chairman Greenspan leaves knowing that his mess will fall to his apprentice, Ben Bernanke. I hope there is no damaging recession or financial crisis looming.*

Bunning was not alone in recognizing the potential long-term consequences of Fed policy. As early as 2004, Center for American Progress forums and publications warned that Federal Reserve policies were fostering a housing bubble and placing the long-term health of the national economy at risk.

Over the past decade, the aggressiveness of the Fed in promoting consumer demand through easy credit has been extraordinary. In December of 2000 the Federal Reserve's Fed Funds Rate (the interest rate charged by member institutions for overnight lending) was 6.4 percent. A year later it had dropped to less than 2.0 percent, and by mid 2003 it had dropped to 1.0 percent, where it stayed for more than a year.

In a publication on the principles of monetary policy, the San Francisco Federal Reserve Bank explains that:

> *For the most part, the demand for goods and services is not related to the market interest rates quoted in the financial pages of newspapers, known as nominal rates. Instead, it is related to real interest rates—that is, nominal interest rates minus the expected rate of inflation.*

For the first half of 2004, the Fed Funds rate was 60 basis points (0.6 percent) below the rate of inflation. That meant the rate charged to banks ***was not just low*** in real or inflation adjusted terms—***it was negative***. In other words, the Fed was virtually paying banks to borrow. Almost anything you might spend money on would appreciate more rapidly than the cost of the money. Banks, hoping to make the most of a good thing, borrowed as much as possible in order to loan as much as possible. Homeownership and housing prices soared. For a time, life was good.

But McCain's apparent unawareness of the Fed's role in creating the housing and mortgage crisis is far less remarkable than his apparent unawareness of the Fed's current role in mitigating it. McCain told the same group:

> *I have always been committed to the principle that it is not the duty of government to bail out and reward those who act irresponsibly, whether they are big banks or small borrowers.*

What?

Those remarkable words were spoken in the wake of a series of the biggest government-backed bailouts in the nation's history—some occurring only days before McCain's speech. Even the famous "Chrysler bailout" of 1979, which amounted to less than $3 billion in today's inflation-adjusted dollars, seems like a pittance compared to actions that the Federal Reserve has been taking on nearly a daily basis. Yet nowhere in McCain's March 27 speech does he even mention the Federal Reserve or monetary policy.

Whatever "bailout" proposals McCain was drawing a line in the sand to prevent, he seemed completely oblivious to the extraordinary manipulation of interest rates, open market operations, and lending policies by the Federal Reserve in order to bail out the biggest financial institutions in America.

The subsidies offered by the Federal Reserve last month to improve the balance sheets of (first) commercial banks (and then shortly thereafter) investment banks in the weeks preceding McCain's address are so numerous and diverse they are difficult to catalogue. They would doubtless send the likes of Jefferson, Madison, and Jackson into a state of apoplexy, confirming their worst suspicions about the elitist bias of central bankers. Each of the Fed's recent actions rewards some segments of the economy at the expense of others, but the two groups that are consistently big winners are the nation's commercial banks and investment banking firms.

Let's start with interest rates. Since the subprime mess emerged as a major problem last fall, the Fed has cut the key (Fed Funds) interest rate from 5.25 percent to 2.25 percent. The Federal Reserve will not loan you money at that rate, but it is the rate that they charge most banks. Traditionally, these funds have been available to banks only on a short-term or "overnight" basis, but in addition to lowering the rates the Fed has also relaxed the terms. Initially, commercial banks were allowed to borrow for 30 days, but on March 16 the term of loans from the Fed Funds window was extended to 90 days.

Once again, the Fed is loaning money below the rate of inflation. I pointed out in a report published by the Center for American Progress a few weeks ago just how significant that move alone can be to the bottom line of virtually any bank. Since the business of banking involves borrowing at interest rates less than the rate at which the money is lent, a three-point cut in the cost of money to banks (as we have seen over the past six months) has huge implications.

For instance, the average interest charged on credit cards has declined to just above 13 percent at the end of last month from just above 14 percent last September. Because banks are now borrowing at three percentage points less than they paid in September, however, the $900 billion that Americans owe on their credit cards bumps up banks' incomes by more than a billion dollars a month. A similar story can be told with respect to car loans, home improvement loans, or even student loans.

Losers

But there are also losers. Perhaps the most obvious are elderly individuals whose savings allow them to supplement the income they receive from Social Security to afford the medications, food, heat, and other necessities of daily life. Federal Reserve data indicate that interest being paid on three-month certificates of deposit, a common investment used to earn income on the savings of such individuals, has dropped to 2.6 percent last week from about 5.6 percent in September. A couple living off the interest from a lifetime savings of $250,000 would experience a drop in monthly income from about $1,170 a month to about $540.

Another loser in the Fed's new interest rate policy is the ordinary consumers. Since rates started falling in September, the dollar has fallen 15 percent against the euro, and by about the same amount against the yen. The sky high price of commodities, including heating oil, gasoline, corn and wheat, is directly related to the decline in the dollar.

These increases burden the budgets of most families, but they have a disturbing impact on precisely the families who may face the greatest challenge in holding on to their homes and meeting their mortgage payments. Rising real estate values have forced would-be homeowners to shop for homes farther from their jobs. Far-out suburbs where large numbers of families with modest incomes have flocked are also where a large portion of the subprime mortgage problems are concentrated. The $4-a-gallon gasoline prices projected by some sources for this summer will place the heaviest burden on precisely these communities.

More Bailouts

But interest rate cuts are only one subsidy the Fed directed first toward commercial banks and then swiftly toward investment banks. One highly creative move by the Fed was made on March 12, when it established a $200 billion "bond lending facility," which allows commercial banks to swap certain kinds of mortgage-backed securities for U.S. Treasury bonds. These mortgage-backed securities, which central, commercial, and investment bankers alike have come to refer to as "toxic waste," are deemed by the new Fed policy to be of equal value to securities backed by the good faith and credit of the U.S. government. This is not dissimilar to the Fed offering to exchange your recently wrecked Honda Civic for a brand new Lexus.

The result is that American taxpayers will now own a lot of potentially worthless paper that they traded for perfectly good money all in order to, using John McCain's language, "bail out and reward those who act irresponsibly."

To provide some perspective on the magnitude of the Fed's action, $200 billion is more than three times the amount the Federal government spends in three years on education at every level from preschool to post graduate programs. Put another way, it is more money than Congress has spent on all earmarks over the course of the past 20 years and perhaps much longer.

Only two days after setting up the $200 billion swap fund, the Fed made more groundbreaking moves by extending an undisclosed level of emergency credit to Wall Street's fifth-largest investment bank, Bear Stearns Cos., which was neither a member of the Federal Reserve System nor a commercial bank. Two days later, the Fed agreed to inject $29 billion in capital into the failed investment bank as part of a deal allowing a commercial bank, J.P. Morgan Chase & Co., to purchase it. In return for that $29 billion, the Federal Reserve took charge of $29 billion in illiquid Bear Stearns assets, which might also be accurately labeled as "toxic waste."

Later that same week, the Fed expanded what they had done for Bear Stearns to the entire investment banking industry. On March 17, the Fed opened a lending window for investment banks for the first time since the 1930s. Such banks can get overnight money at the bargain rate of 2.5 percent. "We have tested the window because we want to remove the stigma from the window," Morgan Stanley's chief financial officer, Colm Kelleher, told Bloomberg News. The Lehman Brothers Inc. CFO told Bloomberg that the new window was "very attractive." Indeed, U.S. investment banks borrowed $37 billion from the federal government the first week the Fed began making the funds available.

The beneficiaries of these generous tax payer-financed policies are not just businesses that failed to perform due diligence and got caught holding bad investments. Some of the recipients of this largess were more perpetrators than victims.

Acting Irresponsibly

A recent story in the *The Oregonian* discloses that employees of J.P. Morgan Chase circulated a memo outlining steps to inflate the income and assets of mortgage loan applicants who would otherwise not qualify for subprime loans. An official spokesman for the bank said that the memo did not represent bank policy and that the bank was investigating the origins of the memo.

The newspaper pointed out, however, that the memo appeared to confirm allegations by some mortgage brokers that "large national lenders drove the weakening of standards." The story quoted Todd Williams, a mortgage broker with Evergreen Ohana Group in Portland, saying that the memo represented "a perfect example of one of the big five banks out and out telling mortgage brokers to commit fraud," said. "And this has been going on for years."

.But no institution appears more deserving of the label "perpetrator" in the subprime mess than Goldman Sachs & Co. As I pointed out in a column published this past December, Goldman was the issuer of some of the most "toxic" of the subprime "waste" that it sold to banks as safe and reliable securities, including pension funds and other investment houses. In 2006, Goldman went to market with one particularly noxious package of securitized mortgages labeled GSAMP Trust 2006-S3. It was made up of 8,274 second-mortgage loans, nearly all from California. The average equity held by the "homeowners" in this mortgage package was less than one percent. About 58 percent of the loans were no-documentation or low-documentation. In other words, no one really knew whether these borrowers occupied the residences used as collateral, whether they were employed, or whether they actually owned any of the assets listed on the mortgage application.

This batch of second mortgages created a $496 million package, which Goldman split into 13 separate securities, selling them to investors around the world for an average price of about $40 million apiece. By last October, seven of these securities had already become completely worthless, and the remaining six had greatly eroded in value.

But the remarkable part of the Goldman Sachs subprime story was that as one part of the investment bank was selling the high risk securities to other banks and investors, another Goldman team had concluded these securities were worth far less than the amount for which they were selling them. So while their customers continued to buy them, Goldman began placing a huge portion of the firms' money into short positions—betting that the price of the securities would fall.

It worked. In the firm's fiscal year that ended this past November 30, Goldman earned more than a third of its record-setting $11 billion in annual income from profits on the short selling of subprime mortgages.

Goldman is benefiting yet again from the crisis the investment bank contributed so much to creating. Michael DuVally, Goldman's CFO, recently confirmed that his company was "testing" the Fed facility and had borrowed an undisclosed portion of the $37 billion lent by the Fed during the week of March 17 at the 2.5 percent rate specified by the Fed to help investment houses hard-hit by being long on subprime securities. The firm also failed to disclose how they planned to use the low-interest Fed loans.

Fed Policy is Government Policy

But the point here is not the behavior of any particular bank or investment banking house. The questionable conduct of some major beneficiaries of Federal Reserve policy simply underscores the extent to which those using the rhetoric of "moral hazard" or "not rewarding those who act irresponsibly" are turning a blind eye to the current management of the nation's monetary policy.

Article I, section 8 of the Constitution expressly grants to Congress the authority "to coin money" and "regulate the value thereof." The 1913 Federal Reserve Act in effect delegated that authority to what the Federal Reserve itself refers to as an independent entity "within the government" that "is ultimately accountable to Congress."

It is that delegated authority that is being used in the current efforts to manipulate financial markets and subsidize businesses that made poor market decisions. Congress may choose to delegate these authorities to the Fed—although some constitutional scholars question that—but the Congress is ultimately responsible and the actions taken are those of the government.

The Price of the Conservative Cop Out

So why are so few conservatives acknowledging that this elephant is in the corner of the room? The same ideology that contributed to creating this crisis—the failure to recognize an appropriate role for government in limiting the excesses of the marketplace—also prevents many conservative political leaders from acknowledging the damage that has been done or the extraordinary steps that government has taken and must yet take to repair the damage.

Even more troubling, these conservative leaders are using their opposition to a few needed policy directives that would greatly enhance our capacity to contain this crisis as proof that they are maintaining their "free market" convictions. In fact, they are ensuring that the blunt tools of monetary policy will do even more damage to market principles.

The real danger of the current crisis lies in the fact that it is really two separate crises that will feed off of each other as the entire economy nosedives in a downward spiral if there is not effective intervention. The surplus of unsold homes drives down real estate values. As real estate values fall, more and more people owe more on their homes than they are worth. Added to that, about one million homes are financed with adjustable-rate mortgages, in which the interest rate and monthly payment will be adjusted upward during the current year.

The key to solving the problem faced by banks, by businesses squeezed by the credit crunch, and by all Americans threatened by the consequences of a softening economy, is to keep as many of those troubled borrowers in their homes as possible. While Chairman Bernanke has advocated that mortgage holders take steps to ensure that happens, he has very limited means to provide direct, meaningful, and effective incentives. He does not operate the Federal Housing Administration, the Department of Housing and Urban Development, or the U.S. Treasury.

Committees in both houses of Congress have reported legislation that would facilitate greater home retention. I have proposed an additional step—a tax credit to mortgage holders who agree to write down the terms of their mortgages. All of these proposals should be examined carefully. None of them begin to tread on the principles of free markets in a magnitude that even begins to approach current Fed policy. Each of them may contribute to allowing the Fed to scale back the most obtrusive aspects of its current involvement in credit and equity markets.

Center for American Progress

ABOUT THE CENTER FOR AMERICAN PROGRESS

The Center for American Progress is a nonpartisan research and educational institute dedicated to promoting a strong, just and free America that ensures opportunity for all. We believe that Americans are bound together by a common commitment to these values and we aspire to ensure that our national policies reflect these values. We work to find progressive and pragmatic solutions to significant domestic and international problems and develop policy proposals that foster a government that is "of the people, by the people, and for the people."

Center for American Progress
1333 H Street, NW, 10th Floor
Washington, DC 20005
Tel: 202.682.1611 • Fax: 202.682.1867
www.americanprogress.org