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The credit crunch one year on

Mission creep at the Fed

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In a special section marking the anniversary of the credit crunch, we start with the Federal Reserve. Its creative response to the crisis may have staved off catastrophe, but may also have put its independence at risk

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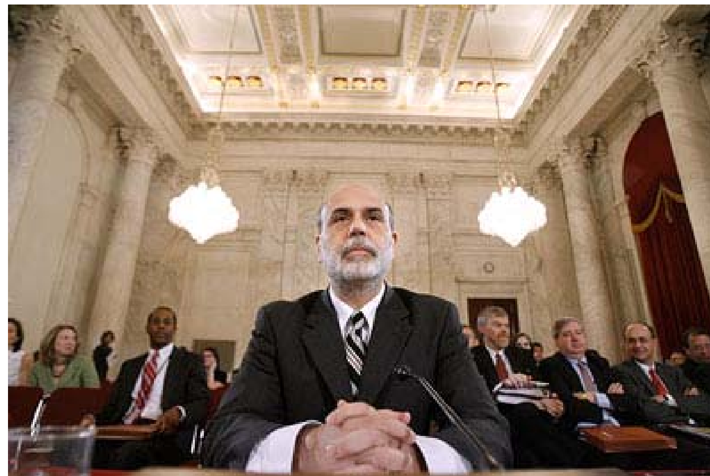


WHEN he was still in academia, Ben Bernanke once argued that Franklin Roosevelt's greatest contribution to ending the Great Depression was not a specific policy, but his "willingness to be aggressive and to experiment…to do whatever it took to get the country moving again." That would fairly describe how Mr Bernanke has battled perhaps the biggest financial crisis since FDR's time, which erupted one year ago this week.

The chairman of the Federal Reserve has cast aside any notion that central bankers should be boring. He has slashed interest rates; rolled out a dizzying array of new lending programmes; backed the debt of Bear Stearns, a failing investment bank; agreed to lend to Fannie Mae and Freddie Mac, America's troubled, quasi-private mortgage agencies; argued for fiscal stimulus and mortgage write-downs; and proposed an expansion of the Fed's regulatory domain.

The Fed did not seek its bigger role, but acted because no one else could. Mr Bernanke is now consumed with responsibilities he never imagined when he became chairman in early 2006. Since the crisis broke, he has been at his desk seven days a week, fuelled by cans of Diet Dr Pepper from a small refrigerator in his office. Even if his aggression and experimentation do not prevent a recession, they have softened the impact of falling house prices, rising default rates and the credit squeeze on America's economy. But they have also created new political risks for the Fed.

The central bank is lending to private companies on an unprecedented scale and is thus making decisions it long sought to avoid about the allocation of credit. It is also acquiring new powers of oversight. Politicians could chafe at the Fed's power: why, they might ask, should unelected officials choose who benefits from

taxpayers' money? And they might press the central bank to pursue political ends—such as propping up favoured borrowers—that interfere with monetary policy.

Events beyond the Fed's control magnify these risks. Unemployment and inflation are likely to remain uncomfortably high for the next year or two; such a combination has fuelled political antagonism in the past. And the next president will have an instant opportunity to fill three seats on the Fed's seven-member board of governors (one is vacant; another soon will be; a third governor's term has expired). He and Congress will have a chance to shape the Fed's priorities on both regulation and monetary policy.

So far there is no congressional clamour to rein in the Fed, and Mr Bernanke thinks its monetary independence is safe. "We've been able to keep a good separation between monetary policy and these other areas," he told Congress last month. But his predecessors worry, nonetheless. Paul Volcker urged Congress in May that if it wanted to prop up favoured sectors, it should do so transparently, not through the Fed. "That's the way to destroy the Federal Reserve in the long run." Alan Greenspan, in the paperback edition of his memoir, due out next month, makes a similar argument (see article).

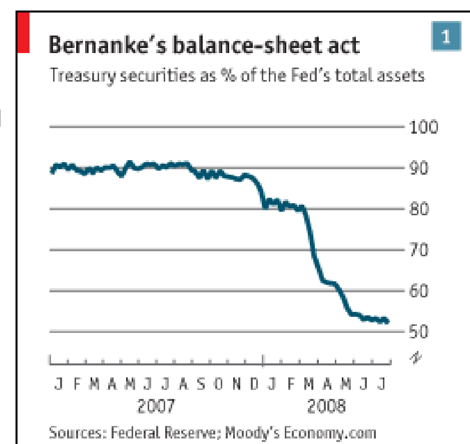
Fed officials note that although they have acted in new ways, other central banks have done similar things. They point out that the European Central Bank (ECB) has long had the ability to lend against a wide variety of government and private collateral, as the Fed now does.

But the Fed's independence is more tenuous than the ECB's. The Federal Reserve Act is much easier to change than the Maastricht treaty. The Fed is also required to strive for both full employment and price stability, whereas stable prices are the ECB's sole aim. Moreover, Americans traditionally are more suspicious than Europeans of giving any government body so much sway. In the first century of its existence the United States established two central banks, but closed them out of suspicion of such centralised power. The Fed, a blend of public and private authority, was set up only in 1913.

History suggests the Fed is especially vulnerable at times of economic turmoil. The Depression led to an overhaul that shifted power from its reserve banks to Washington, DC. The stagflation of the 1970s coincided with congressional efforts to take control of the Fed's budget and the requirement that it seek both full employment and stable prices. The crisis that began a year ago may yet mark another turning-point in the relationship between America's politicians and its central bank.

By far Mr Bernanke's most innovative response to the credit crisis has been the expansion of the Fed's tool kit from control of short-term interest rates to the deployment of its balance-sheet to restore liquidity to specific markets, such as that for inter-bank loans. A year ago 91% of the Fed's assets were invested in government bonds. Now the share is 52%. Loans to banks and investment banks backed by a hotch-potch of collateral account for the difference (see chart 1).

Mr Bernanke often notes this simply returns the Fed to its roots as lender of last resort: it was created primarily to prevent financial panics. But now that its lending goes beyond the federal government, it faces fine judgments. To whom should it lend and on what terms? And how does it avoid becoming a crutch for markets that cannot stand up on their own?



Politicians have asked the Fed to favour certain industries or keep interest rates low almost from its birth. In 1921 the Fed rejected requests from Congress to buy long-term agricultural debt. In the 1940s and again in the 1960s, under pressure from the Treasury, it bought bonds to hold down long-term interest rates. In the 1970s, at the behest of Congress, it bought the debt of federal agencies such as Fannie Mae and Freddie Mac.

A 2002 staff study pointed out the risks of favouring particular assets or borrowers: it could result in too much investment in preferred sectors and too little in others, drag the Fed into arguments about fiscal policy and compromise its monetary policy. In recent decades the Fed largely extracted itself from anything resembling credit allocation. The last of its Fannie bonds matured in 2003.

In the past year the current has begun to reverse. When the crisis first hit, Mr Bernanke's first step was to

lower the interest rate and lengthen the term on direct loans to banks from the Fed's discount window. When banks were slow to respond, the Fed devised its "term auction facility" to make loans at the discount window cheaper and more anonymous (and therefore with less stigma for the borrowing bank). It was creative, but not radical: the Fed has always lent to banks, though seldom on such a scale, and the eligible collateral is the same. The facility is likely to become permanent.

Subsequent steps have strayed further from tradition. In March the Fed created a facility to swap up to $200 billion of its Treasuries for investment banks' holdings of hard-to-trade mortgage-backed securities. A week later it took over $30 billion (later lowered to $29 billion) of Bear Stearns' obligations to prevent a chaotic failure of the firm and enable its takeover by JPMorgan Chase. It also opened its discount window to investment banks, the first time since the Depression that non-banks had borrowed from that window. And in July it agreed to lend to Fannie Mae and Freddie Mac from the window should it "prove necessary". Although each step was a logical, targeted response to financial upheaval, the result was to prop up certain firms and markets.

Vincent Reinhart, a former Fed staffer now at the American Enterprise Institute, says it is ironic that the Fed named the special-purpose vehicle that holds the Bear Stearns assets Maiden Lane, after the street behind the Federal Reserve Bank of New York. The bail-out opened a back door to the Fed that makes it much harder to say no to similar pleas, he argues.

The pleas soon started coming. In April Chris Dodd, chairman of the Senate Banking Committee, demanded that the Fed permit top-rated securities backed by student loans to qualify for its $200 billion swap programme. "If the Fed and the treasury can commit $30 billion of taxpayer money to enable the takeover of Bear Stearns by JPMorgan Chase, then surely they can step in to enable working families to achieve the dream of a higher education for their children," he declared.

Two weeks later the Fed said it would accept any AAA-rated securities as collateral, including those backed by student loans. Mr Dodd praised the decision. But Allan Meltzer, a Fed historian at Carnegie Mellon University, cringed, saying it looked as if the Fed had caved in to political pressure: "It gets close to the idea of credit allocation. And every Fed chairman without exception worried about that."

Fed officials say the move was in the works before Mr Dodd spoke up. The central bank has turned down other entreaties, notably to buy mortgage-backed securities directly. Officials do not deny that some of their programmes move closer to credit allocation: that is why they were "designed to be self-liquidating as markets improve", Donald Kohn, vice-chairman of the Fed, said in May.

However, self-liquidation is not imminent. On July 30th the Fed extended and expanded several of its programmes, for example extending investment banks' access to the discount window until at least the end of January. In any event, the expiry of new arrangements will not restore the previous status quo. Vikram Pandit, Citigroup's chief executive, said in June that "regardless of whether that window is officially opened or closed, the market now assumes that it will be opened if necessary on an ad hoc basis."

Now that the Fed has extended public backing beyond banks to investment banks and the mortgage giants, it is likely, logically enough, to oversee the borrowers. But in expanding the Fed's non-monetary duties, America is going against the international trend of recent years.

Central banks should be independent, the theory goes, because the power to spend money should be separate from the power to print it. By the same reasoning, many central banks have given up non-monetary tasks, such as bank supervision, because they involve more political judgments that could interfere with monetary policy. Hank Paulson, America's treasury secretary, has advocated a similar arrangement, but the Bear Stearns episode upended the landscape.

The Fed's new duties have not been formalised, but they will be greater, as will the potential for conflict over how it uses them. With these new duties, "it's getting into areas that are not typically thought to require the degree of independence that monetary policy does," Mr Volcker noted.

Although the Fed could make regulatory decisions less political, those decisions could also politicise the Fed. It could identify too closely with the firms it regulates, and err in favour of financial stability rather than price stability when the two are at odds. It could be drawn into contentious debates about how financial institutions should run themselves. And it may be blamed when the next crisis occurs. There is a precedent: in 1994 Congress gave the Fed broad authority to act against abusive mortgage loans. Democrats have repeatedly

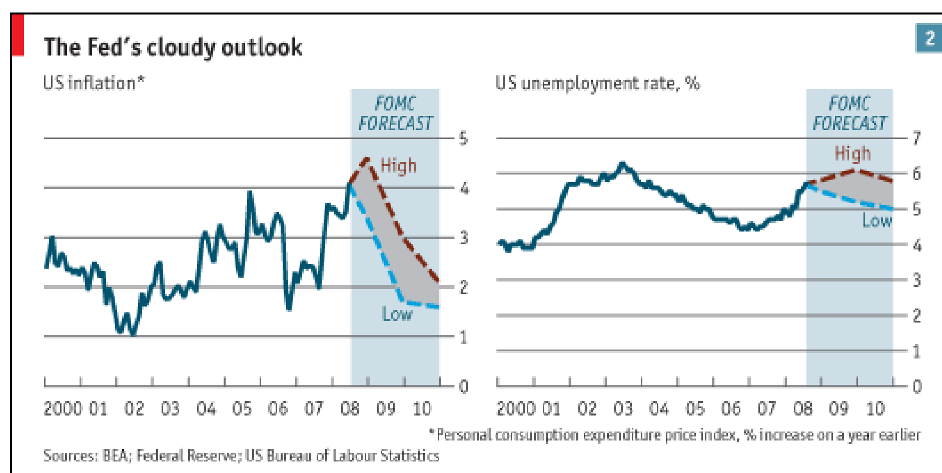
charged that the Fed's failure to use those powers more energetically worsened the sub-prime crisis.

Ben Bernanke, policy wonk

As well as adding to the Fed's policy tools and supervisory duties, Mr Bernanke has also waded into matters that do not involve the Fed directly, something for which Mr Greenspan was often criticised. At first Mr Bernanke sought to stay out of such debates. That has since changed, as he has supported fiscal stimulus and sweeping writedowns of troubled mortgages. He has also commented on exchange rates, a subject normally left to the Treasury.

Mr Bernanke's interventions have, like his creative use of the Fed's balance-sheet, taken some of the burden of economic stabilisation off interest rates. He has avoided endorsing specific controversial proposals. It also helps that Democrats see him as prodding the executive branch towards action. His sharpest critics in Congress are conservative Republicans.

The risk, though, is that one day Mr Bernanke will have to take a view more at odds with the party in power. And that could happen when the economic circumstances are particularly testing. For the next year or two, the Fed is unlikely to achieve either full employment or price stability, if its forecasts are correct (see chart 2).



The Fed is in no hurry to tighten policy. On August 5th, when it held interest rates at 2%, it backtracked on its earlier optimism about growth, suggesting it would raise rates later rather than sooner. But if inflation expectations rise, it may have to increase rates while unemployment is unpalatably high. A similar set of circumstances in the early 1990s coincided with congressional efforts to strip reserve-bank presidents, who then as now were more hawkish than governors, of their votes on interest rates.

Ominously, this comes at a time when appointments to the Fed have become more politicised. Just as Republicans did when they controlled the Senate in the late 1990s, Democrats have refused to move on many of George Bush's recent nominations to the Fed, arguing that filling the empty seats is a job for the next president—even though governors have staggered, 14-year terms precisely to distance the Fed from the political cycle. Of the two presumptive presidential nominees, Barack Obama has, perhaps surprisingly, been more forthright than John McCain in supporting the independence of the Fed. (That may reflect the influence of Mr Volcker, who advises Mr Obama.)

Nevertheless, American politics are becoming more populist and interventionist, and the Fed may not be spared. What might be done to reduce these risks to the central bank? Consensus has emerged on one point: the need for clear responsibility when the failure of a financial institution threatens the entire economy. A formal procedure exists for bailing out an insolvent bank's depositors and then winding down the institution; Mr Bernanke and others favour something similar for investment banks. Mr Greenspan proposes a "standby panel of senior federal financial authorities" to determine when a failure is important enough to merit intervention.

But the job may inevitably fall to the Fed. "The Fed is the only agency that has the power to serve as a

liquidity provider of last resort, a power that has proved critical in financial crises throughout history," Mr Bernanke noted last month. But whether that also means the Fed must remain a day-to-day supervisor, as he contends, is less clear. Moving those responsibilities, now shared by a patchwork of agencies, to a separate body, as Mr Paulson first proposed, could both rationalise America's regulatory structure and make the Fed a smaller political target.

The Fed itself could do more to ensure that its eventual mix of duties does not interfere with its commitment to price stability. Mr Bernanke has long said a numerical inflation target would be a safeguard of the Fed's independence: sacrificing the target to other priorities would demand explanation. When some colleagues balked at a target, he agreed to a compromise: policymakers would publish three-year economic forecasts, and their third-year inflation number would be a proxy target.

But the system is already showing its weaknesses. The energy-price shock forced officials to raise the third-year inflation forecast by a tenth of a percentage point in June, with none of the public debate a change in a target would have entailed. Frederic Mishkin, who is stepping down as a governor on August 31st, said recently that the Fed should publish forecasts for five or more years to make their preferred inflation rate more explicit and harder to abandon.

The Fed's creativity in the past year was justified; it stepped in when no other agency or political body could or would. But it should not ignore the risks it runs as a result. Among Roosevelt's actions during the Depression was an overhaul of the Fed's governance, making it more responsive to Washington. Mr Bernanke would no doubt prefer that this is one aggressive experiment that will not be repeated.

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