Monetary Policy under Bernanke: A Variation on a Redistributionist Theme

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Abstract
The Bernanke Fed continues the long history of US monetary institutions being used as tools for enhancing the resources and power of the federal government. Historically, inflation has been the most common way of conducting this transfer of resources from the public to the state. Various regulatory interventions have accomplished the task as well. What differentiates the Bernanke Fed is that it has used powers obtained during a crisis to undertake policies that have redistributed wealth directly to banks and large financial institutions under the guise of monetary policy, and it has done so in ways that undermine the rule of law.

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I. Introduction

The Bernanke Fed continues the long history of US monetary institutions being used as tools for enhancing the resources and power of the federal government. Historically, inflation has been the most common way of conducting this transfer of resources from the public to the state. Various regulatory interventions have accomplished the task as well. Two things differentiate the Bernanke Fed from its predecessors. First, it has adopted two new techniques for enlisting monetary policy in the task of transferring resources. Second, rather than adding the resources transferred from the public to the general revenue of the federal government, it has transferred those funds to banks and other financial institutions. Both of the two new techniques function as redistribution schemes that move resources from the economy as a whole into the banking system. Given the slow, though improving, recovery from the Great

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Recession, the effectiveness of these techniques as innovative monetary policy is questionable, and they are perhaps better understood as elements of the ongoing bailout of the US banking system by both Congress and the Fed. In this way, they are another example of the government's manipulation of monetary policy to acquire resources to be redistributed for political gain.

I examine the theory behind this view of monetary policy and provide a brief overview of how US monetary institutions have played the role of revenue raiser historically. I then turn to the two new techniques the Bernanke Fed has employed, ostensibly to speed up recovery from the Great Recession, and I explore how they redistribute resources to the banking system. I conclude with a few thoughts on how this operation has subverted the democratic process and the rule of law.

II. Monetary Policy in a Public Choice View of Politics

After more than half a century of work in the tradition of public choice economics, the basic implications that follow from assuming behavioral symmetry between market actors and political actors should be clear enough. Broadly self-interested political actors look for ways to maintain and expand their control over resources and power through various forms of exchange, just like market actors do. We most often think of elected officials and bureaucrats in this context, but other political actors, including those in charge of monetary policy, behave in similar ways. Any attempt to understand the direction of monetary policy must assume that central bankers are no less interested in augmenting their power and resources than are market actors.

The next step is to recognize that political actors, like market actors, will strive to improve their own positions by exchanging their assets with others. Viewing politics as another forum for exchange has also been at the heart of the public choice approach to political economy. Political actors will exchange assets in a variety of ways, depending on their particular role within the political process. Providing benefits for groups that directly support their power is always key. For example, elected officials will be most responsive to the voters who put them in power, and directing resources toward their constituents will always be a temptation.

However, that spending cannot come from nowhere; the resources must be acquired from somewhere. All government spending is ultimately redistribution and a zero-sum game at best.

This fact is most obvious when we think about taxation offsetting spending, but it is no less true if the resources are acquired through increased government borrowing. Assuming, for the moment, no role for monetary policy, any dollars raised through government debt are dollars unavailable for other uses, whether private investment or consumption. Government is not creating wealth, only redistributing it, particularly given its propensity to spend on consumption goods and transfer programs and to be wasteful in its investment spending. Borrowing also has one big political advantage over taxation: it is less immediately painful for those who are providing the resources. Taxation takes its bite now, while the costs of government debt tend to be subtle and long run.

There is a third option beyond taxation and borrowing. Governments can acquire spending power through monetary policy. Creating money or otherwise manipulating the monetary system has long been a way for governments to augment their revenue without requiring the citizenry's approval, as taxation usually does. It also does not require the public's approval of the purposes to which the funds are being put, unlike much borrowing (e.g., war bonds). If the revenue-raising goals of monetary policy are also cloaked in the technicalities of economic theory and the mechanics of monetary institutions, those goals are less likely to be obvious, and the public is less likely to pay attention to exactly what is happening.

Normally, manipulating the monetary system is accomplished through inflation, hence what is often called the "hidden tax of inflation." Directly spending newly created money enables governments to transfer resources to themselves from the public by diluting the value of the public's money as the new funds are created. Buying up existing bonds through standard open-market operations takes that interest off the budget, freeing governments to issue additional bonds for the same overall interest expense as before. So even getting newly created funds to bond dealers and banks enables governments to indirectly gain resources via what amounts to an interest-free loan. As the new funds get spent, the value of the public's money holdings gets diluted. The new expenditures are ultimately supported by a loss of the public's wealth.

III. US Monetary Institutions as a Source of Government Revenue

This use of the monetary system as a revenue raising device has a long history in the United States. That US history is part of an even longer history of monetary manipulation by governments that goes back centuries. Governments have long recognized that there was money to be made by making money. Gaining "seigniorage" through owning mints was one way to do this, but kings historically did everything from clipping or shaving coins to revaluing coins and paper currency to gain additional revenue. In more modern times, the attempt to use the monetary system as a revenue raising device has taken the form of regulatory interventions into banking systems, up to and including central banks. One narrative of the history of US banking institutions emphasizes that almost every major federal intervention into the monetary and banking system has corresponded to a time of war or other crisis. This narrative fits the broad story told by Higgs (1987), who sees such crises as key moments in the growth of government in general, especially from the late nineteenth century onward. This narrative continues with the Bernanke Fed.[1]

The First and Second Banks of the United States were the first attempts by the federal government to intervene in what was then an undeveloped US banking system. Both banks were one-fifth government owned, and their life spans precede and follow the War of 1812, with the second bank being chartered not long after the war's end. Their impact on both the federal government and its revenues was quite small, mostly because they had few powers associated with the creation of money and the federal government itself was still seen as constitutionally limited in its powers, especially as compared to the states. From 1837 onward, banking was almost exclusively regulated at the state level. Although most states depoliticized the process of obtaining a bank charter, they also heavily regulated what banks could do, especially with respect to creating currency. Specifically, state governments required that banks not only make their currency redeemable in some reserve commodity (which banks would do anyway), they also required them to purchase specified bonds as collateral in case the bank should become insolvent. Those bonds were usually state government bonds, but some states allowed privately issued bonds, especially from railroads, to meet that requirement. This law was clearly a way for the state governments to ensure a market for their bonds as the state-chartered banks wanted to provide currency for their customers. This

[1] For more on this history, see the comprehensive account in Timberlake (1993) or a more abbreviated version in Horwitz (2013).

was a clever way to create an artificial demand for state bonds and move resources from the private sector to the state governments.

Having banking regulations differ by state became a problem as the economy became increasingly integrated nationwide through the mid-nineteenth century. The lack of a nationally integrated banking system to match it led to demands by some for a federal system. As with most calls for increasing government regulation, there were both Baptists and bootleggers here. A number of commentators really did believe that a larger role for the federal government in banking was needed to deal with the problems of the pre-Civil War system, but these calls for reform aligned nicely with the self-interest of others who would materially benefit from a larger federal role. In 1862, investment banker Jay Cooke had obtained a monopoly over underwriting federal debt thanks to his connections with Secretary of the Treasury Salmon P. Chase. Any sort of federal role in banking that included Treasury bonds as collateral like the states had been doing would benefit Cooke greatly. Unsurprisingly, he was a major lobbyist for a federal role as Congress debated change in the early 1860s.[2]

In 1863, Congress created the National Banking System by authorizing the federal government to offer charters to interested banks. These "national banks" would be regulated by the federal government, and those regulations would include setting reserve requirements and, crucially, a new set of bond-collateral requirements.[3] Members of Congress realized that requiring federally chartered banks to purchase federal government bonds as collateral for currency issue would provide a source of financing for the North's war effort. The Civil War provided Congress with an opportunity to both address the lack of a nationally integrated monetary system and help finance the war effort. Even in the absence of a central bank to print money or conduct monetary policy, banking regulations could still be used to generate seigniorage for the federal government.

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[2] I thank an anonymous referee for pointing me to the Cooke-Chase connection.

[3] Banks were still prevented from operating branches across state lines. This prohibition on interstate banking would remain a feature of the US banking system until its full repeal in 1994. The lack of a truly integrated nationwide banking system was a primary cause of the US having so many small, underdiversified banks and therefore being far more prone to bank failures than countries with true nationwide banking, such as Canada.

The bond collateral requirements of the National Banking System were a major cause of the escalating series of financial panics in the late nineteenth and early twentieth centuries. Although the regionally based Federal Reserve System was created primarily to end and prevent those panics, having even a decentralized central bank turned out to be useful with the outbreak of World War I. The first serious inflationary episode of the century followed the US's entrance into the war, as the Fed used its limited powers to help acquire the resources required to fight the war. That episode of inflation is often blamed for the severe, though short, recession of 1920–21. Once again, a new intervention into the banking system by the federal government is associated with crisis, war, and the desire for revenue.

In the early twentieth century, Federal Reserve notes were still redeemable for gold and gold coins still circulated in the US economy. That ended in 1933 when President Roosevelt took the United States off the domestic gold standard. This action increased the Fed's ability to conduct expansionary monetary policy by removing redeemability as an economic constraint on such expansions, at least by US citizens. Foreign central banks could redeem Federal Reserve notes for gold, but that process took more time and offered a much weaker feedback system. Two years later, the Banking Act of 1935 centralized more of the Fed's power in Washington and gave it the explicit ability to conduct open market operations. These two moves together meant the Fed had more power to gain seigniorage through inflation and that such expansions would be more efficient at doing so. It is not coincidental that this occurred at a time of crisis in the depths of the Great Depression as a significant expansion of government spending was underway. Monetary expansion might well have been called for from a macroeconomic perspective, but loosening the constraints on money creation, and the power to buy and sell US government bonds on the open market, were more than useful tools to finance that new spending.

Another example of this narrative is President Nixon's decision to close the "gold window" in 1971. During the 1960s, inflation rates began to rise under Presidents Johnson and Nixon, partially as a result of using newly created money to finance the war in Vietnam. The war's unpopularity made it difficult to raise taxes or have targeted bond sales as a way to finance it. As the extra dollars made their way overseas and the dollar's value fell, foreign central banks began to redeem the dollars for gold. Faced with the gold outflow and the need to restrict, if not reverse, the money creation that was helping to finance the war, Nixon chose instead to end the redemption rights of the foreign central banks. This decision removed the last economic check on the Fed's ability to generate seigniorage and allowed the last few years of the war to continue to be financed through money creation.

IV. Bernanke's Monetary Policy as a Redistribution Scheme

This is the historical context out of which we can look at the actions of the Bernanke Fed. In the wake of the 2008 financial crisis, the Fed took on new powers and adopted unorthodox strategies to address the problems with financial institutions and, later, to speed up the recovery process. My focus here is on two of those that have received less attention than policies like quantitative easing, yet have played a significant role in how the Bernanke Fed's policies have transferred resources from the public. These policies, like those of the past, remain a way for government to extract revenue, but rather than using that revenue for government expenditures in general, it has been transferred directly to the banks and other financial institutions without going through the federal budgetary process. Under the guise of technical changes in monetary policy, Bernanke's Fed has turned the central bank into a redistribution machine.

Almost immediately after the crisis began, the Fed engaged in the first of these two new policies by starting to pay interest on the excess reserve balances of commercial banks. The amounts have been small, but this was nonetheless a first. Normally, paying interest on reserves is intended to make monetary policy contractionary because as long as that rate is above the yield on safe assets, it encourages banks to hold rather than lend their reserves. So why would the Bernanke Fed do this if, at the same time, it was expanding the monetary base through asset purchases associated with the Troubled Assets Relief Program and then quantitative easing? The capital injections associated with the Fed's response to the crisis were not only in violation of Bagehot's (1873) principle that during a crisis, central banks should only "lend to good banks at penalty rates," but also their size ran the risk of igniting inflation. Interest on reserves helped offset the possibility of inflation by encouraging banks to sit on the new reserves rather than lend them out into the money supply. Adopting these two policies at the same time suggests that the Fed's aim with those capital injections was bank solvency, not bank liquidity. The goal was to rescue troubled banks, not to expand the money supply. If the goal were the latter, why offset the capital injections with interest payments on the reserves they created?

By paying interest on reserves, the Fed transfers resources to banks by providing them a risk-free payment on their excess reserve balances. One reason that bank lending has not rekindled in the way we normally see in a recovery is that the spread between the interest rate they are getting on their excess reserves and the risk-adjusted returns available in the market is so small. Faced with the choice between a certain 0.25 percent on their excess reserves and a risky percent or two in the market, many banks have chosen the path of least resistance. The Fed has purchased underperforming assets at prices no one in the market would pay, then turned around and paid banks interest on the same funds the Fed just gave them for those underperforming assets. The net effect is to swap the assets on the banks' balance sheets from instruments on which they had taken large capital losses to excess reserves on which they are earning a return. From the banks' perspective, this is a huge gain in wealth with very little risk attached. Regardless of one's view of the necessity of central bank action to help the banks, there is no doubt that this is a complex use of monetary policy to transfer purchasing power from the general public to the banks.

The second policy tool that has benefited banks directly is the expanded use of reverse repurchase agreements, or "reverse repos." The current use of reverse repos is, by the Fed's own admission, more or less the equivalent of paying interest on reserves. The Fed is selling securities to its various authorized buyers with the promise to buy them back the next day at a higher price. From the seller's perspective, this does indeed look like interest on reserves as they profit from turning their cash into an appreciating asset overnight. Whatever the Fed's arguments about the need for this tool, it also amounts to a redistribution to all of its reverse repo counterparties. According to the Fed, as of August 2015, it has 170 reverse repo counterparties, covering a wide range of entities—111 of the largest 2a-7 money market funds, 13 government-sponsored enterprises, 24 banks, and the 22 primary dealers (Federal Reserve Bank of New York 2015). In other words, these reverse repo operations have guaranteed the equivalent of interest on reserves to 170 different financial institutions, all of which are large-sized organizations, and some of which are government-sponsored enterprises.

This is yet another way of using monetary policy as a tool of redistribution. Once again, rather than directly transferring resources through simple inflation, which is subtle enough, the higher-level complexity of this set of policies disguises what is really happening even more thoroughly. The net result of both interest on reserves and the reverse repos with the larger group of counterparties is a transfer of wealth toward banks and other financial institutions. As others have argued (Hummel 2011), this is all part of the Fed taking on the role of a central allocator of capital rather than a director of monetary policy. Central banks and national governments have long played a role in manipulating the monetary system as a way to raise revenue, but the 2008 financial crisis and Great Recession appear to have opened the door to a new stage in this process. Central bank monetary policy has become an explicit tool of the redistributionist state. It is perhaps most notable that the redistribution is not from the haves to the have nots, but from the purchasing power of the general public to the deposit accounts of large banks and financial institutions. This is regressive redistribution to those at the top masked by the technicalities of monetary policy and central banking.[4]

V. Democracy and the Rule of Law

All of this redistribution has been an end run around the democratic process. One of the lingering complaints about how the Bernanke Fed has behaved is that it took on a large number of new powers, and decided on new tools for monetary policy, with a minimum of consultation with the other parts of the democratic process. It is not at all clear that the new powers it took on are within its mandate, though section 13(3) of the Federal Reserve Act does provide for emergency lending to any financial institution in "unusual and exigent circumstances." That clause was invoked several times in the fall of 2008, and none of the emergency powers the Fed claimed were ever examined by Congress, even after the fact. If transferring resources to the financial sector was thought to be a good policy, it could have been put to the democratic test. Just as central banks have used inflation to avoid either raising taxes or the risk of being unable to find purchasers of government debt at a sufficiently low interest rate, in order to pay for wars and other crises, so has the Bernanke Fed subverted the democratic process by arrogating new powers without explicit approval and then using them to engage in a backdoor transfer to the banking system.

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[4] It is on this point that both free-market critics of crony capitalism and left-wing critics of the so-called 1 percent can find common ground.

These actions fit nicely into Higgs's (1987) argument about the role that crises have played in the growth of the scope and scale of government power. Faced with the call to "do something," the power of government grows, often by constitutionally questionable means, and when the crisis subsides, the growth in government only partially retreats. This is exactly what has happened with the Fed, as its recently acquired powers have not gone away, nor are they likely to at any point in the future. In addition, the way the Fed has used monetary policy to obscure the central allocation and redistribution of wealth aligns with Higgs's discussion of the way in which increases in the scope of government power can conceal the real costs of the government's response to a crisis.[5] It is interesting to speculate on whether the public would support the Bernanke Fed's policies if the real results were clear.

Finally, as White (2010) argues, the Bernanke Fed has undermined the rule of law with precisely these sorts of grabs for new powers without the explicit consent of Congress. White argues that even section 13(3) does not give the Fed unlimited authority, making a number of its actions examples of putting itself above the law. In White's (2010, pp. 456–57) words, "Whatever the extent of its statutory authority, the Fed violates the rule of law by its repeated use of 13(3). Under the cover of emergency, the Fed undertakes essentially fiscal operations of subsidizing certain classes of firms at taxpayer expense. . . . If the statute law allows the central bank an indefinitely wide range of actions, practically without constraint, then we have not the rule of law but the rule of central bankers."

The Fed has always had elements of crony capitalism and it has long been a tool for raising government revenue. The Bernanke Fed has taken advantage of a crisis to arrogate new powers for itself and then use those powers to redistribute the public's wealth to banks and major financial institutions under the guise of new tools of monetary policy needed to address the crisis. Not only does this behavior distract the Fed from its central mission, at which it arguably failed massively in the crisis, it undermines the rule of law and removes pretty much any constraint on its behavior in the future.

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[5] For example, consider how a military draft, by not paying soldiers the wages necessary to attract them voluntarily, makes the costs of fighting a war seem lower than they really are. Even if explicit wage payments are lower, it does not change the opportunity cost of diverting human capital to the destruction of war rather than letting it contribute to the production of the market.

If the gradual end of the gold standard over the twentieth century removed the last of the economic constraints on the Fed's ability to act at its discretion, the Bernanke Fed may be remembered for using the crisis that opened the twenty-first century as the excuse for removing the last of the Fed's political constraints. That does not bode well for monetary policy or the rule of law in the decades to come, and only adds to the reasons that it might be time to rethink the value of central banks.

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