

The Federal Reserve System's Overreach into Credit Allocation

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Abstract

The Federal Reserve System's attempts to direct the allocation of credit since 2007 have been overreaching, wasteful, morally hazardous, and fraught with serious governance (potential cronyism) problems. Accordingly, the Fed should remove itself, or be removed by Congress, from the formulation and implementation of credit-allocation policies.

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I. Introduction

The Federal Reserve System's attempts to direct the allocation of credit since 2007, begun under the leadership of Chairman Ben Bernanke and New York Federal Reserve Bank President Timothy Geithner, have been overreaching, wasteful, morally hazardous, and fraught with serious governance problems.¹

Before 2007, the Federal Reserve System had five main roles: (1) clearing and settlement of checks, (2) issuing paper currency, (3) supervising and regulating commercial banks, (4) acting as lender of last resort, and (5) formulating and implementing monetary policy. Since 2007, of its own initiative, the Fed has expanded its activities by undertaking unprecedented credit allocation policies that do not fit into any of these traditional categories (the Fed's own claims to the contrary notwithstanding). A central bank already charged with five

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¹ Jeffrey Rogers Hummel (2011) makes a set of arguments that overlaps with mine against the Fed's expanded role, while Marvin Goodfriend (1994, 2014; Goodfriend and King 1990) has for two decades repeatedly called for removing the Fed from credit allocation. See also Thornton (2009) and McCulloch (2014).

tasks, and not excelling in all of them, should not be expanding its activities into an area where it is almost certain to do more harm than good. Accordingly, the Fed should remove itself, or be removed by Congress, from the formulation and implementation of credit-allocation policies.

II. Recent Credit Allocation Policies and Their Beneficiaries

Here, “credit allocation policies” means *efforts to increase the share of financial funds* going toward private uses that Federal Reserve policymakers prefer, implicitly at the expense of other credit uses that private-sector actors prefer. For example, Fed purchases of mortgage-backed securities (MBS) allocate a larger share of credit toward the housing industry. Based on a compilation by the Government Accountability Office (2011), with my own two additions at the end, here is a list of twenty-two Fed credit allocation initiatives in recent years, the dates they commenced, and their beneficiaries:

- Term Auction Facility (December 2007): depository institutions
- Dollar Swap Lines (December 2007): foreign-domiciled commercial banks doing US dollar business
- Term Securities Lending Facility (March 2008): primary dealers, a set of select Wall Street securities firms (numbering twenty at the time) from which the New York Fed trading desk routinely buys bonds, and to which it sells bonds, in the execution of monetary policy operations
- Primary Dealer Credit Facility (March 2008): primary dealers
- Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (September 2008): money market mutual funds
- Commercial Paper Funding Facility (October 2008): issuers and holders of commercial paper
- Money Market Investor Funding Facility (October 2008, but never used): money market mutual funds
- Term Asset-Backed Securities Loan Facility (November 2008): holders of MBS
- Bridge loan to JP Morgan Chase (March 2008): JPMorgan Chase; Bear Stearns shareholders, bondholders, and counterparties
- Maiden Lane LLC (March 2008): JPMorgan Chase; Bear Stearns shareholders, bondholders, and counterparties

- Revolving AIG Credit Facility (September 2008): AIG and its counterparties
- Securities Borrowing Facility (October 2008): holders of MBS
- Maiden Lane II LLC (November 2008): AIG counterparties, especially Goldman Sachs
- Maiden Lane III LLC (November 10, 2008): AIG counterparties, especially Goldman Sachs
- life insurance securitization (March 2009, but never used): AIG counterparties
- credit extensions to affiliates of some primary dealers (September 2008): four broker-dealer firms
- Citigroup nonrecourse lending commitment (November 2008): Citigroup
- Bank of America nonrecourse lending commitment (January 2009): Bank of America
- Agency Mortgage-Backed Securities Purchase Program (November 2008): bondholders of Fannie Mae and Freddie Mac
- Operation Twist (September 2011, enlarged June 2012):² holders and guarantors of long-term MBS, housing finance firms that originate long-term fixed-rate mortgages, and housing construction firms
- Quantitative Easing 1 (January 2009):³ same beneficiaries
- Quantitative Easing 3 (September 2012):⁴ same beneficiaries

III. Nonmarket Credit Allocation Is Inefficient

Credit is fungible, and can be re-lent by intermediaries that are free to seek end borrowers offering the highest risk-adjusted returns. Some of the lending programs listed that directed funds to particular classes of intermediaries, such as the Term Auction Facility, therefore might have had little impact on the mix of end uses of credit. Fannie Mae and Freddie Mac as intermediaries are constrained to lend to the housing market, however. Thus, allocations of credit to Fannie Mae and Freddie Mac should be expected to reduce the availability of

² Operation Twist refers to the replacing of short-term securities with long-term securities in the Fed's portfolio, to reduce long-term interest rates relative to short-term rates.

³ QE1 consisted of \$1,250 billion in MBS purchases, but its effects on broader monetary aggregates (M2) were offset by paying interest on reserves.

⁴ QE3 refers to a series of MBS purchases of \$40 billion per month, similarly offset by interest on reserves.

credit to other sectors in real terms. Likewise, programs in which the Fed purchases securities from end users, such as the Commercial Paper Funding Facility, can be expected to alter the final mix of credit uses.

To the extent that they did alter the allocation of credit, the programs are almost certain to have been wasteful, directing funds to less than the most productive uses, even if Fed policymakers have had the best of intentions. While the beneficiaries of the programs are obvious, a full analysis must also consider the less obvious costs. The losers from preferential credit allocations are all those potential users of funds who suffer by having credit diverted away from them. The full set of losers and the magnitude of their losses is impossible to identify because we cannot observe the counterfactual state of the world.

Nonetheless, consistent with being on the short end of Fed credit allocation (other factors, namely rising credit standards, deleveraging, and growing federal debt, were working in the same direction), several identifiable sets of credit demanders complained of facing tight credit while the Fed directed credit toward housing. The complaining would-be borrowers include hospitals (Abelson 2008), college students (Luhby 2008), auto buyers and financiers (Dash 2008), and small businesses (Sussman 2012). In the aggregate, the US flow of funds accounts (Board of Governors 2014, p. 3) show that while the growth of nominal home mortgage debt slowed in 2009 to a mere 0.6 percent, it remained positive. Credit to other parts of the private nonfinancial sector actually shrank in 2009, nonmortgage consumer credit by 3.9 percent and total business credit by 2.1 percent. Home mortgage debt did begin shrinking in 2010, while the two other sectors returned to positive but slow growth after mid-2010.

Resources are also wasted in the rent-seeking game of competing for preferential allocations, for example, by banks deliberately becoming too big or too connected to be allowed to fail. In standard economics terms, political credit allocation creates both a deadweight loss triangle and a Tullockian rent-seeking loss rectangle.

Financial markets generate prices and quantities of financial assets by aggregating the decentralized judgments of millions of market investors, who are staking their own funds, about the most promising avenues for investment. In credit allocation policy Federal Reserve officials, risking not their own but taxpayers' funds, substitute their own judgment for the financial market's about the proper prices of

various securities and the proper shares of the supply of funds that should go to specific firms or segments of the financial market.⁵ The likelihood that any central committee will improve on a competitive market's allocation of funds, even if the committee is limited to tinkering around the margins, is vanishingly small. In particular, a committee that allocates funds to prop up insolvent financial firms, making investments that prudent market participants shun, is following a recipe for throwing good money after bad, and it creates moral hazard (reduces the incentive to invest prudently) as a toxic byproduct.

The Dodd-Frank Act of 2010 restricts special Fed lending to “broad-based” programs, ruling out any program limited to a single firm. While a step in the right direction, having this rule in place before 2010 would have barred only about half of the credit allocation programs listed earlier. The same reasons (avoiding favoritism and moral hazard) that favor broad over narrow lending, taken seriously, recommend an even broader-based approach: the Fed should not try to allocate loanable funds to *any* subset of private intermediaries or ultimate borrowers.

Given our present monetary system (putting consideration of alternative regimes aside), the Fed would best avoid credit misallocation by focusing exclusively on the scarcity of *money*, not credit, in the economy *as a whole*. Suppose that there is an agreed nominal policy target such as the path of nominal income. When money is too scarce to support the target then the Fed should provide more money to the economy as a whole, and vice versa when money is too abundant to reach the target. The cleanest way to inject and withdraw money is through open-market purchases of Treasury securities.⁶

IV. Quantitative Easing Plus Interest on Reserves Is a Credit Allocation Policy

The Fed has defended the last two items on the list, its massive QE1 and QE3 purchases of mortgage-backed securities, as the conduct of

⁵ On the risk to taxpayers, see Edward J. Kane (2013), who identifies bailout guarantees as a “taxpayer put.”

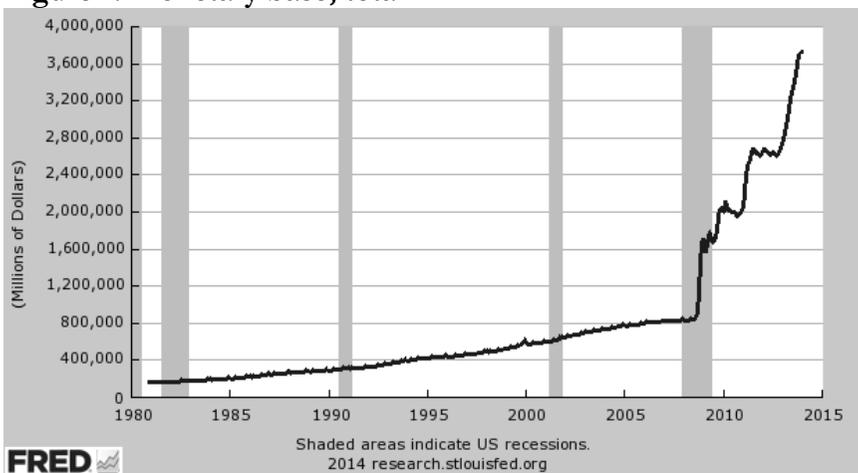
⁶ Granted, although a Treasuries-only policy avoids picking favorites among private borrowers, it does favor the Treasury over private borrowers. QE2 was an example. There does not seem to be a feasible way for the Fed instead to buy and sell shares of “the market portfolio” of all assets, which would be preferable because it would be more allocatively neutral.

monetary policy. Monetary policy means that the central bank *varies the economy's stock of money* in pursuit of some ultimate goal (like low inflation or milder business cycles). The Fed's decisions about *how many* securities to purchase represent monetary policy, because they alter the size of the monetary base, also known as the stock of "high-powered money," the narrowest of the monetary aggregates. But the Fed's decision to purchase *mortgage-backed rather than Treasury* securities of a given volume does *not* qualify as monetary policy because it does not alter the quantitative impact on the monetary base or broader monetary aggregates.

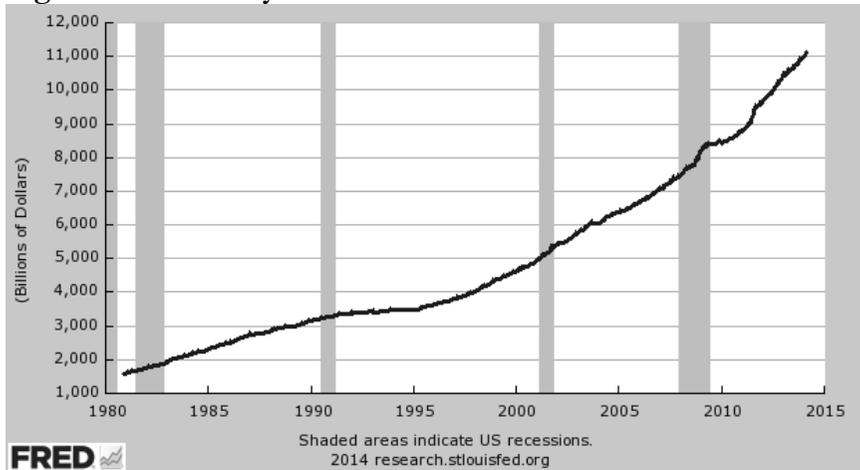
The QE programs, furthermore, have been deliberately *combined with interest on reserves in order to negate their monetary policy impact*, that is, to minimize their impact on the quantity of money held by the public. This "sterilization" can be seen in the nearly unaltered path in the broader monetary aggregate M2 even while the monetary base has skyrocketed (figure 1). Credit allocation policy, by contrast, seeks to redistribute a given volume of credit (for example, change the mix of bank assets funded by M2 deposits) and thereby to change the relative prices of assets.

As figures 1 and 2 show, the Fed's asset purchases from 2009 through 2014 (QE1, 2, and 3) dramatically increased the monetary base, but the Fed has paid sufficient interest on reserves to keep the excess bank reserves bottled up and thus to keep the stock of money held by the public (M2) on a nearly undisturbed growth path.

Figure 1. Monetary base; total



Source: St. Louis Fed, using data from the Board of Governors of the Federal Reserve System.

Figure 2. M2 money stock

Source: St. Louis Fed, using data from the Board of Governors of the Federal Reserve System.

The combination of quantitative easing 1 and 3—the acquisition of a massive position in MBS—with interest on reserves is correctly categorized not as monetary policy but as fiscal policy. The Fed’s aim has been to raise the price of mortgage-backed securities relative to other securities without altering the path of the broader monetary aggregates. It is holding up the price of MBS by effectively borrowing funds from the commercial banks, inducing them to hold massive excess reserves by paying interest on reserves at a rate (0.25 percent) in excess of the prevailing rate on interbank loans or short-term Treasury bills (the fed funds rate has been below 0.25 percent since January 2009; the 1-year Treasury Bill secondary market rate remained below 0.25 percent from March 2011 to May 2015). In general, borrowing and spending in pursuit of a policy goal (here, higher MBS prices) is a fiscal policy, not a monetary policy.

V. Targeted Lending Programs Are Credit Allocation Policies

The Fed has defended the earlier items on the list, its extraordinary targeted lending programs—which at their peak lent hundreds of billions of dollars—and even its bailouts of Bear Stearns and AIG in 2008, as falling under its traditional role as a “lender of last resort” (LLR). In so doing it has stretched the classical LLR concept beyond any reasonable interpretation. A classical LLR, following the principles laid down by the banking authority Walter Bagehot (1873), temporarily lends reserves to illiquid banks as copiously as necessary

to prevent money and credit from contracting system-wide, but avoids moral hazard by lending only at penalty rates and only to solvent banks. In the words of LLR scholar Thomas Humphrey (2010), “The Fed has deviated from the classical model in so many ways as to make a mockery of the notion that it is . . . an LLR in the traditional sense of that term.”

Referring to the “long-embedded” and “time-honored” classical conception of the LLR role, former Fed chairman Paul Volcker similarly observed in early April 2008 that in the Bear Stearns bailout, the Fed operated at “the very edge of its lawful and implied powers, transcending in the process certain long-embedded central banking principles and practices. . . . What appears to be in substance a direct transfer of mortgage and mortgage-backed securities of questionable pedigree from an investment bank to the Federal Reserve seems to test the time-honored central bank mantra in time of crisis: lend freely at high rates against good collateral; test it to the point of no return” (as quoted by Brinsley and Massucci 2008).

A classical lender of last resort does not lend to insolvent banks, nor to insolvent (or even solvent) investment houses like Bear Stearns, nor to insurance companies, primary dealers, or money market mutual funds. It does not lend at below-market rates even to solvent banks. How low were the Fed’s lending rates? Bloomberg News, based on its analysis of information that became public only later as a result of its Freedom of Information Act lawsuit against the Board of Governors of the Federal Reserve System, reported that “during the crisis, Fed loans were among the cheapest around, with funding available for as low as 0.01 percent in December 2008.” Comparing these low Fed loan rates with the borrowers’ earnings on the assets they held (computing the net interest margin), Bloomberg reporters estimated that the subsidy was worth about \$13 billion in the aggregate to its recipients (Ivry, Keoun, and Kuntz 2011). Even if this is an overestimate of the size of the transfer, the important fact is that it was positive rather than negative. Traditional last-resort lending is supposed to be at a penalty rate, not a subsidy rate. It aims to provide emergency liquidity, not to boost earnings.

The Fed’s bailout and subsidy operations were the sort of fiscal exercises that have traditionally been regarded as the exclusive prerogative of the elected Congress to initiate, as in the creation of the Reconstruction Finance Corporation of the 1930s or the Chrysler bailout of the 1970s or the Resolution Trust Corporation of the 1980s.

The Fed's defenders sometimes warn that criticism of its lending decisions violates the independence that it needs to operate effectively. The principle of independence for the Federal Reserve, however, applies to its *monetary policy* decisions.⁷ Congress does nothing to violate the Fed's monetary policy independence when it questions—or even chooses to audit—the Fed's credit allocation or *fiscal policy* decisions. The Fed should not get a free pass from critical scrutiny by miscategorizing its credit allocation policies as monetary policy or last-resort lending.

VI. Credit Allocation Policy Is Prone to Favoritism and Capture

When the Federal Reserve System engages in credit allocation policy—rather than monetary policy involving open-market transactions in Treasury securities only—at least two governance problems arise. First, potential conflicts of interest make the governance structure of the twelve reserve banks problematic, especially at the Federal Reserve Bank of New York (FRBNY), which has done most of the policy design and implementation. The reserve banks have their boards of directors drawn from member bank executives (Class A directors), nonbankers nominated by the member banks (Class B), and other financial and nonfinancial market participants nominated by the Board of Governors (Class C). As the 2011 GAO report notes, “Some of the institutions that borrowed from the emergency programs had senior executives and stockholders that served on Reserve Banks’ board of directors. . . . We identified at least 18 former and current Class A, B, and C directors from 9 Reserve Banks who were affiliated with institutions that used at least one emergency program.”

For example, General Electric's CEO served as a Class B director of FRBNY, while “GE was one of the largest issuers of commercial paper and General Electric was one of the companies FRBNY consulted when creating the emergency program to assist with the commercial paper market.” FRBNY Class A directors included the CEOs of JPMorgan Chase and Lehman Brothers, firms that were beneficiaries of Fed credit allocation programs (Lehman failed anyway). Although the board of directors is not directly consulted on credit policy, it hires, interacts familiarly with, and can fire the reserve bank president who does make policy.

⁷ Cargill and O'Driscoll (2013) provide evidence that the Fed's postwar monetary policy record “demonstrates the sensitivity of the Fed to political institutions despite its de jure independent status.”

Most notoriously, the chairman of the New York board was a member of the Goldman Sachs board of directors during the period in which Goldman shareholders (including this individual) benefited from a not publicly disclosed FRBNY credit-allocation decision to have the insolvent AIG (under FRBNY receivership) repay Goldman and other creditors 100 cents on the dollar on collateralized debt obligations that might have been settled for as little as 60 cents on the dollar (Teitelbaum and Son 2009). The same FRBNY chairman led the search committee seeking a new FRBNY president to replace the departing Timothy Geithner, and chose an individual (William Dudley) who had spent ten of the previous twelve years as a Goldman Sachs partner, managing director, and chief economist.

In recognition of the appearance of conflicts of interest, and in accordance with provisions of the Dodd-Frank Act, as the GAO report notes, since 2010, “all of the Reserve Banks have changed the directors’ roles to remove the Class A directors from the process of appointing the bank president.” This shift attenuates the member banks’ influence over the president, which is warranted with respect to credit allocation policy but unfortunate with respect to monetary policy.

It is desirable to retain member banks’ influence over the president with respect to monetary policy because reserve bank presidents as a group have a better track record in Federal Open Market Committee voting than do members of the Board of Governors. That is, commercial bankers are inflation hawks, because a rise in the expected inflation rate brings a rise in nominal interest rates, which punishes the typical commercial bank that borrows short and lends long (e.g., uses one-year deposit liabilities to fund thirty-year fixed-rate mortgage assets). Having shorter liabilities means that a bank must roll over its liabilities sooner than its assets, and thus must pay higher rates on deposits before it starts earning higher rates on loans. Because their constituents are inflation hawks, reserve bank presidents tend to be more hawkish on inflation than governors (Chappell and McGregor 2000). In a discretionary monetary policy regime, a more hawkish FOMC is desirable for reasons explained by Kenneth Rogoff (1985): it allows the Fed to achieve low inflation more credibly and thus with smaller short-run output and employment losses from differences between actual and expected inflation.

Potential conflicts of interest can be entirely avoided, while retaining the FRB member banks’ desirable indirect input into

monetary policy via the FRB presidents, only by removing the Fed entirely from credit allocation. If the Fed gives no financial institution favored credit allocation treatment, in the form of a bailout or concessionary loan, it does not matter which institutions are represented on an FRB's board of directors.

The second governance problem, the potential for regulatory capture, arises regardless of which institutions' representatives sit on an FRB's board of directors. When the FRBNY staff set out to design credit allocation programs to aid favored segments of the financial system, they consulted with the intended beneficiaries. Notes the GAO (2011) report, "According to FRBNY officials, FRBNY's Capital Markets Group contacted representatives from primary dealers, commercial paper issuers, and other institutions to gain a sense of how to design and calibrate some of the emergency programs." This consultation process—essentially asking, "How can we most effectively boost your net worth?"—is clearly ripe for industry capture of its ostensible regulator—and this episode may well indicate that capture has already happened.

VII. Ad Hoc and Thoroughgoing Reform Possibilities

So long as monetary policy is conducted in a discretionary manner, it is useful to maintain the independent input of the reserve bank presidents on the FOMC. The reserve banks should therefore not become mere outposts of the Federal Reserve Board in order to eliminate commercial bankers' representation on the reserve banks' boards of directors. A better way to remove the potential for conflicts of interest is to require the Federal Reserve System to leave the creation of fiscal and credit-allocation policies to Congress, and their execution to the US Treasury. (If it wants to act in the general interest, Congress should decline to create any such policies.)

A straightforward way to separate the Fed from credit allocation, without major changes to the institutional status quo, is to commit the Fed to holding only US Treasury obligations on its balance sheet, as recommended by Marvin Goodfriend (2014). Even "last resort" provision of bank reserves to the market can be provided by open-market purchases of Treasury securities, letting the interbank market allocate the funds among banks, rather than by putting loans to favored banks on the Fed's balance sheet (Goodfriend and King 1990). Market participants supplying loanable funds, because they aim to be paid back, have every reason to follow Bagehot's wise precepts of not lending to insolvent banks and not lending at subsidy rates. Goodfriend likens his recommendation to the 1951 "accord"

between the Federal Reserve System and the US Treasury. We could also liken it to the FDIC Improvement Act of 1991, which sought to correct the FDIC policies that had suffused the banking system with moral hazard.

A more thoroughgoing reform would be to alter the institutional status quo so as to end the Federal Reserve System and return its useful functions to the private sector. White (2011, 2013, 2015) and Selgin, Lastrapes, and White (2012) make cases for alternative arrangements of this sort.

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