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New York Fed Characterizes Wall Street-Government Incest

By Neil Irwin
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NEW YORK -- The low-slung cubicles wrap around the ninth floor of a building three blocks from Wall Street, each manned by a young staffer staring at flashing numbers on a flat-screen computer monitor and working the phones to gather the latest chatter from financial markets around the world.

It could be any investment bank or hedge fund. Instead, it is the markets group of the Federal Reserve Bank of New York, which has been on the front lines of the government's response to the financial crisis. Federal Reserve and Treasury Department officials make the major decisions, but the New York Fed executes them.

The information gathered there provides crucial insights into the financial world for top policymakers. But the bank is so close to Wall Street -- physically, culturally and intellectually -- that some economic experts worry that the New York Fed puts the interests of the financial industry ahead of those of ordinary Americans.

"The New York Fed sticks out as being not just very, very close to Wall Street, but to the most powerful people on Wall Street," said Simon Johnson, an economist at MIT. "I worry that they pay too much deference to the expertise and presumed wisdom of a sector that screwed up massively."

Even some former insiders at the Fed say the bank does not pay enough attention to the fundamental flaws in the country's financial system or to the risks associated with bailing out financial firms -- for instance, the chance that banks will be encouraged to take more unwise gambles. These experts worry that the New York Fed has adopted the mindset of a trading floor: well attuned to ripples in financial markets but not to long-term trends and dangers.

Last month, for instance, Wall Street bond traders wanted the central bank to ramp up its purchase of Treasury bonds, which would help the traders by driving up prices. But Fed officials in Washington and around the country concluded that such a move would be counterproductive in the longer run, in contrast to some New York Fed staffers, whose views more closely mirrored those on Wall Street.

New York Fed employees "play a very valuable role, day in, day out, with detailed contacts with the big financial firms," said William Poole, a former president of the Federal Reserve Bank of St. Louis who is now at the Cato Institute. "What I think is missing is a longer-run perspective. They tend to be sort of short-term in their outlook, which is true of a lot of the financial firms. Traders have a horizon of a few hours or a few weeks, at most." ad_icon

The New York Fed's home is a fortresslike building, with bars securing the windows on lower floors. Its main lobby resembles a Gothic cathedral: dim, quiet, with stone walls, as if to inspire a mix of fear and awe.

Like the other 11 regional Federal Reserve banks, the New York Fed is a curious mix of public and private, part of a system Congress created in 1913 to avoid concentrated power in Washington or New York alone. Its board of directors is composed of bankers, businesspeople and community leaders, who select the bank president with approval from Fed governors in Washington. Banks in New York, Connecticut and parts of New Jersey own shares in the New York Fed, though its profits are returned to the U.S. Treasury.

The man in charge is a soft-spoken economist named William C. Dudley, who took over as president in January, replacing Timothy F. Geithner when he became Treasury secretary.

With a proclivity for button-down Oxford shirts and rumpled suits, Dudley does not fit the mold of a Wall Street executive. He has won fans across the Federal Reserve System for a collaborative style, as well as a talent for explaining complicated problems in the financial world and drawing up solutions to them.

It is his résumé that alarms some critics, who see an example of a too-cozy relationship between financial firms and their lead regulator. One of several bank officials who have worked in the private sector, Dudley was at Goldman Sachs for two decades, including 10 years as chief economist, before joining the New York Fed in 2007.

The bank's board of directors, which selected Dudley, includes such corporate titans as Jamie Dimon, the head of J.P. Morgan Chase, and Jeffrey Immelt, General Electric's chief. Richard Fuld, then the chief executive of Lehman Brothers, resigned from the Fed just days before his firm went under. Stephen Friedman, who sat on Goldman's board, resigned as chairman of the New York Fed board earlier this year after controversy arose over his purchase of Goldman stock while at the Fed.

"I don't think they're consciously doing things to tilt the playing field to Goldman Sachs and the other major banks," said Dean Baker, co-director of the Center for Economic and Policy Research. "But when you work at a place, you tend to internalize their views, and that is going to color your policies. It's not that they're being deliberately corrupt; it's that they come to incorporate the interests of major banks in their views."

Dudley argues that he has been willing to take on large banks repeatedly, especially with stress tests earlier this year that many viewed as onerous and which required some banks to raise more capital.

For their part, senior Fed officials in Washington say the experience Dudley and some of his colleagues have in the private sector has proved invaluable in helping them understand how markets are failing.

"He has been the right person at the right place at the right time," said Donald L. Kohn, vice chairman of the Federal Reserve System Board of Governors.

On the ninth floor, the first employees show up at 4 a.m. and hit the phones to collect the latest on overnight trading in Asia and Europe.

The workers on the front lines are "trader analysts." Many of them are around age 30, with master's degrees in international affairs or public policy from schools such as Johns Hopkins and Columbia. Some stay at the bank for decades, rising through the ranks; others go to Wall Street firms within a few years (some of those converts have looked to return to the Fed lately as investment banks have shed jobs by the thousands).

The staff, though paid much less than Wall Street workers, is well compensated by government standards. The 289 bank officers earned an average of $204,000 in 2007 -- more than Cabinet secretaries.

"They're the eyes and ears of the Federal Reserve in financial markets, and they wouldn't be doing their jobs if they weren't sensitive to what's occurring in that world," Kohn said. Then it is up to the board and the Fed's policymaking committee "to take that information, weigh it along with all the other information we get and set policy." ad_icon

This intimacy with the firms they regulate can give Fed officials crucial intelligence. At the height of the financial crisis in September, staffers learned from their market contacts that Wall Street's two largest investment banks, Goldman Sachs and Morgan Stanley, were in mortal danger because their trading partners were so quickly losing faith in them, according to an update on the day's market activity by the New York Fed staff obtained by The Washington Post. Four days later, the central bank brought the two firms under the Fed's protective umbrella by agreeing to make them "bank holding companies."

But in allowing Goldman and Morgan to convert themselves to bank holding companies that received access to greater federal aid, Fed officials exempted them from the usual requirements, potentially putting taxpayer money at risk. (Since then, the firms' fortunes have improved enough that the government has incurred no losses.)

In responding to the financial crisis, the New York Fed has designed many of its programs to try to take advantage of some of the same business practices that contributed to the crisis.

Last fall, Fed staffers in New York and Washington began developing ideas to address paralysis in the markets for credit card loans, auto loans and other forms of consumer debt.

In Washington, Fed staffers wanted the central bank to hire a small number of firms to purchase the securities backed by these loans, thus injecting fresh credit into the market. But New York Fed staffers thought it better to let any investor put up money, matched with a loan from the Fed, to buy the securities. They argued that this approach would restart private markets more effectively and could be deployed faster. The downside: The New York Fed's strategy could allow private investors to earn huge returns while the government limited their losses.

Federal Reserve Chairman Ben S. Bernanke and other top Fed officials sided with New York.

The New York Fed, in scrambling to save the financial industry, has even taken a page out of the industry playbook, adopting a trick known as "special purpose vehicles." These entities, as used by Citigroup and other banks, contributed to the financial meltdown. But the Fed turned to similar entities when it bumped up against legal restrictions on its ability to buy risky assets. When the central bank decided to rescue Bear Stearns and, later, American International Group, New York

Fed lawyers suggested creating separate limited liability corporations to buy the assets. The Fed then lent money to these new entities.

Dudley said the Fed has made such moves to support the overall economy, helping to keep a deep recession from getting much worse. When programs have helped individual firms, they have done so only to prevent catastrophic damage to the broader U.S. economy.

"Nobody here is trying to do anything but support the economy and support market functioning," he said in an interview. "We are worried about the stability of the system, not any individual institution."

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