The Fed's Main Street problem: Worries rise that money won't go where it's most needed

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It wasn't supposed to work like this: The Federal Reserve was not going to have to come back and rescue the economy the way it did during the financial crisis, because American business was going to learn its lesson about not preparing for unexpected risks and wouldn't need a central bank to bail it out.

But here we are again, and the crisis of 2020 is starting to look a lot like the crisis of 2008.

Markets were gummed up, companies with too much debt were in danger of failing, and the Fed again was called on to expand its balance sheet and take extraordinary measures to save the day.

Wednesday's backslide notwithstanding, the stock market has been cheering the Fed's efforts. The S&P 500 as of Tuesday's close had gained nearly 27% from its closing low on March 23, the same day the Fed said it would be buying Treasurys and mortgage-backed securities in unlimited quantities, as opposed to a previously set $700 billion limit.

But the implementation of a seemingly infinite form of quantitative easing kicked off both a rally on Wall Street and a broader debate on the nearly unmitigated support the Fed has now pledged to help financial markets and the underlying economy. While the central bank has pledged to focus on Main Street — it even has a lending facility with those words in it — critics say it is implementing programs geared at Wall Street, and will come to regret it.

Danielle DiMartino Booth, the CEO of Quill Intelligence,, was a senior aide to then-Dallas Fed President Richard Fisher during the financial crisis. She said that the current central bank officials are overstepping their bounds and veering into questionable legal territory.

"One day, this should to go to the Supreme Court. It's such a deep violation of the Federal Reserve Act. It's such an infringement of how capital markets operate," Booth said in an interview this week.

"They're doing everything that we said could not be done," she added. "Right now, the markets are assuming that the Fed is not only bigger than the economic data, but the Fed is bigger than the coronavirus."

Taking control

Booth is not alone in her criticism of the Fed for overreach.

Jeffrey Gundlach, founder of DoubleLine Capital and often called the "bond king," said in a tweet that the Fed's extraordinary efforts were evidence not that it was succeeding but that it "has failed and is fundamentally broken."

Gundlach's assertions are sort of correct about the Fed exceeding its normal authority, but overlook a key point.

The central bank's enabling legislation contains a key proviso that it can roll out in times of crisis — namely, Section 13(3) that allows it broad lending powers so long as it's not using them to prop up failing banks, rescue insolvent firms or to take toxic assets off a company's balance sheet.

But those legal arguments over the Fed's interventions will wait for another day.

For now, the debate is focused on the Wall Street vs. Main Street conundrum that could shape the central bank's legacy and dictate how it will respond to the next crisis.

Former FDIC Chair Sheila Bair complained in a Tuesday op-ed for CNBC.com that "our elected officials have ceded too much responsibility for the economy to the Federal Reserve. But the Fed is not well equipped for this role. It is essentially a big bank, primarily configured to lend to other big banks."

Bair said she finds "no fault" with the Fed for the actions it has taken, but noted that "these kinds of programs do not trickle down to the real economy, as we learned in the years following the 2008 crisis when working families continued to struggle."

Two roads that meet

To be sure, there's an argument to be made that helping Wall Street does help Main Street.

Companies, after all, employ people, and bankrupt companies lead to unemployed workers. Moreover, stock market behavior has closely correlated with consumer confidence. And well-functioning financial markets ensure that money can continue to flow to the areas of the economy that need it.

Indeed, while Main Street and Wall Street often seem to run parallel and at great distance, they in fact intersect at various, critical locations.

"What they're trying to do is make sure the recession doesn't evolve into something much deeper and darker," said Quincy Krosby, chief market strategist at Prudential Financial. "The Fed is approaching this from every angle. Ultimately, it may be for Wall Street, but it's connecting the dots from Wall Street to Main Street."

The Fed ultimately will be judged on how well its programs work.

So far, small businesses have been complaining about red tape in getting loans, and some of the other programs, particularly the Main Street facility, haven't even gotten off the ground yet, with details skill sketchy on how it will be implemented.

Moral hazard

The Fed has another problem.

In taking its historically unprecedented actions, the Fed is venturing into familiar financial crisis ground known as "moral hazard." That means that while the Fed may be well-intentioned, its multitude of moves, from cutting short-term rates to near zero to its alphabet-soup list of liquidity and lending programs (here's a full timeline of what it has done) may just keep encouraging bad behavior while not getting money to where it's needed most.

"The financial moral hazard is very real," said George Selgin, senior fellow and director of the Center for Monetary and Financial Alternatives at the Cato Institute. "The more markets the Fed props up, the more tempted borrowers are not to price in future risk."

In addition, Selgin said the aggressive moves by the Fed, particularly in the area of business lending and purchasing corporate bonds, takes Congress off the hook and gives legislators an easy out for policy by delegating it to the hands of unelected central bankers. The result, he said, could be Congress using the Fed balance sheet as a "slush fund" to juice the economy without the political consequences.

Companies, meanwhile, can continue to rely on the Fed when times get rough.

"The more the Fed intervenes in these crises, the less prepared firms are for the next rainy day," Selgin said. "They're expecting the Fed each time to show up with an even bigger umbrella."

Howard Marks, the Oaktree Financial founder whose "memos" are widely read on Wall Street, defined moral hazard as when "people and institutions are protected from pain, but bad lessons are learned."

"The bank bailout of 2008 as been roundly cited as a case of the government putting Wall Street ahead of Main Street, and it contributed significantly to the populism that has riven American politics ever since," Marks said in a new memo released Tuesday. "The recent step to rescue leveraged lenders may add further fuel to that fire."