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Should We Give the Fed More Power ¦ Or Less?

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Oct. 28, 2009 (Phil's Stock World delivered by Newstex) --
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Courtesy of Washingtons Blog

Congress is suggesting that the Fed be given more powers, making it the chief risk regulator of the entire banking system.

Specifically, as summarized by Huffington Post, a new bill introduced by Democrats in Congress "gives the Federal Reserve the power to determine which firms are actually [#x2dc]too big to fail and pose systemic risk to the financial system."

Given the Feds history (as discussed below), that is like appointing the head of the Medellin drug cartel as drug tzar.

Admittedly, the Congressional bill allows other agencies a seat at the risk regulator table. But those are likely token seats. If the drug tzars office was staffed by the head of the Medellin drug cartel - who had the majority vote - and some law enforcement officers who have a history of either (a) being on the take or (b) looking the other way, what do you think would the result would be?

High-Level Fed Officials Speak Out

High-level officials of the Fed itself have criticized the Feds actions. For example, the head of the Federal Reserve bank of San Francisco - during a talk on how runaway bubbles can lead to depressions - admitted:

Fed monetary policy may also have contributed to the U.S. credit boom and the associated house price bubble ¦

Fed Vice Chairman Donald Kohn conceded that the governments actions "will reduce [companies'] incentive to be careful in the future." In other words, hes admitting that the governments actions will encourage financial companies to make even riskier gambles in the future.

Kansas City Fed President and veteran Fed official Thomas Hoenig said:

Too big has failed¦.

The sequence of [the government's] actions, unfortunately, has added to market uncertainty. Investors are understandably watching to see which institutions will receive public money and survive as wards of the state¦

Any financial crisis leaves a stream of losses among the various participants, and these losses must ultimately be borne by someone. To start the resolution process, management responsible for the problems must be replaced and the losses identified and taken. Until these actions are taken, there is little chance to restore market confidence and get credit markets flowing. It is not a question of avoiding these losses, but one of how soon we will take them and get on to the process of recovery¦.

Many of the [government's current policy revolves around the idea of] "too big to fail" ¦. History, however, may show us a different experience. When examining previous financial crises, both in other countries as well as the United States, large institutions have been allowed to fail. Banking authorities have been successful in placing new and more responsible managers and directions in charge and then reprivatizing them. There is also evidence suggesting that countries that have tried to avoid taking such steps have been much slower to recover, and the ultimate cost to taxpayers has been larger¦

The current head of the Philadelphia fed bank, Charles Plosser, disagrees with Bernankes strategy of the endless printing-press and ever-increasing fed balance sheet:

Plosser urged the Fed to "proceed with caution" with the new policy. Others outside the Fed are much more strident and want plans in place immediately to reverse it. They believe an inflation storm is already in train.***

Bernanke argued that focusing on the size of the balance sheet misses the point, arguing the Feds various asset purchase programs are not easily summarized in a single number.

But Plosser said that the growth of the Feds balance sheet was a key metric.

"It is not appropriate to ignore quantitative metrics in this new policy environment," Plosser said.***

Plosser is bringing the spotlight right back to the Feds balance sheet.

"The size of the balance sheet does offer a possible nominal anchor for monitoring the volume of our liquidity provisions," Plosser said.

The former head of the Feds Open Market Operations says the bailout might make things worse. Specifically, the former head of the Feds open market operation - the key Fed agency which has been loaning hundreds of billions of dollars to Wall Street companies and banks - was quoted in Bloomberg as saying:

"Every time you tinker with this delicate system even small changes can create big ripples, said Dino Kos, former head of the New York Feds open-market operations . . . "This is the impossible situation they are in. The risks are that the governments $700 billion purchase of assets disturbs markets even more.

And William Poole, who recently left his post as president of the St. Louis Fed, is essentially calling Bernanke a communist:

Poole said he was very concerned that the Fed could simply lend money to anyone, without constraint.

In the Soviet Union and Eastern Europe during the Cold War era, economies were inefficient because they had a soft-budget constraint. If a firm got into trouble, the banking system would give them more money, Poole said.

The current situation at the Fed seems eerily similar, he said.

"What is discipline - where are the hard choices - when does Fed say our resources are exhausted?" Poole asked.

But the strongest criticism may be from the former Vice President of Dallas Federal Reserve, who said that the failure of the government to provide more information about the bailout could signal corruption. As ABC writes:

Gerald ODriscoll, a former vice president at the Federal Reserve Bank of Dallas and a senior fellow at the Cato (NYSE:CATO) Institute, a libertarian think tank, said he worried that the failure of the government to provide more information about its rescue spending could signal corruption.

"Nontransparency in government programs is always associated with corruption in other countries, so I dont see why it wouldnt be here," he said.

Of course, former Fed chairman Paul Volcker has also strongly criticized current Fed policies.

Global Agencies Speak Out

BIS - the central banks central bank - slammed the Fed and other central banks for blowing bubbles and then "using gimmicks and palliatives" which "will only make things worse".

The head of the World Bank also says:

Central banks [including the Fed] failed to address risks building in the new economy. They seemingly mastered product price inflation in the 1980s, but most decided that asset price bubbles were difficult to identify and to restrain with monetary policy. They argued that damage to the [#x2dc]real economy of jobs, production, savings, and consumption could be contained once bubbles burst, through aggressive easing of interest rates. They turned out to be wrong.

Economists Speak Out

Stephen Roach (former chief economist for Morgan Stanley (NYSE:MS) , and now director of Morgan Stanley Asia) is one of the most influential and respected American economists.

Roach told Charlie Rose this week that we have had terrible Federal Reserve policy for the past 12 years under Greenspan and Bernanke, that they concocted hair-brained theories (for example, that we should let the boom and bust cycle occur, but then "clean up the mess" once things fall apart), and that we really need to reform the Fed.

Specifically, heres the must-read

portion of the interview:

STEPHEN ROACH: And whats missing in the debate that drives me nuts is going back to the very function of central banking thats at the core of our financial system. Do we have the right model for the Fed to go forward? And, you know, I think weve minimized the role that the custodians, the stewards of our financial
system, the Federal Reserve, played in leading to this crisis and in making sure that we will never have this again. I think weve had horrible central banking in the United States for the past dozen of years. I mean, we elevate our central bankers, we probably .

CHARLIE ROSE: From Greenspan to Bernanke.

STEPHEN ROACH: Yeah.

CHARLIE ROSE: Both.

STEPHEN ROACH: We call them maestro, and, you know, we make them sound larger than life. And, you know, and the fact is, they condoned policies that took us from one bubble to another. They failed to live up to their regulatory responsibility granted them by law. They concocted new theories to explain why these things could go on forever, and they harbored the belief, mistakenly in my view, that monetary policy is too big and blunt an instrument, and so you just bring it in to clean up the mess afterwards rather than prevent a mess ahead of time. Well, look at the mess were in right now. We need a different approach here. We really do.

Leading economist Anna Schwartz, co-author of the leading book on the Great Depression with Milton Friedman, told the Wall Street journal that the Feds entire strategy in dealing with the financial crisis is wrong. Specifically, the Fed is treating it as a liquidity problem, when it is really an insolvency crisis.

Moreover, prominent Wall Street economist Henry Kaufman says that the Federal Reserve is primarily to blame for the financial crisis:

"I am convinced that the misbehavior of some would have been much rarer " and far less damaging to our economy " if the Federal Reserve and, to a lesser extent, other supervisory authorities, had measured up to their responsibilities ¦

Kaufman directly criticized former Federal Reserve Chairman Alan Greenspan for not using his position to dissuade big banks and others from taking big risks.

"Alan Greenspan spoke about irrational exuberance only as a theoretical concept, not as a warning to the market to curb excessive behavior," Kaufman said. "It is difficult to believe that recourse to moral suasion by a Fed chairman would be ineffective."

Partly because the Fed did not strongly oppose the repeal in 1999 of the Depression-era Glass-Steagall Act, more large financial conglomerates that were "too big to fail" have formed, Kaufman said, citing a factor that has made the global credit crisis especially acute.

"Financial conglomerates have become more and more opaque, especially about their massive off-balance-sheet activities," he said. "The Fed failed to rein in the problem."¦

"Much of the recent extreme financial behavior is rooted in faulty monetary policies," he said. "Poor policies encourage excessive risk taking."

Economist Marc Faber says that central bankers are money printers who create bubbles, and that the system would be much better now if the Fed hadnt intervened. Specifically, Faber says that - if the Fed hadnt intervened - the system would be cleaned out, the system would be healthier because debt load and burden on taxpayers would be reduced.

Economist Jane DArista has shown that the Fed has failed miserably at its main task: providing a "counter-cyclical" influence (that is, taking the punch bowl away before the party gets too wild).

The Fed has also failed miserably in its role as regulator of banks and their affiliates. As well-known economist James Galbraith says:

The Federal Reserve has never been an effective regulator for the straightforward reason that it is dominated by economists and bankers and not by dedicated skeptics who make bank regulation a full-time profession.

The Fed has performed terribly in many other tasks as well.

And the Fed is unlawfully refusing to disclose to Congress or the American people who its giving money to and what it is really doing.

Conclusion

Given the above, isnt it obvious that Congress is attempting to give the Fed more powers at a time when it should be audited, and then ended?

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