THE WALL STREET JOURNAL.
WSJ.com

OPINION | DECEMBER 16, 2009, 9:23 P.M. ET

Obama vs. the Banks

Why make risky loans when you can exploit the Fed-Treasury interest rate spread?

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Over the weekend, President Barack Obama went on the offensive against Wall Street for not lending more to Main Street. On CBS's "60 Minutes," the president declared, "I did not run for office to be helping out a bunch of fat cat bankers on Wall Street." He was joined on the Sunday morning circuit by his chief economic adviser, Lawrence Summers, who echoed the message of intimidation.

Wall Street fat cats are always a convenient political target, but bankers are responding to the incentives generated by the economic policies of the Treasury and the Federal Reserve. First and foremost is the Fed's policy of near-zero intere rates.

What this means is that banks can raise short-term money at very low interest rates and buy safe, 10-year Treasury bonds at around 3.5%. The Bernanke Fed has promised to maintain its policy for "an extended period." That translates into an extended opportunity for banks to engage in this interest-rate arbitrage.

Why would a banker take on traditional loans, which even in good times come with some risk of loss? In today's trouble times, only the best credits will be bankable. Meanwhile, financial institutions are happy to service their new, best customer: the U.S. Treasury. That play on the yield curve is open to banks of all sizes.

The Fed's policy makes sense if the goal is restoring bank profitability by generating cash flow. It is a terrible policy if th goal is fueling small business, the engine of economic growth and job creation. Large, nonfinancial corporations have access to banks. They can also tap the public credit markets and have access to internally generated funds. Not so for small business, which depends heavily on banks for credit.

Since the financial crisis began, the Fed has worked in tandem with the Bush/Paulson Treasury and now with the Obama/Geithner Treasury. One must assume its policies have the administration's approval. That puts the administration's policies at war with its stated goals. Larry Summers is a first-rate economist and must understand the economic incentives those policies have created. In short, the weekend interviews, along with the president's meeting with bankers on Monday, was political theater.

While the public is upset with $10 million to $20 million banker bonuses, public policy should focus on what is generating them. The largest banks have had their risk appetites whetted. They are not looking to traditional lending, b to proprietary trading and a renewed commitment to innovative financial products. But as Obama adviser and former Fed Chairman Paul Volcker noted, financial products such as credit default swaps and collateralized debt obligations brought the economy to the brink of disaster. It is excessive risk-taking by Wall Street that is generating the profits fror which the bonuses are being paid. Curb the former and you curb the latter without government planning of banker pay

Has recent experience taught the leaders of large financial institutions the need to curb their risk appetite? Not really. The lesson they have learned is that presidents of both parties, the Fed and Congress will come to their rescue when they get in trouble. Under a vague set of ideas, scarcely a theory, some banks are viewed as too big to fail. They will be propped up, bailed out and generally protected from the consequences of their own bad decisions. That generates incentives to engage in excessively risky activities.

A few bankers lost their jobs or quit in the aftermath of the financial crisis, but that small risk is evidently one most of Wall Street's fat cats will accept. Mr. Obama may not have run for president in order to reward them, but that is the effect of his policies.

Sending scarce resources to major banks in the form of funds from the Troubled Asset Relief Program (TARP), ultra-low interest rates, and the Fed's targeted credit schemes has diverted needed capital from real, productive activity. Now the politicians feel the public's anger and are complaining about the lack of lending and the size of executive compensation. If Congress wanted banks to lend and to limit pay packages, it should have put those in as conditions in the TARP legislation.

The TARP was hastily arranged, poorly designed and badly executed. Nonetheless, Congress acted in haste and now gets to repent at leisure. Meanwhile, the totality of the policies to aid the major financial institutions is delaying the recovery of the broader U.S. economy and the hiring of its unemployed workers.

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