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Monetary Politics At Work…once again

Over the past several months, the Credit Crisis has triggered numerous interventions by the Federal Reserve. In one way, this has quieted earlier concerns by many market participants that this Fed was an overly academic Fed and had insufficient "market" experience to run the world's most important Central Bank. Many observers did compliment the Bernanke-led Fed for its Lender of Last Resort activities and its inventiveness in creating various technical devices to make Federal Reserve credit more broadly available. As the Credit Crisis has deepened, weakening many financial intermediaries, the Fed has been running in Crisis Management mode. Inexorably, the Fed has and continues to step out onto to thin ice of monetary politics. Virtually all democratic states find this conflict arises between the Executive and Legislative branches and an "independent Central Bank." No one has ever disputed Willie Sutton's adage as to why he robbed banks. "Because that is where the money is!"

The Congress and the Executive always feel they have a right (and sometimes a "duty") to govern the money creation process because they know that the ability to create money is the ability to enhance one's power. How, say these elected officials, is it that we give over such power to an agency over which we have so little control (at least in the short run)? The exercise of this power comes at a price, however. As the Fed exercises its power to intervene within the monetary institutions of our society, it invites increasingly more concern by elected officials. This time is no different. We should consider the following.

Fed backing of the Treasury (Paulson) Bailout Plan

Fed Stealth Rate Cuts

Fed as Investment Banker

Let's look at the list from a bottom's up perspective---'fundamental analysis!' The Fed was an active participant in the sale of Bear Stearns to JP Morgan Chase. And, the Fed came under considerable criticism in allowing JPM to buy Bear Stearns at very distressed asset prices **with a 29 billion dollar back up.** The Fed in effect gave JPM a put on bad assets back to the Fed. The last time I remember a Central Bank in this position was when the Bank of Japan gave Shinsei Bank a "put" on 20% of the balance sheet in its sale of Long Term Credit Bank. Japanese politicians screamed to the heavens over this, joined by rival bankers. This put is much bigger. The deal that got done was so widely criticized that JPM raised its bid some five times to quiet the outburst and to get the deal finished, but the put did not disappear!

The Federalization of Fannie and Freddie continues to draw interest because while the common shareholders were wiped out, the debt holders were not. Some would argue that debt holders took a risk—and were compensated accordingly---that the lack of a formal Government guarantee should have been enforced. There are some intriguing questions as to which politically astute bond managers benefitted. No doubt, there were strong geo-political considerations as well because Fannie and Freddie debt was widely held internationally---and much of it by lenders to the US (buyers of US Treasuries). But this only underscores the political aspects that attach to such decisions and that directly invites the Congress and the Executive to poke their camel noses under the Fed tent! **Transparency?** Guess it doesn't apply to Washington.

The Fed was extremely active in the decision to bail out AIG for some $85 billion dollars while (essentially simultaneously) allowing Lehman to go into bankruptcy. Fed historians will mull over these decision for years. Is the Fed well equipped to play a role as the nation's ultimate Investment Banker? Is its staff suitably trained for such a role? The fallout from Lehman's bankruptcy is wide and severe. Did the Fed really have the right scenario analysis at hand when it reached its decision? A great deal more analysis will be needed after we learn the real thinking behind that decision. At this moment, there are serious doubts whether implementing a lesson on moral hazard using Lehman was the best course of action. There seems to be more applause for the AIG bailout

Wachovia, Citi and Wells Fargo

The latest brouhaha is the Wells Fargo top up of the initial Citi bid for Wachovia. A key to this transaction is that both the Fed and the FDIC were involved up to their ears and the incipient failure of Wachovia was something that no government official could stomach. Wells first turned away from the auction for the carcass of Wachovia despite its big deposit base. In stepped Citi and stripped the carcass of the healthy meat and let the Government assume some of the liabilities that were too pungent for Citi's consumption. Now, Wells Fargo comes to the party, and ups the price significantly, seemingly willing to take on whatever toxicity that goes with buying the common and buying the entirety. Typically, a corporate buyer would always prefer selected assets and leave the liabilities behind. This time, however, it may be that Wells got back into the fray because it found a big tax benefit to a subsequent write-down of all the assets. If you have good corporate profits, the Treasury becomes your partner for at least 34% of that write-down! Another wonderful taxpayer subsidy! The final act is yet unknown as Citi threatens a lawsuit based on claims that it had exclusive rights to the deal and that the Fed and the FDIC already cleared the transaction. Investment banking has risks as well as reward. Will Citi sue the Government as well? Stay tuned.

The Paulson Bailout

Many economists, some of them from both sides of the political spectrum have attacked the Treasury plan on two, principled grounds. First, buying the toxic assets only suggests a "Lemons" problem of major proportions. The Treasury watches Buffett come home with two wonderful deals using preferred stock and buying into an entire balance sheet, not just the toxic waste that may have dubious value, yet disdains to do what other Governments have done in similar banking crisis. In Sweden and in Japan, there is ample precedent for a Buffett type deal. And both countries got their banking systems back on track. What's so different here?

Ok, this is still a Treasury deal, not the Fed's deal. But the Fed is backing it and has not winced, despite the fact that among its many Ph.D. economists, both the Lemons problem and good precedent from other banking crisis are widely known. This leads us to wonder about the Fed's basis for making this decision and not publicly coming out against the plan. Politics is surely afoot here. And it has not and will not work to the Fed's advantage. Fed independence comes at a price. The Fed was not independent in this case. It was co-dependent. We should concern ourselves what price will be paid for this dependency relationship.

Stealth Monetary Policy

For the past two weeks, while the credit markets have deteriorated, the Fed Funds rate has stood high on a pole. Meanwhile, while not announcing any rate cuts, the Fed has allowed the average effective Funds Rate to slip some 70 basis points below that flapping flag of signal irrelevancy. So the Fed is not, repeat, not sterilizing all of its Lender of Last Resort supplied liquidity. Why the wait? Is it solely because of stated pre-occupation with inflation? That seems dubious to us. It sounds like not getting in the way of the Treasury bus and not offering opponents to the Paulson bill respite and a place to vote it down! Again, that is a heavy price to pay because it has to make the Fed a partial monetary eunuch. After the vote (today?), the Fed will almost surely produce an intermeeting cut and it will be a cut of at least 50 basis points, maybe more. Won't someone in the Congress ask (after the Bill passes) the obvious? "Why didn't you do this sooner and take off some of the pressure?" Monetary politics is coming to your nearest theater. Watch for it!

Finally, there is a central but underlying question to ask about Fed policy these past few months. No one could fault the Fed's strenuous efforts to play its Lender of Last Resort role. They have done so capably and even imaginatively. But they have apparently relied on an unproven theory of separation, namely that one can supply liquidity and then sterilize the monetary impact. And seemingly, for an FOMC often attached to fundamental monetary economics, they seem indifferent to a well established historical finding: **monetary bases in crisis period often behave pro-cyclically**. That means Central Banks have aggravated Booms (too much credit) and Busts (too little). If there was one thing that we thought that was well established it was that in a fractional reserve banking system, the Fed should be acting counter-cyclically. This was the fundamental reason to have a Central Bank---to avoid this "inelasticity" (as it used to be called before 1913).

We raise this issue but do not wish to burden this note with even more length and explore the fallacy that underlies this "separation" theorem in times of crisis. But, someone has to raise the question of whether this FOMC as a subset of the Fed in the entirety, is guilty of fighting a "last war" (Stagflation) when it should be fighting the biggest banking crisis since 1932! I asked one central banker the question and his reply hinted that there was a divergence between Fed thinking in New York and in Washington. History rhymes once again. Did Mark Twain ever write on monetary politics?