The Fed Didn't Bail Out Wall Street? It Just Ain't So!

BY ROBERT P. MURPHY

In his *New York Times* column ("It's Monetary Policy, Not a Morality Play," September 9, 2007), Tyler Cowen decried the clichéd pattern of casting all financial stories into "simple moral narratives." Although many commentators have questioned the Fed's handling of the credit crunch last August and September, Cowen sees no hanky-panky:

> Talk of a bailout is overstated. Some institutions have benefited from Fed policy, but the story is not a conspiratorial one: liquid markets are good for many investors, and if the Fed succeeds in keeping markets running, that helps hedge funds, too. . . .
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> It is true that a more liquid short-term loan market can give a highly leveraged institution a second chance. . . . But keeping loan markets open is not a bailout; it's simply getting part of the economic infrastructure back on line, much as the police clear a road after a traffic accident.

Cowen's recommendation is that journalists and other analysts drop the emotions and write neutrally about the "largely technical subject" of monetary policy, for this is the only way that Fed Chairman Ben S. Bernanke and his colleagues can do their jobs: "[I]f interest-rate cuts are portrayed as a bailout for hedge fund managers, it's harder for the Fed to cut interest rates, if that turns out to be the appropriate policy."

Although I sympathize with Cowen's position, nonetheless he's dead wrong. It's true that the "man on the street" is suspicious of rich financiers, not to mention exotic derivative products he doesn't even understand, but this is one case where knee-jerk hostility is perfectly justified. Not only did the Fed inappropriately provide relief to rich investors at the expense of everyone else, but its earlier policies also were responsible for the crisis in the first place!

For some reason, many free-market economists have a blind spot when it comes to the Federal Reserve.

Commodity Money

If the government would simply get out of the way, the free market would handle money and banking just fine. Commodity money such as gold and silver arose spontaneously on the market without prodding from kings or sultans, and if used today it would serve as a much better unit of account and store of value than rapidly depreciating pieces of paper with presidential portraits. There is no "science" of monetary policy, no more than there was a science of automobile production in the U.S.S.R. The economic lesson of the twentieth century is that central planning doesn't work. Yes, some planners can be better than others; if we had to have a Fed chair, Paul Volcker was much better than his predecessors. But to advise journalists to keep their mouths shut so that the "experts" can take care of us is asking for the impossible.

According to economists such as Ludwig von Mises and F. A. Hayek, the boom-bust cycles of market economies are caused by government intervention. Artificially low interest rates provide an illusory period of prosperity by short-circuiting the ability of market interest rates to guide investors and entrepreneurs. In a free market, if people save more, interest rates fall and investment expands. This is how the market coordinates con-

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sumption and production decisions over time. But when interest rates drop *not* because of increased real savings, but only because the Fed bumps up the electronic entries showing how much the banking system holds in "reserves," then the consequent business activity cannot be sustained. Firms will hire more workers and start new projects, but there won't be enough capital goods and resources to accommodate them all. The Fed's easy-money policies can postpone the crisis, but it can't create new drill presses or tractor-trailers. Eventually some of the projects will have to be discontinued, workers will need to be laid off, and equipment and resources will need to be reallocated to more appropriate ends.

This appears to be exactly what happened with the bursting housing bubble and the corresponding crisis in the credit markets. Cowen thinks this is just part of the normal "zigs and zags of daily profit and loss" in a market economy, and he asks, "[W]ill we continue to blame Zeus for lightning strikes?" Yet there is a very strong argument that the policies of former Fed Chairman Alan Greenspan greatly exacerbated, if not caused outright, the unsustainable boom in housing. Trying to jumpstart the economy out of recession from the dot-com crash, Greenspan's Fed cut interest rates from 2001 to 2004. In real terms, the Fed funds rate was pushed to the lowest it had been since the late 1970s. (For a fuller analysis see my article "The Worst Recession in 25 Years?" at http://tinyurl.com/2pa5tq.) The most outrageous stories we're hearing—of people with poor credit and no down payment trying to flip a $500,000 house with an interest-only mortgage—would not have occurred under "tight" monetary policy, let alone in an environment where politics didn't influence interest rates at all.

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So far I've painted the Fed as the culprit, but does that make it the villain? After all, maybe it was all an honest mistake to be chalked up to the imperfect though still "largely technical subject" of monetary policy. Alas, I cannot grant Cowen even this. The "conspiracy theorists" have every reason to be suspicious of the Fed, and of the government-financial complex in general. For example, when President Bush wanted a new secretary of the treasury, he picked Henry Paulson, the CEO of Goldman Sachs, the big investment bank. (He wasn't the first Goldman Sachs officer to hold the post.) Another odd fact is that the Fed stopped publishing the M3 monetary aggregate on March 23, 2006, even though many analysts consider it *the* measure of the money supply. The Fed said the decision was based on cost—what's the marginal cost of collecting M3 data when the Fed already calculates M2?—but it was also at a time when M3 was rising rapidly and the dollar was falling in the currency markets. (The Fed's own charts of M3 can be viewed at http://tinyurl.com/25ky9p.)

Mortgage-Backed Securities

For an example directly relevant to the current discussion, Cowen doesn't mention that when the Fed injected "additional liquidity" into the economy in August, it didn't snatch up Treasury securities, as we teach our macro-econ undergrad students. No, it bought $38 billion of *mortgage-backed securities* (MBS). (The previous record for an open-market-operation purchase of MBS had been $8.6 billion, set in September 2005. For a more detailed discussion, see John Paul Koning's article, "The Fed Bought What?" at http://tinyurl.com/2kshgz. Technically the Fed used repurchase agreements, making the $38 billion infusion only temporary.)

If the point wasn't to rescue big funds from their bad investments, but only to reassure investors in general that they could access credit, why target MBS?

Tyler Cowen thinks the Fed's recent actions are comparable to when the "police clear a road after a traffic accident." But as I've shown, a better analogy would have the police firing their guns into the traffic and causing an accident, then ordering poorer drivers off the road so that any bankers injured in the pile-up could be rushed to the hospital.

The layperson's suspicion of the Fed is entirely justified.