Dismantling the Temple

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This article first appeared in the August 3, 2009 issue of *The Nation*. We thank *The Nation* and *Agence Global* for permission to reprint it here.

The financial crisis has propelled the Federal Reserve into an excruciating political dilemma. The Fed is at the zenith of its influence, using its extraordinary powers to rescue the economy. Yet the extreme irregularity of its behavior is producing a legitimacy crisis for the central bank. The remote technocrats at the Fed who decide money and credit policy for the nation are deliberately opaque and little understood by most Americans. For the first time in generations, they are now threatened with popular rebellion.

During the past year, the Fed has flooded the streets with money–distributing trillions of dollars to banks, financial markets and commercial interests–in an attempt to revive the credit system and get the economy growing again. As a result, the awesome authority of this cloistered institution is visible to many ordinary Americans for the first time. People and politicians are shocked and confused, and also angered, by what they see. They are beginning to ask some hard questions for which Federal Reserve governors do not have satisfactory answers.

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Where did the central bank get all the money it is handing out? Basically, the Fed printed it, out of thin air. That is what central banks do. Who told the Fed governors they could do this? Nobody, really–not Congress or the president. The Federal Reserve Board, alone among government agencies, does not submit its budgets to Congress for authorization and appropriation. It raises its own money, sets its own priorities.

Representative Wright Patman, the Texas populist who was a scourge of central bankers, once described the Federal Reserve as "a pretty queer duck." Congress created the Fed in 1913 with the presumption that it would be "independent" from the rest of government, aloof from regular politics and deliberately shielded from the hot breath of voters or the grasping appetites of private interests–with one powerful exception: the bankers.

The Fed was designed as a unique hybrid in which government would share its powers with the private banking industry. Bankers collaborate closely on Fed policy. Banks are the "shareholders" who ostensibly own the twelve regional Federal Reserve banks. Bankers sit on the boards of directors, proposing interest-rate changes for Fed governors in Washington to decide. Bankers also have a special advisory council that meets privately with governors to critique monetary policy and management of the economy. Sometimes, the Fed pretends to be a private organization. Other times, it admits to being part of the government.

The antiquated quality of this institution is reflected in the map of the Fed's twelve regional banks. Five of them are located in the Midwest (better known today as the industrial Rust Belt). Missouri has two Federal Reserve banks (St. Louis and Kansas City), while the entire West Coast has only one (located in San Francisco, not Los Angeles or Seattle). Virginia has one; Florida does not. Among its functions, the Federal Reserve directly regulates the largest banks, but it also looks out for their well-being–providing regular liquidity loans for those caught short and bailing out endangered banks it deems "too big to fail." Critics look askance at these peculiar arrangements and see "conspiracy." But it's not really secret. This duck was created by an act of Congress. The Fed's favoritism toward bankers is embedded in its DNA.

This awkward reality explains the dilemma facing the Fed. It cannot stand too much visibility, nor can it easily explain or justify its peculiar status. The Federal Reserve is the black hole of our democracy–the crucial contradiction that keeps the people and their representatives from having any voice in these most important public policies. That's why the central bankers have always operated in secrecy, avoiding public controversy and inevitable accusations of special deal-making. The current crisis has blown the central bank's cover. Many in Congress are alarmed, demanding greater transparency. More than 250 House members are seeking an independent audit of Fed accounts. House Speaker Nancy Pelosi observed that the Fed seems to be poaching on Congressional functions–handing out public money without the bother of public decision-making.

"Many of us were...if not surprised, taken aback, when the Fed had $80 billion to invest in AIG just out of the blue," Pelosi said. "All of a sudden, we wake up one morning and AIG was receiving $80 billion from the Fed. So of course we're saying, Where is this money coming from? 'Oh, we have it. And not only that, we have more.'" So who needs Congress? Pelosi sounded guileless, but she knows very well where the Fed gets its money. She was slyly tweaking the central bankers on their vulnerability.

Fed chair Ben Bernanke responded with the usual aloofness. An audit, he insisted, would amount to "a takeover of monetary policy by the Congress." He did not appear to recognize how arrogant that sounded. Congress created the Fed, but it must not look too deeply into the Fed's private business. The mystique intimidates many politicians. The Fed's power depends crucially upon the people not knowing exactly what it does.

Basically, what the central bank is trying to do with its aggressive distribution of trillions is avoid repeating the great mistake the Fed made after the 1929 stock market crash. The central bankers responded hesitantly then and allowed the money supply to collapse, which led to the ultimate catastrophe of full-blown monetary deflation and created the Great Depression. Bernanke has not yet won this struggle against falling prices and production–deflationary symptoms remain visible around the world–but he has not lost either. He might get more public sympathy if Fed officials explained this dilemma in plain English. Instead, they are shielding people from understanding the full dimensions of our predicament.

President Obama inadvertently made the political problem worse for the Fed in June, when he proposed to make the central bank the supercop to guard against "systemic risk" and decide the terms for regulating the largest commercial banks and some heavyweight industrial corporations engaged in finance. The House Financial Services Committee intends to draft the legislation quickly, but many members want to learn more first. Obama's proposal gives the central bank even greater power, including broad power to pick winners and losers in the private economy and behind closed doors. Yet Obama did not propose any changes in the Fed's privileged status. Instead, he asked Fed governors to consider the matter. But perhaps it is the Federal Reserve that needs to be reformed.

A few months back, I ran into a retired Fed official who had been a good source twenty years ago when I was writing my book about the central bank, *Secrets of the Temple: How the Federal Reserve Runs the Country*. He is a Fed loyalist and did not leak damaging secrets. But he helped me understand how the supposedly nonpolitical Fed does its politics, behind the veil of disinterested expertise. When we met recently, he said the central bank is already making preparations to celebrate its approaching centennial. Some of us, I responded, have a different idea for 2013.

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"We think that would be a good time to dismantle the temple," I playfully told my old friend. "Democratize the Fed. Or tear it down. Create something new in its place that's accountable to the public."

The Fed man did not react well to my teasing. He got a stricken look. His voice tightened. Please, he pleaded, do not go down that road. The Fed has made mistakes, he agreed, but the country needs its central bank. His nervous reaction told me this venerable institution is feeling insecure about its future.

Six reasons why granting the Fed even more power is a really bad idea:

1. It would reward failure. Like the largest banks that have been bailed out, the Fed was a co-author of the destruction. During the past twenty-five years, it failed to protect the country against reckless banking and finance adventures. It also failed in its most basic function–moderating the expansion of credit to keep it in balance with economic growth. The Fed instead allowed, even encouraged, the explosion of debt and inflation of financial assets that have now collapsed. The central bank was derelict in enforcing regulations and led cheers for dismantling them. Above all, the Fed did not see this disaster coming, or so it claims. It certainly did nothing to warn people.

2. Cumulatively, Fed policy was a central force in destabilizing the US economy. Its extreme swings in monetary policy, combined with utter disregard for timely regulatory enforcement, steadily shifted economic rewards away from the real economy of production, work and wages and toward the financial realm, where profits and incomes were wildly inflated by false valuations. Abandoning its role as neutral arbitrator, the Fed tilted in favor of capital over labor. The institution was remolded to conform with the right-wing market doctrine of chairman Alan Greenspan, and it was blinded to reality by his ideology (see my *Nation* article "The One-Eyed Chairman," September 19, 2005).

3. The Fed cannot possibly examine "systemic risk" objectively because it helped to create the very structural flaws that led to breakdown. The Fed served as midwife to Citigroup, the failed conglomerate now on government life support. Greenspan unilaterally authorized this new financial/banking combine in the 1990s–even before Congress had repealed the Glass-Steagall Act, which prohibited such mergers. Now the Fed keeps Citigroup alive with a $300 billion loan guarantee. The central bank, in other words, is deeply invested in protecting the banking behemoths that it promoted, if only to cover its own mistakes.

4. The Fed can't be trusted to defend the public in its private deal-making with bank executives. The numerous revelations of collusion have shocked the public, and more scandals are certain if Congress conducts a thorough investigation. When Treasury Secretary Timothy Geithner was president of the New York Fed, he supervised the demise of Bear Stearns with a sweet deal for JPMorgan Chase, which took over the failed brokerage–$30 billion to cover any losses. Geithner was negotiating with Morgan Chase CEO and New York Fed board member Jamie Dimon. Goldman Sachs CEO Lloyd Blankfein got similar solicitude when the Fed bailed out insurance giant AIG, a Goldman counterparty: a side-door payout of $13 billion. The new president at the New York Fed, William Dudley, is another Goldman man.

5. Instead of disowning the notorious policy of "too big to fail," the Fed will be bound to embrace the doctrine more explicitly as "systemic risk" regulator. A new superclass of forty or fifty financial giants will emerge as the born-again "money trust" that citizens railed against 100 years ago. But this time, it will be armed with a permanent line of credit from Washington. The Fed, having restored and consolidated the battered Wall Street club, will doubtless also shield a few of the largest industrial-financial corporations, like General Electric (whose CEO also sits on the New York Fed board). Whatever officials may claim, financial-market investors will understand that these mammoth institutions are insured against failure. Everyone else gets to experience capitalism in the raw.

6. This road leads to the corporate state–a fusion of private and public power, a privileged club that dominates everything else from the top down. This will likely foster even greater concentration of financial power, since any large company left out of the protected class will want to join by growing larger and acquiring the banking elements needed to qualify. Most enterprises in banking and commerce will compete with the big boys at greater disadvantage, vulnerable to predatory power plays the Fed has implicitly blessed.

Whatever good intentions the central bank enunciates, it will be deeply conflicted in its actions, always pulled in opposite directions. If the Fed tries to curb the growth of the megabanks or prohibit their reckless practices, it will be accused of damaging profitability and thus threatening the stability of the system. If it allows overconfident bankers to wander again into dangerous territory, it will be blamed for creating the mess and stuck with cleaning it up. Obama's reform might prevail in the short run. The biggest banks, after all, will be lobbying alongside him in favor of the Fed, and Congress may not have the backbone to resist. The Fed, however, is sure to remain in the cross hairs. Too many different interests will be damaged–thousands of smaller banks, all the companies left out of the club, organized labor, consumers and other sectors, not to mention libertarian conservatives like Texas Representative Ron Paul. They will recognize that the "money trust" once again has its boot on their neck, and that this time the government arranged it.

The obstacles to democratizing the Fed are obviously formidable. Tampering with the temple is politically taboo. But this crisis has demonstrated that the present arrangement no longer works for the public interest. The society of 1913 no longer exists, nor does the New Deal economic order that carried us to twentieth-century prosperity. The country thus has a rare opportunity to reconstitute the Federal Reserve as a normal government agency, shorn of the bankers' preferential trappings and the fallacious claim to "independent" status as well as the claustrophobic demand for secrecy.

Progressives in the early twentieth century, drawn from the growing ranks of managerial professionals, believed "good government" required technocratic experts who would be shielded from the unruly populace and especially from radical voices of organized labor, populism, socialism and other upstart movements. The pretensions of "scientific" decision-making by remote governing elites–both the mysterious wisdom of central bankers and the inventive wizardry of financial titans–failed spectacularly in our current catastrophe. The Fed was never independent in any real sense. Its power depended on taking care of its one true constituency in banking and finance.

A reconstituted central bank might keep the famous name and presidentially appointed governors, confirmed by Congress, but it would forfeit the mystique and submit to the usual standards of transparency and public scrutiny. The institution would be directed to concentrate on the Fed's one great purpose–making monetary policy and controlling credit expansion to produce balanced economic growth and stable money. Most regulatory functions would be located elsewhere, in a new enforcement agency that would oversee regulated commercial banks as well as the "shadow banking" of hedge funds, private equity firms and others.

The Fed would thus be relieved of its conflicted objectives. Bank examiners would be free of the insider pressures that inevitably emanate from the Fed's cozy relations with major banks. All of the private-public ambiguities concocted in 1913 would be swept away, including bank ownership of the twelve Federal Reserve banks, which could be reorganized as branch offices with a focus on regional economies.

Altering the central bank would also give Congress an opening to reclaim its primacy in this most important matter. That sounds far-fetched to modern sensibilities, and traditionalists will scream that it is a recipe for inflationary disaster. But this is what the Constitution prescribes: "The Congress shall have the power to coin money [and] regulate the value thereof." It does not grant the president or the treasury secretary this power. Nor does it envision a secretive central bank that interacts murkily with the executive branch.

Given Congress's weakened condition and its weak grasp of the complexities of monetary policy, these changes cannot take place overnight. But the gradual realignment of power can start with Congress and an internal reorganization aimed at building its expertise and educating members on how to develop a critical perspective. Congress has already created models for how to do this. The Congressional Budget Office is a respected authority on fiscal policy, reliably nonpartisan. Congress needs to create something similar for monetary policy.

Instead of consigning monetary policy to backwater subcommittees, each chamber should create a major new committee to supervise money and credit, limited in size to members willing to concentrate on becoming responsible stewards for the long run. The monetary committees, working in tandem with the Fed's board of governors, would occasionally recommend (and sometimes command) new policy directions at the federal agency and also review its spending.

Setting monetary policy is a very different process from enacting laws. The Fed operates through a continuum of decisions and rolling adjustments spread over months, even years. Congress would have to learn how to respond to deeper economic conditions that may not become clear until after the next election. The education could help the institution mature.

Congress also needs a "council of public elders"–a rotating board of outside advisers drawn from diverse interests and empowered to speak their minds in public. They could second-guess the makers of monetary policy but also Congress. These might include retired pols, labor leaders, academics and state governors–preferably people whose thinking is no longer defined by party politics or personal ambitions. The public could nominate representatives too. No financial wizards need apply.

A revived Congress armed with this kind of experience would be better equipped to enact substantive law rather than simply turning problems over to regulatory agencies with hollow laws that are merely hortatory suggestions. Reordering the financial system and the economy will require hard rules–classic laws of "Thou shalt" and "Thou shalt not" that command different behavior from certain private interests and prohibit what has proved reckless and destructive. If "too big to fail" is the problem, don't leave it to private negotiations between banks and the Federal Reserve. Restore anti-monopoly laws and make big banks get smaller. If the financial system's risky innovations are too complicated for bank examiners to understand, then those innovations should probably be illegal.

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Many in Congress will be afraid to take on the temple and reluctant to violate the taboo surrounding the Fed. It will probably require popular rebellion to make this happen, and that requires citizens who see through the temple's secrets. But the present crisis has not only exposed the Fed's worst failures and structural flaws; it has also introduced citizens to the vast potential of monetary policy to serve the common good. If Ben Bernanke can create trillions of dollars at will and spread them around the financial system, could government do the same thing to finance important public projects the people want and need? Daring as it sounds, the answer is, Yes, we can.

The central bank's most mysterious power–to create money with a few computer keystrokes–is dauntingly complicated, and the mechanics are not widely understood. But the essential thing to understand is that this power relies on democratic consent–the people's trust, their willingness to accept the currency and use it in exchange. This is not entirely voluntary, since the government also requires people to pay their taxes in dollars, not euros or yen. But citizens conferred the power on government through their elected representatives. Newly created money is often called the "pure credit" of the nation. In principle, it exists for the benefit of all.

In this emergency, Bernanke essentially used the Fed's money-creation power in a way that resembles the "greenbacks" Abraham Lincoln printed to fight the Civil War. Lincoln was faced with rising costs and shrinking revenues (because the Confederate states had left the Union). The president authorized issuance of a novel national currency–the "greenback"–that had no backing in gold reserves and therefore outraged orthodox thinking. But the greenbacks worked. The expanded money supply helped pay for war mobilization and kept the economy booming. In a sense, Lincoln won the war by relying on the "full faith and credit" of the people, much as Bernanke is printing money freely to fight off financial collapse and deflation.

If Congress chooses to take charge of its constitutional duty, it could similarly use greenback currency created by the Federal Reserve as a legitimate channel for financing important public projects–like sorely needed improvements to the nation's infrastructure. Obviously, this has to be done carefully and responsibly, limited to normal expansion of the money supply and used only for projects that truly benefit the entire nation (lest it lead to inflation). But here is an example of how it would work.

President Obama has announced the goal of building a high-speed rail system. Ours is the only advanced industrial society that doesn't have one (ride the modern trains in France or Japan to see what our society is missing). Trouble is, Obama has only budgeted a pittance ($8 billion) for this project. Spain, by comparison, has committed more than $100 billion to its fifteen-year railroad-building project. Given the vast shortcomings in US infrastructure, the country will never catch up with the backlog through the regular financing of taxing and borrowing.

Instead, Congress should create a stand-alone development fund for long-term capital investment projects (this would require the long-sought reform of the federal budget, which makes no distinction between current operating spending and long-term investment). The Fed would continue to create money only as needed by the economy; but instead of injecting this money into the banking system, a portion of it would go directly to the capital investment fund, earmarked by Congress for specific projects of great urgency. The idea of direct financing for infrastructure has been proposed periodically for many years by groups from right and left. Transportation Secretary Ray LaHood co-sponsored legislation along these lines a decade ago when he was a Republican Congressman from Illinois.

This approach speaks to the contradiction House Speaker Pelosi pointed out when she asked why the Fed has limitless money to spend however it sees fit. Instead of borrowing the money to pay for the new rail system, the government financing would draw on the public's money-creation process–just as Lincoln did and Bernanke is now doing.

The bankers would howl, for good reason. They profit enormously from the present system and share in the money-creation process. When the Fed injects more reserves into the banking system, it automatically multiplies the banks' capacity to create money by increasing their lending (and banks, in turn, collect interest on their new loans). The direct-financing approach would not halt the banking industry's role in allocating new credit, since the newly created money would still wind up in the banks as deposits. But the government would now decide how to allocate new credit to preferred public projects rather than let private banks make all the decisions for us.

The reform of monetary policy, in other words, has promising possibilities for revitalizing democracy. Congress is a human institution and therefore fallible. Mistakes will be made, for sure. But we might ask ourselves, If Congress were empowered to manage monetary policy, could it do any worse than those experts who brought us to ruin?

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