Levy Economics Institute of Bard College

Policy Note

2013 / 8

"UNUSUAL AND EXIGENT": HOW THE FED CAN JUMP-START THE REAL ECONOMY

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Introduction

Though it is not widely understood, the Federal Reserve has enormous untapped power to directly stimulate or influence the flows of lending and spending that generate jobs. Doing so would fulfill the Fed's often neglected "dual mandate": to strive for maximum employment as well as stable money. Fed technocrats often plead that legal or technical barriers won't allow them to do this, but their objections reflect an institutional bias that favors finance over industry, capital over labor. The central bank, as I will explain, has abundant precedent from its own history for taking more direct actions to aid the economy. And it has ample legal authority to lend to all kinds of businesses that are not banks.

The main obstacle standing in Bernanke's way is political: the fiercely one-sided politics dominated by conservative Republicans and their patrons in banking. Together, they have cornered the chairman. Discussion of monetary policy is always limited to a rather small circle of influential policy experts and financial interests. Most citizens are clueless and easily ignored by unaccountable decision makers; so are most elected politicians. If Bernanke proposes controversial measures, he might be standing nearly alone. What's missing from Fed politics is the left: the countervailing voices of progressives, liberals and labor, who could make the case for more drastic action by the Fed.

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My intention for this policy note is to provoke a wider argument. I want progressives to intrude on the privileged circle that talks to the august Federal Reserve and help citizens join the conversation. So long as the insulated central bank maintains its privileged structure—unaccountable to voters but intimately connected to the bankers it regulates—the people are bound to be left out in the cold.

Direct Intervention for the Real Economy

It's true that a small chorus of liberal economists, notably led by Paul Krugman in *The New York Times*, have criticized the Fed for not moving faster, but their policy prescriptions are mostly tame and within the accepted boundaries of polite discussion. Democrats, with few exceptions, seem to have lost their appetite for provocative ideas, while Republicans are zestfully pushing their crackpot nostrums.

But what else can the Fed chair do? Actually, quite a lot. Instead of pumping more money into the banking system, where much of it feeds speculation, the chairman should figure out how to get it to the sectors of commerce and industry that really need it.

The Fed, for instance, could use its regulatory muscle to unfreeze the risk-averse bankers who are still unwilling to lend—the same bankers whose reckless risk taking nearly brought down the entire system five years ago. The Fed could create special facilities for directed lending (just as it did for the imperiled banking system) that gets the banks to relax lending terms for credit-starved sectors like small business. If bankers refuse to play, it could offer the same deal to financial institutions that are not banks. The Fed could collaborate on delivering debt reduction for millions of underwater home mortgages and the $1 trillion overhang of student debt (see Greider 2013). It could help organize and finance major infrastructure projects, like modernizing the national electrical grid, building high-speed rail systems, and cleaning up after natural disasters—public works that create jobs the old-fashioned way. The Fed could influence the investment decisions of private capital by backstopping public-private bonds needed to finance the long-neglected overhaul of the nation's common assets.

These are plausible examples of what the central bank might do if it truly tried to fulfill its dual mandate. Orthodox monetary economists will be horrified by such talk: these alternatives, they will say, are technically impossible, maybe even illegal. A few of the suggestions would probably require clarifying legislation and congressional cooperation. But the Fed can carry out direct interventions to help the economy recover, because it has done so before.

Unusual and Exigent Circumstances

During the Great Depression, the Federal Reserve was given open-ended legal authority to lend to practically anyone if its Board of Governors declared an economic emergency. This remains the law today. The central bank can lend to industrial corporations and small businesses, including partnerships, individuals, and other entities that are not commercial banks or even financial firms. The Fed made thousands of direct loans to private businesses during the New Deal, and the practice continued for 20 years. Only in more recent times has the reigning conservative doctrine insisted that this cannot be done.

The original authorizing legislation for such lending was enacted in 1932 as section 13(3) of the Federal Reserve Act, and the wording was left deliberately vague. An emergency was defined as "unusual and exigent circumstances." Whatever did that mean? In practice, it meant whatever the Board of Governors decided it meant. Fed governors must now get approval from the Treasury secretary, but they do not have to ask Congress for permission.

Section 13(3) is often depicted as antique legislation left over from the New Deal, but the provision is very much alive and active. It was invoked repeatedly at the height of the recent crisis, when the Bernanke Fed intervened massively to rescue the financial system, directing aid to corporations, individual investors, and other nonbank businesses. When Bear Stearns collapsed in the spring of 2008, the Fed declared "unusual and exigent circumstances" to legitimize its rescue of the failed brokerage, with the New York Fed lending $29 billion to grease the JPMorgan Chase takeover of Bear Stearns. The Fed was rescuing a failed brokerage house, not a bank (and when Lehman Brothers went belly-up a few months later, investors there were outraged that the investment house didn't get the same treatment).

In the fall of 2008, as Wall Street's crisis accelerated, section 13(3) was again invoked to justify a far more controversial intervention: the $180 billion bailout of American International Group. AIG is not a bank but a giant insurance company, and it was obviously insolvent. Normally, a failed corporation would proceed to bankruptcy court, where its creditors would fight over what was left. In this case, the Fed stepped in to save AIG because among its leading creditors facing huge losses were the nation's largest financial institutions: Goldman Sachs, Citigroup, JPMorgan Chase, and others. The Fed used its section 13(3) authority many more times during the crisis, creating liquidity loans and guarantees to protect investors across broad markets—mutual funds, commercial paper, primary dealers, securities lending, and others.

The AIG bailout left a very bad odor with Congress, which later tightened the terms of section 13(3) modestly in order to prevent another such rescue. The Fed can still lend to "individuals, partnerships, and corporations" if they are "unable to secure adequate credit accommodations from other banking institutions." But it can no longer create a special lending facility to protect a single insolvent company. Whether or not these interventions were justified, the point here is that the central bank was willing to save certain corporate enterprises when it believed the consequences of their failure would threaten the largest banking institutions. Yet the Fed declined to do something similar for the overall economy and help millions of indebted homeowners and unemployed workers.

The Federal Reserve had no such inhibitions during the Depression. It became an active lender to nonbank businesses, even to very small mom-and-pop enterprises. Additional New Deal legislation expanded the Fed's role, authorizing direct industrial loans; it was expected to become the government's lead agency. "The entire Federal Reserve System has almost $280,000,000 to lend for working capital, constituting virtually a revolving fund of that amount for the use of industrial and commercial units," a Federal Reserve Bank of Minneapolis (1934) pamphlet boasted during the Depression..

The Fed did make a lot of loans, but it was swiftly eclipsed by the Reconstruction Finance Corporation, a more aggressive and effective New Deal agency that supervised corporate workouts, much like the Obama administration's rescue of the auto industry. The Fed's industrial lending was eventually halted in the 1950s, but the practice appeared again in 1970, when the Nixon administration urged the Fed to intervene on behalf of the debt-ridden Penn Central Railroad. The administration and the central bank worried that the collapse of this industrial corporation would spark a financial crisis. So the Fed assured bankers it would back them up. Some critics say the Penn Central rescue was an early harbinger of the "too big to fail" phenomenon.

Redirecting the Power of Money Creation

Bernanke should draw upon the Fed's New Deal experiences to demonstrate what is possible now and what to avoid. Of course, our current troubles are not nearly as bad as the horrendous unwinding that occurred from 1929 to 1933. But this crisis is not over, as Bernanke knows. He is anxious to avoid a bloody repeat of the full catastrophe. But the central bank has a blind spot. It knows a lot about macroeconomics and the daunting complexities of finance, but not so much about the everyday business savvy needed to succeed in the real economy.

The Federal Reserve's most distinctive asset is money—its awesome and somewhat mysterious power to create money and inject it into the economy by buying financial assets of one kind or another. If that power is abused, it can destabilize society. In an economic crisis, however, the money-creation power can be harnessed to public purposes and used to restore order and justice. That is essentially what Bernanke's Fed attempted during the recent crisis when it created those surplus trillions for banking. The fact that the strategy did not entirely succeed suggests that maybe this power should be applied in a different direction.

Fed money is not exactly "free," but it has this great virtue for government: it doesn't cost the taxpayers anything. Fed expenditures do not show up in the federal budget, nor do they add anything to the national debt. In a sense, this freshly created money belongs to the people—all of us—and can be used in unusual ways to advance the shared public interest. Lincoln did this when he printed "greenbacks" during the Civil War. Various Fed governors have done it when they were faced with "unusual and exigent circumstances." There are worthy opportunities awaiting the Fed's attention.

Jane D'Arista, author of *The Evolution of U.S. Finance* and a leading reform advocate, insists that the central bank has numerous levers to drive reluctant bankers to support a vigorous recovery with more plentiful lending. "The Federal Reserve as an instrument of credit policy is weak, and right now we need it to be strong," she said.

The Fed could alter reserve requirements to punish bankers or reward them. It could stop paying interest on the enormous idle reserves banks are now sitting on and start charging a penalty rate for banks that won't use their lending capacity. The Fed can steer banks to neglected categories of lending—small businesses, for instance—by lowering the reserve requirement on those loans. Above all, D'Arista believes, the Fed can simultaneously begin to reform the banking system from the bottom up.

"Let's forget the big guys," she said. "They're hopeless. We're not going to get anywhere with them. However, the community bank is an engine of growth, and here is a way to help them. Community banks are naturally skittish. They need real reassurance for the kind of lending that isn't corporate scale. This could also involve them in infrastructure projects initiated by state and local governments. That's where the Fed's discount window could come in and help. It is a way of backstopping the little community bank and the medium-sized bank." She envisions consortiums of small banks participating in big projects. The Fed could help organize them.

Stephen Sleigh, a labor economist and director of the national pension fund for the International Association of Machinists and Aerospace Workers union, has similar ideas about how the Fed can persuade private capital investment to finance major infrastructure projects. "Part of Bernanke's strategy of pushing down interest rates, both short-term and long-term, is to force conservative money into investments like construction," Sleigh observed. "That makes perfect sense, but the capital is not flowing. It's still on the sidelines. I would love to see the Fed start talking about infrastructure. The Fed needs to be working on new tools and find ways to get the conservative money off the sidelines and start rebuilding the American economy."

Conservative investors like pension funds and insurance companies lost an important source of income when the Fed lowered interest rates drastically. Sleigh explained: "As a pension fund manager, I need investments that are going to provide reliable, steady income that can sustain our long-term assumptions. Traditionally, the 10-year Treasury bond was a way to pay the bills, but it doesn't do that anymore, because it is trading now at less than 2 percent."

A solution Sleigh envisions would involve bond borrowing for public-private infrastructure projects that would be "labor-intensive and great for long-term economic growth and would absolutely help us meet our obligations, because these bonds are going to yield 6 to 8 percent on our investments." The Federal Reserve's blessing and its willingness to accept the infrastructure bonds as collateral on the Fed's lending could be a powerful lure for capital investors—including China, which owns a mountain of low-yielding US Treasuries. "Wouldn't that be an amazing story," Sleigh said, "if the Chinese, instead of holding Treasury notes, invested $100 billion in building high-speed rail in the United States?"

Conclusion

These ideas sound farfetched to the usual experts who dominate monetary politics. But stay tuned. As Bernanke surely understands, the economic crisis is not over. We are still at risk of things turning worse. If that occurs, these and other proposals for action will become highly relevant.

Bernanke's term as chairman expires in January 2014. If the economy subsequently spins out of control, he will be the scapegoat. Something similar occurred between 1929 and 1933, when the Federal Reserve suffered a historic disgrace. After the market crash, some Fed governors saw the peril and pushed for stronger action. But conservative bankers prevailed. They let nature take its course.

We are threatened by a similar tragedy. To avert that possibility, citizens need to force their way into the conversation. Reforming the Federal Reserve and the financial system is a long-term challenge. It cannot begin until the people find their voice and we, as citizens, reclaim our right to be heard.

Read the full text of William Greider's original article in The Nation *here.*

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