The Fed in Denial

By Simon Johnson *Thu, Jul 24, 2014*

The largest US banks are still 95% debt-financed, according to the Global Capital Index. With that much leverage, it does not take a lot to create fear of insolvency, writes this leading blogger.

The United States Federal Reserve System is one of the most powerful governmental organizations in the history of the world. America's central bank has control over the supply of dollars, and currently exerts great influence over interest rates, both for short-term and long-term borrowing.

And, though the Fed was partly responsible for the regulatory failures that led to the global economy's near-meltdown in 2008-2009, post-crisis reform has left it with even greater authority and more responsibility for overseeing the financial system.

That is a worrying outcome, because senior Fed officials seem to have slipped back into their pre-2008 ways, ignoring concerns about dangerous financial-sector behavior—even when those concerns are expressed by members of the US Senate Banking Committee. This is not only unfortunate; it is also dangerous, because the Fed's political position is much more precarious than its leadership seems to realize.

In many countries, people on the right of the political spectrum provide a bastion of support for the central bank. In northern Europe, for example, the European Central Bank's independence is seen as essential for price stability—and politicians on the right typically attach a higher priority to this goal.

The situation is quite different in the US. Here, the right, represented by the Republican Party, has long been suspicious of the Fed, reflecting its opposition to a powerful federal government, as well as nostalgia for the days of the gold standard (particularly the version that operated before the Fed was created in 1913). The Fed as it currently operates is being protected by the left (the Democratic Party).

For example, I recently testified at a hearing of the House Financial Services Committee on Republican-proposed legislation that would impose on the Fed greater limitations on both monetary policy and regulation. House Democrats oppose the bill and invited me to the hearing, where I explained that the proposed constraints would, in my view, greatly hamper the Fed's effectiveness—including its ability to help the economy return to full employment and to prevent the financial system from spinning out of control again.

Under current circumstances, the Democrats are strong enough—with control of the Senate and of the presidency—to fend off these assaults. Consequently, senior Fed and White House officials seem rather confident that nothing dramatic will happen that would undermine the Fed's independence.

I would not be so sure. The main problem is that the Fed has not moved with alacrity to implement fully key provisions of the Dodd-Frank financial reforms, which were passed in 2010.

For example, the Dodd-Frank legislation specifies that all large financial institutions should draw up meaningful "living wills"—specifying how they could be allowed to fail, unencumbered by any kind of bailout, if they again became insolvent.

Creating such living wills is not an option; it is a requirement of the law. Yet, in a recent speech that reviewed the landscape of financial reform, Fed Vice Chairman Stanley Fischer skipped over the requirement almost completely.

Fischer appears to prefer to rely on the resolution powers of the Federal Deposit Insurance Corporation, which is empowered to takeover failing financial institutions, with the expectation that it will impose losses on creditors in such a way that will not cause global panic. (I am on the FDIC's systemic resolution advisory committee, but I am not responsible for the agency's plans or potential actions.)

Unfortunately, as currently constructed, these resolution powers are unlikely to work. They do not apply across borders, there is not enough loss-absorbing capital in large complex financial institutions, and the funding structure of big bank holding companies remains precarious.

Senior Fed officials emphasize that big banks fund themselves with more equity now than they did in the past. But the Global Capital Index constructed by Thomas Hoenig, the FDIC's vice chairman, indicates that the largest US banks are still 95% debt-financed. With that much leverage, it does not take a lot to create fear of insolvency.

Yet, despite repeated and responsible expressions of concern—including from Senate Democrats—the Fed continues to ignore these profound problems. If anything, in his most recent speech, Fischer seemed to brush aside any such fears – assuring his audience that there is great social value in continuing to have extremely large financial firms that operate with so very little equity capital (and therefore a great deal of leverage).

This is more than disappointing. It is profoundly dangerous to the economy. And it imperils the Fed's future ability to take action as needed.

In recent interviews, including with *The New Yorker*, Fed Chair Janet Yellen has indicated at least general concerns about financial-sector behavior and the vulnerability of big banks. But unless the Fed acts on such concerns—including by implementing the requirement that large financial institutions adopt meaningful living wills—its independence will come under even greater pressure.

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