CHAPTER 12

Prosecuting the Guilty, Revealing Crisis Lending, and Endangering Fed Independence

"Is there any point to which you would wish to draw my attention?"
"To the curious incident of the dog in the night-time."
"The dog did nothing in the night-time."
"That was the curious incident," remarked Sherlock Holmes.

The absence of criminal charges after the financial crisis naturally brought to mind the lack of a dog's nocturnal barking, which Holmes noted in that interchange with Dr. Watson in "Silver Blaze" by Sir Arthur Conan Doyle.[1] This chapter initially examines that subject in some detail.

Explaining the Lack of Criminal Prosecutions after the Financial Meltdown

Bank profits came under threat in 2011 especially. Even before suffering a rash of investor lawsuits, Bank of America's capital had been under downward pressure because of increasingly delinquent real-estate loans acquired in an ill-fated merger with Countrywide Financial. In what I mistakenly thought at the time was the apex of chutzpa, that bank was accused of fraud over losses on mortgage bonds by none other than American International Group Inc. (AIG), the previous private seller of numerous suspect collateralized debt obligations but by then majority-owned by the Treasury. Yet in September 2011 in an even greater degree of audacity, the Federal Housing Finance Agency (FHFA), the conservator of Fannie Mae and Freddie Mac, brought on behalf of its two wards a civil suit against 17 domestic and foreign banks, including Bank of America. It accused them of intentionally selling mortgages of allegedly poor quality to the naïve government-sponsored agencies—that of course were actually sophisticated buyers fully capable of conducting due diligence themselves, though typically they didn't do so, instead relying only on the sellers'

D. E. Lindsey, A Century of Monetary Policy at the Fed
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word—in the lead-up to the financial crisis. It demanded that the banks buy back many of the ones that eventually became worthless.[2]

The suits occurred even though it was the ever-rising HUD requirements setting affordable-housing goals for the GSEs, in order to effectuate an unwise but bi-partisan policy of excessively augmenting homeownership, that forced Fannie and Freddie to acquire in some form or guarantee more and more subprime-style mortgage loans of increasingly doubtful credit quality. It was just such GSE activity—by helping to provide an assured demand for the rotten residential housing loans—that partly though significantly accounted for the lowering of standards in the shadow banking sector, in turn encouraging those questionable loans in the first place. These civil lawsuits piled on top of others brought against the bank sellers of housing-related instruments by roughly a dozen other investors and federal government agencies that decided to try to recoup the losses resulting from plummeting prices on their voluntary investments in mortgage-related securities. (So much for the propriety of what Harvard philosopher Robert Nozick called "capitalist acts between consenting adults.")

A slap in the face of prosecutors on November 28, 2011, was the rejection by the aforementioned US District Court Judge Jed S. Rakoff of the SEC's proposed $285 million settlement of civil charges with Citigroup:

> In his ruling the New York judge denounced as "pocket change" a penalty agreed to by Citigroup as part of the settlement, claiming it was paltry compared with losses of more than $700 million in a $1 billion deal called Class V Funding III.
>
> Judge Rakoff also attacked the boilerplate language used in many SEC settlements, where defendants neither admit nor deny wrongdoing . . .
>
> The vast majority of enforcement actions filled by the SEC are resolved before coming to trial. In the past year, the SEC went to trial in 19 cases, while filing a record-high 735 enforcement actions.[3]

Although the ruling was right, the reasoning can be questioned. To be sure, emails at the time from some staff at Citigroup demonstrated both a derogatory opinion of the mortgage-backed securities and doubts about whether the bank should be pushing them with customers.[4] But most of Citigroup's clients in this area were not naïve rubes open to deceitful advice that soon would part them from their money. Rather they were "big boys"—sophisticated investors—who simply were hiring the investment bank for its market-making services and couldn't care less about who constructed the contractual arrangements or the bank's own internal outlook for such investments. Now, I'm not suggesting that caveat emptor (let the buyer beware) should apply to "little people" like you or me. But it's a different story for them. In any event most of the big commercial banks retained as investments on their books a lot of those ill-starred and insufficiently hedged securities—perhaps demonstrating stupidity but not evil intent toward customers. The judge's conclusion was correct because no regulator should deprive a person or corporation of property without either admission of guilt or due process of law.

Even so, in a development fraught with ominous portents, the administration established the Residential Mortgage-Backed Securities Working Group in January 2012 to investigate misconduct involving the "pooling and sale of risky mortgages in the run-up to the 2008 financial crisis."[5] A relevant government website describes this initiative as:

> a collaborative effort by the Securities and Exchange Commission, the Department of Justice (including many United States Attorneys' Offices), the New York State Attorney General's Office, and others to investigate RMBS misconduct. The Group is looking for evidence of false or misleading statements, deception, or other misconduct by market participants (such as loan originators, sponsors, underwriters, trustees, and others) in the creation, packaging, and sale of mortgage-backed securities.[6]

In addition, 49 state attorneys general after year-long negotiations arranged in February 2012 a $25 billion civil settlement with five banks who admitted no culpability for what the *Washington Post* called the "notorious 'robo-signing'" of documents for loan modifications and foreclosures.[7] But the newspaper editorialized in the same issue that "no one has produced evidence that large numbers of homeowners who were current on their mortgages were cast out of their homes because of bank misconduct. This looks like a case of spectacular wrongdoing with hardly any victims."[8] The banks had resisted initial government proposals that they absorb the hit for write-downs of loans held by investors for which the banks just collected payments. They argued that it amounted to transfers of wealth to the GSEs and the investors in RMBS.

> The mix of remedies in the settlement highlights the central tension behind the discussions: Should the deal be structured primarily to punish banks, or should it use allegations of wrongdoing to pressure banks to provide relief that would keep more borrowers in their homes?[9]

In light of the various legal assaults on banks, Jamie Dimon astutely concluded that the repercussions would be widespread, in that "it could be 'three to 10 years' before the industry emerged from lawsuits brought by investors looking for compensation for the losses incurred on structured products underpinned by bad mortgages."[10] Here's an estimate as of August 2013 of recent legal expenses for JPMorgan Chase alone:

$1.8 billion (2012–2013): two settlements related to mortgage-foreclosure settlements;
$410 million (2013): settlement of allegations of energy market manipulation;
$296.9 million (2012): settlement of claims concerning mortgage-backed securities;
$228 million (2011): settlement of allegations the bank manipulated bidding process for municipal securities.[11]

In September the bank reached a $920 billion agreement with three US agencies and one UK agency for civil negligence related to the London Whale episode and made another $300 million refund to credit-card customers combined with $80 million in fines. In the next month Dimon entered negotiations with Attorney General Eric Holder on behalf of four federal agencies and five state attorneys general to settle alleged civil misdeeds related to pre-crisis sales of RMBS mainly by Bear Stearns and WaMu. Recall that in 2008 JPMorgan had acceded to Treasury's requests for it to acquire these errant entities in an attempt to resist the spread of contagion. But the recent persecution of the bank didn't show much gratitude, as the government's attitude had turned vindictive, apparently in response to criticism on the left of the supposedly deceitful behavior of big banks in selling RMBS. The Department of

Justice countered a $3 billion offer from JPMorgan with a proposed total fee of $13 billion. The terms would not halt the ongoing federal criminal investigation centered in Sacramento, California, of mortgage-related activity by the firm or individual employees. The new effort had to rely on the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), which "lets the government sue people or groups, rather than charge them with a crime, for fraud that affects a federally insured financial institution."[12] The act contained not only a lower hurdle for proof and a broad subpoena power but also a ten-year statute of limitations.

It's hard to find fault with this editorial in the *Washington Post*:

> The problem is that our legal system is supposed to hold people accountable for specific violations of specific rules. That's not what happened to JPMorgan. The government's case rests not only on a sweeping assertion that the bank deliberately hoodwinked mortgage experts at Fannie Mae and Freddie Mac but also on a novel interpretation of a previously obscure 1989 law that enabled Justice to sue after the usual five-year statute of limitations had passed . . .
>
> This is what happens when the government comes under populist pressure to nail Wall Street hides to the wall. The populist narrative casts the crisis as a crime consciously perpetrated by greedy financiers on an unsuspecting public. This version of events does not allow for the possibility that everyone, from Wall Street to Main Street to Washington, acted on widely held economic beliefs that turned out not to be true—the most important of which was that house prices would never come down and could therefore offset the risk of default on home mortgages. The remedy for bubbles and panics, if any, lies in systemic reform, an objective that the case against JPMorgan and other big banks hardly advances at all.[13]

The Federal Housing Finance Agency was too impatient to wait for the resolution of these broader negotiations, in which the bank refused to admit to wrongdoing. The agency foreswore any bank mea culpa by accepting on October 25 JPMorgan's offer to compensate the GSEs for a fraction of the pre-crisis sales both of private-label RMBS and mortgages that the GSEs then packaged into RMBS. One editorial board wasn't pleased:

> The government assault on J.P. Morgan Chase is an injustice for many reasons, but the case has now reached tragicomic heights with the bank's agreement on Friday to pay $5.1 billion for supposedly conning Fannie Mae and Fannie Mae. So the government-favored mortgage giants that did as much as anyone to foment the housing bubble and bust are now presented as victims.
>
> The premise of the allegations settled on Friday is that while it may appear that Fan and Fred were recklessly gambling on the housing market for years before the crisis, they were duped by Morgan and other banks into buying risky mortgage-backed securities that they did not understand. This is the Little Orphan Fannie defense.
>
> Even the partisan Financial Crisis Inquiry Commission, created by the 2009 Pelosi Congress and chaired by a former state Democratic Party chairman, didn't try to sell that line.[14]

That settlement brought to $8 billion the amount that the bank has tapped of the $28 billion that it had reserved since 2010 to cover legal expenses.[15] Shortly after mid-November, the bank finally put the civil charges behind it by reaching a $13

billion overall out-of-court settlement with the Justice Department. The bank conceded no wrongdoing let alone illegality in constructing and selling mortgage-backed securities before the meltdown, though it acknowledged a "statement of facts" that described the loans as risky and not always complying with the bank's own guidelines. The proceeds of the fine were to be distributed widely. The authorities considered the agreement a template for other large US banks, the top five of which at that point already had shelled out some $85 billion in legal expenses since the crisis.

Late in the year, JPMorgan Chase expended another $2.6 billion in civil charges to cover its involvement in the Bernie Madoff affair. (Don't ask if the far guiltier SEC faced any fines.) In 2013 alone, the bank agreed to pay more than $22 billion to resolve governmental probes and civil suits, of which it actually paid out about half in that year.

As for criminal prosecutions, Andrew Ross Sorkin presented the conventional view of the lack of criminal charges after the meltdown before recounting Attorney General Eric Holder's second theory for letting large financial organizations, as opposed to individuals, off the hook.

> In the aftermath of the financial crisis, the prevailing view is that nobody on Wall Street was held accountable for the damage caused to the economy and millions of Americans. But the fact that prosecutors have not claimed a big-time scalp in the financial crisis obscures the issue of prosecuting companies themselves and the complications such prosecutions raise.[16]

Holder's second explanation involving prosecutorial worries about knock-on effects occurred in testimony before the Senate Judiciary Committee in March 2013.

> "I am concerned that the size of some of these institutions becomes so large that it does become difficult for us to prosecute them," Mr. Holder told lawmakers. Prosecutors, he said, must confront the problem that "if you do prosecute, if you do bring a criminal charge, it will have a negative impact on the national economy, perhaps even the world economy. And I think that is a function of the fact that some of these institutions have become too large."
>
> Mr. Holder continued, acknowledging that the size of banks "has an inhibiting influence." He said that it affects "our ability to bring resolutions that I think would be more appropriate."[17]

Now consider a third view to explain the lack of criminal prosecutions. It is this view that is the one being offered as valid in this part of the chapter. In November 2009 government prosecutors lost the first criminal case brought in response to the financial crisis, as a jury acquitted two Bear Stearns hedge fund managers of the charge of lying to investors. The prior granting of dodgy mortgage credit in some instances involved criminal fraud. Neil Barofsky, the special inspector general in charge of oversight of TARP, provided ample documentation.[18] But subsequent cases of criminality during the collapse are hard to find. "Some financial executives have said it is unfair to punish them for what is nothing more than their failure to predict the financial crisis. Many legal experts have said much of the most controversial behavior likely was a product of poor judgment, not criminal wrongdoing."[19] Michael Lewis, author of *The Big Short* and himself critical of allowing proprietary

trading to mix with advice to clients, indicated in a CNBC interview on May 3, 2012, that his research had uncovered no criminality.[20]

Consistent with such an observation, the following news broke on August 10, 2012:

> Goldman Sachs has come into a run of luck—or so it seems.
>
> The SEC has dropped its investigation into the bank's disclosures related to the sale of subprime mortgages. And the DOJ has dropped its criminal probe into allegations stemming from a 635-page Congressional report that described how Goldman profited by betting against clients and appeared to have misled customers.[21]

Charles Lane later put the matter perceptively in an op-ed piece:

> As Lanny Breuer, then the chief of the Justice Department's criminal division, explained in an interview with PBS's "Frontline" last year, it's one thing to say, in hindsight, that bankers knowingly sold their victims shoddy securities and quite another to prove, beyond a reasonable doubt, "that you had the specific intent to defraud" and "that the counterparty, the other side of the transaction, relied on your misrepresentation."
>
> Having reviewed the facts, Breuer concluded not only that he couldn't bring many criminal fraud cases but also that illegal conduct did not cause the crash.
>
> The real scandal is the counterproductive behavior that was perfectly legal: Americans' shared, erroneous belief in ever-rising housing prices and corresponding mania to profit from them . . .
>
> It is human nature, perhaps, to reduce complex historical processes to the machinations of an evil few. The rule of law exists to control that dangerous tendency.[22]

A knowledgeable observer usefully summarized this explanation:

> Barney Frank, who recently retired as the top Democrat on the House Financial Services Committee, said past convictions were an unfair standard to use when considering the government's success in reforming the financial sector.
>
> "People don't fully understand. One of the reasons we had to pass a lot of new laws is a lot of bad things weren't illegal. It will be fair to judge going forward," Frank said.[23]

We'll rely on the editorial board of the *Wall Street Journal* to draw an overall conclusion. After reviewing the analysis presented above, their words somehow seem driven less by ideology and more by evidence:

> [T]he 2008 crisis wasn't the result of bank fraud, despite liberal mythologizing. It was a classic credit panic caused by bad government policy coinciding with the rational exuberance of bankers who were responding to the incentives for excessive risk-taking that government created.[24]

Releasing Information about Fed Lending in the Crisis

After the financial disaster hit, the Fed was exemplary in describing publicly the detailed structure of all its new innovative programs as well as releasing each week the total amount of reserve funds extended in each program. In addition, the Fed disclosed every month each program's borrowing stratified by the top five banks, the

next five, and the rest. But the Fed had no wish to subject individual borrowers to any stigma in financial markets by starting to reveal the identity of each institution—just as it had never done so for regular discount window loans. Had it made the names public, banks could only avoid losing counterparties by shunning discount credit just when society needed them to borrow.

However, because the Fed's emergency programs substituted for fiscal policy responsibilities, the Congress could not stand idle. At the instigation of Senator Bernie Sanders (Independent, Vermont), the Dodd-Frank law enacted in July 2010 gave the Government Accountability Office—as the General Accounting Office was renamed in 2004—authority to carry out a one-time audit of the Fed's emergency programs during the crisis. The Board released in early December 2010 the "detailed information on more than 21,000 individual credit and other transactions conducted to stabilize markets during the financial crisis."[25] The Dodd-Frank legislation also required the Fed on an ongoing basis to disclose with a two-year lag the identity of banks that tap the window for regular discount credit.

Furthermore, the Dodd-Frank bill curtailed Fed independence. Not only did the Treasury—rather than a politically independent body, which would have been preferable—get new authority to head up the group of regulators monitoring of systemic risk. But also the bill disallowed the Fed from granting discount credit only to specific individual nonfinancial companies in "unusual and exigent circumstances," which previously could have been extended under Section 13(3) of the earlier Federal Reserve Act. The Dodd-Frank Act instead permitted only programs for "broad-based" industry-wide emergency Fed lending with the Treasury Secretary's approval. Unfortunately, as Don Kohn has emphasized, the Fed must supply the name of any nonbank borrower at the discount window to the Congress within a week. Because the Fed's request for confidentiality may not be honored, the implied deterrence from tapping the window is obvious.

At the height of the crisis, *Bloomberg News* had gone to court to get more detailed information about the *individual institutions* borrowing all regular as well as emergency discount window credit at the time:

> On November 7, 2008, Bloomberg filed a Freedom of Information Act suit in U.S. District Court in New York. In it, Bloomberg claimed the documents it sought "are central to understanding and assessing the government's response to the most cataclysmic financial crisis in America since the Great Depression". . .
>
> After the filing, Bloomberg News carried stories with headlines such as, "Fed Defies Transparency Aim in Refusal to Identify Bank Loans." The story said, "Americans have no idea where their money is going or what securities the banks are pledging in return."
>
> Another story noted that the Bloomberg suit asserted, "The Federal Reserve should identify U.S. banks funded by its emergency lending because taxpayers are 'involuntary investors' who need to know the risks."
>
> Of course, that is the real issue involved concerning detailed disclosure of the loans. Bloomberg essentially argued that the risk that the Fed and thus taxpayers would lose money on some of the loans was more important than the risk that disclosure could disrupt the Fed's herculean effort to prevent a collapse of the financial system.[26]

In April 2011 *Bloomberg* won its Freedom of Information case, as did *Fox Business Network*, which had filed a similar suit. The court forced the Fed to make public the

details of its massive extension of regular and emergency window lending during the crisis. The specifics encompassed identities of the individual borrowing institutions, including some foreign banks through their American branches and agencies, along with the exact amounts borrowed. On November 28, 2011, *Bloomberg* published a news account based on these FOIA requests for Fed documents on its lending during the meltdown.[27] The next day a synopsis of the story appeared in the *Washington Post*.[28] Judy Woodruff interviewed Bob Ivry, the story's main author, on PBS's *The NewsHour.* After the story broke, Chairman Bernanke vociferously denied most of the accusations in various accounts, making an accusation of his own of "egregious errors." He wrote a cover letter for a four-page a staff analysis that went to the ranking members of the House financial services committee and Senate banking committee.

The following initial part of the *Bloomberg* story contended that shaky banks borrowed "secretly" and made hypocritical public statements and lobbying efforts:

> The Federal Reserve and the big banks fought for more than two years to keep details of the largest bailout in U.S. history a secret. Now the rest of the world can see what it was missing.
>
> The Fed didn't tell anyone which banks were in trouble so deep they required a combined $1.2 trillion on Dec. 5, 2008, their single neediest day. Bankers didn't mention that they took tens of billions of emergency loans at the same time they were assuring investors their firms were healthy. And no one calculated until now that banks reaped an estimated $13 billion of income by taking advantage of below-market rates . . .
>
> Saved by the bailout, bankers lobbied against government regulations, a job made easier by the Fed, which never disclosed the detail of the rescue to lawmakers even as Congress doled out more money and debated new rules aimed at preventing the next crisis.[29]

Two *Bloomberg* employees appeared on the *Bloomberg* TV channel to defend the story's content and to deny that it ever described the banks as "insolvent," as the Fed staff had claimed (p. 3). The employees noted that they couldn't have proven such a charge anyway because the Fed kept bank supervisory reports confidential.

What incredible distortions in both the *Bloomberg* story itself and the personal apologia, which definitively cast doubt on the news organ's objectivity and believability, at least in this matter. In point of fact, most of the largest banks were not "in trouble so deep they required" a bailout. Indeed, the Treasury initially had to coerce most of them into accepting unneeded TARP funds, precisely *because* they were so "healthy." Nor were they subsequently "saved by the bailout." The sound banks rather saw a profitable opportunity to borrow from the central bank at an interest rate charged by the Fed in the relevant program that the Fed had set below private rates prevailing at the time financial markets were so distorted.

Emergency discount lending in a financial crisis certainly is justified, as noted in a quote from the FOMC Secretary in the original story:

> "Supporting financial-market stability in times of extreme market stress is a core function of central banks," says Bill English, director of the Fed's Division of Monetary Affairs. "Our lending programs served to prevent a collapse of the financial system and to keep credit flowing to American families and businesses."[30]

But whether banks would have availed themselves of discount facilities knowing that their identity would eventually become public knowledge is another question.

> "The fact that we have never taken any money from the government has made us, from a reputation point of view, so attractive with so many clients in the world that we would be very reluctant to give that up," said Josef Ackermann, Deutsche Bank's chief executive, explaining to analysts last week why the German lender didn't borrow from the ECB.
>
> Mr. Ackermann said Deutsche Bank still is scarred from its experience borrowing from the Federal Reserve in the first phase of the financial crisis in 2008. U.S. regulators encouraged banks to borrow under the cloak of promised confidentiality, but when the banks' identities were subsequently disclosed by the Fed, the recipients were dubbed bailout recipients. "We learned our lesson," Mr. Ackermann said.[31]

Regarding the rates charged, parts of the last paragraph in the four-page Fed staff memo were somewhat vague in quantitative terms:

> Finally, one article incorrectly asserted that "banks reaped an estimated $13 billion of income by taking advantage of the Fed's below-market rates." Most of the Federal Reserve's lending facilities were priced at a *penalty* over normal market rates so that borrowers had economic incentives to exit the facilities as market conditions normalized, and the rates that the Federal Reserve charged on its lending programs did not provide a subsidy to borrowers.

Still, the Fed's statement really left open only this question: *Should* the Fed have set the official lending rates below at least some private market rates at the time of financial distress? *Bloomberg*'s rebuttal concluded that the Fed's rates became cheaper when borrowing costs surged during the financial crisis. *Bloomberg*'s November 28 story contained the following paragraph, "The Fed says it typically makes emergency loans more expensive than those available in the marketplace to discourage banks from abusing the privilege. During the crisis Fed loans were among the cheapest around, with funding available for as low as 0.01 percent in December 2008, according to data from the central bank and money market rates tracked by *Bloomberg*."[32]

But were the Fed's procedures inconsistent with Walter Bagehot's admonition that the central bank should make emergency loans only at a high rate to prevent most opportunistic activity? It turns out that Bagehot wouldn't have frowned on the Fed's lending rates. Charles Goodhart's exegesis of Bagehot's writings proved that Bagehot never claimed that the central bank's rate should be at a penalty (nor did he ever use that word) relative to private rates prevailing at the time of a banking crisis: "Certainly the rate should be above that in effect in the market prior to the panic, but not necessarily above the contemporaneous market rate."[33] That's just what the Fed had done![34, 35]

Yet the Fed may not have reacted positively to *Bloomberg*'s revelation on November 28 of the temporary subsidy rates on the Fed's emergency loans during the financial crisis, which might explain why the Fed underplayed the subsidy rate that was part of the new central bank liquidity swap arrangement announced two days later on November 30, 2011. True, the program's details had been worked out by the Fed and five other central banks on Thanksgiving, November 24. At that time dollar

borrowing from the ECB had been running about $1-3/4 billion.[36] They agreed to supplement a liberalization of dollar swaps made two-and-one-half months earlier by reducing the interest rate imposed by the Fed on foreign central banks by 1/2 percentage point.[37] The ECB, as always, passed that charge through fully to any private European bank borrowing in dollars.

The *Wall Street Journal* later wrote: "The move by central banks last week brought down the ECB's rate to about 0.58 percentage points, well below the market rate [of 1.16 percent]."[38] And the action reduced that private rate by only 40 basis points, thereby enhancing by 10 basis points the relative advantage of dollar borrowing from the ECB.

The effect of that altered incentive appeared in a story by the same reporter a day later:

> The European Central Bank lent $52.29 billion in U.S. dollars to European banks, a surge over recent levels but well below those seen during the 2008 financial crisis . . .
>
> The demand appeared to be more a case of bargain-hunting than of panic.
>
> "I don't think [the volume] is necessarily a sign of funding difficulties, it's just a sign that the facility is more attractive," said Peter Chatwell, an analyst at Credit Agricole CIB.

A chart on page 37 of the Board's late February 2012 *Monetary Policy Report* showed that the stresses induced by the European financial crisis had caused the official lending rate to become a subsidy after early September 2011 relative to the cost of borrowing dollars in private markets for foreign exchange swaps. But as Bagehot had foreseen, crisis conditions can cause what normally is a penalty official rate appropriately to become a temporary subsidy. Even so, the Fed did not advertise this subsidy-lending rate to foreign central banks.[39, 40]

Imperiling Federal Reserve Independence

The Fed's sequential programs of doubtful lasting macroeconomic efficacy involving massive purchases of securities, together with the earlier unorthodox lending initiatives that were economically effective, ended up endangering its independence. That threat didn't arise because the explosion of the monetary base per se risked engendering inflation, which won't occur despite the worries of some prominent conservatives inside and outside the System. Instead, eventual policy tightening is capable of preventing any potential inflationary pressure because the Congress in October 2008 gave the Fed authority to pay interest on depository reserves. The Fed thus has the authority to control the all-important funds rate even in the face of humongous amounts of excess reserves. From the perspective of policy effectiveness, that authority has rendered in my view all the talk of an "exit strategy" to reduce its balance sheet a waste of breath.

A potentially more telling issue is that, through various programs, the Fed has endangered its political independence by infringing on what should have been the prerogatives solely of the Congress and the Treasury. At the height of the 2008 financial crisis, an appropriate framework for a governmental bailout or resolution of an interconnected but insolvent nonbanking entity was unavailable. In the circumstances, the Fed acceded to Treasury pressure to extend its own credit in the Bear Stearns and

AIG episodes. Fed lending to the associated Maiden Lane facilities contributed to the unusual surge in its balance sheet. Kenneth Kuttner, though, rightly cautioned:

> Saddling the Fed with bailout duties obscures its core objectives, unnecessarily linking monetary policy to the rescue of failing institutions . . . In view of these concerns, it would be desirable to return to Bagehot's narrower conception of the LOLR [lender of last resort] function, and turn over to the Treasury the rescue of troubled institutions, as this inevitably involves a significant contingent commitment of public funds.[41]

Indeed, Allan Meltzer went so far as to claim this:

> The change to an independent policy did not survive the 2007–9 crisis . . .
>
> Chairman Ben Bernanke seemed willing to sacrifice much of the independence that Paul Volcker restored in the 1980s. He worked closely with the Treasury and yielded to pressures from the chairs of the House and Senate Banking Committees and others in Congress . . .
>
> After the Treasury supported General Motors and Chrysler with what will be a growing bailout of automotive companies, the Federal Reserve accepted General Motors Acceptance Corporation (GMAC) as a bank, enabling GMAC to borrow at the discount window. GMAC at once began to offer zero interest rate loans for up to five years to borrowers with below median credit ratings. This appears to be a response to pressure from prominent members of Congress, a further sacrifice of independence. Many members of Congress want the Federal Reserve to allocate credit to borrowers that they favor. This avoids the legislative and budget process just as Fannie Mae and Freddy Mac did. It subverts the principles of an independent central bank.[42]

The passages of TARP in October 2008 followed by the Dodd-Frank Act of July 2010 essentially extricated the Fed's balance sheet from the whole issue of bailouts versus resolution of insolvent institutions, a big step in preserving its political independence. Already in May 2010, Chairman Bernanke had emphasized the importance of central bank independence within government. He bolstered his case by quoting David Ricardo:

> Additionally, in some situations, a government that controls the central bank may face a strong temptation to abuse the central bank's money-printing powers to help finance its budget deficit. Nearly two centuries ago, the economist David Ricardo argued: "It is said that Government could not be safely entrusted with the power of issuing paper money; that it would most certainly abuse it . . . There would, I confess, be great danger of this, if Government—that is to say, the ministers—were themselves to be entrusted with the power of issuing paper money." Abuse by the government of the power to issue money as a means of financing its spending inevitably leads to high inflation and interest rates and a volatile economy.[43]

But he didn't mention another Ricardo quote that by implication criticized on those very grounds the Fed's large-scale purchases of Treasury debt. As Richard H. Timberlake wrote:

> David Ricardo had observed a Bank of England operating in the mode anticipated for the Bank of the United States. His perceptive comment on the relationship of a central

> bank to its government stands as a caution for all time. "It may be considered," he remarked, "whether a bank lending many millions more to Government than its capital and savings can be called independent of that Government."[44]

In his aforementioned presentation in Japan, Bernanke allowed for such cooperation with the government by an allegedly independent central bank under certain conditions.

> The Bank of Japan became fully independent only in 1998, and it has guarded independence carefully, as is appropriate. Economically, however, it is important to recognize that the role of an independent central bank is different in inflationary and deflationary environments. In the face of inflation, which is often associated with excessive monetization of government debt, the virtue of an independent central bank is its ability to say "no" to the government. With protracted deflation, however, excessive money creation is unlikely to be the problem, and a more cooperative stance on the part of the central bank may be called for. Under the current circumstances, greater cooperation for a time between the Bank of Japan and the fiscal authorities is in no way inconsistent with the independence of the central bank, any more than cooperation between two independent nations in pursuit of a common objective is inconsistent with the principle of national sovereignty.[45]

Not surprisingly, Fed bashing by Democrats, Independents, and Republicans alike started to become a parlor sport in the course of Bernanke's time as chairman. Representative Barney Frank resuscitated a proposal to remove Reserve bank presidents from voting on the FOMC. As we have seen, the Democratic-sponsored Dodd-Frank Act required that the emergency Fed lending that had been justified by "unusual and exigent circumstances" henceforth be generalized programs broadly available that also get Treasury approval. Independent socialist Senator Bernie Sanders successfully sponsored a plank in the act that mandated identifying publicly the individual recipients of such credit during the financial crisis. Sanders and Republican libertarian Representative Ron Paul stumped anew for ongoing disclosure of the parties getting the Fed's regular discount lending and for Fed audits by the Government Accountability Office (GAO). In addition, Paul on his own reiterated his desire ultimately to "end the Fed" and return gold to its rightful place.

Other Republican presidential candidates joined the fray. Rick Perry in August 2011 claimed that Bernanke was "almost treacherous—or treasonous in my opinion." In a series of debates, Mitt Romney, Rick Santorum, Herman Cain, and Newt Gingrich all indicated that they would not reappoint Bernanke to another term. Gingrich, easily the most intemperate, exhibited some difficulty keeping his facts about the Fed straight. Readers of this book know that an amendment to the Federal Reserve Act in 1977 created the Fed's dual mandate and that the Humphrey-Hawkins Act passed the next year affected only its reporting requirements. But Gingrich asserted that "I would prepare legislation to eliminate the Humphrey-Hawkins Act, which has totally confused the Fed."[46] No, it wasn't the Fed that was confused. Recall that "Newt Gingrich made between $1.6 million and $1.8 million in consulting fees from two contracts with mortgage company Freddie Mac, according to two people

familiar with the arrangement."[47] Gingrich explained in a presidential debate that Freddie Mac paid him so much for his services as an "historian." If so, that GSE obviously was short-changed.

At a hearing in February 2012, Representative Scott Garrett took umbrage at the Board's distribution to the Congress of an advocacy piece on housing policy. The Fed no doubt forwarded the study in the belief that the transmission of mortgage rates—that were supposedly lower than otherwise owing to its unconventional monetary policies—had been impaired. Elevated unemployment implied that many existing and potential homeowners were unable to afford mortgage payments and couldn't service outstanding mortgage debt. Furthermore, because of declines in house prices, a mounting and worrisome share of mortgage holders were in foreclosure and numerous others were underwater and unable to refinance. On top of that, much higher underwriting standards and down payments for granting mortgages lessened their availability and meant that many potential new home buyers couldn't get financing to buy homes. According to the Fed's white paper, these conditions had prevented lower mortgage rates from having a bigger simulative effect on homebuilding. The white paper included the following text:

> In many of the policy areas discussed in this paper—such as loan modifications, mortgage refinancing, and the disposition of foreclosed properties—there is bound to be some tension between minimizing the GSEs' near-term losses and risk exposure and taking actions that might promote a faster recovery in the housing market. Nonetheless, some actions that cause greater losses to be sustained by the GSEs in the near term might be in the interest of taxpayers to pursue if those actions result in a quicker and more vigorous economic recovery.[48]

In other words, the government needed to help the Fed by strengthening the bite of monetary policy regardless of the heightened impairment to the GSE's finances and risk to the taxpayer. (Now that's keeping one's priorities straight!)

According to an analysis in the *Washington Post*,

> Many of the white paper's ideas to help the housing market echo Obama administration proposals, such as helping homeowners refinance into more affordable mortgages and selling foreclosed buildings for use as rental properties . . .
>
> "We have to be really careful because of our special independence," Jeffery Lacker, president of the Federal Reserve Bank of Richmond, said last month on CNBC. "And when the central bank strays into fiscal policy, it gets itself entangled in politics, and that can threaten our independence" . . .
>
> Garrett said that "the Congress has a lot of interest in monetary policy. I guess the comparable would be for us to do a House resolution with regard to monetary policy. Is this an invitation now to Congress that we should be issuing resolutions to what the monetary policy [is] that the Fed should be doing?
>
> "It was not the intent of that white paper to provide a set of recommendations," Bernanke replied. "I know you're skeptical, but we are trying very hard to avoid encroaching on Congress's fiscal responsibilities . . . I apologize if it was misinterpreted."[49]

Even after Bernanke's apology, Senator Orrin Hatch (Republican, Utah) piled on:

> Your staff's white paper contains a number of conjectures and proposes consideration of a number of policies that are clearly in the province of fiscal policy, including policies that would directly allocate losses to innocent taxpayers, even though those taxpayers did not undertake the risks that led to the losses."[50]

Despite the white paper's extensive advice, the Fed actually hasn't pointed out the ultimate steps necessary to solve fundamentally housing's woes. In stark contrast, Paul Volcker had done so:

> There is one very large part of American capital markets calling for massive structural change that so far has not been touched by legislation. The mortgage market in the United States is dominated by a few government agencies or quasi-governmental organizations. The financial breakdown was in fact triggered by extremely lax, government-tolerated underwriting standards, an important ingredient in the housing bubble. The need for reform is self-evident and the direction of change is clear.
>
> We simply should not countenance a residential mortgage market, the largest part of our capital market, dominated by so-called Government Sponsored Enterprises.
>
> Collectively, Fannie Mae, Freddie Mac and the Home Loan Banks had securities and guarantees outstanding that exceed the amount of marketable U.S. Treasury securities. The interest rates on GSE securities have been close to those on government obligations.[51]

Republicans also voiced a stream of criticisms about many of the Fed's actual policies. The four top Republican leaders of the House and Senate wrote to Bernanke in September 2011, recommending that the FOMC "resist further extraordinary intervention in the U.S. economy." The letter went on to say, "It is not clear that the recent round of quantitative easing undertaken by the Federal Reserve has facilitated economic growth or reduced the unemployment rate."[52]

Not quite a year later, presidential candidate Mitt Romney opined similarly,

> I don't think a massive new QE3 is going to help this economy . . . The Fed's first action, quantitative easing, was effective to a certain degree. But I believe that the QE2, the second round of easing, I don't think it had the impact that they were hoping for."[53]

Some other Republicans had worried that the associated "money creation" would generate escalating inflation.

> More than a year after Republicans from House Speaker John Boehner of Ohio to presidential candidate Ron Paul of Texas warned that the Fed's second round of asset purchases risked a sharp acceleration in prices, the surge has failed to materialize . . .
>
> Gingrich said in September that Bernanke was "the most inflationary, dangerous and power-centered chairman" in the central bank's history.[54]

Rather than Bernanke's inflationary record, the last statement actually reflected Gingrich's inflated rhetoric.

Republicans in March 2012 introduced bills in the Congress that limited the Fed's mandate to an inflation goal alone, restricted its portfolio to Treasury securities,

repos, and reverse repos, except in emergencies, and expanded the voting authority of Reserve bank presidents. Representative Kevin Brady (Republican, Texas) introduced the Sound Dollar Act in the House and Senator Mike Lee (Republican, Utah) did the same for a companion bill in the Senate. Stanford economics professor John Taylor testified in support of the entire bill. His defense of a *single* goal for monetary policy was inexplicable in light of the *two* components of the Taylor rule. But his testimony went on to assert more understandably that

> [T]here is already considerable chatter and speculation in the markets about the circumstances under which the Fed would start buying mortgage backed securities again. The fact that the Fed can, if it chooses, intervene without limit into any credit market—not only mortgage backed securities but also securities backed by automobile loans, or even student loans—raises more uncertainty, and of course raises questions about why an independent agency of government should have such power.[55]

William Poole of the Cato Institute and the University of Delaware agreed on instituting a single inflation goal and constraining the Fed's portfolio but disagreed on changing the rotating vote of most presidents. Laurence Meyer of Macroeconomics Advisors opposed all the features of the bill. He added, "Please recognize that the greatest threat to the stability of long-term inflation expectations is an assault on the independence of the Fed's monetary policy decisions."[56]

In an effort to burnish its image as an inflation fighter in the face of worries on the right about excessive creation of the monetary base and recommendations on the left to raise its inflation goal, the FOMC had announced after its January 2012 meeting a long-run inflation objective of 2 percent for the PCE. Despite the press briefing that placidly revealed the unavoidable delay in attaining that objective in the event of an inadvertent miss, in testimony about a week later on February 2 Bernanke ran into a buzz saw of criticism from Representative Paul Ryan, chairman of the House Budget Committee:

> "My interpretation is that the Fed is willing to accept higher levels of inflation than your preferred rate in order to chase your employment mandate," Mr. Ryan said.
>
> "I wouldn't say that's correct," Mr. Bernanke replied. "We will not actively seek to raise inflation or to move away from our [2%] target," Bernanke said. "We're always trying to bring inflation back to the target."[57]

Only a couple of minor facts can be advanced in Ryan's defense. In December 2012, the whole Committee released guideposts for eventual funds-rate firming that included an acceptable rate of consumer inflation for the extended period of economic weakness of as much as 2-1/2 percent. And previously, Vice Chair Yellen in April expressed a preference for an outcome that minimized the welfare loss in optimal-control simulations of the Board's econometric model by pushing inflation a little above 2 percent for an extended period. The purpose was to gain a faster decline to the natural rate of unemployment, which would require a minor overshoot of actual unemployment below its natural rate for a couple of years.[58] Even so, in his fifth press conference Bernanke did correctly observe that those simulations "still involve inflation staying quite close to 2 percent."[59] Bernanke was reemphasizing the hard-won gains for central bank credibility by using the simulated proximity of

inflation to 2 percent to counter the arguments of liberal economists that the Fed should permit the medium-term inflation gap to widen more.[60]

On July 24, 2012, the House of Representatives, to honor Representative Ron Paul (Republican, Texas), passed by a lopsided 327 to 98 vote his bill to have the GAO audit the Fed's monetary policy and foreign currency functions, in addition to its existing Fed audits. Bernanke had called the bill "a nightmare scenario."[61] Although it was destined to bite the dust in the Senate, presidential candidate Mitt Romney in mid-August pushed to incorporate the idea into the party platform. In doing so he personified the word "oxymoron."

> "I would like to see the Fed audited," Romney said today. Still, he cautioned that Congress shouldn't be given the authority to run the central bank. "I want to keep it independent," he said. "There are very few groups that I would not want to give the keys to. One of them is Congress."[62]

The Republican Party also must have wished to recognize Paul's efforts in a more obvious lost cause, as its platform included a plank recommending a new Gold Commission. That side of the aisle also opposed pursuing large-scale asset purchases for a third time.

After the decision to implement QE3, the reaction of Republican Party spokesmen was vociferous. For example, Tennessee Senator Bob Corker said, "I'm disappointed in the Federal Reserve's actions today and truly believe Chairman Bernanke is beginning to do serious damage to the Fed as an institution."[63]

St Louis Bank president James Bullard expressed a similar concern. "What I'm worried about is this creeping politicization," said Mr. Bullard. Pressure from politicians is often for central bankers to do more.[64]

John Cochrane of the University of Chicago's Booth School echoed the concerns about the practical threat to the Fed's autonomy in an op-ed piece. He summarized how, by becoming a "financial czar," the Fed was exceeding its legitimate democratic role and as a consequence understandably endangering its independence.

> [T]he Fed has crossed a bright line. Open-market operations do not have direct fiscal consequences, or directly allocate credit. That was the price of the Fed's independence, allowing it to do one thing—conduct monetary policy—without short-term political pressure. But an agency that allocates credit to specific markets and institutions, or buys assets that expose taxpayers to risks, cannot stay independent of elected, and accountable, officials.[65]

He also saw dangers to the Fed's political independence in the Dodd-Frank mandate for it to monitor systemic risk. Officials had asserted that the elevation of financial stability rendered macroprudential policy the Fed's first line of defense against imbalances such as bubbles. Note that "macroprudential policy" was defined as follows by Tobias Adrian and Nellie Liang, senior staffers of the New York Fed and the Board, respectively:

> Macroprudential policies—both structural through-the-cycle and cyclical time-varying—are usually viewed as the primary tools to mitigate vulnerabilities and promote financial stability. These regulatory and supervisory tools, such as bank capital requirements or sector-specific loan-to-value ratios, can shore up the resilience of the financial system to possible adverse shocks.[66]

But in another op-ed, Cochrane said that in carrying out its new responsibilities, it should tread carefully. He recommended three qualities of an ideal version of macroprudential policy:

> Humility. Fine-tuning a poorly understood system goes quickly awry. The science of 'bubble' management is, so far, imaginary.
>
> Follow rules. Monetary policy works a lot better when it is transparent, predictable and keeps to well-established traditions and limitations, than if the Fed shoots from the hip following the passions of the day.
>
> Limited power is the price of political independence. Once the Fed manipulates prices and credit flows throughout the financial system, it will be whipsawed by interest groups and their representatives.[67]

Still, the attractiveness of macroprudential policy to central bankers is understandable. (This point would be even more obvious if Chapter 2 in this book is correct in identifying the real source of the Great Depression. Recall that chapter claimed that traditional monetary policy conduct in the form of the Fed-sponsored near doubling of the Treasury bill rate in the two years ending in mid-1929 together with the organization's laggard unwinding of the elevated bill rate because of inadequate reserve injections in the early 1930s were responsible.) According to *Bloomberg*,

> "It is a brave central banker who would deliberately induce a recession in order to head off the mere risk of a future financial correction," Bank of England Deputy Governor Charlie Bean said in a May 20 speech. "That explains the interest in deploying additional policy instruments."
>
> Fed officials have raised financial-stability concerns at meetings in recent months. Among assets that have drawn the gaze of officials in speeches and minutes of meetings are premiums on longer-term debt, price-earnings ratios on some small capitalization stocks, declining credit quality on some high yield loans, and farmland values . . .
>
> Success for so-called macroprudential regulation would see policy makers deflate potential excesses by limiting access to credit, protecting economic expansions from burst bubbles or blunt interest-rate increases. The trouble is, the track record of such tools is at best mixed.
>
> "Central banks are doing a lot on macropru right now," said Gavyn Davies, chairman of London-based hedge fund firm Fulcrum Asset Management LLP. "The basic lesson from past attempts is, they haven't worked for very long and they haven't worked very well, so we have to do better than we have in the past."[68]

Actually, although I certainly advocate applying a sufficiently strict but unchanging regulatory and supervisory regime to nonbank financial institutions—both those who are not Systemically Important Financial Institutions as well as those that are—I dissent from imposing a time-varying, discretionary macroprudential policy on any nonbanks. My opposition is not so much rooted in its possible ineffectiveness, though I share that concern. Rather, I contend that in this country applying to certain large nonbanks the Orderly Liquidation Authority for Systemically Important Financial Institutions mandated by Dodd-Frank, which Chapter 11 of this book supported, will prove to be fairly effective, though not infallible. That prospect would render any macroprudential policy imposed on them mostly superfluous. If the authorities recognize soon enough when interconnected nonbanking institutions

are entering insolvency and immediately shut them down, then no significant hits to creditors should occur and contagion thus should be avoided. But another crucial consideration for me is even more important: discretionary macroprudential policy clearly would excessively impair the predictability of economic arrangements. Well-intentioned but highly fallible bureaucrats, acting to avoid an unreliable impression of threatening systemic risks, should not be taking it upon themselves to alter judgmentally the maneuvering room of nonbank economic agents over time. Such a discretionary approach is no way to promote the flowering of human ingenuity and progress through the rule of law not regulators.

Wait a minute—didn't the discussion of Weber's ideal types in Chapter 7 contain the following text:

> Second is the case of a . . . tightening trajectory over time that more or less replicates an adjusted Taylor rule. Presumably, without unusual surrounding developments, disastrous economic or severe bubble-related financial outturns would be minimized . . . [Still,] in some circumstances imposing on nonbanks as well as banks stricter supervision and regulation that is well designed would counter the smaller emerging bubbles that can result even if monetary policy were appropriately positioned.

Don't those words mean that I've already contended that at times a judicious discretionary adjustment to macroprudential policy even for nonbanking institutions, assuming it's appropriately designed, would be efficacious in putting a stop to certain lesser emerging financial imbalances that could impair overall stability despite adherence to an adjusted Taylor rule? Yes, but . . . Just because a given policy initiative *would be effective* doesn't necessarily mean that it *should be adopted*. Although many parallels don't hold in the following analogy, I submit that the essential one that I'm now invoking does directly relate: It's arguably true that dropping atomic bombs on Hiroshima and Nagasaki *was effective* in shortening the duration of World War II and saving American lives. Even so, as a political judgement based on overall humanitarian considerations, I nevertheless *would have opposed* President Truman's decision to use nuclear weapons. Analogously, in the case of discretionary alterations of macroprudentiaI policies for nonbanks, I assert that in the end it's better to stray occasionally from optimal economic outcomes if the benefit is the opportunity to continue pursuing policies that are justifiable ethically.

But based on his practical experience in the United Kingdom, my old boss Don Kohn has offered a much more reassuring take on discretionary macroprudential policy for nonbanks than I just did. After a four-decade career in various aspects of monetary policy at the Fed, he became an external member of the Financial Policy Committee (FPC) at the Bank of England as well as a Senior Fellow at Brookings. By way of introduction, he explained that unlike monetary goals, the macroprudential objective "cannot be defined numerically." Instead,

> the authorities must identify risks to financial stability that could arise in different ways: for example, from excessive leverage, dangerous exposure to runs, mispricing of risks, or concentrated or poorly understood distribution of risks in the financial system. And the FPC will act to mitigate these risks using a broad set of tools.

> Many of these are forms of old tools—capital standards, liquidity requirements, supervisory oversight—that have been, and still are, used as part of microprudential regulation. But now we propose also to deploy them in a new way—by varying them over the cycle or changing them in response to specific risks; by considering the system as a whole; by setting standards so that market participants internalize, that is take into account, the wider costs or externalities, of financial instability; and by paying special attention to protecting against tail risk, like runs and fire sales that threaten to disrupt intermediation and to feedback on economic activity.[69]

In personal correspondence, Kohn elaborated:

> In concept, [macroprudential policy] addresses externalities—stuff not appropriately priced by the market. Among those externalities would be the huge cost for innocent bystanders from financial crises. You can see this of course in recent years in the US but also think about the Asian financial crisis of 1997–98. And the response to the crisis has created moral hazard, which is only partly addressed by the Orderly Liquidation Authority, which in my view does not address the externalities sufficiently. It does allow orderly liquidation of Systemically Important Financial Institutions, but SIFI failure wasn't the only source of problems; Lehman did make everything worse but the economy was dropping pretty rapidly before that and was headed for a deep recession in any event.[70]

As to recent practice, in late June 2014 the United Kingdom subjectively imposed a high mortgage-to-income limit only on banks issuing retail deposits—commercial banks and building societies. And as Kohn privately noted as well "the interest rate stress does apply to all lenders, but . . . [i]n the UK, unlike the US before the crisis, almost all the mortgage lending is through the banks; the nonbank securitization market is very limited. Our intent is that under the most likely path for the UK housing market our restraints [wouldn't act to] change current practices, but only to protect against a deterioration in credit quality."[71]

But shortly afterward, a devastatingly convincing critique of the current practices used in the United States to apply macroprudential policies to nonbanks appeared in an otherwise generally unconvincing overall review of the Dodd-Frank Act by the staff of the Republican majority of the House Committee on Financial Services.[72] It identified numerous conceptual and actual flaws of having the Financial Stability Oversight Council designate some nonbanks, especially insurance companies, to be Systemically Important Financial Institutions. The report prompted the Committee's former chairman, Barney Frank, to lead off his testimony on July 24, "I was pleasantly surprised by the bipartisan tone of the Republican Staff report."[73] The Q & A session featured a "[l]ittle dust-up between Rep. Scott Garrett of New Jersey and Frank: Frank says he was skeptical of designating non-bank institutions as systemically important institutions."[74]

Macroprudential policies inevitably add to the scope of the central bank's responsibilities and obviously enter areas that require coordination—even control—by other organs of a democratic government. But early in the New Year, Kohn also expressed profound worries about whether the Fed's unorthodox monetary policies during and after the financial meltdown could pose an unusual threat even to its traditional

political independence in conducting monetary policy per se. That danger would be particularly ominous after the time arrives to start firming its policy. Kohn's words well capture my own concerns, warranting an extended quote:

> A number of the actions the Federal Reserve took during and after the crisis straddled the line between fiscal and monetary policies. They involved taking some limited fiscal risk onto the central bank's balance sheet, and they entailed close cooperation between the monetary and fiscal authorities . . .
>
> Just as the distinctions between liquidity and solvency problems become much less sharp in a crisis, so, too, do the distinctions between fiscal and monetary policies designed to limit the scope of the crisis.
>
> The Federal Reserve did not expect to take losses on any of these facilities—and all those loans were indeed repaid without any losses to the Federal Reserve or the taxpayers. And the very act of making those loans helped to limit the extent and duration of the crisis—fulfilling one of the principal rationales for the founding of the Federal Reserve 100 years ago. But had the financial panics continued and deepened and many more borrowers failed, the taxpayer could have suffered losses.[75]

Kohn already had led off his paper with his disquieting conclusion. It perfectly summarizes the entire last part of the chapter on political threats to the Fed's independence that is absolutely necessary for an ideal setting of monetary-policy instruments. Kohn said,

> Naturally, understandably, and appropriately, these circumstances have increased the scrutiny of central banks and raised questions about the goals, governance, and accountability of these institutions. The issue before us is whether we should worry that this scrutiny will result in an erosion of their independence from the elected government. We should be concerned about the potential for reduced independence: evidence over time and across countries indicates that less independence is correlated with higher inflation. To foreshadow my answer: the actions that the Federal Reserve and other central banks took should not and need not lead to a loss of monetary policy independence, but we need to be vigilant. The risks and threats to independence have increased. (p. 1.)

The next chapter interrupts our provincial concentration by casting our net far and wide around the globe. We'll first offer an explanation of the Bank of Japan's inability to prevent mild but stable deflation in comparison with our attainment of a low but positive inflation rate, albeit one below the Fed's 2 percent target. Next, we'll turn to the Bank of England's implementation of inflation targeting, quantitative easing, and forward guidance. Finally, the chapter examines the trembling in the Euro-zone after Greece came clean about the extent of its deficit and debt problems, causing the currency crisis to erupt, as well as the ameliorative actions undertaken by the ECB. In all three cases, we'll apply quantitatively the novel theory of inflation advanced in Chapter 5 and adopted to explain our domestic inflationary experience in Chapter 9. Though much technical research remains to be done, perhaps the suggestive results offered in the following chapter will serve to stimulate such future work. The rough and preliminary foreign experience about to be introduced in Chapter 13 does seem to me to offer promising support for the new theory. But you can judge for yourself.