MONEY FOR NOTHING: INSIDE THE FEDERAL RESERVE

Educational Discussion Guide – November 4, 2013

FOUNDING

When and why was the Federal Reserve System created?

MANDATE

What was the Federal Reserve originally intended to do?

How has the Federal Reserve's mandate changed since 1913?

HISTORICAL COMPARISON

Did the US have other central banks before the Federal Reserve System?

Why were those central banks discontinued?

STRUCTURE

Describe the Fed's Public and Private structure.

What does the Fed do with the proceeds of its operations?

If Federal Reserve officials aren't elected, who appoints them? Who oversees the Fed?

THE GOLD STANDARD

When the Fed was created the U.S. and most major nations were on the gold standard. How did the pre-World War I gold standard work?

What was the purpose of making paper currencies convertible to gold?

THE GREAT DEPRESSION

How did Federal Reserve policies impact the Great Depression?

What role did the Gold Standard play in the Fed's decision making?

What did economists learn from that experience? How many years passed before it become broadly accepted that Fed policy worsened the Great Depression?

THE BRETTON WOODS SYSTEM

Describe the Bretton Woods monetary system of 1944.

How long did that system last? Why did it fail?

THE GREAT INFLATION

What role did Federal Reserve policy in the "Great Inflation" of 1965-1979?

What did economists learn from that experience?

PAUL VOLCKER

When Paul Volcker came into office inflation was 13% per year and the future of the US dollar as a reserve currency was in question.

What policies did Volcker use to try to lower inflation?

How did economists and the general public view his polices at the time? In retrospect?

ALAN GREENSPAN

How do you reconcile Alan Greenspan's free market ideology and his frequent interventions in financial markets?

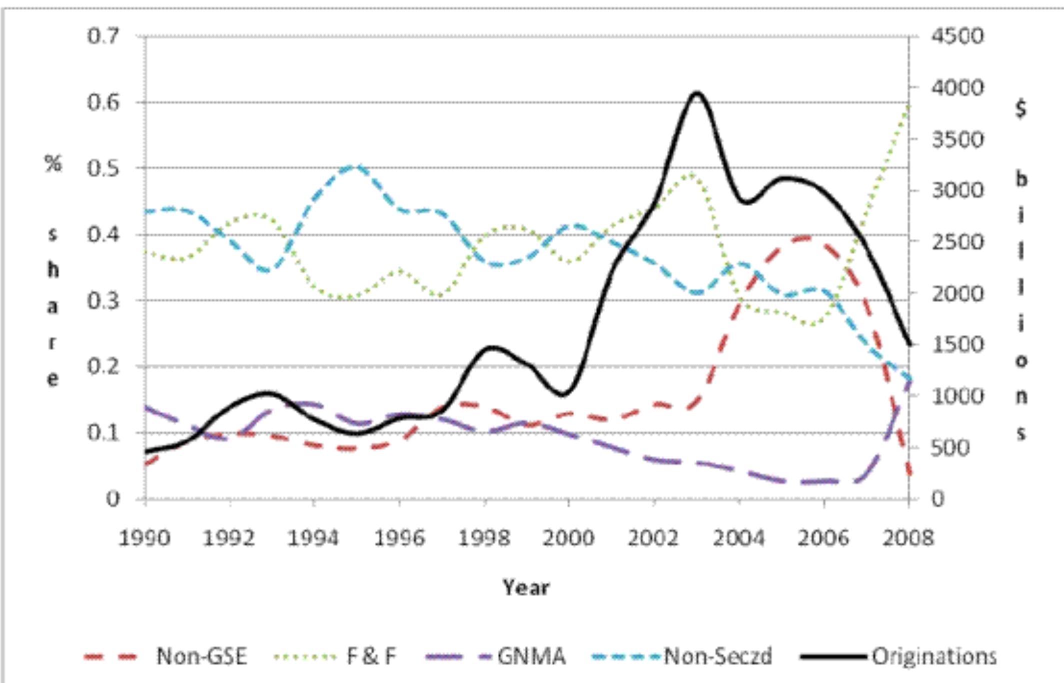
What were the key successes and failures during his 1987-2006 tenure at the Fed? Was Greenspan in some ways a victim of his early success?

Was it a mistake for the American public to place so much faith in one man?

FED POLICY AND THE HOUSING BUBBLE: 2001-2005

What incentives did low interest rates provide homebuyers during this period? (Note: In 2004 - 30% of mortgages originated in the US were adjustable. The real Fed Funds Rate was negative until Spring, 2005).

What incentive did 1% interest rates provide to Wall Street Investment banks (see chart below which shows Non-GSE mortgage securitizers– i.e. Wall Street– nearly tripling their market share in 2003-4)?



What incentives did low interest rates provide pension funds and other large institutional investors searching for higher yields in 2001-5 in an effort to make their projected 7-8% annual returns?

Chairman Bernanke claimed in September, 2012 that low interest rates (brought about by the Fed's "QE 3" policies) would boost housing prices. Yet he denies that low interest rates had the same effect in 2001-2005. How do you reconcile his two statements?

THE ROLE OF THE FED AS REGULATOR

The Fed waited until 2009 to require all mortgage lenders to verify borrowers' ability to pay, years after lenders had ceased making these so-called "liar loans".

Why didn't the Fed act in a more timely way?

What opposition might Chairman Greenspan have faced if he had exercised this authority in 2004 or 2005?
The Dodd-Frank legislation passed in the wake of the crisis gave the Fed more power as a banking regulator. Can we expect an institution that overlooked the largest housing and credit bubble in US history to foresee future financial crises?

THE CULTURE OF ECONOMICS

Is it surprising that so few mainstream economists warned of the imbalances building in the financial system from 2001-2006? That many at the Fed gave speeches praising the efficiency and resilience of our financial system even after the crisis began?

When Raghu Rajan (one of the film's interview subjects) presented a paper at Jackson Hole in 2005 as the Chief Economist of the IMF, he accurately asserted that financial innovation had made the financial system riskier, but Larry Summers referred to him as a "luddite". What does the harsh criticism directed at those who did correctly warn about growing imbalances say about the culture of economics in general?

What conflicting incentives do economic students, professors, regulators, and financial professionals face during a speculative boom? When going against the grain of conventional economic wisdom?

BEN BERNANKE

In 2002-2004 Ben Bernanke and Alan Greenspan argued that holding interest rates low would insure the US did not fall into a "Japan-style" deflationary trap. In hindsight, does that argument hold up? Or did the Fed's fueling of a credit bubble unleash even greater deflationary forces on the US economy?

Ben Bernanke and other Fed officials failed, in late 2007, to predict a recession, much less the financial meltdown that had already begun. Why didn't Bernanke understand the crisis as it unfolded? What can the Fed do to improve its forecasting ability?

Ben Bernanke and his colleagues deserve credit for singlehandedly preventing a total collapse of the financial system in September 2008 (Congress did not enact TARP until October).

But in September 2008 Warren Buffett loaned Goldman Sachs $5 billion at 10% interest and also received stock warrants that he sold in 2013 for a $2 billion profit, while the Fed repeatedly loaned Goldman Sachs far greater amounts at 2% interest or less with no stock warrants.

With the benefit of hindsight – should the Fed have demanded better terms for itself and the US taxpayer?

TOO BIG TO FAIL

Recent studies have shown that the US largest banks can still borrow more cheaply than their competitors because market participants believe they are "Too Big To Fail" and would receive government backing in a crisis.

What's wrong with having our largest banks profit from this subsidy in good times and rely on public support in bad?

What are some possible solutions?

QUANTITATIVE EASING

Have the Fed's QE 2, Operation Twist, and now QE3 and 4 (the 2012 programs to create roughly $1 Trillion per year to buy MBS and government debt) benefitted the US economy? How do we measure the benefits?

Is QE a "free lunch"? If not, what are the costs of these policies and who pays them?

Does the Fed have an endgame strategy for weaning the stock, mortgage, and government debt markets from its support?

MACRO RISKS

During the credit boom in 2001-2006 US households and financial firms rapidly expanded their leverage.

To ease the crisis that ensued the Fed and the US Treasury have dramatically levered their own balance sheets.

What are the long-term risks of these policies?

Have other countries followed these types of policies successfully?

The US has the power to create the world's reserve currency. Is there are any limit as to how many dollars the US Treasury and Fed can borrow and print? Are there other currencies that might replace the dollar as the world's reserve currency?

THE PATH AHEAD FOR THE FED

In his public comments from 2010 onward Fed Chairman Ben Bernanke has frequently mentioned his goal of pushing up stock and housing prices. Is there evidence that the "wealth effect" actually boosts economic growth and employment in the long run?

Does the Fed have a mandate to specifically target higher stock and house prices?

What, if anything, would you do differently if you were appointed Fed Chair?