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BALANCE OF POWER
IN MONETARY AND FISCAL POLICYMAKING
AND ITS EFFECT ON ECONOMIC OUTCOMES

By
Rachel Ng

A Thesis Submitted to the Department of Economics
of Trinity College in Partial Fulfillment of the
Requirements for the Bachelor of Arts Degree

Economics 498-99

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ABSTRACT

By analyzing the balance of power between key policymakers involved in restoring the economy back to health during two periods in history – the Nixon administration and the 2008 financial crisis –, my thesis reveals the detrimental effects the political business cycle has on the success of recovery. In the Nixon era, the evidence supports the notion that Nixon coerced Burns into lowering interest rates past Burns' threshold, which exacerbated inflation and sent the economy into the dismal state of stagflation. Contrary to the popularly held belief that the Fed acts as an arm of the Treasury, Bernanke held his own in discussions with Paulson. They worked together cooperatively during the 2008 crisis to bail out the failing banks and saved the financial system from severe systemic risk. The hindrance to recovery during the 2008 crisis, instead, stemmed from disagreement in the legislative branch. Since taxpayer-funded bailouts were unpopular with voters, political gridlock delayed Congress' authorization of critical bailout funds to the Treasury. Other themes include: 1) conflict of duty versus friendship and 2) expansion of the Fed's powers.

DEDICATION

I would like to dedicate this thesis to my marvelous advisors, Professor William Butos and Professor Adrienne Fulco, my loving family, and my effervescent friends, for their very gracious support and profound insight throughout the process. Thank you for your inspiration and guidance, and for cheering me all the way to the finish line.

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1. INTRO

During periods of economic instability, countries are plagued by years of output loss, unemployment, and price instability. Studies show that complementary fiscal and monetary policy can expedite recovery time. The current literature on the topic of balance of power between the fiscal and monetary authorities in policymaking examines the relationship from a helicopter view using quantitative methods. My thesis takes the literature a step further and analyzes the balance of power during the implementation of economic policy using qualitative evidence from two actual instances of policy coordination in U.S. history. By assessing the relationship between the key policymakers involved in restoring the economy back to health during the Nixon administration and during the 2008 financial crisis, my thesis seeks to determine how the balance of power has played out in real world policymaking during periods of economic instability and how that relationship affects economic outcomes. I hope my research contributes to efforts that promote more effective government policymaking concerning economic decisions.

The first chapter of my thesis explains the purpose for the creation of the Federal Reserve System and how the Fed's powers differ from those of the fiscal authority. Two crucial theories to understand are the policy coordination theory, which inspired this thesis, and the political business cycle theory, which has presented itself in both the Nixon era and 2008 crisis, albeit in relationships between different agencies. The next two chapters are central to my thesis. After describing the economic overview that led up to the inflation problem in the Nixon administration and to the liquidity crisis of 2008, my paper then analyzes the fiscal and monetary response to those issues and the results of the

policies implemented. Finally, the last few chapters explain the implications of my conclusions.

2.1 Inception of the Fed

The need for an independent monetary authority to maintain economic stability was realized centuries ago. The markets sometimes encountered liquidity and credit crises that free market forces could not diffuse on its own. While the value of the Federal Reserve System was indisputable, the institution was criticized time and time again because of its seemingly limitless power. Few checks existed on the Fed compared to its three government counterparts in the executive, legislative, and judicial branches. Hence, the clout given to the Board of Governors to control monetary policy nearly free of restrictions was troubling to the public. Even more cause for concern was the public's perception that the Founders' intentions for creating the Federal Reserve System was to expedite political objectives through an unchecked agency. Historically, there is evidence of this relationship between the Fed and the rest of government. In the early years of the Fed's inception, the fiscal authority often held the upper hand in monetary affairs, which they legally had no jurisdiction.

The first attempt at a centralized banking system in the U.S. was in 1791 when Alexander Hamilton spearheaded the movement to create the First Bank of the United States. Having a central bank would make collecting and disbursing government funds

more efficient and aid in the issuance of government debt.[1] The First Bank had a capital stock of $10 million, 55 directors, and branches in major cities throughout the nation.[2] It performed the basic banking functions of accepting deposits, issuing bank notes, making loans, and purchasing securities. Its influence, however, was frightening to many people. The First Bank gave the federal government power over state banks because it could affect the dynamics of lending. When the First Bank redeemed notes, the state banks lost reserves and were less creditworthy, which hindered their lending potential.[3] Hence, Thomas Jefferson referred to the Bank as a "financial monopoly."[4] Both houses of Congress, representing public opinion, defeated the bill to renew the Bank's charter and allowed the First Bank to expire after twenty years of operation.[5] The next attempt to create a central bank did not occur until 1816 when President James Madison signed the bill to charter a Second Bank of the United States.[6]

Madison supported a central bank because absence of such an entity made it difficult for the Treasury to raise funds that the federal government needed to operate.[7] The Second Bank of the United States was much larger with $35 million in capital stock.[8] Referred to as the "fiscal agent for the federal government," the Second Bank dealt in foreign exchange, issued money, and could influence the availability of credit.[9] The public opposed the bank because of its immense power over the financial system. The way the Bank was structured allowed room for abuses of power:

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[1] (Bryan & Champ, 2002)
[2] (Federal Reserve Bank of New York, n.d.)
[3] (Bryan & Champ, 2002)
[4] (Federal Reserve Bank of Philadelphia, 2009)
[5] (Federal Reserve Bank of Philadelphia, 2009)
[6] (Federal Reserve Bank of New York, n.d.)
[7] (Bryan & Champ, 2002)
[8] (Federal Reserve Bank of New York, n.d.)
[9] (Bryan & Champ, 2002)

> While it was subject to congressional oversight, it was organized largely as a private institution so that its directors would have ample incentive to manage its assets in a fiscally responsible manner. However, the SBUS may have suffered from an identity crisis. According to some of its critics, the SBUS may have occasionally lost sight of the public good in the interest of making profits for its stockholders.[10]

President Andrew Jackson, especially, believed "such a concentration of power in the hands of a few men irresponsible to the people" was dangerous.[11] At the time, the public thought the Second Bank's ability to influence state bank note issuance and loan-making capabilities – interestingly, the powers the Fed has today – gave the federal government too much power. Giving that kind of power to a national bank "run by an aristocratic elite" frightened the common man's economic freedoms.[12] Congress did not renew the Bank's charter and it expired in 1836.

Yet, lack of any central banking authority hurt the stability of the American economy. Without federal regulation, problems such as inadequate bank capital, unreliable bank notes, risky loans, and insufficient reserves overwhelmed the financial system. The most severe failures occurred in 1873, 1884, 1890, 1893, and 1907.[13]

The Panic of 1907 was the tipping point for many Americans who believed that the U.S. banking structure was out of date and in need of major reform. During the Panic of 1907, the NYSE fell almost 50 percent from its peak the previous year.[14] Many state and

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[10] (Bryan & Champ, 2002)
[11] (Federal Reserve Bank of New York, n.d.)
[12] (Bryan & Champ, 2002)
[13] (Levantrosser, 1991)
[14] (Evans, 2009)

local banks and businesses entered bankruptcy. As news spread, lenders were reluctant to make loans and interest rates soared to 70 percent.[15] After the series of financial failures, and the Panic of 1907 in particular, the country realized a need for an entity to reduce financial instability, improve the quality of financial services, and strengthen the payments system.

Moen and Tallman argued that unequal regulation among financial organizations was the reason for a concentration of riskier assets in the less regulated intermediaries – primarily trusts – which caused the panic in 1907.[16] These trust companies became distressed, and in an attempt to rescue the New York money market, the big five trust company presidents pooled money together to save any trust that might face a sudden run.[17] Soon, wealthy financiers, including the prominent J.D. Rockefeller and J.P. Morgan, added to relief efforts by depositing millions to help the trusts from collapsing. Secretary of the Treasury George Cortelyou supported this effort by depositing $25 million of the Treasury's funds in national banks, $37.6 million in NY national banks, and providing $36 million in small bills to meet runs.[18] As a result, the Treasury's working capital was reduced to just $5 million, preventing the Treasury from contributing more aid throughout the rest of the panic.[19]

In theoretical terms, depositors were not insured against the risky activities the banks were partaking in so the threat of financial disruption led to a shift from bank deposits to gold or currency issued by the government. The drain of gold and currency into

[15] (Bruner & Carr, 2007)
[16] (Moen & Tallman, 1990)
[17] (Moen & Tallman, 2007)
[18] (Moen & Tallman, 1990)
[19](Moen & Tallman, 1990)

private hands forced reductions in bank assets and liabilities and threatened additional bank failures. Since there was no established lender of last resort, banks attempted to protect themselves against runs or currency demands by holding gold or currency reserves. If all banks sought to increase their gold holdings simultaneously, short-term interest rates would have risen as high as 100 percent annually.[20] To reduce the demand for gold, clearinghouse associations or groups of bankers pooled resources to provide payment facilities during periods of stress. Because such private facilities had to assume the risk of defaults, bankers were eager to shift responsibility for maintaining the payments and clearing mechanism to a central bank. Since "inelastic currency and immobile reserves" were the main reasons for the persistence of banking problems, the nation hoped for a central bank independent of the Treasury to provide a ready reserve of liquid assets and to allow for currency and credit to expand and contract seasonally.[21]

The structure of the banking system at the time of the failures involved privately owned institutions that were responsible for public activities including providing currency, maintaining domestic payments systems and international payments, and serving as lenders of last resort in periods of financial disturbances following threat of failure by major banks or financial institutions.[22] One of the principal problems bankers hoped to correct was to increase the seasonal response, or elasticity, of the note issue by eliminating provisions of the National Banking Act that tied the amount of currency to the stock of government bonds. Bankers wanted a central bank to reduce fluctuations in market interest rates, particularly those caused by the seasonal demand for currency and the

[20](Meltzer, 2003)
[21] (Johnson, 2010)
[22] (Meltzer, 2003)

financing of crop harvests, and to encourage the development of a broad national market in commercial paper and bills of exchange patterned on the London market.[23] The opposition, on the other hand, voiced fears that the central bank would operate similarly to a monopoly that would be run for the benefit of the big bankers.

The government's response to the Panic of 1907 was the passage of the Aldrich-Vreeland Act of 1908. It was a temporary measure designed to make the money supply somewhat more elastic during emergency currency shortages and it also created the National Monetary Commission, a body of nine senators and nine house representatives who were responsible for making a comprehensive study of the desirable changes to the central banking system in the United States.[24] The Commission submitted a report to Congress detailing 59 sections of recommendations and draft legislation for proposed changes to current banking and currency laws.[25] The Aldrich Plan called for the establishment of a National Reserve Association with fifteen regional district branches and 46 geographically dispersed directors who would be in charge of making emergency loans to member banks, printing money, and acting as the fiscal agent for the U.S. government.[26]

The Aldrich Plan was contested by President Woodrow Wilson's banking and currency reform plan. Wilson offered a solution that appeared to unite competing public and private interests. Instead of giving controlling interest to private bankers, his plan gave an important role to a public board, while delegating some autonomy to regional banks, which – at the time – were allowed to set their own discount rates. His proposal for a public-private partnership with semiautonomous, privately funded regional Reserve Banks

[23] (Meltzer, 2003)
[24] (Meltzer, 2003)
[25] (United States, National Monetary Commission, 1912)
[26](Meltzer, 2003)

supervised by the Federal Reserve Board was well regarded. The directors of the twelve reserve banks, who represented the various commercial, agricultural, and financial interests within each region, would control each bank's portfolio. In addition, membership of nationally chartered banks was mandatory rather than optional. As a result of Wilson's plan, the country's reserves could be pooled together to strengthen the individual parts by making total reserves available in the case of a crisis. Reserve banks could lend to other reserve banks without any required formal provisions.[27]

After months of hearings, debates, and amendments, the 30 sections of the proposed legislation were enacted as the Federal Reserve Act of 1913 on December 23rd. Congress officially established the Federal Reserve System in the United States with the creation of the Federal Reserve Bank "to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."[28] The founders of the Federal Reserve System wanted to design an organization with the proper incentives. The early structure reconciled the public nature of the central bank's task with responsible control of money and credit. The system was made up of both private and public entities to be headed by a seven member Federal Reserve Board of appointed public officials who would oversee eight to twelve private regional Federal Reserve banks, each with its own branches, board of directors, and district boundaries. The institution was supposed to provide a currency with stable value, capable of expanding and contracting in response to demand; a payments system that efficiently transferred money and cleared checks in a growing national economy; and the services of a

[27] (Meltzer, 2003)
[28] ("FDIC law," 2013)

lender of last resort.[29] The discount rate was the Federal Reserve's main channel of influence, yet rising interest rates were unpopular and provoked concerns about bankers' domination of the economy.

Two political appointees – the Secretary of the Treasury and the Comptroller of the currency – served as ex officio members of the Federal Reserve Board, with the secretary as Board Chairman. Though the top leaders were politicians, the Federal Reserve Board gained some influence after the enactment of the Banking Act of 1935.[30] The Act increased the Board's power by giving it a majority on the open market committee. The Banking Act of 1935 removed the secretary and the comptroller from the Board, though the secretary was still allowed to influence monetary policy decisions. Thus, the legal change did not reduce the politicians' decision-making power dramatically and the Treasury retained its strong influence until 1951.[31] The twelve regional reserve banks, on the other hand, completely lost their semiautonomous status. Much of their original independence weakened and the national Federal Reserve officially became a central bank. Devaluation of the dollar in 1934 gave the Treasury the financial resources to affect interest rates by buying securities. Marriner S. Eccles, then chairman at the time, expressed concern about the Treasury's actions but felt powerless to prevent them. Eccles also wanted to prevent inflation due to a large flow of gold, but he believed monetary policy could do little to stimulate expansion at the prevailing interest rates of the 1930s.

Developments in the Federal Reserve System decelerated when the United States' focus shifted to fighting the enemies in both world wars, causing government spending to

[29] (Meltzer, 2003)
[30] (Meltzer, 2003)
[31] (Meltzer, 2003)

skyrocket. The country lent its allies $7.3 billion and an additional $2.2 billion after the First World War.[32] In the first half of the 1940s, the Federal Reserve helped to finance World War II by purchasing government securities at fixed interest rates. The policy was continued even after the war ended and the Federal Reserve complained that it had become an "engine of inflation."[33] President Roosevelt and his Treasury Secretary, Henry Morgenthau, wanted interest rates to remain low, however, so the U.S. could more cheaply finance peacetime and wartime deficits. Monetary policy played a crucial role in their scheme and though Chairman Eccles wanted to increase interest rates, the Fed complied with Roosevelt's wishes. Eccles sacrificed the Fed's independence to help lower the Treasury's cost of debt finance and as a result, the Fed became subservient to the Treasury's needs.[34] The Federal Reserve summarized its "primary duty" in wartime as "the financing of military requirements and of production for war purposes," and Eccles described his action as "a routine administrative job… [T]he Federal Reserve merely executed Treasury decisions."[35] In both world wars, the Federal Reserve issued money, as was expected, to support the Treasury's interest rate policy.[36]

2.2 Powers Granted to Fiscal and Monetary Authorities

In the United States, the responsibility of managing the financial status and

[32] (Meltzer, 2003)
[33] (Meltzer, 2003)
[34] (Meltzer, 2003)
[35] (Meltzer, 2003)
[36] (Meltzer, 2003)

economic landscape is shared between two separate government entities – the fiscal and monetary authorities. Fiscal policy generally deals with taxing and expenditures, while monetary policy affects the money supply and interest rates.

2.2.a Fiscal Authority

The fiscal authority consists of several players including Congress and the Department of the Treasury. Congress, the legislative branch of government, is said to have "power of the purse" because it manages the budget and spending of tax revenue. Congress can affect the economy through changes to taxes and spending programs. It also has ultimate voting power on the passing of bills. Under the executive branch of government is the Treasury, whose mission is to "create economic and job opportunities by promoting the conditions that enable economic growth and stability at home and abroad, strengthen national security by combating threats and protecting the integrity of the financial system, and manage the U.S. Government's finances and resources effectively."[37] The Treasury is in charge of regulating national banks, determining international economic policy, collecting income and excise taxes, issuing securities, reporting the government's daily financial transactions, and manufacturing coins or bills for circulation.

2.2.b Monetary Authority

The monetary authority of the United States, on the other hand, simply refers to the Federal Reserve Bank, which is comprised of seven decisive players known collectively as

[37] ("Duties & functions," 2011)

the Board of Governors. Each member of the Board is appointed by the President and confirmed by the U.S. Senate, and can serve a full term of fourteen years.[38] From the Board, the President chooses a Chairman and Vice Chairman, who serve four-year terms.

The Federal Reserve Act of 1913 established the Federal Reserve System to act as a check on fiscal policy. Its purpose was to provide the nation with a safer, more flexible, and more stable monetary and financial system. Today, the Federal Reserve's main duties are to 1) conduct monetary policy by influencing monetary and credit conditions in pursuit of maximum employment, stable prices, and moderate long-term interest rates, 2) contain systemic risk that may arise in financial markets, and 3) provide financial services to depository institutions, the U.S. government, and foreign official institutions.[39]

The Federal Reserve carries out its duties and maintains the 2 percent inflation target through control of the money supply, thereby affecting the federal funds rate.[40] The Federal Reserve has three major conventional monetary policy tools in its arsenal:

1) Open Market Operations: A major component of the Federal Reserve System is the Federal Open Market Committee (FOMC). The FOMC oversees open market operations, which refers to the purchase and sale of securities in the open market to influence the level of balances that depository institutions hold at the Federal Reserve Banks.[41]
2) Reserve Requirements: the Fed dictates the percentage of certain deposits that depository institutions must hold in reserves of cash or in an account at a

[38] ("The structure," 2003)
[39] ("Federal Reserve: Mission," 2009)
[40] (Board of Governors of the Federal Reserve System, 2013)
[41] ("Federal Reserve: Open market operations," 2013)

Federal Reserve Bank.[42]

3) Discount Window Lending: the Fed is known as the "lender of last resort" for depository institutions seeking credit.[43] It should be noted, however, that borrowers are reluctant to use the window because there is a certain stigma of weak credit attached.[44]

To cool down a heating economy, and essentially, inflation, the Federal Reserve implements contractionary monetary policy. Some measures the Fed may use to achieve this end are increasing the interest rate, increasing reserve requirements, reducing the money supply, or some combination of the three. An increase in the federal funds rate reduces the attractiveness of holding onto cash relative to now higher-yielding money market instruments. As a result, the amount of money demanded and the growth of the money supply decrease, while savings increases. A higher federal funds rate also offsets incentives for banks to make more illiquid loans.

To stimulate a bearish economy, on the other hand, a decrease in the federal funds rate through an expansionary monetary policy is often used. In this case, the opposite occurs. Lower interest rates make borrowing money for investments more attractive. The Fed can also use open market operations to inject more capital into the economy by purchasing Treasury bonds on the open market.

[42] ("Federal Reserve: Reserve requirement," 2013)
[43] ("Federal Reserve: The discount rate," 2014)
[44] (Mizen, 2008)

2.3 Policy Coordination Theory: A Monetary-Fiscal Game

Studies show that complementary monetary and fiscal policy can expedite recovery time after a crisis. When the Federal Reserve is not burdened with political pressures, it is able to do its intended job. As a result, when central bank independence increases, inflation decreases.[45]

Bianchi and Ilut claim that when the fiscal authority leads U.S. economic strategy, fiscal imbalances generate long-lasting and persistent increases in inflation, and the monetary authority loses its ability to control inflation.[46] The authors used a Dynamic Stochastic General Equilibrium model to test multiple scenarios of varying power balances between the fiscal and monetary authority. They found a passive monetary authority and active fiscal authority mix was the most recurrent regime throughout history. Their interpretation of the fiscal and monetary dynamic during post World War II shows that inflation dropped only when fiscal policy accommodated Chairman Volcker's contractionary monetary policy. Moreover, a disinflationary attempt by the monetary authority actually led to more inflation when the fiscal authority did not support it. Lastly, their research demonstrates that inflation stabilized once fiscal discipline is restored.

Nordhaus, Schultze, and Fischer use the term *monetary-fiscal game* to reflect the fact that monetary and fiscal policies in many large countries are executed by separate

[45] (Cargill, 2012)
[46] (Bianchi and Ilut, 2013)

authorities and have conflicting objectives.[47] Though both authorities are committed to economic stability, the conflict exists because they rank certain indicators of different importance. The monetary authority views price stability as a top indicator of the health of the economy, whereas the fiscal authority holds maximum employment in high priority. When both entities are preoccupied pursuing their own objectives, the fiscal authority attempts to lower unemployment by raising the deficit and the monetary authority raises interest rates to fight inflation. Increases in fiscal spending on programs targeted towards lowering the unemployment rate deepens the budget hole and puts upward pressure on interest rates. The higher interest rates set by the Fed in turn make the debt more strenuous to pay back. If each authority carries out its end independently, the policies exacerbate the initial problem and also cause the federal budget to swell. While this arrangement for economic policymaking is not perfect, the alternative is worse. The authors' findings show that countries with dependent central banks have more inflation than countries with independent central banks, thereby indicating a strong negative relationship between independence and inflation. As a result, the best-case scenario would be an independent central bank that has a cooperative relationship with the fiscal authority. In other words, if both agencies respect each other's goals in regards to the deficit and to inflation with accommodative policies, then the economy can reach a higher bliss point.

Under many of the general equilibrium models used to analyze the effects of monetary policy, researchers assume that the fiscal authority is committed to adjusting surpluses to stabilize debt. Other factors, however, such as the political business cycle

[47] (Nordhaus, 1994)

theory, which I explain in the next section, make this assumption more complicated.

2.4 Political Business Cycle Theory

One of the central tenets of the political business cycle theory is that policymakers in democracies are motivated by partisan and electoral incentives. Politicians are pressured to vote within party lines and to support the wants of their constituents in order to improve their chances at reelection. Due to these incentives, researchers suggest that economic outcomes follow the electoral calendar. Studies show that politicians support economically favorable policies running up to elections.

Nordhaus' model of electoral outcome cycles assumes that policymakers are office-seeking and that citizens form adaptive expectations and retrospective evaluations.[48] In other words, citizens judge incumbents based on their past performance. Voters often prefer candidates who they expect will enhance their material well-being, usually through better aggregate economic performance.[49] Researchers at the Survey Research Center of the University of Michigan discovered from their national poll of American households that "more people felt that unemployment was a greater evil than inflation" and a majority of the respondents "indicated that they were hurt 'little' or 'not at all' by inflation. Moreover, they would not be willing to accept substantial increases in unemployment in order to halt increasing prices."[50] Hence, incumbents have powerful incentives to improve voters' economic fortunes through employment or at least hint at the ability to do so.

[48] (Nordhaus, 1975)
[49] (Franzese, 2002)
[50] (Hibbs, 1977)

Thus, Nordhaus claims that a predictable surge in stimulatory macroeconomic policies will occur leading up to an election year. The reason is because politicians hope to spur real economic improvement and delay any adverse outcomes until after the election. A politician sitting in office when economic growth is positive significantly increases his or her chances at reelection. In a slower economy, however, politicians must choose to support policy between a trade-off in inflation or unemployment. Politicians tend to address high unemployment because it is one of the major indicators of economic health and individual hardship. The public experiences a larger drop in utility when there are fewer job opportunities compared to higher prices. And, an even more effective strategy to improve an incumbent's chances at reelection other than lowering the unemployment rate, Tufte says, is to increase real disposable income per capita.[51] He suggests the easiest policy instruments to implement and the easiest to control timing-wise are transfers of wealth such as social security, veterans' benefits, or other direct payments, as well as tax cuts, delayed hikes, spending increases, delayed cuts in public works, and public hiring.

Due to the existence of the political business cycle, the Federal Reserve's independence is habitually threatened by political influences. These political influences include pressure to expand the money supply to accommodate budget deficits and increase business activity as well as the bureaucratic structure of the Fed itself due to nominations and confirmations. While the Federal Reserve was created to be an independent monetary entity separate from the motivations of Congress, policymakers bounded by certain legal restraints have historically turned to central bankers to do their "dirty work" in the short-

[51] (Tufte, 1978)

term.[52] Several periods in history show evidence of the Fed Chairman acquiescing to these political demands. Bradley found evidence that fiscal deficits increased the Fed's inclination to conduct expansionary monetary policy.[53] Buchanan and Wager argued that whenever the Fed implemented accommodative expansionary monetary policy to adjust for budget deficits that were caused by excess fiscal government spending, inflation would grow.[54]

Despite the goal of separation, an informal channel by which a relationship has developed between the fiscal and monetary authorities is through regular meetings between presidents and chairmen that are "off the books." Politicians have also been able to influence the Fed through the institutional structure, call on the help of media by issuing a statement about their desired monetary policy course, threaten the Fed's independence, and further instigate the Fed to cooperate through public pressure. Grier notes that these threats include audits of Fed expenditures, removal of budgetary autonomy, and shortening of the Board of Governors' tenures.[55] Grier's congressional influence model implies that changes in Fed leadership alone will have little effect on equilibrium policy without a corresponding change in legislative preferences.

The executive branch's appointment power and legislative branch's confirmation power of members to the Board of Governors similarly subject the Federal Reserve to political influence. Once appointed and confirmed, members of the Board of Governors can serve a term of fourteen years. The fourteen-year term was intended to safeguard members' positions on the Board if they decided to vote contrary to the views of the president – who serves four-year terms – who appointed them. The loophole of this check

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[52] (Salmon, 2012)
[53] (Bradley, 1985)
[54] (Buchanan and Wager, 1977)
[55] (Grier, 1991)

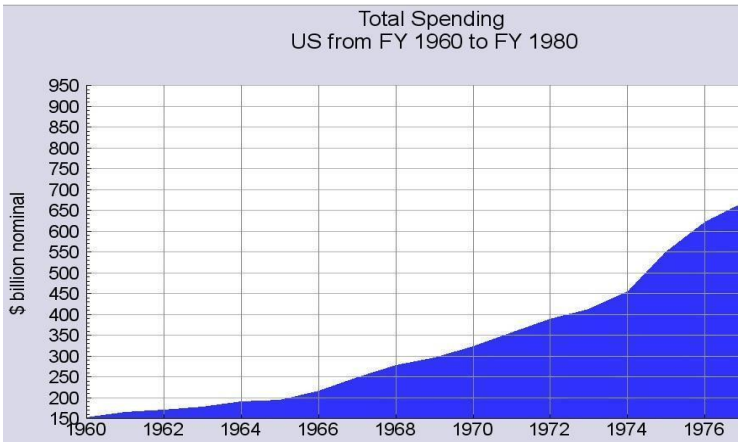
and balance system is that the president also selects two members of the Board to be the Chairman and Vice Chairman for four years, thereby having the indirect ability to shape the Fed's image and message to the public. The Chairman holds tremendous power, as he or she represents the "public face" of the Fed, sets the agenda during Federal Open Market Committee (FOMC) discussions, and holds final appointment power over all appointments within the Fed. A politically strategic appointment of the Vice Chairman can also create a loyal advocate in the FOMC and affect monetary policy decisions that way.

I take current literature that models monetary and fiscal policy interactions a step further by examining two real instances of policy coordination in particular. The first instance is the relationship between President Richard Nixon and Fed Chairman Arthur Burns during the 1970s. The second instance is the relationship between Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke in the 2000s.

3.1 Policy Coordination Instance I: the Nixon Administration

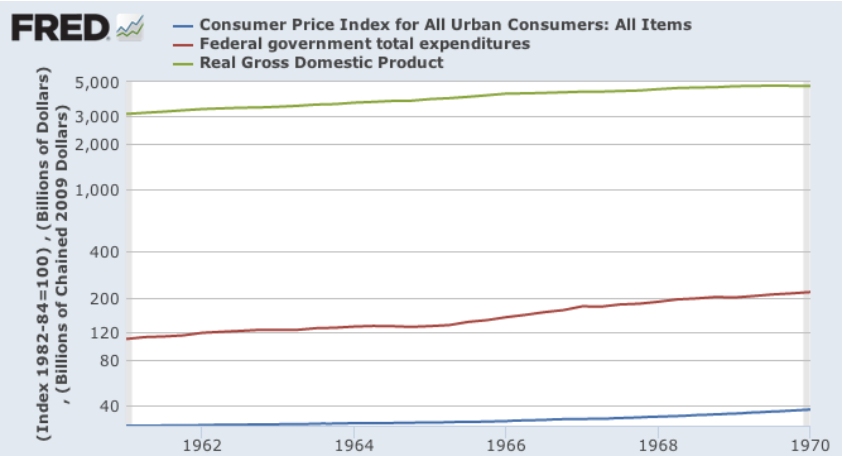
3.1.a Economic Overview

On January 20th, 1969, Richard Nixon was inaugurated the 37th President of the United States. At that moment, Nixon not only inherited the presidency from Lyndon B. Johnson, but also an overheated economy. Although GDP growth catapulted due to increased federal spending, it was accompanied by an unruly inflation rate.



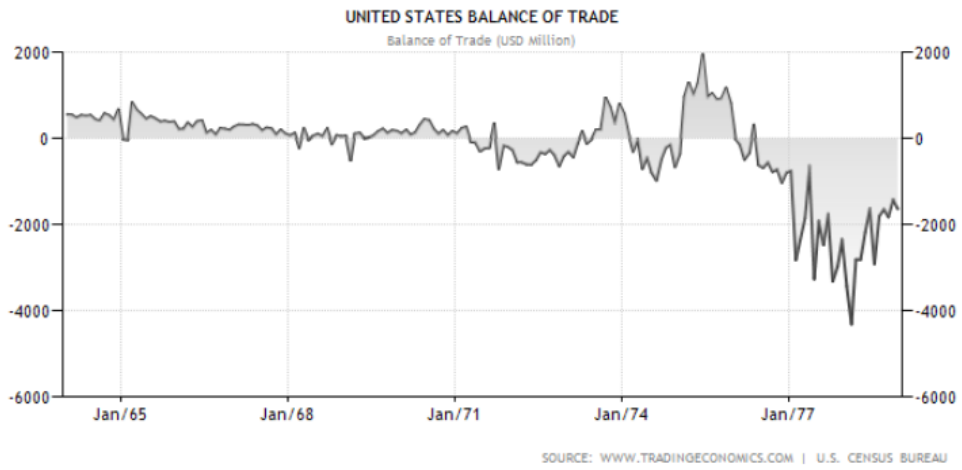
(U.S. Government Spending, 2014)

Under President Johnson's administration, federal spending increased substantially due partly to U.S. involvement in Vietnam and partly to the "Great Society" concept, which sought to improve quality of life in the United States through a boost in GDP. Federal funds poured into military expenditures as well as educational programs, initiatives to fight the "War on Poverty," and the establishment of Medicare and Medicaid. Total U.S. government expenditures grew rapidly throughout the 1960s. During Lyndon Johnson's term as president, fiscal spending increased from $177.4



(FRED, 2014)

billion in 1963 to $296 billion in 1969, the year Nixon took office. While increased federal spending boosted real economic growth to 4.9%[56], it also caused the inflation rate to grow to a troublesome 4.7%. To meet the increased demand, firms needed to hire more workers or increase current workers' wages. A bump in consumers' purchasing power led to an increased demand for imported goods. The U.S. developed a balance of payments deficit as more U.S. dollars floated overseas in the form of payment for an increasing amount of imports at home. The deficit was worrisome because the dollar served - and still serves - an important role in the world as a "key currency." People wanted to hold U.S. dollars because it was a stable currency and because it was the medium used for most international transactions. Since foreign countries were accumulating stockpiles of U.S. dollars in their central bank reserves, the Federal Reserve needed to print more money to meet the large demand for dollars. Increasing the money supply devalued the U.S. dollar and international consumers were able to buy more goods for the same amount of money than they could previously. Another wave of increased consumer demand occurred and this continuous cycle exacerbated inflation domestically. Globally, expansion of the U.S. money supply caused foreign nations'



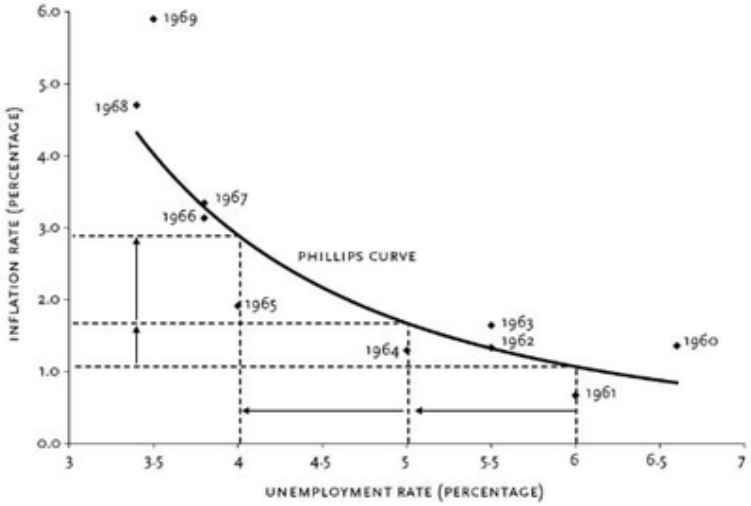
[56] (Amadeo, 2014)

home currencies to depreciate as well. Then, other countries began to suffer from rising inflation too. It could be said that the U.S. was exporting inflation to other countries due to its expansionary policies and its oversupply of U.S. dollars in the market.

The sheer size of the balance of payments deficit that the federal government was running - $7 billion - aggravated inflation.[57] Under the Bretton Woods system, the U.S. had committed itself to backing every dollar abroad in exchange for gold at a rate of $35 per ounce. The United States only had $14.5 billion of gold, which would not be enough to redeem the $45.7 billion in U.S. dollars held by foreign countries. The Fed raised interest rates to six percent in order to make the dollar more attractive to hold in the hopes of deterring foreign nations from approaching the gold window. As Germany and Japan's economy recovered after World War II, the U.S. share of the world's economic output fell considerably and there was more need for other currencies like the deutsche mark and yen. Nations began to trade in their dollars for gold at the U.S. window, which led to a run on gold. Inflation skyrocketed to 6.2 percent in 1969, yet the Federal Reserve continued to defend the gold standard and decided to raise the interest rate to 9.19 percent.[58] A mild recession began later that year and the unemployment rate rose to 6.1 percent by the end of 1970.[59] Not only was the rise in the unemployment rate significant because it was the highest the U.S. had seen in a decade, but also because it accompanied a

[57] (Keran, 1969)
[58] (FRED, 2014)
[59] (Lowenstein, 2011)

Figure 1 The Phillips Curve, 1961–1969



(Hoover, 2008)

rise in inflation. Traditional economic theory states that unemployment and inflation move in opposite directions. The Phillips Curve represents this trade-off as a downward-sloping curve of efficient policy prescriptions. As the graph shows, the unemployment rate was much lower and the inflation rate was much higher than equilibrium in the year 1969.[60] The Johnson administration left Nixon an overheated economy and Nixon's policies made the situation worse.

3.1.b Key Players of Policy

At the forefront of addressing the issue of rising inflation were Richard Nixon, President of the U.S. from 1969 to 1974, and Arthur Burns, Chairman of the Federal Reserve from 1970 to 1978. Nixon was one of the major players influencing policy alongside Congress on the fiscal side of government affairs. Within the monetary authority, Arthur Burns held the most weight in the decisions concerning policies to be executed by the Fed.

Richard Nixon was well acquainted with the White House prior to his presidency. He

[60] (Hoover, 2008)

previously served as Vice President in Dwight D. Eisenhower's administration and ran unsuccessfully against John F. Kennedy for the presidency in 1960. Nixon believed he lost the election against Kennedy because of a poor economy. The Fed Chairman, William McChesney Martin Jr., had tightened interest rates during the campaign, which contributed to the onset of a recession at the time. Burns had warned Nixon that the tightening would damage his chances in the election. Nixon grew an aversion towards contractionary monetary policy after losing to JFK and never forgot the power of the Fed, or of Burns' political savvy. Although Nixon originally stated he was against government intervention and a believer of "New Federalism," a term for policies that advocate devolution, he shifted to Keynesianism because it was the popular school of thought believed to maximize economic performance. Therefore, it was the more politically advantageous stance. In addition to shifting his views to the middle ground, Nixon also used other tactics to increase his popularity. Throughout his first term as president and especially in the months leading up to his next presidential election in 1972, Nixon was so engrossed in being re-elected that he did nearly anything to improve his chances at securing a second term. He bugged the offices of suspicious officials, broke into the Democratic National Committee headquarters, and manipulated expenditures for the election among other illegal acts. Burns pondered, "is there anything that he would not do to further his reelection?"[61] The Nixon administration contained a substantial amount of evidence showcasing the political business cycle theory at work.

In fact, one of Nixon's politically strategic moves was nominating Arthur Burns to be the Chairman of the Federal Reserve. President Nixon believed Burns was a loyal friend and

[61] (Burns , 2010)

could count on Burns to do his bidding on the monetary front. In appointing Burns, Nixon had reaffirmed the Fed's "independence" but added that he expected Burns would "independently… conclude that my views are the ones that should be followed."[62] Little did he foresee that Burns would not be a willing puppet.

Arthur Burns started his career as an economics professor until he was asked to chair President Eisenhower's Council of Economic Advisors from 1953 to 1956. Prior to his stint at the Fed, Burns was the president of the National Bureau of Economic Research. He had authored a book titled *Prosperity Without Inflation*, in which he explained that economic policies since the Employment Act of 1946, which promote maximum employment, were the cause of an upward drift in prices. Burns' preference for controlling inflation over achieving maximum employment should have been Nixon's first indication that their philosophies would be at odds. Throughout Nixon's presidency, Burns continually challenged the President's proposals. Burns eventually gave into Nixon's demands, however, and expanded the money supply. The 180-degree reversal in Burns' opinion was triggered by threats to the Fed's independence and a realization that monetary policy by itself could not combat this new kind of inflation. Stagflation challenged the traditional economic theory that inflation and unemployment were inversely related. Thus, Burns, a die-hard advocate of the Fed's independence, needed to approach the situation with an open mind and was in part coerced into promoting economic policy reform that included fiscal assistance. As a result, Burns developed a reputation for being overly influenced by the executive branch.

[62] (Goldner, 2006)

3.1.c Diagnosing the Economic Problem

The first task that greeted the Nixon administration when they entered the White House was stabilizing the economy. While Burns and Nixon both agreed that inflation was soaring to levels requiring attention in 1969, they disagreed about the extent of the problem and how to address it.

Burns thought a myriad of factors contributed to the skyrocketing inflation rate including the expansion of a middle class, the onrush of technology, the Bretton Woods system, and the economic booms abroad. The most prominent problem in the late 1960s though, he declared, was the growing private economy and the power of labor unions. While federal war spending had played a significant part in stimulating markets during World War II, the amount of government expenditures declined after the end of the war. While the annual rate of federal expenditure on goods and services dropped by $74 billion between 1945 and 1947, the rate of expenditures by individual consumers rose by $80 billion.[63]

This growth was made possible due to credit expansion. The rapid rate of spending on capital goods was accompanied by a rapid increase in indebtedness. During the post-war period, the federal debt changed little. Meanwhile, the outstanding private debt rose almost three-fold from $154 billion at the end of 1946 to $416 billion ten years later. When demand strained the nation's stock of physical resources, as long as markets were free and competitive, costs of production and prices became unstable. Increased demand for goods created an increased demand for labor as well. As a result, employers bid actively for labor

[63] (Burns, 1958)

under such conditions, which caused wages to rise. When wages rose, prices rose in similar fashion. Furthermore, since there was a real expectation that incomes or both prices and incomes would move higher, the momentum for more demand was strengthened again all around.

Not only did the private economy pick up pace, but also a general recognition of the government's responsibility to help maintain that prosperity had formed. The passing of the Employment Act of 1946 declared that the federal government had a continuing responsibility to use all practicable means to foster free competitive enterprise, to prevent or moderate economic fluctuations, and to promote maximum employment, production, and purchasing power. The Act was a revolutionary change in economic and political thought because the previous generation deplored government intervention and supported free markets.

The ability of trade unions to win large wage increases hurt the economy because the increases were substantially larger than the increases in general industrial productivity. Labor compensation per hour in the private nonagricultural sector increased 61 percent, whereas non-agricultural prices at wholesale rose only 28 percent.[64] Thus, the unions caused a big shock to the expectation of rising prices and incomes.

As these forces gathered strength and came to reinforce one another, they increased people's confidence in their own economic opportunities. Hence, government policies and the sustained expansion of aggregate demand since the end of World War II allowed the economy to operate in a state of practically full employment. This fueled the growth of

[64] (Burns, 1958)

inflation and the economy became overheated.

Burns stated that if consumers and businesses had maintained their level of spending even when their incomes increased, or if they had not gone into debt to expand their purchases, then the level of prices would not have risen as much. If the federal government had restrained the expansion of demand, the rise in the overall level of prices would also have been suppressed. If trade unions had used their power to keep wage advances in line with increases in general productivity, the rise in prices would have been checked. Lastly, Burns claims that the labor and wage increase was so problematic because it was not accompanied by an equally sufficient increase in productivity. In other words, the corresponding effectiveness each worker provided per marginal increase in the labor supply was subpar in comparison.

Tackling creeping inflation was of the utmost importance to Burns because like unemployment, it could also eat away at a person's savings. Inflation would create difficulties for workers living on pensions or on income from fixed-interest securities because real prices would escalate by much more than the periodic payments received from the financial products. Inflation would reduce the ability to sell in foreign markets, distort the calculation of profits, and eventually lead to depression. Although the effects of high inflation would not be as immediately perceived by the public as the effects of unemployment, the harm in the long run would be just as bad or worse.

President Nixon conceded that inflation was a concern, but he argued that it was not as critical a concern as the unemployment rate. He took this stance because Nixon was consistently more invested in achieving his political ambitions. He was motivated to act on

issues that would please the American people for re-election purposes rather than prioritize issues based on how pressing they were. Addressing unemployment was more important to Nixon because it was the public's indicator of a good or bad economy, which would significantly affect his popularity. The political business cycle distorted Nixon's priorities. He disregarded the importance of stabilizing the inflation rate and concentrated instead on improving the unemployment rate because a good economy would enhance his chances in the next election. This trade-off was likely a political move as opposed to a righteous move for the public good.

3.1.d Philosophies About Government Policy

At the beginning of Arthur Burns' career as Chairman of the Fed, he was very focused on his duty to maintain economic stability above all else. His diagnosis of the economy was that inflation was too high. For that reason, he made it his first priority to calm down the heated economy.

In his book *Prosperity Without Inflation*, Burns listed the following major general principles suggested by historical experience that he believed would serve as a useful guide to governmental efforts. The first principle is to promptly countermove any signs of faltering in the economy before the problem gets out of control. Second, efforts have to be coordinated so that the steps taken by different agencies of the government will reinforce one another. Third, the actions should be on a sufficient scale to give reasonable promise of checking the recession, yet not so powerful as to stimulate massive speculation of other excesses that may create trouble later. Fourth, Burns emphasized that the start of a

recession should ordinarily be addressed firstly by easing credit conditions, later by reducing taxes, rescheduling federal expenditures, and a large public works program only as a last resort.

In regards to policy, he recommended that the appropriate public policy response to cope with inflation should be "mindful of the need to encourage private enterprise, innovation, and investment."[65] Looking towards the long run, he admitted that the government had - in principle - many options to achieve that goal.

> We could reduce government expenditures or restrain their expansion in times of great economic exuberance. We could raise taxes. We could restrain the expansion of credit. We could modify the arrangements under which wages are set. We could alter the price-making process. We could reduce tariffs and abandon or modify other governmental devices for supporting prices. We could work harder and produce more. We could remove or reduce artificial obstacles to higher productivity. And, in principle, we could do any of these things or some combination of them in a great variety of ways.[66]

In practice, however, Burns declared that the variety of the Federal Reserve's choice of policy tools is more limited.

> Some methods of seeking general price stability - such as the allocation of credit or wage and price fixing - are ruled out by our traditions of freedom… Other policies, which would stress the expansion of supply rather than the

[65] (Burns, 1958)
[66] (Burns, 1958)

> restraint of demand, may prove very helpful in the long run but quite ineffective in the short run.[67]

Burns' acquiescence of "realism" played into his belief that government policies for restraining inflation should have "the quality of austerity." His desire for stricter policies explains his avidness for price controls. He reasoned that the public would not choose the correct option because their incentives were distorted by factors such as time or self-interest. For instance, people were not likely to support the austere policies needed to contain inflation because they feared for the security of their jobs. As a result, Burns justified intervention by rationalizing that it was the government's purpose to fulfill that role of the "invisible hand." Burns' slight deviation from the average economist's complex for a laissez faire economy is perhaps what caught Nixon's radar. Nixon honed in on Burns' ability to be practical and manipulated him to act in accordance with his political plans.

Richard Nixon's philosophy and actions were mostly motivated by political gain rather than fulfilling his duty as President. Prior to the 1960 presidential campaign in which he lost to John F. Kennedy, Nixon was a strong opponent of government intervention. He expressed that "it is the purpose of the government to do for people what they cannot do at all, or do so well, for themselves. In all other matters, government should stay out."[68] Due to his extreme suspicion that a slow economy was the cause of his defeat, Nixon changed his public image and became a proponent of the Keynesian school of thought. Keynesianism is a demand-side theory that focuses on changes in the economy in the short

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[67] (Burns, 1958)
[68] (Levantrosser, 1991)

run.[69] Whereas Nixon once supported minimal government interference in the free market, now he insisted that policies aimed at influencing aggregate demand would stimulate the economy. Nixon's political ambition suffocated his moral compass throughout his career - ironically - in public service. Since his motivations were insulated to getting reelected, Nixon approved any strategies he thought would improve his popularity at the polls. Nixon concluded that it would be politically advantageous to lower unemployment, which would have a more immediate and direct impact on the American people's utility than tackling inflation. Thus, he took all routes to achieve that goal.

3.1.e Addressing the Increasing Inflation – Policy Approaches

Arthur Burns' plan during his tenure as Chairman of the Federal Reserve in the Nixon administration was to decrease the money supply using contractionary monetary policy to combat the increasing inflation rate. Since he could not preside over fiscal policy, Burns resorted to advocacy. He "argued strenuously for a tough anti-inflation objective – 1 ½ % to 2% for the year" and for a halt to increases in government spending to cool down the economy.[70] He recognized that the most significant causes of the skyrocketing inflation – diminishing gold reserves and the fact that union workers were able to negotiate wage increases of more than 30% over three years – were more difficult to resolve from a monetary policy standpoint. At most, the Federal Reserve could influence the wage policies of trade unions and the pricing policies of business firms indirectly. Thus, Burns' proposal to resist inflation was the creation of a price and wage review board, a suggestion that supported the implication made in his book *Prosperity Without Inflation* that he was fond of

[69] (Blinder, 2008)
[70] (Burns, 2010)

price controls. The creation of a price and wage review board was out of the Fed's jurisdiction though, since it fell under fiscal policy.

Nixon, conversely, was avid in the Fed conducting expansionary monetary policy to increase the money supply and spur more business activity. Nixon's wishes would have theoretically lowered interest rates and boosted employment, but at the cost of scalding an already overheated economy and worsening inflation - a potential event Burns was trying to avoid.

Burns contended that "the monetary authority…has laid the foundation for recovery…What is holding back the economy now is not any shortage of money but a certain shortage of confidence. If we flooded the banks even more than we have I think you could have awful problems in 1972 and beyond."[71] When Burns refused to agree with Nixon's ideology and shared his proposal to contract the money supply and contain prices, Nixon was perplexed. Nixon had nominated Burns to be Chairman because he thought Burns was an "old friend and party loyalist," and therefore would side with him in matters.[72] The longer Burns held out on Nixon, the more Nixon pushed and tried to persuade Burns, becoming increasingly more aggressive in his tactics every time. Burns noted in his diary that Nixon's "entire manner was imperial."[73]

Nixon started the political chess game with friendly fire, but civility quickly escalated to antagonistic threats. Herbert Stein, one of his economic advisers, said Nixon "tended to worry exceedingly about his reelection prospects and so to feel impelled to

[71] (Abrams & Butkiewicz, 2012)
[72] (Abrams & Butkiewicz, 2012)
[73] (Burns, 2010)

extreme measures to assure his reelection."[74] Nixon wrote Burns a "long and anxious letter about the importance of getting the money supply up."[75] When Burns didn't budge, White House aides inundated the Fed with memos about the need to lower rates. Although Burns predicted that "the harassing of the Fed by the President and his pusillanimous staff will continue and may even intensify," he still wanted Nixon to know that he was his "best friend" and "by standing firm, [he would] serve the economy – and thereby also the President – best."[76] Burns clearly indicated that he had, in his view, eased monetary policy sufficiently and stated that further expansionary monetary policy would likely raise inflationary expectations and interest rates.

Although Burns feared the consequences of higher unemployment as well and was committed to the success of the Nixon administration, he was even more worried about the long-run implications of aberrant inflation. Thus, he continued to pursue his anti-inflationary objectives. Towards the end of the year, Burns gave a speech promoting his idea for a wage and price review board that would issue guidelines and attempt to restrain inflation through encouragement and public statements. When Burns communicated the Fed's stance, he frequently spoke out about higher interest rates, contrary to what Nixon wanted.

Nixon met Burns in private and instructed him to censor his communication with the press. Nixon lectured Burns that the entire administration should speak with one voice and that Burns was "expected to conform to publicly announced Administration policies."[77]

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[74] (Higgs, 2009)
[75] (Burns, 2010)
[76] (Burns, 2010)
[77] (Burns, 2010)

John Connally, the new Treasury Secretary and official spokesman, was that one designated voice to the public. Connally was one of Nixon's greatest assets, as he had no abiding economic philosophy and was blindly loyal. He proclaimed to Nixon, "I can play it square, I can play it round, just tell me how you want me to play it."[78] And the way Nixon wanted to "play it" was by ganging up on Burns so he would feel pressured to expand the money supply. "Everybody except Arthur thinks [the money supply] ought to be higher and let's just keep hitting him on that" Nixon commanded. Following Nixon's wishes, Connally approached Burns and confessed, "We need to drive this interest rate down." Burns replied reluctantly, "We could make matters worse by making money easier…If anybody gets the notion, you see, that we are easing monetary policy further, that will intensify these fears of a rise in interest rates later on."[79] Conally pressured Burns by belittling his opinion and emphasizing that he was in the minority, and thereby likely wrong:

> If I read the tea leaves right, that isn't the way things are going. They're going the other way. I said, you're isolating yourself more and more…Normally the Treasury and Federal Reserve will be right together and that's the way I want it, but if you're going to isolate yourself, I can't go with you.[80]

Burns recognized the importance of speaking with one voice to boost public confidence and to exude federal unity in resisting inflation, but he did not want to implement monetary policy to which he was not committed. He assured Nixon that he was "fully sensitive to the need of avoiding any impression of a conflict between us" and in his diary wrote that he "practiced great restraint in Pepperdine precisely because [he] wanted to avoid loose talk

[78] (Lowenstein, 2011)
[79] (Abrams & Butkiewicz, 2012)
[80] (Abrams & Butkiewicz, 2012)

about a confrontation."[81]

Out of the public eye though, Burns continued to resist pressures to conduct expansionary monetary policy and continued to support a wage council. He wanted to remain true to his duty as Fed Chairman and stressed that he was "doing [his] basic job at the Fed." He continued, "I'm a dedicated man, to serve the health and strength of our national economy."[82] Burns knew expanding the money supply was the wrong policy to pursue because "to drive interest rates lower would run the risk of accelerating an international monetary crisis."[83] Burns could not support Nixon's strategy because it conflicted with his knowledge of economics. He worried that more expansionary monetary policy would worsen the U.S. balance of payments deficit and further accelerate the outflow of international reserves.

Even though Burns valiantly battled Nixon's desire to expand the money supply, he did not conduct the sufficient contractionary monetary policy needed to alleviate the economic burden. Abrahms claims "the 'old' Arthur Burns, author of *Prosperity without Inflation*, would have applied a tighter monetary policy, but he surely knows that this would have been vehemently opposed by Connally, Shultz, and, most importantly, Nixon."[84] While Burns did not follow Nixon's orders, his inactivity was a detriment to the U.S. economy as well. Without active monetary policy to eliminate, or even contain, inflation and the potential run on gold in the U.S., the symptoms of instability lingered. Between 1957 and 1971, the U.S. lost roughly 60 percent of its international reserve assets and from

[81] (Burns, 2010)
[82] (Abrams & Butkiewicz, 2012)
[83] (Abrams & Butkiewicz, 2012)
[84] (Abrams & Butkiewicz, 2012)

1970 to 1971, the U.S. lost approximately 8 percent of its gold reserves.[85]

In July 1971, Burns mustered the courage to speak at a congressional hearing and said that the traditional rules of economics were not applicable to the current economic situation anymore.[86] He told Congress that the concern about inflation was now accompanied by a recession. The situation was abnormal because the traditional laws of economics say inflation should not exist during a recession, and there should not be a recession when there is high inflation. Despite extensive unemployment at the time, wage rate increases did not stabilize. While industrial capacity idled, commodity prices continued to rise. The economy was in a state of stagflation and Burns believed the solution would be an incomes policy, a provision that would attach wage increases to increases in labor productivity. By attaching wage increases to a corresponding increase productivity, Burns hoped raises would stop growing unreasonably and exponentially larger.

In addition to an incomes policy, Burns thought that the U.S. should devalue the dollar against gold and raise the gold price above $35 in order to mitigate the balance of payments deficit and to avoid a possible run on gold in the United States.[87] Since the U.S. dollar was a key currency in the world, it was used as a reference for international transactions and setting exchange rates. When Americans experienced an increase in purchasing power and increased their consumption of imported goods, large sums of U.S. dollars floated abroad and piled up in the reserves of foreign nations' central banks. Foreign countries accumulated almost US $45.7 billion. Meanwhile, the U.S. held a mere $14.5 billion in gold, which left the country vulnerable to a run if all the other nations

[85] (Burns, 1971)
[86] (Burns, 1971)
[87] (Burns, 1971)

wanted to convert their dollars into gold.[88] Setting the U.S. dollar to gold exchange rate higher appreciated the value of the dollar and made it less attractive to convert.

The pressure to address the gold window intensified in the spring of 1971 when Germany was forced to purchase US $5 billion to stabilize its exchange rate.[89] Severe upward pressure prompted Germany to let the deutsche mark float, a radical move in an era when most currencies were pegged to the dollar.[90] Burns believed devaluing the dollar would stall other countries from exchanging their gold reserves because they would receive less gold for each dollar when converted. By making it less attractive to approach the gold window, Burns hoped to eliminate, or at least postpone, a run on gold in the U.S. generated by its allies of the Bretton Woods Agreement.

3.1.f Implementation of the New Economic Policy

In 1971, Nixon initiated and Congress passed the New Economic Policy (NEP), which the press coined as the "Nixon Shock."[91] The NEP's major provisions included closing the gold window, floating the dollar, imposing a ten-percent tariff on imports, and placing a 90-day freeze on wages and prices.

The policy was discussed during a secret meeting at Camp David among Nixon's most trusted advisors. The reason for commencing the meeting was mostly for Nixon and Connally to confirm support for the provisions of the policy as opposed to actual debate. Nixon knew the public perceived Burns as a trustworthy government official because the

[88] (Time, 1971)
[89] (Time, 1971)
[90] (Time, 1971)
[91] (Office of the Historian, 2013)

Chairman's "advocacy or comments on non-monetary matters was being interpreted widely as Administration policy," and thus was adamant on gaining his support. Nixon said of Burns: "He plays all the bureaucracy. He plays all the press. He does the leaks."[92] The Nixon tapes reveal, however, that Burns was not on the same side as Nixon and strongly opposed to closing the gold window. Nixon's other advisors were split on the issue.

Regardless of discord among Nixon's advisors, Nixon pushed forward and officially addressed the nation about the outline of his New Economic Policy on August 15th, 1971. The overall message of his speech titled "The Challenge of Peace" was to create a new prosperity without war. The policy targeted unemployment, inflation, and international speculation. It required action on three fronts. Nixon proclaimed, "we must create more and better jobs; we must stop the rise in the cost of living; we must protect the dollar from the attacks of international money speculators."[93]

In regards to unemployment, Nixon wanted to create jobs and boost productivity. To help the two million workers released from the Armed Forces and defense plants, Nixon hoped to stimulate American industry by calling on Congress to enact the Job Development Act of 1971 and stimulate production.[94] The Act would provide a ten percent job development credit for one year and a subsequent five percent credit afterwards. In addition, Nixon proposed to repeal the seven percent excise tax on automobiles, to impose a ten percent cut in foreign economic aid, and to speed up the implementation of the personal income tax exemptions scheduled to take effect in roughly a year and a half.

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[92] (Abrams & Butkiewicz, 2012)
[93] (Peters & Woolley, 2014)
[94] (Nixon, 1971)

To deal with inflation and the rising cost of living, Nixon ordered a freeze on all prices and wages in the United States for a period of 90 days, as well as a freeze on all corporate dividends. The 90-day freeze consisted of four phases over 1,000 days. The price and wage controls were applied almost entirely to the biggest corporations and labor unions, which were viewed as having price-setting power. After the 90-day freeze, increases would have to be approved by a Pay Board and a Price Commission.

Lastly, Nixon hoped NEP would stabilize the dollar by temporarily suspending its convertibility into gold and by imposing a ten percent tax on imported goods. He admitted to the American people that "this action will not win us any friends among the international money traders," but that the government's primary concern was for American workers. In reality, Nixon actively sacrificed a growing inflation rate in the hopes of inflating the currency unduly.[95] He believed cheapening American goods against those of foreign countries' would give him enough of a temporary advantage to get through the next election.

With these government actions, Nixon hoped to renew confidence, maintain fair global competition, and open the door to new prosperity. He concluded the speech by saying "Our best days lie ahead."[96]

3.1.g NEP Outcomes

In President Nixon's presentation of the policy to the press, he brilliantly packaged

[95] (Burns, 2010)
[96] (Nixon, 1971)

the program not to be perceived as America abandoning its commitment to the gold standard, but as America taking charge. 75 percent of the American people supported it in the polls, a testament to why Nixon won the 1972 presidential election against Democratic Senator George McGovern by a landslide.[97] The consequences of NEP were felt soon after the election though, and America paid the price. NEP was widely considered a political success, but a disaster to the economy. The provisions of the Nixon Shock policies failed to contain the rising inflation and in fact, made it even worse. Although Nixon had ambitious intentions to lead America to prosperity, the results of his New Economic Policy failed on all fronts.

Wage and price controls interfered with all the fundamentals of a free market economy. When workers deserving of higher wages were not granted pay raises, their incentives to work hard were diminished. Halts to pay raises also lowered consumer demand for goods because workers did not have as much money to spend. On the supply side, price controls prevented businesses from lowering prices and boosting demand. Even more crucial, however, price controls denied businesses the ability to raise the prices of their products when the cost of their imported materials rose. Businesses, therefore, had no choice but to reduce hiring to counteract these market forces. Contrary to his intention to lower the unemployment rate, Nixon effectively made it increase.

The first wave of price and wage controls curbed inflation temporarily, conveniently just enough for Nixon to coast through the 1972 election. The freeze had destabilizing long-term effects when coupled with the Fed's expansionary monetary policies though. The

[97] (Sanders, 2008)

controls kept prices too high and the expansion weakened the value of the dollar, which reduced demand and purchasing power. Controls also prevented wages from reaching equilibrium so salaries remained too high and businesses were forced to lay off workers. During the last phase of the freeze in June 1973, it was evident that the controls were not working.

Signs indicating the onset of a recession appeared in November 1973. For three consecutive quarters, the economy posted negative GDP growth rates. In Q3 of 1974, GDP growth was down 3.9%; in Q4 1974, the GDP growth rate was -1.6%; and Q1 1975, -4.8%.[98] In May of 1975, the unemployment rate reached 9 percent and inflation hovered stubbornly around 12 percent.[99] Ranchers stopped shipping their cattle to the market, farmers drowned their chickens to avoid losses, and consumers emptied the shelves of supermarkets.[100]

NEP's suspension of the convertibility of gold was also a failed attempt to stabilize the economy. When Nixon raised the value of gold to $38 and then $42, he effectively ended the Bretton Woods System.[101] Closing the gold window had devastating domestic and international repercussions. The dollar's value immediately fell, which made imported goods more expensive. Prices soared and created even more inflation. The 10 percent import tax imposed by NEP had the same effect and made foreign goods more expensive for U.S. consumers. Even though the tax was intended to help reduce the balance of payments deficit, it had a terrible effect of pushing inflation into the double digits, far from

[98] (Federal Reserve Economic Data, n.d.)
[99] (Federal Reserve Economic Data, n.d.)
[100] (Stanislaw & Yergin, 2002)
[101] (Stavetski, 2012)

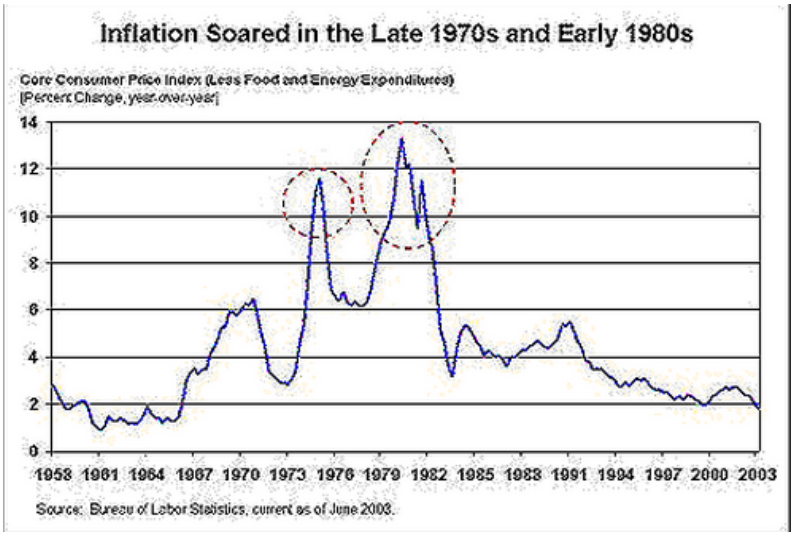
the 2 percent target. Other countries responded by printing more of their own currency to lower interest rates as well as their currencies' value. These two provisions exacerbated inflation at home and hurt trade relations with allies of United States.

When Burns still stood his ground against expanding the money supply, Nixon spread rumors to further his "unemployment-at-all-costs" agenda. Nixon declared arrogantly, "I'd be delighted to be the first president in 25 years to take the Fed on if it becomes necessary."[102] The first threat was a personal attack against Burns. Nixon threatened to add additional members to the Board of Governors, which could have potentially weakened Burns' individual power. Nixon ordered George Schultz and John Connally to "find the easiest money man in town," a "guy that's more interested in the job front than the inflation front,"[103] "one that will speak up to Burns."[104] If the additional Board members were loyal to Nixon, Burns would be outnumbered when voting on policies. Nixon requested that Bob Haldeman get the "story leaked through the Colson apparatus" to caution Burns that "recommendations are being made from among the President's economic advisors that… the Federal Reserve Board…the membership be expanded."[105] "Let's teach Arthur something that he'll learn to be more cooperative," Nixon snickered.[106]

The second threat was an institutional attack against the independence of the Federal Reserve. Nixon requested Haldeman to leak another rumor that "In view of the fact that the president has responsibility for full employment, the President is considering

[102] (Abrams & Butkiewicz, 2012)
[103] (Abrams & Butkiewicz, 2012)
[104] (Abrams & Butkiewicz, 2012)
[105] (Abrams & Butkiewicz, 2012)
[106] (Burns, 2010)

legislation to… [bring] the Fed…[in to the] executive branch…The independence of the Fed…is seriously in question…it might sort of worry Arthur a little."[107] Indeed it did. Connally also warned Burns in person, "If you want to maintain the independence of this Federal Reserve System, you oughtn't to be talking about wage and price policies and fiscal affairs…it's not your business… sure you're knowledgeable about it, but what the hell, you're running the Federal Reserve now."[108] Burns felt strongly about the Fed's independence and did not want to be the reason for a momentous structural change. In fact, Burns was actually offered a choice between the position of Treasury Secretary and Fed Chairman, in which he chose the latter "in favor of the independence" he would have at the Fed.[109] Throughout the ordeal, Burns was conflicted whether to honor his friendship with the President or a Fed Chairman's duty to the American people and to the institution. In an effort to appease all dimensions, Burns conducted expansionary monetary policy at the request of the President and in turn was able to maintain the independence of the Federal Reserve System.



In an effort to protect the independence of the Fed, Burns began to conduct expansionary monetary policy. The economy shifted into expansion in 1971, as Burns

[107] (Abrams & Butkiewicz, 2012)
[108] (Abrams & Butkiewicz, 2012)
[109] (Burns, 2010)

allowed the money supply to grow at an annual rate of 8% in the first quarter, and 10% in the next.[110] During the duration of Burns' chairmanship, the federal funds rate fell from above 9 percent to under 4 percent and the inflation rate skyrocketed from 5.5 percent to nearly 11 percent.[111]

Nixon's New Economic Policy and pressure for expansionary policy fanned the flames of economic instability rather than extinguishing them. On top of that offense, the U.S. economy was barraged by adverse macroeconomic factors such as an international economic boom, crop failures in the Soviet Union, and an increase in the price of oil, which caused inflation to blow out of proportions.

3.1.h Summary

The U.S. economy began to experience an uncomfortable inflation rate when the Nixon administration took office because of high federal spending during the Johnson administration and the substantial influence unions had in achieving wage increases. Burns and Nixon did not see eye to eye on how the government should address the instability. Burns pushed for contractionary monetary policy as well as price and wage controls. Since Nixon held securing his second term as president to a higher priority, he pressured Burns to carry out expansionary policy instead. They were both aware that expansionary policy would have exacerbated inflation further, but Nixon argued it would have helped unemployment. When Burns was reluctant to follow Nixon's command on the monetary front, Nixon threatened Burns' position as Chairman and the Federal Reserve's

[110] (Lowenstein, 2011)
[111] (FRED, 2014)

independence to implement policy. Burns eventually gave in to Nixon's demands and the Fed expanded the money supply. The U.S. economy combusted due to the oversupply of U.S. dollars, which set in motion the upward pressure of inflation at home and abroad.

On the fiscal side, Nixon passed the New Economic Policy. Although the NEP was well-received by the American people, the policy was met with antagonism abroad. U.S. allies who signed the Bretton Woods Agreement were furious because it effectively ended the gold standard. The U.S. would no longer honor its agreement to support the dollar's value in exchange for gold. Not only did this provision strain the trust needed for global trade, but it also caused the dollar to depreciate and made imported goods more expensive, which in turn led to even more inflation. Outside macroeconomic factors combined with this myriad of adverse conditions and added more fuel to an already raging fire.

3.1.i Themes

3.1.i.a Burn's Conflict Between Friendship and Duty

Arthur Burns and Richard Nixon shared a friendly relationship before Nixon became president. Their jobs complicated their friendship, as they often had to make controversial decisions. Burns wanted to remain congenial, but at the same time, he needed to persuade Nixon to implement the appropriate policies to address the problems in the economy. Instead of prescribing the correct medicine for the illness, Nixon was more preoccupied in pursuing his own objective - getting reelected. Nixon's stubbornness was the cause of much of Burns' anguish. Burns stated that the President's "friendship was one of the three that

has counted most in my life."[112] A few months later, however, Burns wrote that he recoiled at Nixon's "cruelty" and "anti-Semitic outbursts." Nevertheless, Burns "was not prepared, in view of an old friendship, to do damage to the President." Burns' diary details the push and pull of emotions between President Nixon and himself. Sometimes, Nixon would flatter Burns' intelligence, once calling him "a rare jewel" and saying he "did not think that one could find another half dozen men like me in the entire country."[113] Nixon made Burns feel special by purporting that he was a valued member in his inner circle and that his "views will receive primary weight."[114] He professed to Burns that he talked "frankly" with him since they were both "friends" and politicians, so he did not want Burns "to communicate any part of his thinking to our staffs or others in government.[115]

Yet, other times, Nixon would exclude Burns from meetings. Burns noticed that "the President was not fully comfortable with… me." Consequently, Burns careened between spirited shows of independence and dogged displays of loyalty. He frequently debated whether he should resign or "stay on and do nothing to support the President?"[116] History tells us Burns decided to remain Chairman and his diary reveals that he did so to avoid "a political bombshell" and embarrass the President. He wrote, "I decided to give him - for a decent interval anyhow - such support as I morally could."[117] Though Burns only intended to provide moral support initially, he eventually buckled under Nixon's unwavering attitude and aggressive behavior. Burns yielded to the President's desire for expansionary policy, contradictory to his own prescription.

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[112] (Lowenstein, 2011)
[113] (Burns, 2010)
[114] (Abrams & Butkiewicz, 2012)
[115] (Burns, 2010)
[116] (Burns, 2010)
[117] (Burns, 2010)

Burns' change of heart can be traced back to his subconscious thoughts of realism. Although Burns asserted a firm stance on preserving the independence of the Federal Reserve in the beginning of his diary, evidence of his true feelings in his other works suggest he was subconsciously more worried about the feasibility of policies and the political repercussions of his actions. Throughout Burns' writing, he constantly made it a point to separate what should be done in principle, and what could actually be done in reality. This thinking embodied the actions he took during his time as Chairman. While he believed in principle that the Federal Reserve was established to be an independent monetary authority for the United States, realistically, Burns conceded that the Fed had to succumb to political influences on some occasions during the means in order to carry out its end goal of economic stability.

He suggested that the powers of the Federal Reserve were limited first by the political protest that would result from any policies augmenting unemployment, even if the trade-off was mitigating inflation:

> A credit policy that is sufficiently restrictive to bring down the price level is, to be sure, always possible. But a policy which did that would in all likelihood bring down also the volume of employment. Federal Reserve officials are likely to shrink from such a course, not only because of their responsibility under the Employment Act, but also because they are apt to feel, whether consciously or not, a wholesome concern over the political uproar that would follow.[118]

[118] (Burns & Frasca, 2011)

Secondly, Burns said that the Treasury's recurring need to borrow money was another practical factor that restricted the Federal Reserve's application of credit restraints. The increasingly large magnitude and frequency of the Treasury's refinancing operations posed a formidable challenge to the Fed's pursuit of restrictive credit policy. Secretaries of the Treasury were keen on maintaining a satisfactory budget and ensuring the marketability of new issuances of Treasury notes, which depended largely on the interest rate. When the economy experienced a boom, a restrictive credit policy was favorable in order to suppress commodity prices and lead to lower budget calculations. Without support from the Federal Reserve, the new Treasury issuances would upset the prices and yields of outstanding securities. Burns' following statement on the matter implied that he would be willing to adjust monetary policy based on the needs of the Treasury:

> If [the Secretary of the Treasury] communicated such thoughts to the Chairman of the Federal Reserve Board, he is merely acting in the line of duty. And in fact, all this is so clearly understood and recognized that the Federal Reserve authorities can be counted on to take the Treasury's needs into account without being prodded.[119]

Hence, it can be deduced that Burns was passionate about the philosophical independence of the Fed, but acknowledged the limitations of realism in its practical application.

3.1.i.a.a A New Perspective on Burns' and Nixon's Relationship

In contrast to the reputation that Arthur Burns garnered for being a pushover, there

[119] (Burns, 1958)

is evidence that suggests he was in fact was a source of influence on Nixon as well. In literature prior to his time at the Fed, Burns continually advocated for inflation price and wage controls. As a result, it can be questioned whether Nixon's establishment of a wage and price review board and the price controls during the 90 day freeze was a result of Burns' recommendation. The following passage Burns wrote in *Prosperity Without Inflation* provides important insight into his beliefs and desire for tighter price controls:

> A nation's prosperity rests fundamentally on the enterprise of individuals seeking to better themselves, their families, and their communities. It depends far more on what individuals do for themselves than on what the government does or can do for them. The government may, however, significantly influence the course of our economy by pursuing policies that stimulate private citizens to act in ways which will tend to sustain prosperity. Considerable success has attended governmental efforts in recent years to maintain an environment that favors higher production, expanding employment, and rising living standards.[120]

This paragraph suggests that Burns believes government intervention is justified when it promotes the public good, specifically when the policy's objective is to sustain prosperity.

> The purchasing power of the consumer's dollar has not, however, been maintained. It is true that the rise in the price level that has occurred since 1954 is moderate by historical standards. However, in view on the rigidity which of late has characterized the wage level and only to a lesser degree the

[120] (Burns, 1958)

> price level during economic contractions, **still greater moderation of price advances** must be sought during economic expansions in order to prevent a creeping type of inflation in the future.[121]

Burns points out that amidst all the government's successes, the one area the government has lacked to improve is a stable dollar. The even more critical point to note from this excerpt - emphasized in bolded text - is that Burns is explicitly advocating for more active price tapering during expansions. Burns continued by explaining why he believed the government did not pursue control over prices:

> Although governmental resistance to inflation has significantly stiffened of late, it is difficult to avoid the conclusion that the government is not yet prepared to act as decisively to check inflation as it is to check recession. In the event of a recession, the general attitude of government is apt to be that everything which is at all reasonable must be done without much delay, and that if inflationary pressures develop later as a result of the stimulants that are applied, they will be dealt with in due course. On the other hand, once inflationary pressures emerge, the government is unlikely to proceed in the spirit that if a recession develops as a result of its restrictive measures, that difficulty in turn will be dealt with in good season. Rather, the attitude is apt to be that, while everything which is at all reasonable must be done to curb inflation, restrictive policies must not be applied on so vigorous a scale as to take any appreciable chance of bringing on or hastening a recession.

[121] (Burns, 1958)

> Such weighting of the scales of economic policy, however slight, is probably unavoidable in the existing state of public opinion. While the government has the broad responsibility of leading the nation along sound economic channels, no Administration that is too far removed from the prevailing sentiments of the people can long continue to govern. When a threat of unemployment develops, a clamor for governmental intervention comes from all directions. On the other hand, when the price level begins rising, pressures for governmental action are less insistent. Not only that, but governmental steps to curb inflation are sure to be loudly resisted by many, while measures to curb unemployment are just as sure to be applauded in most quarters. There can be little doubt that although people generally and genuinely wish the consumer price level to remain reasonably stable, they also fear depression more than they fear inflation.[122]

Inflationary problems garner less policy attention from the government than recessionary problems. At the onset of a recession, the government is quick to counteract the symptoms. The cause of the government's lack of attention in the area of inflation is because of the American public's partiality towards addressing recession over inflation. This chain of behavior hints at the American political system and the political business cycle. Politicians are so engrossed in fulfilling their duty by representing the views of their constituents in order to gain reelection, most of the time to the extent that benefits of the big picture are often overlooked in favor of the majority opinion.

[122](Burns, 1958)

> Serious depressions are no longer the threat they once were, while creeping inflation has become a chronic feature of recent history and a growing threat to the welfare of millions of people. Not only is a creeping inflation unnecessary to the continuance of prosperity, but it can in time become a grave obstacle to it - either because the inflation may get out of hand or because, if inflation should continue for many years to its gradual inroads on the pocketbooks of people, their concern over inflation may mount to a point where they will be unwilling in the event of a recession to support any large governmental efforts to hasten recovery.[123]

Burns encouraged more attention to inflation by reassuring the public that depressions were threats of the past and that policy-makers have learned from the events of the Great Depression. Furthermore, he stressed the harmful effects of inflation, which were just as, if not even more, grave.

Before assuming the position of Chairman at the Federal Reserve, Arthur Burns provided some general policy recommendations in *Prosperity Without Inflation* that the government should implement to combat creeping inflation. He said:

> What we need more than anything else at this juncture of our great experiment in the management of prosperity is a national declaration of purpose with regard to the level of prices that could have a moral force such as the Employment Act already exercises with regard to our levels of production and employment. This can be simply accomplished by including

[123] (Burns, 1958)

> reasonable stability of the consumer price level among the objectives of the Employment Act which 'it is the continuing policy and responsibility of the federal government to use all practicable means' to promote.[124]

Burns believed the language of the Act was too general. Not only did the lack of specificity cause poor direction in policy-making, but it also allowed government officials freedom in devising their own meaning to fit particular circumstances. Burns' proposition was not to define the language, but rather to urge a broadening of the act to include reasonable price stability among its objectives. This way, it would:

> tend to make it a constant reference point for public and private actions that bear on the level of prices. One of the likely consequences of the suggested amendment would be a greater emphasis in the President's annual Economic Report on the outlook for prices and on how reasonable stability of the price level is to be sought. The reports of the Joint Economic Committee of the Congress would naturally move in a similar direction. Policies that promote stability of the price level would therefore tend to gain in prestige and to exercise increasing power over the thoughts and actions of both government officials and private citizens.[125]

Burns hoped such an amendment to the Employment Act would change the nonchalant attitude and procedures towards inflation and encourage more vigilance in regards to price developments.

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[124] (Burns, 1958)
[125] (Burns, 1958)

Another problem Burns brings up is that inflation is often a self-fulfilling prophecy:

> One of the main factors in the inflation that we have had since the end of World war II is that many consumers, therefore acted in ways that helped to bring about this result.[126]

To solve this problem, Burns recommended:

> A declaration by the Congress that it is the continuing policy of the federal government to promote reasonable stability of the consumer price level, as well as 'maximum employment, production, and purchasing power,' could go a considerable distance in dissipating the widespread belief that we are living in a age of inflation and that our government, despite official assertions and even actions to the contrary, is likely to pursue an inflationary course over the long run.[127]

If the federal government issued such a statement and communicated an intention to target inflation equally as vigilantly as employment, it would assure the public 's confidence and reduce the probability of a self-fulfilling prophecy.

In addition to a public declaration to attend to price stability, Burns demanded that fiscal policy play a more active role in an anti-inflationary program because "monetary and credit controls are undoubtedly helpful in checking private expenditures, but experience suggests that they are not likely to prove helpful enough."[128] He advocated for more effective budget management and stricter antitrust policies to reduce monopolistic

[126] (Burns, 1958)
[127] (Burns, 1958)
[128] (Burns, 1958)

practices.

All in all, Burns claimed that a comprehensive approach to addressing inflation would be most effective because no one policy tool would be sufficiently dependable by itself. When one agency of government was left to deal with the burden of stopping inflation on its own while the rest took an independent course, the inflation would be intensified. Moreover, there were practical limitations on the implementation of any specific policy. Burns supported the informal meetings with the President, the Special Assistant to the President, and the Chairman of the Council of Economic Advisers because they recognized the importance of the Federal Reserve System in the economic sphere of government and it gave the public greater assurance that the government in its entirety was united in tackling inflation.

These excerpts from *Prosperity Without Inflation* show Burns' personal philosophy for strict policy prior to knowing Nixon and suggest that he may have in fact contributed to Nixon's plan for price and wage controls in Nixon's New Economic Policy. Such controls were out of the Federal Reserve's territory in monetary policy and could only be imposed through the legislature. The provision of price and wage controls in Nixon's New Economic Policy suggest that he may have been influenced by Burns to execute the measure. This two-way street contradicts the popular belief that only Burns submitted to Nixon's pressure.

3.1.i.a.b Implications of Mutual Influence

Since Nixon initially had reservations about price controls and changed his mind

after Burns suggested controls in an incomes policy because "the rules of economics are not working in quite the way they used to," it would appear that Nixon was swayed.[129] During his service at the Office of Price Administration, Nixon expressed an aversion to price controls and during the campaign of 1968, he declared that price controls "can never be administered equitably and are not compatible with a free market economy."[130] After Burns

> urged the President to reconsider his objection to a price and wage review board; that something like this was necessary to prevent a sharp rise of wages and prices of steel; that the Cabinet Committee on Ec. Policy could serve as his wage and price review board; that it could perform this function on the principle of an accordion, expanding or contracting in activity as he deemed best, [it] seemed of real interest [to Nixon and] he promised to study the idea.[131]

Nixon's steadfast nature and his long record of acting on his own terms expound how the provision of controls made it into the NEP though. It was Nixon's own belief that a price and wage control would suggest to the American people that he was committed to their interests of keeping consumer goods from getting more expensive. He was a serial political opportunist and much like his public philosophical shift to Keynesianism, he once again deviated from his original view on price controls to improve his popularity among voters. As James Reichley observed, Nixon was "not prepared to take extreme political risks

[129] (Burns, 1971)
[130] (Higgs, 2009)
[131] (Burns, 1958)

for the sake of economic dogmas."[132] Many politically important people including union leaders, big businessmen, members of Congress, and high-ranking economists in the Treasury department prodded for an incomes policy. The clearest smoking gun is this quote by Nixon, which he wrote in his memoir: the imposition of controls was "politically necessary and immediately popular in the short run."[133] Thus, Nixon was motivated to enforce price controls because it was politically advantageous to implement price controls.

The resulting public praise indicated that the price controls were indeed a success politically. The stock markets soared and the Dow-Jones Average rose 32.9 points on the Monday after the President's announcement.[134] Opinion polls revealed that Americans largely approved the President's action, as was subsequently reinforced by Nixon's landslide victory in the next presidential election. For the economy, on the other hand, it was a catastrophe. The controls violated all fundamentals of a free market economy. When businesses could not raise prices to compensate for the increase in the price of imported goods, they had to reduce costs to remain profitable. Since they could not lower wages either, businesses resorted to laying off workers. Nixon's authorization of price and wage controls instigated this chain of events, thereby causing more inflation and, unintentionally to his misfortune, unemployment.

The timeline of events and compelling snippets of conversations between Nixon and Burns recorded on the Watergate tapes indicate that Nixon was firm in his own positions throughout this entire episode of history and a very powerful force in moving both fiscal and monetary policy. Meanwhile, Arthur Burns fluctuated from being resistant to political

[132] (Higgs, 2009)
[133] (Higgs, 2009)
[134] (Higgs, 2009)

influences during the beginning of his chairmanship to ultimately succumbing to those pressures. Therefore, Burns' recommendation may have been one of several influencing factors on Nixon's decision to enforce controls, but he did not plant the seed. Nixon, on the other hand, led Burns to contradict his own personal beliefs and execute expansionary monetary policy.

While the possibility that the Chairman was able to influence the President should not be ignored when analyzing the balance of power between the monetary and fiscal authorities, the more significant point learned from the Nixon-Burns story is the President's imperial manipulation of the Fed. The President's ability to influence the Chairman of the Federal Reserve is hazardous because most politicians operate based on political motivations, as per the political business cycle theory. Due to the distortion of incentives, politicians are less likely to rationally make the socially optimal choice. The Federal Reserve was established to counteract the political business cycle in regards to economic issues, yet the Fed has been trapped multiple times throughout history into submissiveness. During the Nixon-Burns era, the Fed appeased the President's orders for two reasons. First, legal traps compelled Burns to save the independence of the Fed. Second, Burns was motivated by a social obligation to salvage his friendship with Nixon. The Chairman's decision to briefly relinquish the Federal Reserve's independence in order to preserve the future independence of the Fed wreaked havoc on the economy.

3.1.i.b Political Business Cycles

Since President Nixon frequently acted on political motivations, his administration

was full of smoking guns exhibiting the political business cycle theory. In the period leading up to his first and second presidential elections, he pursued all opportunities to improve his chances at the polls. He enhanced his status by supporting Keynesianism, nominating Burns to chair the Fed, tackling unemployment over inflation, and manipulating Burns to increase the money supply. Burns witnessed first-hand that the President "was governed mainly, if not entirely, by a political motive; that he had reached the decision that the kind of changes that we were discussing - on prices & wages, taxes, etc. - were essential for the campaign of 1972."[135]

> During a conversation occurring on October 23, 1969, just after Burns' nomination to the Fed had been announced, Richard Nixon invited Burns 'to see [him] privately anytime' and suggested to communicate through an intermediary in order to preserve 'the myth of the autonomous Fed' (Abrams, 2006). Levin and Taylor (2012 argue that these political pressures are crucial in understanding the rise in inflation and report that Burns (1979) himself acknowledges this: '...the central banks' practical capacity for curbing an inflation that is driven by political forces is very limited.[136]

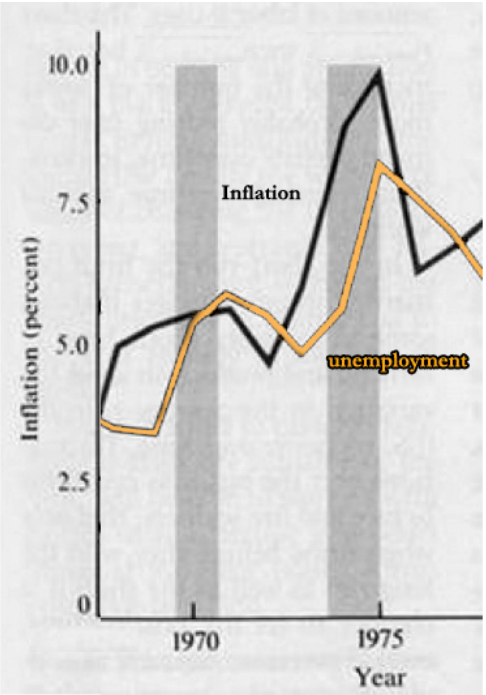
3.1.i.b.a Implications of the Political Business Cycle

The Nixon-Burns era demonstrates the dire consequences of the political business cycle. Since Nixon was centered on political gains, he evaluated every move based on whether it would propel his popularity. These incentives interfered with his decision-

[135] (Burns, 2010)
[136] (Bianchi and Ilut, 2013)

making, as he often went with policies out of self-interest as opposed to which policies would actually provide the greatest utility for Americans.

During his first term, President Nixon chose a politically-inclined strategy to address unemployment as opposed to the more pressing issue of inflation. Nixon's fierce political ambitions willed him to commit many assaults. His offenses ranged from giving orders to trespass property and stealing, to impairing the stability of the U.S. economy. In an attempt to curb unemployment, for example, Nixon crossed into monetary boundaries and coerced Burns to expand the money supply. Nixon wanted lower interest rates to stimulate business and employment. The recession following this ploy, however, rattled the U.S. economy and introduced a new phenomenon known as stagflation.



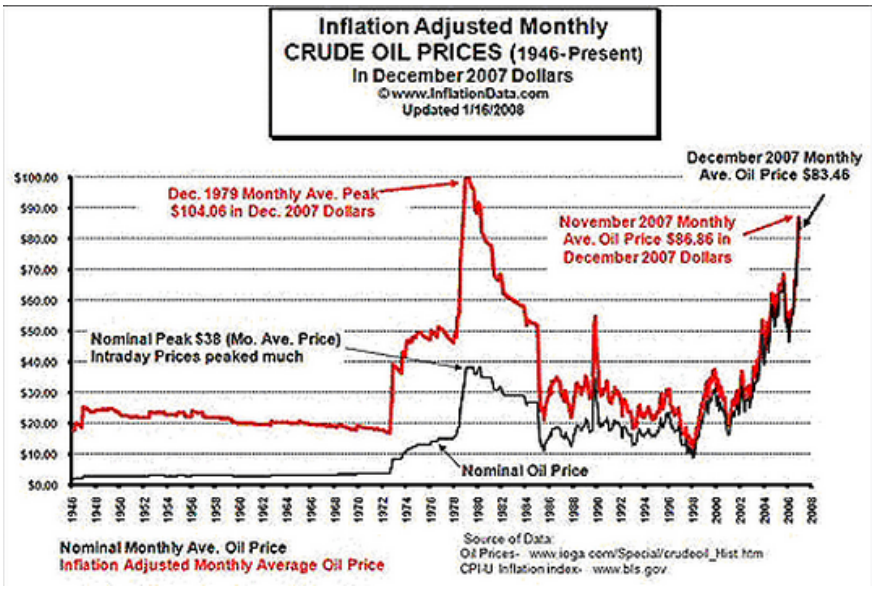
(Rose, 1974)

Before the recession, it was a popularly held belief among economists that inflation and unemployment were inversely related. Thus, a small percentage increase in inflation was tolerable because it meant that GDP was growing and that unemployment would be low. Theoretically, an increase in demand would drive up prices, but that would be compensated by firms' need to hire additional employees. Therefore, if the economy were to slow down and unemployment should rise, inflation would fall. The Fed could then increase the money supply to promote growth without worrying that inflation would grow

out of control.

The 1970s rivaled this dogma because the economy was marked simultaneously by high inflation and high unemployment. Inflation reached levels way beyond the accepted 2 percent target into the double digits at times. Lower GDP growth rates indicated a fall in production and unemployment rose to 8.5% in 1975. Stagflation was the term used to describe this new phenomenon of concurrent high inflation, slow economic growth, and high unemployment.

The market for gasoline was especially disoriented by the Fed's expansion of the money supply. The media popularized the notion that a significant factor causing gas prices to skyrocket was the oil crisis. The price of gasoline escalated after the Organization of the Petroleum Exporting Countries (OPEC) declared an embargo in 1973 and the average price of a barrel of oil peaked to $104.06 in December 1979.[137] The press blamed the high prices on the Arab-Israeli conflict and the oil supply shock. Economists, on the other hand, explain the oil shock as a result of an increase in the price of other consumer goods based on the cost-push inflation theory. Cost-



[137] (Inflation data, 2014)

push rivals the traditional demand-pull theory in that cost-push associates a rise in the price level as a supply-side effect as opposed to a demand side effect. In the cost-push inflation theory, inflation is the result of persistent increases in selling prices and production costs.[138] Thus, the Nixon Administration justified the implementation of price controls to contain the upward pressure in the economy. The upward pressure was misdiagnosed, however, because it was not the cost-push theory at work. As a matter of fact, if you follow the breadcrumbs all the way home, the root cause of the upward pressure on prices in the U.S. was a result of the Fed's expansionary monetary policy. The Fed's printing of more money led to an oversupply of U.S. dollars in the global market and a devaluation of currencies tied to the dollar. When the value of the dollar decreased, the cost of imported goods, such as gasoline, became relatively more expensive. OPEC needed to increase gas prices to adjust for the Fed's monetary shock. Therefore, excluding the more exponential increases that were later brought on by a shortage in supply and the Yom Kippur War, the jump in oil prices in the United States was partly induced by itself.

Not only was the gasoline market disoriented by the Fed's expansionary policy, but also by the price controls put in place through Nixon's incomes policy. The government-imposed price ceiling prevented free market forces from correcting the price hike for gasoline caused by OPEC. Since prices could not exceed a certain maximum, a shortage occurred and the market could not naturally achieve equilibrium. Another market mechanism evolved to resolve this shortcoming: lines. Since gas stations sold gasoline on a first-come-first-served basis, drivers had to wait in long lines to buy gas. Due to Nixon's price controls, the waiting time and raw cost of gas were not reflected in the price paid by

[138] (Batten, 1981)

consumers. The real cost of gasoline was much higher because it would have accounted for these factors.

Inflation was a relatively mild problem when Nixon entered office compared to when he left the White House. Inflation spiraled out of control during his term as president because he failed to address the problem appropriately in its early stages. While subsequent macroeconomic factors were more difficult to control, the stagflation was brought upon America by its own devices - namely, Nixon's fervor for political gain. Inflation was exacerbated by excess liquidity through the Fed's expansion of the money supply, which Nixon pressured Burns into executing.

Milton Friedman fervently argued that the Fed should have undertaken contractionary monetary policy. Friedman opined, "I'm not optimistic because you cannot avoid a rise in interest rates in the next six months… it does seem to me that nothing could be more damaging to you in 1972… [than] if the price rise in 1972 is back up to 7%."[139] He presaged to Nixon that "We don't want a victory which has to be followed by a course of action that puts the Democrats in power for 20 years" in reference to a potential recession from Nixon's strategy.[140] It was too late, however; Burns had given into Nixon's demand for greater expansionary policy and the damage could not be undone. Ben Bernanke wrote in his dissertation that "the Fed's credibility as an inflation fighter was lost and inflation expectations began to rise" during the 1970s, which made it even more difficult to contain.[141] The preceding fifteen years of expansionary policy had unanchored inflation expectations and diminished the Fed's credibility. Long-term nominal interest rates, for

[139] (Abrams & Butkiewicz, 2012)
[140] (Abrams & Butkiewicz, 2012)
[141] (Nielson, 2013)

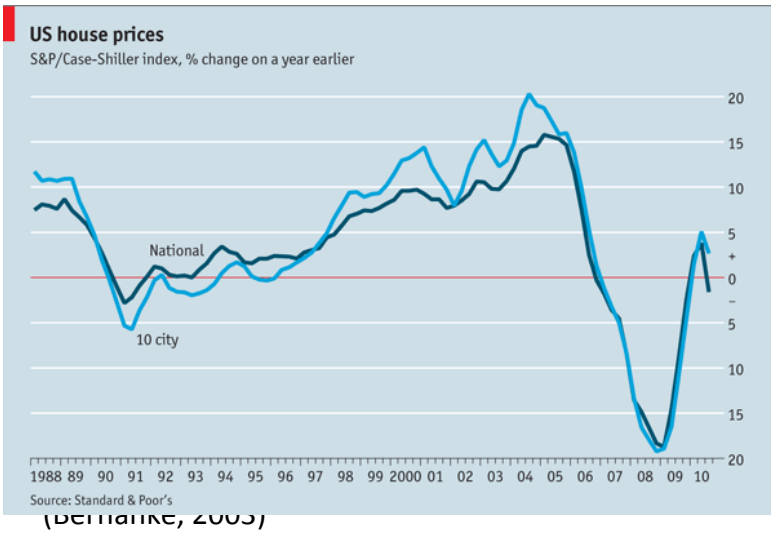
instance, failed to trail the Fed's public announcements. The yield on a 10-year Treasury peaked at 15.3 percent in September 1981, even though the Fed announced its disinflationary program almost two years later in 1979.[142]

Due to the implications of the two aforementioned themes, relieving the Fed of these political pressures would have allowed it to inject the economy with a suitable monetary policy strategy and implement the appropriate measures for faster recovery.

4.1 Policy Coordination Instance II: the 2008 Financial Crisis

4.1.a Economic Overview

The 2008 financial crisis is considered by many as one of the worst crises since the Great Depression. The U.S. economy was threatened by the collapse of multiple large financial institutions, a bearish stock market, and a downturn in the housing market. Due to globalization, the events in the United States had substantial consequences for the rest of the world as well.

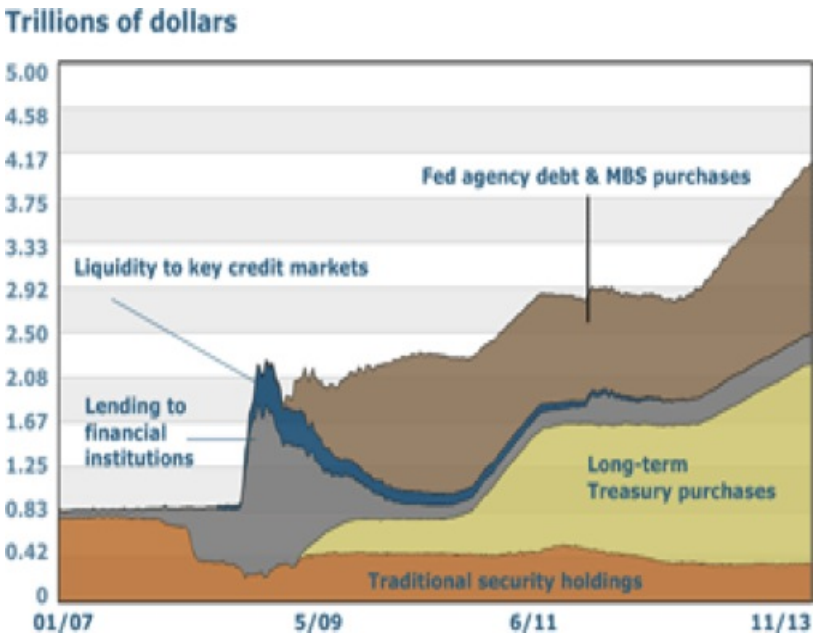


(Bernanke, 2009)

The explosion of the housing bubble sent the U.S. especially, but also the entire global financial system, tumbling down a seemingly never-ending hill. Home values had fallen by

more than 50 percent in some markets and the value of housing stock fell 20 percent, or $4.5 trillion, from its peak. The gargantuan amount of mortgage foreclosures resulted in hundreds of billions of dollars in losses and a tightening of credit.

Though the capital markets are usually volatile, 2008 was exceptionally harsh. Securities suffered large losses. The U.S. lost $8 trillion in stock market wealth between 2007 and 2008.[143] Bear Stearns, AIG, and Citigroup relied on the government's billion dollar bailouts to keep functioning. Lehman was left to go belly up and declare bankruptcy, which some say set in motion the international crisis that followed.



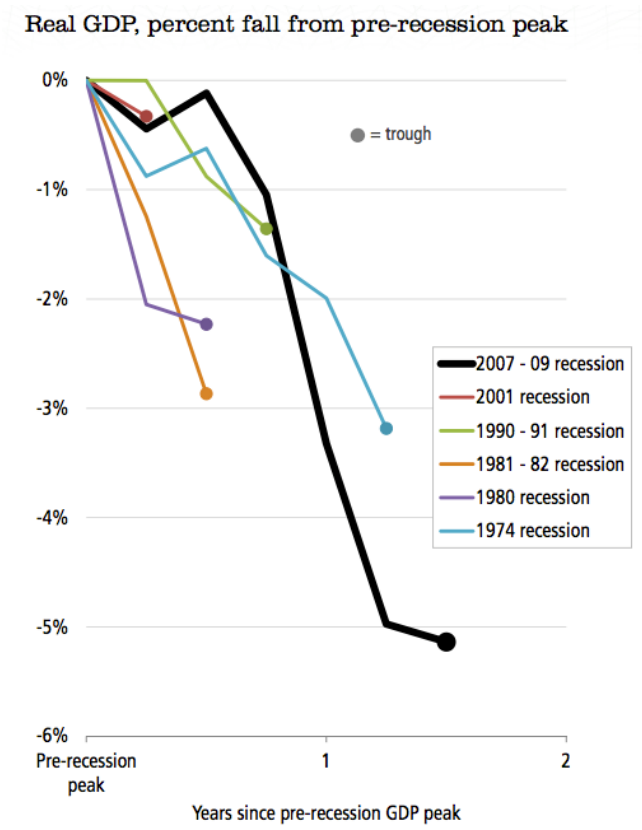
(Butos, 2014)

The government absorbed most of the loss between the Federal Reserve and the Treasury, who actively tried to contain the crisis. A Government Accountability Office audit revealed that the Fed loaned a staggering $16.1 trillion in emergency funds to financial institutions worldwide.[144]

The Congressional Budget Office estimated that the financial crisis cost the U.S. $648

[143] (National Bureau of Economic Research, n.d.)
[144] (Government Accountability Office, 2011)

billion in GDP due to slower economic growth from October 2008 to December 2009.[145] According to the Federal Reserve, the U.S. lost $3.4 trillion in real estate wealth and $7.4 trillion in stock wealth.[146] The Bureau of Labor Statistics stated 8.8 million jobs disappeared.[147]



(U.S. Department of Treasury, 2012)

Upon review, the U.S. Financial Crisis Inquiry Commission reported its findings in January 2011 that the crisis was "avoidable" and was caused by: "widespread failures in financial regulation, including the Federal Reserve's failure to stem the tide of toxic mortgages"; "dramatic breakdowns in corporate governance including too many financial firms acting recklessly and taking on too much risk"; "an explosive mix of excessive borrowing and risk by households and Wall Street that put the financial system on a collision course with crisis"; and key policy makers were "ill prepared for the crisis" because they "lacked a full understanding" of the financial system they oversaw.[148]

[145] (Swagel, 2009)
[146] (The Pew Charitable Trusts, 2010)
[147](The Department of the Treasury, 2012)
[148](The Financial Crisis Inquiry Commission, 2011)

4.1.b Key Players

4.1.b.a Ben Bernanke

Ben Bernanke was nominated to chair the Federal Reserve by President George W. Bush and took office on February 1, 2006 - the same day he began his fourteen-year term as a member of the Board of Governors. President Barack Obama nominated Bernanke for a second term in 2009 because he admired Bernanke's courage and creativity, which helped avoid another Great Depression. Other opinions of Bernanke's handling of the crisis were more controversial. His critics attacked him for failing to foresee the crisis, for bailing out the big banks, and for injecting an additional $600 billion into the banking system.[149]

During his tenure, Bernanke was the most influential player in the Federal Reserve's response to the 2008 financial crisis. He oversaw the bailouts of Bear Stearns and AIG, the collapse of Lehman, a $540 billion loan to money market funds, expansion of open market operations, quantitative easing, and the implementation of several other Fed programs. Before joining the Board, he served as a visiting scholar at several Federal Reserve banks and as Chairman of the President's Council of Economic Advisors from June 2005 to January 2006.[150] From 1979 to 2002, Dr. Bernanke held professorships at Princeton University, Stanford, New York University, and at the Massachusetts Institute of Technology.[151] His interest and expertise lies in the Great Depression.

The Wall Street Journal described Bernanke as a "libertarian-Republican."[152] He firmly supports the division of fiscal and monetary policy, as well as the independence of

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[149] (Chan, 2010)
[150] (Board of Governors of the Federal Reserve System, 2014)
[151] (Board of Governors of the Federal Reserve System, 2014)
[152] (Bullock, 2012)

the Federal Reserve. When questioned about taxation policy, Bernanke responded that it was none of his business as Chairman. Bernanke's personal plea for fiscal policy, however, is to reduce the U.S. budget deficit. Specifically, he favors reform of the Social Security and Medicare programs.

4.1.b.b Henry Paulson

Henry Paulson served the United States as the 74th Secretary of the Treasury from July 10th, 2006 to January 20th, 2009.[153] He identified three issues he hoped to address during his tenure: 1) income inequality, 2) Social Security reform, and 3) spearheading U.S.-China relations. Paulson would take on a lot more responsibility, as he took office when the market peaked and sat through the 2008 crisis.

Coincidentally, Paulson began his career as a staff member under the Nixon Administration, serving as an assistant to John Ehrlichman from 1972 to 1973. When Paulson moved to Goldman Sachs in 1974, he made frequent visits to China and has since built many significant relationships with the Chinese elite. This gave Paulson leverage in persuading President George W. Bush to let him initiate U.S. relations with China and form the Strategic Economic Dialogue (SED). The SED was a forum for top leaders from both countries to meet and discuss economic relations twice a year from 2006 until 2008, when the U.S. economy began to falter. Paulson's purpose for the establishment of SED was to institute "an open, competitive, and liberalized financial market can effectively allocate scarce resources in a manner that promotes stability and prosperity far better than

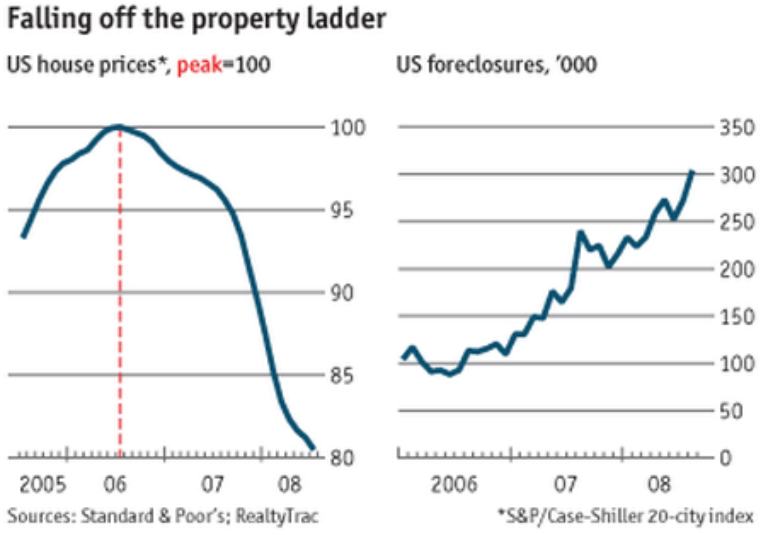
[153] (U.S. Department of Treasury, 2011)

governmental intervention."[154] His influence diminished though when the U.S. went into crisis mode. China hesitated to follow Paulson's advice because, as a former advisor to China's central bank said, "suddenly we find our teacher is not that excellent."[155]

During the financial crisis, Paulson was responsible for strategizing with Bernanke how the government should respond to the Bear Stearns, Lehman, and AIG liquidity crises. Once Paulson got authorization from Congress to spend $700 billion to turn the crisis around, the Treasury was able to supply funds alongside the Fed. Wessel described Paulson as "always forceful, often impulsive, sometimes politically inept" and "hyperactive."[156]

4.1.c Diagnosing the Economic Problem

The 2008 Financial Crisis was caused by a small tumor in one area of the economy that spread through the financial system into a cancerous calamity. The crisis began in the housing market when the number of mortgage delinquencies began to escalate. Since house prices were only expected to increase and lending regulations eased, banks had taken on riskier loans, giving rise to a new

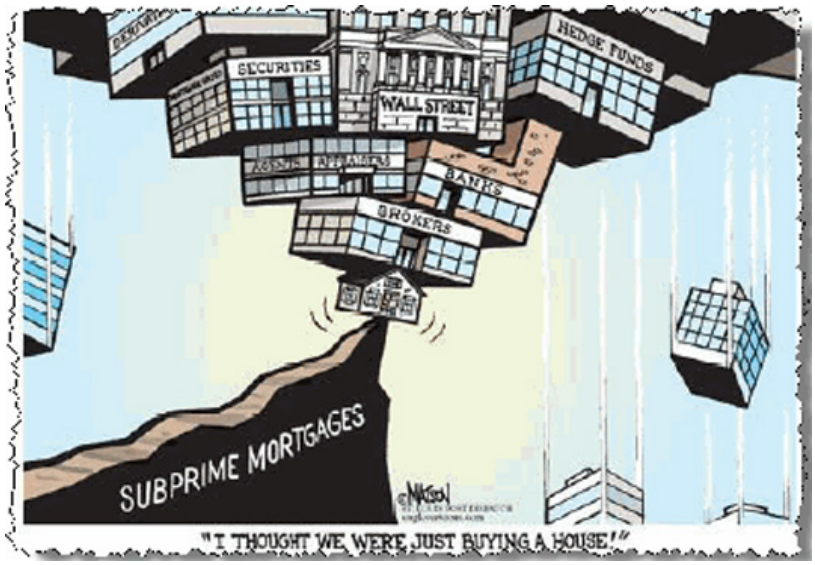


(The Economist, 2007)

[154] (Yidi & Hamlin, 2008)
[155] (Yidi & Hamlin, 2008)
[156] (Wessel, 2009)

practice called subprime lending. Between 1997 and the peak of the housing market in 2006, the price of the average American home increased by 124%.[157] Banks reasoned that, in the event the borrower defaulted, at least the foreclosed home would be sufficient collateral to cover the loan. By 2006, a fifth of all new mortgages were subprime.[158]

Since many subprime borrowers took out larger loans than they could afford to pay back, defaults skyrocketed, asset prices dropped, and banks had to write-down billions of bad loans off their balance sheets. Reduced leverage led to fire sales, lower prices, and even tighter funding. As the economy worsened and unemployment rose, even more people couldn't pay back their loans and defaulted. And in some instances, even though the borrowers had enough money to pay back the loan, it was cheaper to default on the depreciated house than to pay back the original amount of the loan.[159]



(Wall Street Survivor, 2013)

The mortgage crisis in turn triggered the liquidity crisis due to the interconnectedness of the economy. The development of the securitization process and the innovation of risky, complex financial products such as the mortgage-backed security

[157] (The Economist, 2007)
[158] (Bianco, 2008)
[159] (McGrane, 2014)

(MBS) tied investors' returns on the securities to the stream of payments on the mortgage loan. Hence, when housing prices were rising, returns increased. When housing prices began to drop, however, returns also fell. The invention of the securitization process also facilitated the lending boom in the credit market. Instead of holding onto all the loans it originated, banks could now off-load their risk and earn more profit by repackaging them and passing them to investors, who could trade them as securities.

Securitization diversified the risk of the bundled collateral, so the underlying assets were not as safe as the rating of the security suggested. Since securitization widened the distance between lenders and borrowers, very few investors did their due diligence. Lack of regulation for the evolving entities allowed them the freedom to take large risks. Although warning signs appeared, no one wanted to stop the music.

When defaults increased, investors took massive hits to their portfolio returns. Many investors in the MBS market were, in fact, large institutions that were integral to the financial system. Although the most infamous examples include Bear Stearns, AIG, and Lehman Brothers, Countrywide was actually the first firm to topple.

Countrywide used the "originate and distribute" model of spreading risk around: it bought mortgages, then quickly sold them to Fannie Mae, Freddie Mac and others. Unlike traditional banks, Countrywide relied heavily on borrowing overnight in money markets to finance loans that hadn't yet been sold, often using the tri-party repo market. That dependence on the repo market proved to be a huge vulnerability during the onset of the Great Panic. As the number of mortgage defaults increased and dug deeper holes into bank capital, interbank and outside lending tightened. Countrywide's business model was disrupted and the company was now increasingly being viewed as risky. Countrywide

shares, which had been trading at $42 at the beginning of 2007, fell below $30 at the end of July and below $20 in mid-August. They would end 2007 at $8.94.[160] Countrywide was an early admonition of the susceptibility of the tri-party repo market when access to credit retrenched, the reason why Bear Stearns would also sink seven months later.

On March 10th, 2008, Moody's Investors Service downgraded the rating on mortgage-backed debt issued by a Bear Stearns fund. Rumors that the firm – Bear Stearns – itself had liquidity problems spread like wildfire.[161] Two days earlier, Bear Stearns had opened for business with $18 billion in cash or securities. By day's end, $6.5 billion of that was gone, and the firm was down to its last $11.5 billion. [162] Bear Stearns was no longer able to borrow the funds it needed to do business from other financial firms and needed to rely on the government's help to dig them out of the hole.

Lehman's CEO, Dick Fuld, was next to call for help. In just six months, Lehman had taken $6.7 billion in losses on its commercial real estate portfolio.[163] Unfortunately, no one came to Lehman's rescue. Even though the government had saved Bear Stearns, the government justified its action in letting Lehman fail because there was a reasonable chance of selling Bear Stearns' assets close to what they paid for them. Lehman, on the other hand, was worthless because its debts were much greater than its assets and most of its collateral had already been pledged for other loans.

Just days after letting Lehman go under, AIG's chief executive, Robert Willumstad, alerted Geithner on September 11th that the insurance company was having trouble borrowing short-term. AIG scrambled to raise money from private equity sources,

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[160] (Google Finance, 2014)
[161] (Wessel, 2009)
[162] (Wessel, 2009)
[163] (Wessel, 2009)

sovereign wealth firms, and others to continue operating. Their efforts were stonewalled, however, due to a plunging stock market, the company's falling share price, and a downgrade in AIG's debt rating. Credit conditions were already tough because firms were reluctant to lend in the midst of a credit squeeze, but AIG now also needed to post more collateral under its lending agreements. Seeing no other alternative but to support AIG and prevent another devastating shock wave to the financial system, the Fed reluctantly offered a cash transfusion.

Citigroup was the next bank to fall victim to the credit crunch. Its plunging stock price was starting to petrify the public and endanger the status of the bank. On November 23rd, The Fed, the Treasury, and the FDIC agreed to share the burden of 90 percent of Citigroup's $306 billion of troubled assets.[164] In addition to assuming that loss, the Treasury agreed to inject another $20 billion on top of the $25 billion Citigroup had received as part of a broader U.S. banking bailout from the government.[165] The general public was starting to think along the same lines as Thomas B. Michaud, a vice chairman of an investment bank, who probed: "the problem is that other banks would want to get in line [for such government support,] is there enough money to do that?"[166] Moreover, the public protested that their taxpayer dollars were being funneled to save big banks that took on too much risk. Citigroup lost 60 percent of its value in the following week.[167]

Furthermore, significant losses to these "too big to fail" firms created a network credit risk problem. As bank capital eroded, lending channels dried up due to concerns that the lenders would not be paid back. The big banks could not get access to the funds they

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[164] (Dash, 2008)
[165] (Enrich, Mollenkamp, Rieker, Paletta, & Hilsenrath, 2008)
[166] (Enrich, Mollenkamp, Rieker, Paletta, & Hilsenrath, 2008)
[167] (Dash, 2008)

needed in the overnight borrowing market to continue operations. The U.S. experienced a "credit crunch" because of the banking system's anxiety about falling asset prices and new regulations for higher capital requirements. Hence, the Great Panic was sustained by a recurring problem of credit and collateral. Since major global financial institutions had borrowed and invested heavily in MBS, CDOs, and other financial innovations that were backed by failing assets as well, the entire international financial system ached.

4.1.d Whatever it Takes

Although AIG was the last of the big financial firms to be bailed out by the government, the worst was yet to come. The consequences of the financial system's risky behavior would permeate through to the rest of the global economy. The global markets on September 17th were horrendous. The Dow Jones Industrial Average fell 449.36 points, or 4.1 percent, its lowest close in three years.[168] Yields on short-term U.S. Treasury bills fell towards the zero-bound because it was considered the safest asset. Bernanke and Paulson realized that "the markets were going into anaphylactic shock, and that we needed to do something."[169] The Fed could no longer cope with the Great Panic on its own and needed Congress' assistance. Wessel claimed "Bernanke had adopted a new mantra: *whatever it takes*."[170]

4.1.e Summary

The burst of the housing market bubble was the spark that started the fire known as

[168] (Wessel, 2009)
[169] (Wessel, 2009)
[170] (Wessel, 2009)

the 2008 financial crisis. Due to the interconnectedness of the economy, the problems from the mortgage crisis spilled over to the rest of the financial system. As the number of mortgage defaults increased, banks absorbed more and more losses. They were not the only losers from the mortgage delinquencies though. While the mortgage crisis was large on an absolute scale, those losses were modest compared to the trillions that vanished in the U.S. stock market. Due to the development of the securitization process, investors who bought securities backed by mortgage payments also suffered tremendous losses. Large financial firms, along with GSEs Fannie Mae and Freddie Mac, were among some of the biggest investors in the MBS market. As the financial institutions absorbed larger losses, lending channels grew more reluctant to give out loans. The crisis was magnified because financial institutions played simultaneous roles as both lenders and borrowers, which resulted in liquidity gridlock. When lending seized, runs on financial institutions eroded bank capital. The credit crunch brought the onslaught of a recession.

The following period, labeled the Great Recession, deepened the effects of the mortgage crisis and affected the entire global economy. The effects of the credit crunch plaguing the finance firms made its way into the lives of private individuals. Consumer demand for goods declined in favor of building up savings, businesses abandoned investments and laid off workers to preserve cash, employment waned, and losses on loans surged. The effects of the U.S. recession spilled over into the economies of its trading partners as well. Simultaneous contractions occurred within the European Union and Japan. A domino effect arising from mortgage defaults in the U.S. housing market amplified the losses in the increasingly connected financial markets at home and abroad.

4.2 Policy Response - The Bailouts and New Legislation

The two major players – Ben Bernanke, Chairman of the Fed, and Henry Paulson, the Treasury Secretary - countenanced government intervention when the markets failed and lending seized.

4.2.a Monetary Response

2008 proved to be a very exhausting year for the Fed. From adjusting interest rates to rescuing the big banks, the Federal Reserve was the first responder at the scene throughout the 2008 financial crisis. The Fed was committed to leading the U.S. to financial stability throughout the episode, often acting on the edge of legal boundaries by exercising the "unusual and exigent" clause and frequently serving its duty as the "lender of last resort."

When Bernanke took office as Chairman in February 2006, the Fed had $860 billion of loans and securities on its books, nearly all of which were theoretically risk-free U.S. Treasuries. By the end of 2008, that number had grown exponentially to $2.2 trillion. Even more alarming, most of those assets were riskier than U.S. Treasury securities.[171]

At the onset of financial instability towards the end of 2007 when Countrywide was in trouble, the Fed devised a two-pronged response. The first prong was to reduce the rate at which the Fed lent directly to banks by one-half of a percentage point and let banks borrow for thirty days, instead of the usual overnight. Prior, the Fed charged a penalty - one percentage point above the federal funds rate - on loans borrowed from its discount window so that banks would be incentivized to remain healthy enough to borrow more

[171] (Wessel, 2009)

cheaply from other banks in the federal funds market. The purpose of the first prong was to loosen the liquidity gridlock and mitigate the stigma of borrowing from the "lender of last resort." The second prong was more orthodox. The Fed intended to craft a credible speech that would reverse the impression left at the end of the FOMC meeting ten days ago that the Fed was fixated on inflation.[172]

The new year rang in new problems. Bernanke convened an unscheduled conference call on January 9th, 2008 because he was:

> increasingly concerned that our policy rate is too high to fully address the downside risks to growth. We have cut 100 basis points since September, and I think that may possibly have roughly offset the credit factors and the housing factors, but I don't think that we can claim that we have done anything in the way of taking our insurance against what I think are some potentially significant downside risks. Meanwhile, since our last meeting in December, the data have been on the whole negative. the fourth quarter looks all right, but since then we have seen a number of indicators that the economy is sliding.[173]

At the end of the meeting, the Board decided not to follow through with a rate cut, but agreed it would closely monitor the situation.

At the next unscheduled meeting over a video conference call on January 21st, Bernanke expressed even greater worry about the economy and the financial market. Symptoms such as the decline in global stock markets and a 16.5 percent cumulative decline in the S&P 500 since the Board's last FOMC meeting was the cause for mounting

[172] (Wessel, 2009)
[173] (Federal Reserve, 2008)

concerns.[174] Bernanke, a proactive Fed Chairman, said now was the time for action: "I would not be proposing this if I didn't think we were seriously behind the curve in terms of economic growth and the financial situation… We need to do something to get up there."[175]

The next morning, the Fed announced a cut in the benchmark interest rate by three quarters of a percentage point and a decrease in the target overnight lending rate from 4.25 percent to 3.5 percent.[176] Not only was the reduction the Fed's first emergency cut since 2001 and its biggest single reduction since 1990, but the Fed cut the interest rate again just nine days afterwards to 3 percent - an omen that a terrible storm was on the horizon.

In March, indicators of economic instability began to creep again. After Moody's Investor Service downgraded mortgage-backed debt issued by Bear Stearns on March 10th and the credit crunch got tighter, the Fed announced a new emergency lending program called Term Securities Lending Facility (TSLF). The program would allow primary dealer banks to borrow up to $200 billion in Treasury bonds, and in exchange the Fed would take illiquid securities or debt such as MBS as collateral. TSLF also extended the borrowing term from overnight to 28 days. The Fed intended to "promote liquidity in the financing markets for Treasury and other collateral and thus to foster the functioning of financial markets more generally."[177]

Bear Stearns' financial situation was so dreadful that even with the Fed's launch of TSLF, it could not recover on its own. In just one week after Moody's downgrade, Bear Stearns dropped almost $3.3 billion in value.[178] The Fed first lent Bear $12.9 billion in

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[174] (McGrane, 2014)
[175] (Federal Reserve, 2008)
[176] (Lanman, 2008)
[177] (Board of Governors of the Federal Reserve System, 2008)
[178] (Sidel, Berman, & Kelly, 2008)

exchange for $14 billion in collateral to help Bear get through the week. It then ended seventy years of tradition by lending JPMorgan $30 billion to buy Bear and save the company from bankruptcy on March 17th.[179]

On the same day that the Fed agreed to lend JPMorgan the money, the Fed took another big step and broadened its lending authority to include securities dealers for the very first time. Securities dealers could now borrow from the Fed under the same terms as banks. This was revolutionary because the Fed's five governors unanimously voted to invoke a clause from the 1930s in the Federal Reserve Act that waived the prohibition of Fed loans to nonbanks.[180]

At the FOMC meeting the next day, Bernanke expressed his apprehension that the economy would not see a recovery for a while:

> The reason is that I don't see where the recovery is coming from in the beginning of next year. In particular, we won't have a recovery until financial markets stabilize, and the financial markets won't stabilize until house prices stabilize, and there is simply no particular reason to choose a time for that to happen. So I do think that the downside risks are quite significant and that this so-called adverse feedback loop is currently in full play. At some point, of course, either things will stabilize or there will be some kind of massive governmental intervention, but I just don't have much confidence about the timing of that.[181]

Moreover, he grew anxious that the Fed was reaching the limit of its powers. Bernanke

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[179] (Wessel, 2009)
[180] (Ip, 2008)
[181] (Federal Reserve, 2008)

continued:

> I think we are getting to the point where the Federal Reserve's tools, both its liquidity tools and its interest rate tools, are not by themselves sufficient to resolve our troubles. More help, more activity, from the Congress and the Administration to address housing issues, for example, would be desirable.[182]

Interest rates were dropping closer and closer to the zero-bound, making the economy susceptible to a liquidity trap.[183] In such a situation, people hold onto money, even though keeping cash does not provide interest, for the liquidity. Since interest rates theoretically should not be negative, investors become deterred from buying bonds, which would have near zero percent interest as well, because they expect the yields of future issuances to be higher. Thus, open market operations have no effect and monetary policy is no longer useful during a liquidity trap.

Later that day, the Fed issued a statement announcing that it lowered both its target for the federal funds rate and the discount rate 75 basis points. The new rates were 2.25 percent and 2.5 percent, respectively.[184]

Despite Bernanke's trepidation about getting closer to the zero-bound, the FOMC decided to lower its target for the federal funds rate 25 basis points to 2 percent on April 30th.[185] Though Bernanke expressed pride in the FOMC's handling of the instability thus far at the meeting, he provided two caveats. The first caveat was that the situation might get tougher. And second, it might be because of an impending liquidity trap. Bernanke said to his fellow governors:

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[182] (Federal Reserve, 2008)
[183] (Grandmont & Guy, 1976)
[184] (Federal Reserve, 2008)
[185] (Board of Governors of the Federal Reserve System, 2008)

> Let me first say that I think we ought to at least modestly congratulate ourselves that we have made some progress. Our policy actions, including both rate cuts and the liquidity measures, have seemed to have had some benefit. I think the fear has moderated. The markets have improved somewhat. As I said yesterday, I am cautious about this. There's a good chance that we will see further problems and further relapses, but we have made progress in reducing some of the uncertainties in the current environment.
>
> I also think that there's a lot of agreement around the table—and I certainly agree—that we have reached the point where further aggressive rate-cutting is not going to be productive and that we should now be signaling a willingness to sit, watch, and listen for a time.[186]

The next statement by the Fed on June 25th was a happier one. It read: "Although downside risks to growth remain, they appear to have diminished somewhat" and the FOMC decided to keep its target for the federal funds rate at 2 percent.[187] At the meeting the day before, Bernanke agreed "certainly that the crisis atmosphere that we saw in March has receded markedly," yet he continued to caution that the FOMC "not yet rule out the possibility of a systemic event."[188]

In August, the FOMC voted to keep the federal funds rate at 2 percent once again. Though the constant rate sent the public a more optimistic message than the six statements

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[186] (Federal Reserve, 2008)
[187] (Board of Governors of the Federal Reserve System, 2008)
[188] (Federal Reserve, 2008)

prior about the rate declining, the quiet summer months were merely the calm before the storm. A full-blown crisis erupted in September with the fall of Lehman.

Bernanke, Geithner, and Paulson allowed Lehman Brothers to fail on September 14th after a desperate search for someone to buy it. The Fed refused to save Lehman like it did with Bear Stearns because of 1) the political repercussions of another government-funded bailout and because 2) saving Lehman would send a message of moral hazard to other big banks that they too would be saved if their extensive risks failed. If the government bailed out Lehman, the argument was that it would have set the stage for "big bank power" and suggest to the other big financial firms that they would also be bailed out if perhaps they were hit next by the credit squeeze. Since there would be no government bailout, the only way Lehman would survive was if the company was bought whole or in fragments. Sadly, no one stepped up to the plate. When Lehman signed the bankruptcy papers, it was as if the trigger for a systemic financial crisis was pulled.

The next month, AIG was in need of rescuing. On September 16th, the Fed gave AIG $85 billion to save the company from bankruptcy.[189] Though the government wanted to prevent a moral hazard problem from emerging, it also wanted to prevent a similar devastation following the end of Lehman. Hence, Bernanke and Paulson hardened their negotiations with strict terms in their deal with AIG. In exchange for the Fed's $85 billion, AIG had to repay the loan within two years at an interest rate of Libor plus 8.5 percentage points, hand over a 79.9 percent equity stake, and replace senior management.[190]

Despite the pandemonium that occurred within the past week, the Fed voted to hold

[189] (Karnitchnig, Solomon, Pleven, & Hilsenrath, 2008)
[190] (Karnitchnig, Solomon, Pleven, & Hilsenrath, 2008)

rates constant at 2 percent on September 16th.[191] Bernanke explained lack of change in the interest rate:

> I don't really see any reason to change. On the one hand, I think it would be inappropriate to increase rates at this 89point. It is simply premature. We don't have enough information. There is not enough pressure on inflation at this juncture to do that. On the other hand, cutting rates would be a very big step that would send a very strong signal about our views on the economy and about our intentions going forward, and I think we should view that step as a very discrete thing rather than as a 25 basis point kind of thing.[192]

From this day forward, the Fed started being proactive and organizing preventative measures before another collapse happened.

On the Sunday after Lehman declared bankruptcy, September 21st, the Fed turned Morgan Stanley and Goldman Sachs into "bank-holding companies." By changing their legal status, the investment banks were protected by the Fed's public promise for a permanent source of lending in a crisis. In exchange, the companies were required to submit to Fed oversight and limits on how much they could borrow. In essence, the companies would be more regulated.

On October 7th, the Fed stepped outside its normal bank-oriented duties and announced it would buy unsecured commercial paper, also known as non-bank debt, in order to ease the credit crunch. The deepening credit crunch threatened money market mutual funds and commercial paper, an important vehicle for short-term funding used by corporations. A Fed statement explained: "By eliminating much of the risk that eligible

[191] (Board of Governors of the Federal Reserve System, 2008)
[192] (Federal Reserve, 2008)

issuers will not be able to repay investors by rolling over their maturing commercial paper operations, this facility should encourage investors to once again engage in term lending in the commercial paper market."[193]

In the next Fed statement issued on October 29th, the FOMC decided to lower the target for the federal funds rate 50 basis points to 1 percent. At the meeting the day before, the governors discussed other approaches to address the crisis as the federal funds rate moved ever closer to the dreaded zero-bound. Bernanke suggested Milton Friedman's old idea of quantitative easing. Unlike conventional expansionary monetary policy, which seeks to lower interest rates by increasing the money supply through the purchase of government bonds, quantitative easing targets private sector assets instead. In a round of quantitative easing, the Fed would purchase securities from the market, thereby inundating financial institutions with capital to incite lending and smooth liquidity.[194] Though conceptually sound, quantitative easing was in fact never tested and its effects were not fully understood. The following was a conversation between Jeffrey Lacker, of the Federal Reserve Bank of Richmond, and Ben Bernanke:

> **MR. LACKER**: My understanding is that economists such as Woodford and others who have studied this believe that, by using monetary assets to purchase other assets, we can make the price level and thus the inflation rate higher than it otherwise would be. Is that a fair understanding?
>
> **MR. BERNANKE**: I don't think that's right. I think the thrust of the elementary approach to quantitative easing is the old Milton Friedman idea—that changing the composition of money and other assets changes

[193] (Robb, 2008)
[194] (Joyce, Miles, Scott, & Vayanos, 2012)

> relative returns. So it's a way to bring down returns on other assets and create stimulus even if the policy rate is down to zero.[195]

The urgency of dealing with the crisis prompted the Fed to make a quick, educated decision. Janet Yellen, President of the San Francisco Fed, recounts the grim stories she was told in her district: "One auto dealer in my District reports that he is now experiencing the worst period in his thirty-plus years in the business. A home appliance retailer adds that he has never seen more uncertainty and gloom from both the retailers and the vendors. This sentiment is echoed by a large retailer who says simply, 'The holiday shopping season is going to stink.' " The Governors agreed the method of quantitative easing was the best option considering the circumstances.

Citigroup was the next bank to fall victim to the credit crunch. The Fed, in conjunction with the Treasury – which had finally been authorized Congressional money – and the FDIC, guaranteed $306 billion in toxic assets.

On November 25th, the Fed announced the creation of the Term Asset-Backed Securities Loan Facility (TALF), which aimed to provide credit to households and small businesses by supporting securitized assets backed by souring student, auto, and credit card loans.[196] Under TALF, the Federal Reserve Bank of New York would lend up to $200 billion to holders of certain AAA-rated securities backed by newly and recently originated consumer and small business loans.[197]

In the last FOMC announcement of the year 2008, the Fed cut its target range for the federal funds rate further to between zero and a 1/4 percent on December 16th as the

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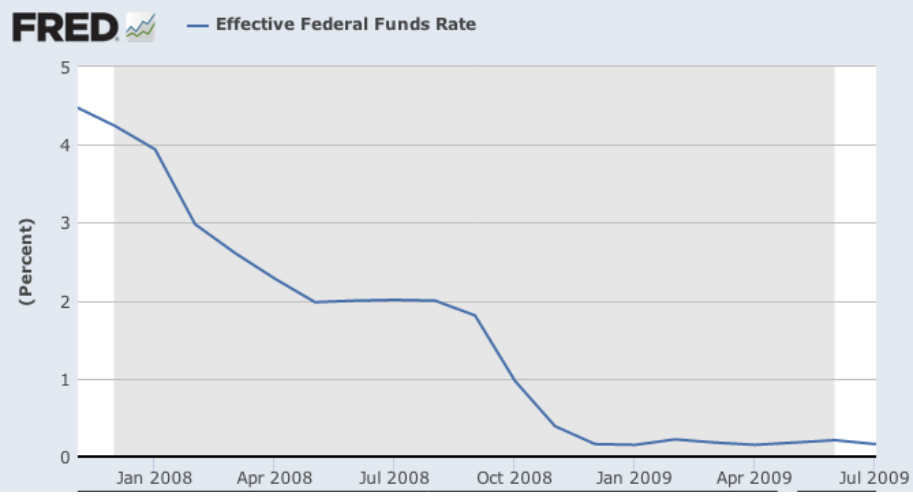
[195] (Federal Reserve, 2008)
[196] (WSJ Staff, 2008)
[197] (WSJ Staff, 2008)

market expected.

The Federal Reserve worked tirelessly in 2008 to stay ahead of the curve. Bernanke's near perfect accuracy in his economic forecasts helped steer the U.S. away from financial disaster. The FOMC reduced interest rates from 3.5 percent at the beginning of the year to 0.25 percent by December in an effort to induce business activity.[198] Moreover, the Fed went above and beyond its normal duties to prevent the financial system from collapse. When the credit crunch attacked the major banks one by one, the Fed established programs that promoted liquidity and took hits to its balance sheet because of the trillions spent on bailouts. The FOMC's calculated speeches built much-needed credibility in such a period of financial stress. Moreover, Bernanke's initiative to increase transparency gave the public "more confidence in the central bank's ability to steer the economy."[199] When the Fed was confronted with a liquidity trap, it cleverly experimented with unconventional monetary policy tools such as quantitative easing. Furthermore, Bernanke aided Paulson in his efforts to acquire funds from Congress by providing moral support and scholarly testimonies. Bernanke proudly exclaimed, "In the absence of our facilities, the risks of



(FRED, 2014)

[198] (Board of Governors of the Federal Reserve System, 2014)
[199] (Mui, 2013)

systemic problems would be much higher."[200]

4.2.b Fiscal Response

While the Fed led the charge, the Treasury as an entity took a backseat until the crisis proved too large for the Fed to handle by itself. Though Treasury Secretaries Paulson and Geithner zealously stepped up to bat, without Congress' power of the purse, all they could offer was their intellect. When the first signs of instability appeared towards the end of 2007 and early 2008, the lone rangers talked strategy with Bernanke until they eventually got the fiscal backing of Congress.

After the JPMorgan-Bear Stearns merger and the potential collapse of the financial system became a more imminent threat, the Treasury started to prepare for the worst. On April 15th, 2008, Neel Kashkari, a young Treasury official and former Goldman Sachs Banker, and Phillip Swagel, the Treasury's economist, proposed to Congress their "Break the Glass" plan. They asked for $500 billion to buy risky mortgage-backed securities from banks and securities firms to take those toxic assets out of the market. The toxic assets would include securities such as subprime loans, not the safe kind guaranteed by government-sponsored mortgage companies Fannie Mae or Freddie Mac. This way, bank balance sheets could be replaced with easily traded Treasury bills, making them seem healthier. Thus, they would be more attractive to lenders and thereby investors.[201] Unfortunately, the financial system had taken a turn for the worst before the "Break the Glass" plan could make it through to a vote in Congress. Fannie Mae and Freddie Mac, the

[200] (Derby, 2014)
[201] (Wessel, 2009)

nation's two largest mortgage finance lenders, were drowning in toxic assets.

Since 1972 until the crisis, Fannie and Freddie were owned by shareholders and run for profit. The two firms were known as government sponsored enterprises, defined as "privately held corporations with public purposes created by the U.S. Congress to reduce the cost of capital for certain borrowing sectors of the economy."[202] Fannie and Freddie had strong political backing in Congress because they were seen as a means to achieve the end goal of homeownership for all Americans. Although the U.S. government did not have any explicit legal obligation to back their debt, it was assumed so, and Fannie and Freddie were able to borrow from all over the world at low interest rates. The GSEs used the money to guarantee repayment of mortgages they had turned into securities and also to build massive portfolios of mortgages. They reaped profits by creating an arbitrage opportunity between the low borrowing rate and the higher interest rate of the mortgages.

Since Fannie and Freddie were wholly invested in housing, everyone knew it was just a matter of when the GSEs would encounter trouble when the mortgage crisis permeated the securities market. When the housing market was at its peak in 2006, very few people expected the significant drop in housing prices and the exponential number of mortgage defaults. Fannie and Freddie's capital dropped substantially as they took losses in order to keep their guarantee of repayment on securitized mortgages. Their own investment portfolios suffered from mortgage defaults as well. Fannie and Freddie's capital issues quickly turned into a financial emergency and they did not have enough time to wait for the "Break the Glass" plan to make it onto Congress' agenda. In early July of 2008, Fannie and Freddie's share prices had fallen more than 60 percent compared to the

[202] (Jaffee, Quigley, & Noll, 2007)

beginning of the year.[203]

On July 10th, Paulson, Bernanke, and their staffs scurried to devise an emergency plan. Otherwise, Fannie and Freddie may not have made it through to the next week. Although it was a hard sell, Paulson persuaded Congress to give him almost unlimited authority to pump money into the mortgage giants. To convince investors to continue lending money to Fannie and Freddie and sustain their operations, Paulson leveraged his new Congressional-given power and implicitly conveyed to the public that the U.S. government fully backed the GSEs' guarantees. He did this by getting Fannie and Freddie's regulator, James Lockhart, to put the companies into "conservatorship" - taking control of them and replacing their chief executives and promising that the Treasury would commit up to $100 billion in taxpayer money to keep the companies solvent if they needed it.[204] On September 7th, the government effectively seized housing-finance giants Fannie Mae and Freddie Mac citing the fact that they were "in danger of losing their ability to borrow money because of mounting losses on mortgages they held in their portfolios or had guaranteed."[205] Business continued as usual on Monday to the relief of Bernanke and Paulson. Fannie and Freddie's preferred shares were dissolved, but the debt holders were protected.

The night of September 18th, 2008 was the climax of the financial crisis. The Fed could finally take a break, as the Treasury finally joined the fight when Bush signed an order allowing the Paulson to use the Exchange Stabilization Fund to stand behind any money market mutual fund that agreed to pay an insurance premium.

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[203] (Wessel, 2009)
[204] (Wessel, 2009)
[205] (Wessel, 2009)

Not long after, Washington Mutual, an aggressive mortgage lender, was the next bank to deteriorate from the unprofitable subprime loans they lent. Within ten days, 9 percent of the bank's deposits were withdrawn. On September 25th, the federal Office of Thrift Supervision seized Washington Mutual and its two thousand branches, and turned the bank to the FDIC. The FDIC arranged for JPMorgan Chase to buy Washington Mutual for $1.9 billion.[206]

October 3rd was the climax of the 2008 financial crisis. On this momentous Friday, Congress authorized the Treasury to use a $700 billion bank bailout fund to fight the crisis.

> The rescue plan authorized the Treasury to buy troubled debt from financial institutions in an effort to ease a deepening credit crisis that is choking off business and consumer loans, the lifeblood of the global economy, and contributing to a string of bank failures in the United States and Europe. The hope is that clearing the balance sheets of bad debt will keep credit flowing and prevent normal economic activity from stalling.[207]

This was a joy for the market, as the Dow Jones industrial average bumped up 115 points. Just a week ago, a similar bailout package was defeated, which sent the Dow down 777 points.[208] The bill, the Emergency Economic Stabilization Act of 2008, passed the U.S. House of Representatives by a vote of 263 to 171 and in the Senate, 74 to 25.[209] President George W. Bush, without hesitation, signed it into law shortly thereafter.

The $700 billion rescue plan enabled by the Emergency Economic Stabilization Act was the first part of the larger Troubled Asset Relief Program (TARP). The Dodd-Frank Act

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[206] (Wessel, 2009)
[207] (Herszenhorn, 2008)
[208] (Herszenhorn, 2008)
[209] (Herszenhorn, 2008)

was the second part of Congress' attempt to help stabilize the financial system. TARP provided eligible institutions access to:

> use the Treasury Department's Capital Purchase Program and the Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program. On October 14, 2008, the U.S. government announced a series of initiatives to strengthen market stability, improve the strength of financial institutions, and enhance market liquidity. Treasury announced a voluntary Capital Purchase Program to encourage U.S. financial institutions to build capital to increase the flow of financing to U.S. businesses and consumers and to support the U.S. economy. Under the program, Treasury will purchase up to $250 billion of senior preferred shares on standardized terms.[210]

Since Citigroup's troubles started after the $700 billion bailout fund was approved by Congress, it was the only bank that received aid from all three of the biggest government agencies that managed the crisis – the Fed, the Treasury, and the FDIC. Specifically, the U.S. Treasury and FDIC backstopped more than $300 billion in losses from troubled assets. The Treasury also made a $20 billion investment in the bank in addition to the $25 billion it already received from the Emergency Economic Stabilization Act of 2008.[211] The generous injection of capital not only diffused Citigroup's immediate credit problem of credit access, but was unable to kill two birds with one stone. The liquidity crisis ended after Citigroup's episode.

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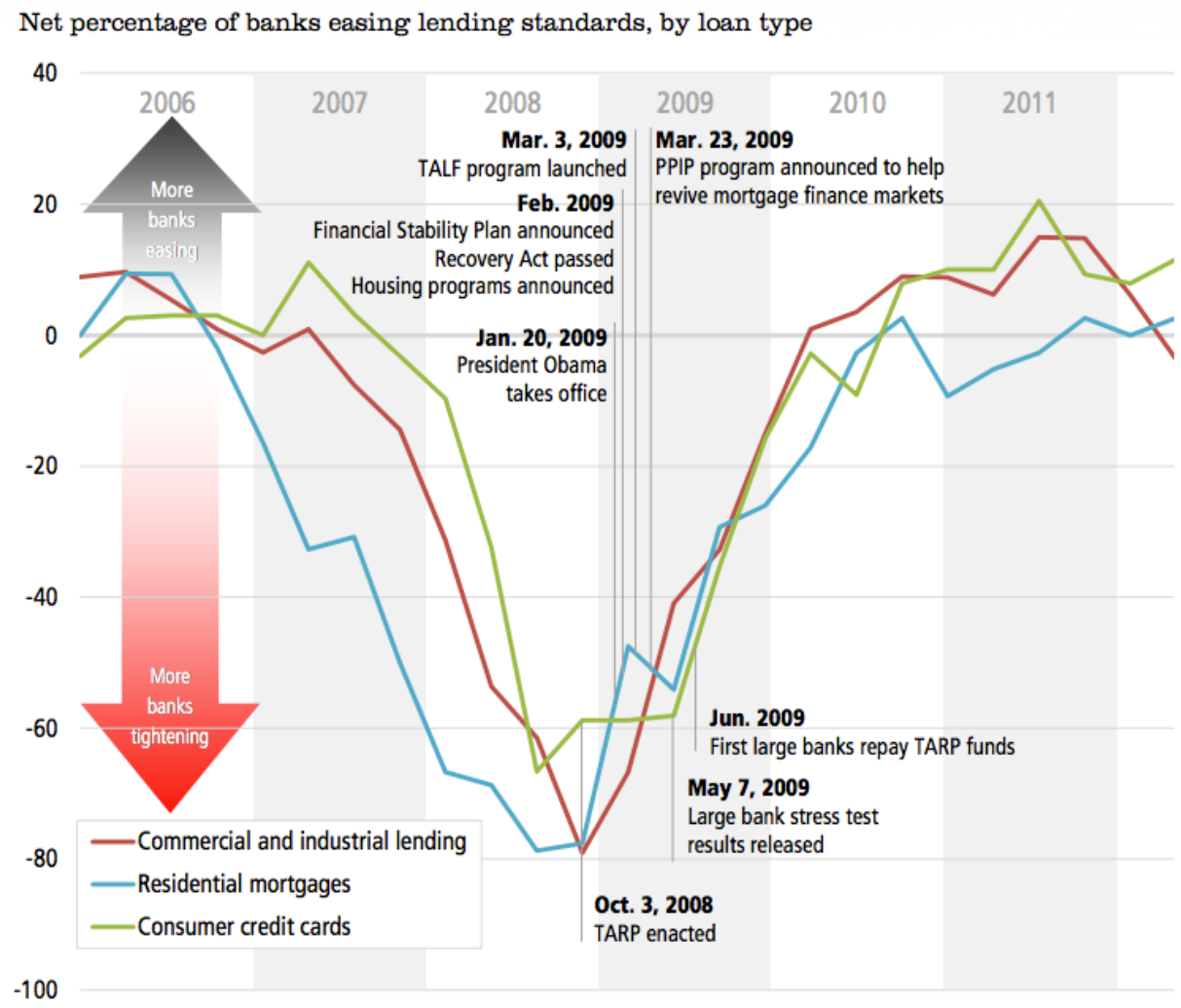
[210] (Board of Governors of the Federal Reserve System, 2014)
[211] (Ellis, 2008)



(U.S. Department of Treasury, 2012)

4.2.c Preventative Measures

In the years following 2008, the government took measures to prevent a similar financial crisis in the future and implemented mechanisms to earlier detect the symptoms of an emerging crisis.

Congress enacted a number of laws that increased regulation and lending standards. The most significant piece of legislation in response to the financial crisis was the Dodd-

Frank Wall Street Reform and Consumer Protection Act signed in 2010. The comprehensive Act contained sixteen critical reforms to existing bank regulations that addressed the major causes of the 2008 crisis. It created the Financial Stability Oversight Council to evaluate whether banks and non-bank financial firms were "too big to fail."[212] If identified by the Council, the bank or firm could be subject to regulation by the Federal Reserve and be asked to increase its reserve requirement. Dodd-Frank contained the Volcker Rule, which prohibited banks from "owning, investing, or sponsoring hedge funds, private equity funds, or any proprietary trading operations for their own profit."[213] In regards to the securities market, the law required that the riskiest derivatives – including credit default swaps – be regulated by the Securities & Exchange Commission or the Commodity Futures Trading Commission. The Act created the Federal Insurance Office under the Treasury Department to assess which insurance companies posed a risk to the financial system. Dodd-Frank established the Office of Credit Rating within the Securities & Exchange Commission to regulate the credit rating agencies and creates the Consumer financial Protection Bureau to protect consumers from "unscrupulous business" practices by banks.[214]

The Fed attempted to safeguard the economy from another crisis by mandating "stress tests" of major banks, increasing oversight of the shadow banking system, and tighter capital standards as critical steps and called for more work on so-called "living wills" that provide a framework for winding down distressed institutions.[215]

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[212] (Koba, 2012)
[213] (Koba, 2012)
[214] (Koba, 2012)
[215] (Mui, 2014)

4.3 Mutual Cooperation

The Fed and Treasury recognized their mutual objective of restoring financial stability to prevent a global meltdown. Both parties worked together throughout the crisis, often discussing new information, strategy, actions to take, and how to support each other's measures. Paulson said in a statement, "I appreciate the additional actions taken this evening by the Federal Reserve to enhance the stability, liquidity and orderliness of our markets."[216] Though the Federal Reserve was commonly thought to only intervene within the traditional banking system, the Fed stretched the law using the "unusual and exigent" clause to inject capital into the financial markets in order to clear up the lending channels.

Bear Stearns was the first firm to approach the Fed for help with short-term financing troubles. Similar to most investment banks, Bear Stearns did not hold deposits like commercial banks. Thus, it relied on borrowing in the repo market. After the rumors spread that Bear was illiquid, lenders in the repo market decided that Bear's collateral was not good enough to secure loans. As a result, Bear could not borrow the funds it needed to do business. If word got out that Bear Stearns was sidelined from the repo market, it would've sent shockwaves through the financial system. "When confidence goes, it goes" Paulson commented.[217] By nighttime on March 13th, Bear Stearns had merely $2 billion cash remaining.[218] The SEC staff warned Bear Stearns that it would have to file for bankruptcy the next morning. After almost two hours of debate at the crack of dawn, Geithner concluded the call by saying, "we've got to make a call here before markets open.

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[216] (Ip, 2008)
[217] Wessel 151.
[218] wessel, 154

What's it going to be?" Bernanke responded, "Let's do it."[219] The Fed agreed to lend Bear Stearns enough money to get through to the weekend. Bear put up $14 billion worth of collateral in order to borrow $12.9 billion from the Fed.

While the Fed provided Bear the capital to continue business, Henry Paulson was in talks with potential buyers to save Bear in the long-term. JPMorgan Chase was Bear Stearns' last hope. Since the Fed was not willing to fund another round for Bear to get through the next few days, Bear had no choice but to move forward with a merger even though the company would be sold at a price lower than expectations. Since JPMorgan refused to take on all the fallout, the only viable option was for the government to subsidize JPMorgan's acquisition of Bear Stearns. JPMorgan offered to buy Bear Stearns at $2 a share, about $236 million in all, and a deal was in the works when the Fed agreed to spend $30 billion of its money to buy mortgage-linked securities that JPMorgan did not want.[220] Bernanke and Geithner were both unwilling to let Bear go under because "it became clear that Bear's involvement in the complex and intricate web of relationships that characterize our financial system, at a point in time when markets were especially vulnerable, was such that a sudden failure would likely lead to a chaotic unwinding of positions in already damaged markets."[221] Bear shareholders, however, were not happy with such a low share price. JPMorgan eventually agreed to pay $10 a share instead of $2 and eat the first $1 billion of losses in the $30 billion pool of assets that the Fed was taking.[222] Although Paulson wanted to remind financial firms the principles of capitalism - shareholders take risks and get the rewards of success and the loss of failure, the negative systemic effects

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[219] Wessel, 158
[220] (Wessel, 2009)
[221] (Geithner, 2008)
[222] (Wessel, 2009)

that would occur due to Bears' interconnectedness within the financial system would be catastrophic.

In the episode with AIG, the Fed once again exercised the "unusual and exigent" clause. Since AIG was predominantly an insurance company, injecting Fed money into AIG would go far beyond the conventional Fed lending to banks. Bernanke pushed the Treasury to take this case. "There was talk of tapping the $50 billion in the Treasury's Exchange Stabilization Fund, a war chest created by Congress in 1934 so the Treasury could intervene in foreign exchange markets."[223] The Treasury could not get approval from Congress quick enough, however, and the Fed once again came up with the money. Paulson knew that Bernanke would find a way to make a loan if he thought the financial system was at risk. The Federal Reserve's general counsel, Scott Alvarez, justified lending AIG enough money to keep it out of bankruptcy because AIG had sufficient capital for the Fed loan. He differentiated this case from Lehman because Lehman's only collateral was the franchise of an investment bank that no one wanted to buy, which made it worthless. Meanwhile, AIG had businesses that still had substantial value and could be sold. Bernanke said, "The company shouldn't have been saved in terms of its own quality and management, etcetera. But we thought that on top of Lehman, this would be just a complete disaster for the markets and the banking system."[224] He justified AIG's rescue and Lehman's collapse because AIG was bigger than Lehman and was involved in an enormous range of both retail and wholesale markets. For example, AIG wrote hundreds of billions of dollars of credit protection to banks.[225] Not only had nearly every major financial institution in the world

[223] (Wessel, 2009)
[224] (Wessel, 2009)
[225] (Wessel, 2009)

bought financial insurance of some sort or placed huge bets with AIG through its hedge fund, but AIG also serviced many households and American companies with insurance, pension, and retirement plans. On September 16th, AIG requested $4 billion from the government to make it to the next day. Seeing no other alternative but to support AIG and prevent another devastating shock wave to the financial system, the Fed reluctantly offered a cash transfusion. AIG ended up drawing $14 billion the night after they accepted the Fed's terms and another $23 billion over the next few days - much more than their anticipated forecast of $4 billion.

When the Great Panic became too great for the Fed to cope with on its own, Bernanke and Paulson approached Congress to provide capital injections to unclog the lending gridlock. They had become close working together tirelessly through the Bear Stearns, Lehman, and AIG episodes, and provided each other support knowing Congress would be hesitant to approve such a large sum of taxpayer money. Paulson confided to Bernanke: "They'll kill me up there. I'll be hung out to dry." Bernanke reassured him: "I'll be with you. I'll go to any meeting. You can count on me."[226]

After much hesitation, Congress finally approved the TARP bill in October and authorized the Treasury $700 billion in funds to stop the credit crisis. The Treasury could also offer capital assistance now. When the final financial institution to fall victim to the credit crisis – Citigroup – called for help, the Treasury, in conjunction with the Fed and the FDIC, was more than able to fund the bailout. On November 23rd, Citigroup reached a deal with federal officials in which the bank would absorb the first $29 billion in losses from a

[226] (Wessel, 2009)

portfolio consisting of selected trouble assets totaling $306 billion.[227] The Fed, the Treasury, and the FDIC would take on 90 percent of the rest of the losses.[228] In addition to assuming that loss, the Treasury agreed to inject another $20 billion on top of the $25 billion Citigroup had received as part of a broader U.S. banking bailout from the government.[229] After Citigroup, the credit crunch ended.

4.4 Disagreement Amongst Fiscal Agencies

4.4.a Difficulties Within Congress

Bernanke and Paulson did not expect their request to Congress for $700 billion to be 'a walk in the park,' but the ordeal was like trying to dissolve oil in water - it took a lot of strategic maneuvering.

Bernanke and Paulson attended back-to-back congressional hearings and tried to convey the urgency of the problem. The challenge was getting Congress to recognize the extent of the problem because the effects of the crisis did not reach the public yet. In fact, Paulson waited so long to approach Congress because he knew Congress would not act until the problem became too big to ignore.

Walter Jones, a Republic, read a letter from a worker from North Carolina: "These bailouts should be about as welcome as malaria. I've read the Constitution. Nowhere does it say that taxpayers are the default dumping ground for mortgages made to people who cannot afford them."[230]

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[227] (Enrich, Mollenkamp, Rieker, Paletta, & Hilsenrath, 2008)
[228] (Cassidy, 2009)
[229] (Enrich, Mollenkamp, Rieker, Paletta, & Hilsenrath, 2008)
[230] (Wessel, 2009)

Bernanke tried to empathize with the politicians from the viewpoint of voters: "Unfortunately, it has a lot to do with them. It will affect their company. It will affect their job. It will affect their economy. That affects their own lives, affects their ability to borrow and to save and to save for retirement, and so on."[231] Politics, specifically gridlock within the House, delayed the funds. House Republicans strongly opposed the request.

When the economics lessons were finished, Bernanke knew it was time to leave politics to the politicians. Paulson went back to Capitol Hill to negotiate what eventually became the $700 billion Troubled Asset Relief Program (TARP). The first TARP proposal was rejected by the House of Representatives by a vote of 228 to 205 on September 29th, just ten votes shy of becoming a bill.[232] After TARP's defeat, the Dow Jones Industrial Average plummeted 778 points by the end of the day.[233] Lawmakers who voted to pass the bill cited the need to avoid financial disaster, while those who opposed the bill did not want to burden taxpayers. After the addition of several conditions and restrictions to protect taxpayers, the Senate passed the second TARP bill on October 1st, and the House finally passed it on October 3rd.[234]

4.4.b Difficulties With the FDIC

The Federal Deposit Insurance Corporation (FDIC) was called upon several times throughout the crisis for help, but its Chairman, Sheila Bair, declined almost every time. She refused to cross legal boundaries and to insure the money market fund deposits. Bernanke,

[231] (Wessel, 2009)
[232] (Wessel, 2009)
[233] (Sahadi, 2008)
[234] (Isidore, 2008)

Paulson, and Geithner found her "stubborn" and "myopic." They grew "impatient with her staff, and they envied the political agility that made her a hero on Capitol Hill as an advocate for beleaguered homeowners."[235] On the other hand, one could also say that she was strong willed and "a fierce and relentless defender of the FDIC fund, putting protection of that kitty above all else, frustrating Bernanke, Geithner, and Paulson, who saw preventing the collapse of the American financial system and economy as a greater goal."[236] Sheila Bair "was reluctant to expose the deposit-insurance fund to potential losses even when the entire economy was at risk."[237]

The FDIC finally responded to Paulson's pleas during the crisis when the firm in trouble more closely aligned with the FDIC's mission. Washington Mutual, an aggressive mortgage lender, was began to deteriorate from the unprofitable subprime loans they lent. Within ten days, 9 percent of the bank's deposits were withdrawn. On September 25th, the federal Office of Thrift Supervision seized Washington Mutual and its two thousand branches, and turned the bank to the FDIC. The FDIC arranged for JPMorgan Chase to buy Washington Mutual for $1.9 billion.[238] Bair agreed to help in this instance because WaMu was a bank in the more traditional sense, but undermined moral hazard by penalizing the bank for its futile risk-taking. She decided that WaMu debtholders should suffer with its shareholders in order to remind investors that taking foolish risks has consequences. Bair's actions were reinforced by the law, which required the FDIC to find the "least-cost" solution to any failing bank in all but extraordinary circumstances.[239] Geithner conceded

[235] (Wessel, 2009)
[236] (Wessel, 2009)
[237] (Wessel, 2009)
[238] (Wessel, 2009)
[239] (Wessel, 2009)

that the market needed to be disciplined, but stressed that the market was too volatile to follow that objective at the time. He retaliated her reasoning by pointing to a 1991 law that said the least-cost rule could be waived for a "systemically important" institution if the FDIC, Fed, and Treasury, in consultation with the president, agreed.[240]

So which viewpoint in this dilemma is 'right'? How far is too far if the government insists that its actions are necessary to save the economy or should they act in accordance and be strictly confined by explicit laws?

Had the Fed not intervened during the 2008 crisis, however, the global economy might have endured a more severe crisis - if that were possible. Though the Fed did not completely overstep its boundaries, it often stood at the edge. The Fed's creative ways in combatting the liquidity trap by introducing unconventional policy tools such as quantitative easing, to interpret the law so that they were able to inject funds wherever it was needed, and doing "whatever it takes." The Fed came to the financial system's rescue almost every time it was in trouble. The Fed had become the lender of last resort not only to the banks but also to the domestic and international financial system.[241] "The Federal Reserve had become a fourth branch of government, nearly equal in power to the executive, legislative, and judicial branches, though still subject to their constitutional authority if they chose to asset it."[242]

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[240](Wessel, 2009)
[241] (Wessel, 2009)
[242] (Wessel, 2009)

5.1 Comparing the Two Episodes of Financial Instability

Studying the balance of power between the monetary and fiscal authorities of government during two periods of economic instability uncovered interesting implications. While the dynamic within government seemed to change depending on who was in power at the time, evidence of the political business cycle existed in both the Nixon era and the 2008 crisis.

During the Nixon Administration, the Chairman of the Federal Reserve, Arthur Burns, and the President of the United States, Richard Nixon, often quarreled over the direction monetary policy should take. Burns wanted to conduct contractionary monetary policy, which would decrease the money supply, increase interest rates, and cool down an overheated economy. Nixon, on the other hand, wanted the Fed to execute expansionary monetary policy to increase the money supply, decrease interest rates, and spur business activity to boost employment. The irony of this situation is that Nixon did not have jurisdiction in monetary affairs. Hence, the individual with greater influence is easily discernible.

Chairman Burns expanded the money supply, contrary to what he thought was the appropriate policy to remedy the economy's high inflation rate. President Nixon used aggressive tactics to coerce Burns into doing so because of his dogged political ambition. Though Nixon was aware that expansionary policy would exacerbate inflation, he prioritized the trade-off of greater employment. The public's perception that the economy was healthy would boost his chances for reelection. Hence, the political business cycle

theory was clearly on display in this episode. Nixon's strategies for economic policy were consistently motivated by his desire for reelection. This desire had terrible consequences for the economy.

Subsequent to Nixon's threats, Burns implemented expansionary monetary policy and exacerbated the existing problems in the economy. An increase in the money supply lowered interest rates and encouraged borrowing. At a time when inflation was already higher than the target, such a policy made an overheated economy grow even hotter. Inflation grew even more rampant and prices across all goods skyrocketed. When coupled with Nixon's New Economic Policy, the high inflation was accompanied by high unemployment, and led to a new economic phenomenon called stagflation.

Who held the upper hand during the 2008 financial crisis is less clear. When the waters started getting choppy in late 2007, the Fed was the first actor to charter the waves. After Countrywide experienced liquidity troubles, the Fed grew weary that Countrywide's crisis was not an isolated event. In an unorthodox move, the Fed lowered the discount rate and extended the borrowing period to help firms in a credit squeeze secure the funds it needed to continue operating. When the credit squeeze turned into a credit crunch and the big banks fell victim one after the other, Bernanke, Paulson, and Geithner all came together to fix the pieces and prevent more fallout. The three were constantly talking to each other over the phone, through video conference calling, and in person. Bernanke's, Paulson's, and Geithner's opinions each seemed to hold equal weight in discussions. Hence, the plan of action they ultimately chose to execute would have been the option all three officials believed would be most effective at lessening the economic instability.

Let's not forget, however, that the Fed held the purse throughout roughly the first ten months of the financial crisis. Until October, when Congress approved the Emergency Economic Stabilization Act of 2008, which authorized the Treasury to use $700 billion to avert further devastation to the financial system, the Fed was the sole funder of the bailouts of Bear Stearns and AIG. The Fed could have dictated the terms of the bailout deals to benefit their objectives. The Fed lent Bear $12.9 billion to continue operating for the rest of the week so the firm could make it to the weekend. To save Bear from completely going under, it then lent JPMorgan $30 billion. In the AIG bailout, the Fed put up $85 billion. Since Bernanke held the purse strings during both events, he could have abused his power and used the money as leverage to get his way if he had an ulterior motive other than economic stability. Though the outcome of such a situation would be speculative, it is likely that the financial system would have recovered at a slower speed than as it currently has. Luckily, Bernanke has proved to be a very righteous Chairman, who has been wholly committed to his duty of restoring the economy to good health.

The same could be said about Paulson. Once the Treasury received $700 billion from Congress, Paulson could then play ball too. Paulson, however, did not leverage the funds for ulterior motives either. He was also a virtuous, albeit aggressive, Treasury Secretary and devoted all his efforts to restore stability in the financial system. When Citigroup was the next bank to call on the government for assistance, Paulson agreed to another controversial bailout to avoid a similar financial devastation that followed Lehman's bankruptcy.

While both Bernanke's and Paulson's commitment to ensuring financial stability are commendable, Paulson's ability to remain steadfast to his duty is a bit more extraordinary

because of his position as Treasury Secretary. Paulson's position as Treasury Secretary is significant because his performance as one of the President's top appointed advisors is tied to how the public perceives the performance of the President. If the performance of the Treasury Secretary leads to positive economic outcomes, the public will likely attribute the positive economic outcomes to the President's perceptiveness. When the incumbent President has a good track record, voters will perceive him as capable, which significantly increases his chances at reelection.

During the 2008 crisis, many citizens voiced their dissent against the government bailouts because the bailouts were funded by taxpayer money. Saving the banks that were "too big to fail" was a very unpopular idea because the public was adamant that the banks engaging in risky behaviors should be penalized if their investments failed. Considering the majority of public opinion swayed towards letting the big banks fail, it would have been in the President's best interest, thereby the Treasury Secretary's best interest to obstruct the bailouts and appease the voters. Thus, if the political business cycle theory were at play in this episode, there would be evidence of the President coercing Paulson to stop the execution of the taxpayer-funded bailouts. The lack of influence on Paulson to do so, however, indicates that the political business cycle theory did not exist in this particular relationship between the President, the Treasury Secretary, and the Fed Chairman. In fact, there is evidence that President Bush pushed for Congress to pass the TARP bill. Perhaps then, Bush can also be credited for his moral obligation to serving the public good and giving Paulson the independence he needed to save the financial system.

Where the forces of the political business cycle theory played out in the 2008 crisis

was in Congress. The politicians in the House of Representatives and in the Senate had slightly greater incentive than the President and Treasury Secretary to deter the bank bailouts because Congressional members are directly elected into office by their district or state. While senators hold six-year terms, representatives in the House serve shorter two-year terms.[243] [244] Hence, House representatives have less time to build a successful track record of their own initiatives and thus win voters' support by advocating for their preferences in public policy. As a result, Congressional members, especially those in the House of Representatives, are closely bound to the will of their constituents. The correlation between voters' policy desires and politicians' votes on Congressional bills was evident in the failure to pass the bailout bill during the first attempt.

A negative by-product of the political business cycle theory in the 2008 crisis was its ability to infect Congress' decision and contribute to the defeat of the bailout bill that could have potentially rescued the financial system. The first TARP bill failed to pass the House of Representatives on September 29th by ten votes.[245] Though the rescue plan was eventually passed on October 3rd, the second time around, the delay of a very critical bill to save the financial system from collapsing demonstrates one of the biggest disadvantages of a democratic system. Lack of bipartisanship on pivotal issues creates lags in enacting imperative laws. Furthermore, if the political parties do not deem an issue to be critical, it most likely will not even make it to the floor for a vote. The problem gets worse when actors lobby for selfish provisions as opposed to for the greater good. Such is the effect brought out by the political business cycle theory in which politicians act based on political

[243] (United States House of Representatives, n.d.)
[244] (United States House of Representatives, n.d.)
[245] (Wessel, 2009)

self-interest. Consequently, "fiscal policy tends to be dictated by elections, partisanship, personalities, the power of opposing or blocking coalitions, and changing fads in economic theory."[246]

When politicians burden the Fed with these incentives and coerce them to act incongruously with their responsibility of economic stability, monetary policy decisions are less objective and sometimes detrimental. As the Nixon era and the 2008 crisis reveal, there is a link between the political business cycle and economic performance. When politicians were motivated only by political incentives to improve their chances at reelection, it had dire consequences for the economy. In the absence of a political business cycle, the Fed was able to implement the appropriate policy and put the U.S. economy on the path to recovery.

6.1 Anomalies of Mutual Influence Inherent in the Current System

In the current monetary and fiscal policymaking system, there are loopholes that allow for both authorities to mutually influence each other, even though – constitutionally – they should make decisions independently.

6.1.a Congress Technically Oversees the Fed

Technically, Congress is responsible for overseeing the activities of the U.S. Federal Reserve. It created the Federal Reserve System by enacting the Federal Reserve Act in 1913. Thus, Congress also has the ability to abolish the current Federal Reserve System

[246] (Nordhaus, Schultze, & Fischer, 1994)

through legislation, as it did previously to the First and Second Banks of the United States. If the Fed strays "too far from what the public deems acceptable," Congress has the power to reform the Fed's structure and mission.[247] This includes reducing the Fed's independence to make decisions about monetary policy. If the Fed Chairman deciphers the threat to the Fed's independence as a legitimate one, the Fed's ability to truly make independent decisions is diminished.

Completely getting rid of the Fed in the near future, however, is an unlikely scenario. Historically, there has been a need for an unbiased entity to respond to unfavorable fluctuations in the economy and there will potentially be immense public backlash to the Fed's abolishment.

Nonetheless, the current arrangement creates a conflict of interest. The prospect that on any given day, Congress could pass legislation that would significantly affect the structure of the Federal Reserve is a looming black cloud over the Fed and hinders its ability to make impartial decisions about monetary policy.

6.1.b President nominates and Congress approves Chairman and Vice Chairman of the Fed

The President's power to nominate the Chairman and Vice Chairman of the Federal Reserve is another loophole in which the Fed's decisions can be influenced by politics. If the political business cycle theory is present, matters are made worse because the President would prefer to nominate a candidate who will achieve his or her ends rather than an official who is fit for the job.

[247] (Wessel, 2009)

6.1.c Few Checks on Fed's actions

Unlike the arrangement of the three branches of government – the executive, legislative, and judicial branches – there is no robust check and balance system on the Federal Reserve "beyond the oath of the chairman and other governors to obey the Constitution and laws of the U.S. and the admonitions of its lawyers, a strong unwritten sense of what constitutes sound central banking, and the awareness that Congress has the power to curb the Fed's independence if it strays too far from what the public deems acceptable."[248]

The Fed's freedom in policy-making is convenient when time is of the essence. In the legislative branch, an initial proposal goes through a very formal and rigorous journey to become law – if it even makes it that far. After a bill is drafted, the Congressional member who wrote the document needs to gather sponsors. Once the member gets enough sponsors, the bill makes its way to committee for revision before it is sent to the "floor" for debate. If the majority votes yes, then the bill is sent to the other house of legislature to be approved through the same process. If the majority votes to pass the bill in the other house as well, it finally makes its way to the President, who can sign the bill into law, veto the bill, or use a pocket veto.[249] Due to the lengthy and challenging process of a bill becoming law, issues that require immediate attention are disadvantaged by this procedure. Moreover, a bill can be stalled at each level in the process if there is political gridlock. As Anna Piretti, an economist at BNP Paribas in New York, mentioned about Congress' authorization of the

[248] (Wessel, 2009)
[249] (The American Journal of Nursing, 1942)

$700 billion rescue plan: "This probably comes a bit too late. If this had been done earlier, it probably would have had a much bigger impact in restoring confidence."[250]

The Fed, on the other hand, is able to implement policy much faster for several reasons. First, there are fewer members on the Board of Governors than there are in Congress. The total number of voting Congressional members is 535, versus the seven members of the Board.[251] Hence, there are fewer members to persuade to vote yes and partisanship is easier to achieve. Second, the Fed acts on call, while Congress follows a strict agenda. Every time another shock occurred during the 2008 crisis, Bernanke would convene a meeting immediately. He often called unscheduled emergency meetings with the Board to discuss the Fed's next plan of action and talked constantly with Paulson about strategies for government policy. An increase or decrease in the interest rate would follow almost a day after the FOMC meeting in which the change was decided. Once a decision was reached in the Fed, policy was frequently implemented shortly thereafter. Congress, in comparison, had strict regulations and it is nearly impossible to convene a meeting to include all members. Moreover, it could take months for a bill to reach the Congressional agenda. As a result, the Fed's free reign over monetary policy was advantageous in dealing with issues that were time-sensitive.

The Fed's unchecked autonomy over monetary policy is problematic, however, given that extraordinary latitude because the Fed could in effect act as a vehicle for politicians to carry out their objectives without being subject to the checks placed on Congress. The problem would be exacerbated in the presence of a political business cycle because politicians would use the Fed as an unrestrained expedient for selfish political

[250] (Evans & Krolicki, 2008)
[251] (Govtrack, n.d.)

gains, which would likely have adverse effects on the economy. Ron Paul cited the dangers of the Fed's unchecked power:

> Only the Federal Reserve can inflate the currency, creating new money and credit out of thin air, in secrecy, without oversight or supervision. Inflation facilitates deficits, needless wars and excessive welfare spending.[252]

A strong example of this situation was Nixon's treatment of the Fed as stopgap to achieve lower unemployment, which would help his reelection campaign for a second term as President. Unfortunately, Nixon's dominance over the Fed led to the implementation of monetary policy that exacerbated the initial signs of economic instability and generated the dismal symptoms of stagflation. Hence, it was popularly believed that "Throughout its postwar history, the Fed has responded to the interests of large banks and Congress, not the public."[253]

6.1.c.a. Fed's Ability to Print Money Out of Thin Air

A mechanism by which the Federal Reserve executes expansionary monetary policy is by printing more money to increase the money supply. In the event a political business cycle occurs and the Fed acquiesces, this power can easily be abused. Moreover, there is no system in place to check the activities of the Fed to stop such exploitation. Ron Paul reflects:

> There is something fishy about the head of the world's most powerful government bureaucracy, one that is involved in a full-time counterfeiting

[252] (Paul, 2009)
[253] (Wessel, 2009)

> operation to sustain monopolistic financial cartels, and the world's most powerful central planner, who sets the price of money worldwide, proclaiming the glories of capitalism.[254]

The Nixon administration, once again, is an instance of this behavior. President Nixon abused the Fed's ability to print money and expanded the money supply to unhealthy levels in the economy, which exacerbated inflation. Hence, the Fed's power to print money seemingly "out of thin air" is a loophole for politicians to influence the economy.

6.1.c.b Pushing legal boundaries

Not only does the lack of limitations on the Fed's actions threaten economic stability in the presence of a business cycle, but it also leaves open questions about the scope and extent of the Fed's powers. During the 2008 financial crisis, lack of oversight allowed the Fed to expand its powers outside of the conventional monetary policy tools. Though the Fed was traditionally thought to be responsible for the health of strictly the banking system, it broadened its services and to new kinds of clientele.

In addition to servicing loans to banks, the Fed now lent money to AIG, an insurance company, and Fannie Mae and Freddie Mac, two GSEs. The loans to the companies were controversial because it deviated from the Fed's traditional clientele and powers. Moreover, the Fed defied the Bagehot's rule, which summarized the Fed's role as lender of last resort to "lend freely at a high rate, on good collateral" during a liquidity crisis.[255] During the 2008 financial crisis, the Fed lent money to banks that were insolvent as well. The Fed decided to forge ahead and provide the liquidity because of the troubled financial

[254] (Paul, 2009)
[255] (Thornton, 2008)

firms' imminent need for a quick injection of capital else they would fail. Since the Fed could act on shorter notice compared to the rest of government, the Fed reinterpreted the explicit language of the Federal Reserve Act to save the financial system from collapsing. Geithner and Bernanke "had few doubts that the U.S. government, broadly defined, should pony up, but they knew this was a step beyond the Fed's traditional role of pumping liquidity into the markets. The lawyers would devise language to get around the requirement that the Fed could make loans, not buy assets."[256] The Fed's lawyer did just that and justified the loans by citing Section 13(3) of the Federal Reserve Act, which allowed the Fed to lend "to any individual, partnership or corporation" if five members of the Federal Reserve Board in Washington declared the circumstances to be "unusual and exigent."[257] This advice allowed the Fed to lend directly to the financial firms in trouble and bypass using banks as an intermediary.

In JPMorgan's acquisition of Bear Stearns, for instance, the Fed stretched the provision so the structure of the deal would meet the boundaries of the language:

> The Fed was effectively spending $30 billion of its money to buy mortgage-linked securities that JPMorgan didn't want. JPMorgan, to the Fed's discomfort, described them unattractively as 'illiquid assets, largely mortgage related' on a Sunday-night conference call with securities analysts, a reference that implied it was sticking the Fed with the worst of Bear's holdings. The structure of the deal stretched Section 13(3) of the Federal Reserve Act. Because the Fed wasn't supposed to buy the securities outright, it borrowed a tool from financial engineers whose handiwork had led to the

[256] (Wessel, 2009)
[257] (Board of the Governors of the Federal Reserve System, 2013)

> Great Panic. It created a 'special purpose vehicle' to hold the assets. Then it made a loan to that entity and argued that the loan had been secured by those Bear Stearns securities. And if they proved to be worth a lot less than the price the Fed had paid, the Fed -not JPMorgan Chase - would eat the loss."[258]

Even Bernanke remarked that in the Fed's attempt to rescue the financial system, they've had to devise creative approaches due to the unique conditions of the crisis, frequently expanding their powers in the process:

> So, there are different ways to look at this. We're crossing certain lines. We're doing things we haven't done before. On the other hand, this financial crisis is now in its eighth month, and the economic outlook has worsened quite significantly. We are coming to the limits of our monetary policy capability. The Congress has passed a fiscal program. I do not know how much political capacity there is to do additional things, although I assure you that we will be thinking hard about it and I hope you will be, too. So I view this really as incremental, and I think we need to be flexible and creative in the face of what are really extraordinary challenges.[259]

6.1.c.b.i Experimenting with Quantitative Easing

As the financial crisis progressed and the economy got worse and worse, the FOMC kept lowering the interest rate. The interest rate was lowered so far down that by

[258] (Wessel, 2009)
[259] (McGrane, 2014)

December, it was a mere ¼ percent above the zero-bound. The economy was nearing a liquidity trap and conventional expansionary monetary policy would no longer be effective past that point. In a radical, yet necessary move, the Fed strayed from the customary monetary approach and began to discuss policy methods that were more unorthodox. During an October meeting, Bernanke proposed to the FOMC that the Fed experiment with Milton Friedman's old idea of quantitative easing. The Fed ultimately chose to that plan of action. On November 25th, 2008 the Fed announced the beginning of the program in which it would purchase up to $600 billion in agency mortgage-backed securities and debt in the first round of QE.[260]

Since constraints on the Fed are generally implicit and its enforcement irregular, the scope of their autonomy falls in a grey area. Hence, the Fed's actions throughout the 2008 crisis were controversial, with an almost even split between praise and disapproval. The Bloomberg National Poll discovered through a survey conducted two years after the crisis that 39 percent of Americans said the Fed should be held more accountable, 16 percent said it should be abolished, and 37 percent said they favored the status quo.[261]

Those who approved of the Federal Reserve's response to the 2008 crisis believed its bailouts and programs were justified because it saved the U.S. economy from complete chaos. Devout critics of the Fed's reaction claimed that the bailouts to the big financial firms trespassed the boundaries of the Fed's powers and created moral hazard problem, in which the Fed would be expected to intervene when systemic risk posed a problem. Anna Schwartz, for instance, denounced the Fed-Bear Stearns loans as "a rogue operation" and

[260] (Board of Governors of the Federal Reserve System, 2008)
[261] (Zumbrun, 2010)

said "the Fed had no business intervening."[262] Other commentators took the middle ground and said the Fed *almost* stepped over the line. For example, Paul Volcker told the New York Economic Club that the Fed had gone to "the very edge of its lawful and implied powers, transcending certain long embedded central banking principles and practices."[263]

6.1.c.c "Fiscal Policy by Monetary Means"

In addition to expanding legal boundaries during the 2008 crisis, the Fed also engaged in activities that would have traditionally been considered fiscal policy. Hence, the term "fiscal policy by monetary means" was used to describe the unprecedented credit allocation programs the Fed undertook.[264] These programs include Maiden Lane –a limited liability company created to facilitate a quick acquisition of Bear Stearns' assets during the crisis –, a bridge loan to JP Morgan Chase, a revolving AIG credit facility, and a Bank of America non-recourse lending commitment.[265] These programs are considered fiscal policy because they target specific firms. The Fed orthodoxly conducts monetary policy and is concerned with the macroeconomy.

One implication of the implementation of these Fed programs is whether they were created on the Fed's own accord or whether the Fed was influenced by other parties to develop such programs. Before Timothy Geithner became Treasury Secretary in 2009, he was President of the Federal Reserve Bank of New York. The NY Fed is a big player in the Federal Reserve System, as it is the largest regional Fed bank and located in the finance

[262] (Wessel, 2009)
[263] (Brinsley & Massucci, 2008)
[264] (Butos, 2014)
[265] (Board of Governors of the Federal Reserve System, 2013)

capital of the United States. It executes the open market operations on behalf of the Federal Reserve System at the direction of the FOMC and it engages in foreign exchange operations on behalf of the US Treasury.[266] As a result, Bernanke and Geithner interacted frequently when they both worked for the Fed. Geithner was one of the few important minds included on the critical conference calls with Bernanke and Paulson regarding the government bailouts. Though any declaration of private interactions between Geithner and Bernanke once Geithner moved onto the Treasury would be speculative because there are no public records, it would not come as a surprise that the two remained close.

The power dynamics between key actors in 2008 are difficult to explore because the crisis happened relatively recently. Useful information, such as phone records between Bernanke and Geithner, is limited, and scholarly research about the crisis is even narrower in breadth or currently in progress. This issue of the exchange of ideas between fiscal and monetary authorities is important to examine further because the Fed is not checked as scrupulously as Congress. Unlike loans approved by Congress, loans extended by the Federal Reserve remain on its balance sheet and are not included in the public debt measurement. As a result, transparency between the Fed and the public are hazy. The Fed's actions are insulated to a group of selected, high-powered individuals. Its actions escape the legislative process, public discussion, and the checks and balances system that oblige Congress. Hence, the Fed's credit allocation programs of 2008 lead to questions concerning the old notion that the Fed was created to act as an arm of the Treasury, which would be inconsistent with the establishment of the Fed for an independent monetary authority and with the Rule of Law of a democracy. Nevertheless, regardless of what influences brought

[266] (Federal Reserve Bank of New York, 2008)

about the Fed's programs, one observation is certain –monetary and fiscal policy became intertwined in the 2008 crisis.

6.1.d Summary

During the Nixon era, examples of political influence over monetary policy were overt. During the 2008 crisis, relationships between key actors were more complex and evidence of political influence was more obscure.

Though there is little consensus about whether the Fed acted appropriately and constitutionally in 2008, the elephant in the room is what to do about the Fed moving forward. Barney Frank, the Chair of the House Financial Services Committee said:

> I think highly of Mr. Bernanke and Mr. Paulson. I think they are doing well, although I think it's been inappropriate in a democracy to have them in this position where they were sort of doing this stuff unilaterally. They had no choice. And it's not to their discredit, but … this notion that you wait until there's a terrible situation and you just hope that the chairman of the Federal Reserve would pop up with the secretary of the Treasury and rescue you. It's not the way in a democracy … you should be doing this … No one in a democracy, unelected, should have $800 billion to spend as he sees fit.[267]

Should the Fed be reformed, abolished, or unchanged?

All in all, the theme that rings throughout the 2008 financial crisis is that the "Fed

[267] (Wessel, 2009)

abandon[ed] 'failed paradigms' in order 'to do what needed to be done.' "[268]

6.2 Implications of Findings for Policy-Makers

6.2.a The Fed as an "Independent" Monetary Authority

Although the Federal Reserve was created to independently "provide the nation with a safer, more flexible, and more stable monetary and financial system" free from the political influences that afflict the fiscal authority, popular opinion alleges that the Fed often operated as an arm of the Treasury throughout the first few decades of its existence.[269] Extreme skeptics claim that the inception of the Fed was in fact a political scheme to spread accountability, or blame, onto a separate entity.[270]

The Nixon administration adheres to the notion that the Fed serves as an arm of the rest of government almost exactly. Under traditional banking theories, a central banker would tackle inflation by conducting contractionary monetary policy. By reducing the supply of money, interest rates would increase and deter borrowing. Less borrowing would decrease business activity and cool down inflation. This was not the course of action Chairman Arthur Burns took in the early 1970s to tackle the onset of inflation. In fact, Burns implemented – though reluctantly – expansionary monetary policy, which had the exact opposite effect. He did not act in accordance with traditional economic theory because he was coerced by President Nixon to fulfill his political desire for more

[268] (Wessel, 2009)
[269] (Board of Governors of the Federal Reserve System, 2009)
[270] (Epstein, 2009)

employment. Nixon's verbal and written threats grew increasingly aggressive and legitimate. As a result, Burns gave in to Nixon's demands for expansionary policy to defend the independence of the Federal Reserve. This chain of events exhibits the commonly held perception that the Fed was created to do the government's bidding.

The 2008 financial crisis was a completely different story. Chairman Ben Bernanke held his own in the bailout discussions with Treasury Secretary Henry Paulson. The Fed's response to the crisis was Bernanke's view of how it could best address the economic instability. Paulson often came to the same conclusion, also on his own. In regards to Bear Stearns' liquidity crisis, Bernanke believed allowing the firm to fail would create chaos in the markets. In other words, Bear was "too big to fail." Paulson agreed. Hence, the 2008 financial crisis was a period with strong-willed characters and a commitment to do "whatever it takes" to save the financial system. In this episode, the Fed showed no signs of submissiveness to the Treasury's wishes.

Therefore, a comparison of both periods in history revealed that the political business cycle does not intrinsically affect the actions of the Fed. The Fed's abandonment of its power to make independent decisions at times – for example, during Burns' chairmanship – was due to circumstantial influences and the steadfastness of the Chairman. Since submissiveness is not inherently embedded in the structure of the Federal Reserve, then the top officials who have control over the Fed's actions should be examined. What qualities should the President look for in candidates when nominating the Fed Chairman and Vice Chairman? A subpar nominee can wreak havoc on the economy.

7.1 CONCLUSION

My thesis sought to apply the policy coordination theory to historical experience. If the theory held true, then history should show that recovery efforts in which the fiscal and monetary authority implemented accommodative policies, the economy would bounce back faster.

Studying the Nixon administration showed the effect of policymaking between actors that were not accommodative, the outcome of which was no recovery and in fact a worse economic state. President Nixon's upper hand in economic matters exacerbated the inflation rate. Due to Nixon's political ambition for reelection, he was focused on increasing employment and threatened Burns to increase the money supply to achieve that end goal even though it was not compatible with the existing conditions in the economy. The Fed's submission to Nixon's demand fueled more inflation and sent the economy into stagflation.

In contrast, the 2008 financial crisis was an example of accommodative policy in which the Federal Reserve and the Treasury Department worked together in determining the next step economic policy should take, and effectively staved off the collapse of the financial system. The parts of government that were not as accommodative during the crisis, however, were the Federal Deposit Insurance Corporation and Congress. The FDIC refused Paulson's request for help with the bailouts several times because Sheila Bair, the Chairperson of the FDIC, believed doing so overstepped the agency's legal powers. Congress was reluctant to aid the bailouts also because it was an unpopular plan among voters. Although TARP was eventually signed into law, had the $700 bailout funds been

approved sooner, fewer banks may have fallen victim to the liquidity crisis and the financial system might have recovered sooner.

As a result, the balance of power between government responders when resolving problems of instability in the economy proved to be of significance to the effectiveness of recovery efforts in both the Nixon administration and the 2008 financial crisis. Moreover, there is evidence of the political business cycle theory existence and the theory's hindrances to recovery efforts in both periods of policy coordination. The theory's omnipresence in policymaking is cause for concern considering the anomalies in the current government structure. Since there are few checks on the Fed, political influences that seep through the loopholes in the system – as demonstrated by the Nixon era – have grim consequences on the economy.

Further questions to consider are whether the anomalies should be addressed and how? The Fed's advantage in having little oversight is that it has been able to react quickly to economic problems. The downside of its seemingly unlimited autonomy is that there are loopholes for political influence in the current structure. Should the system be reformed and if yes, how?

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