

## TRANSPARENCY OR DECEPTION: WHAT THE FED WAS SAYING IN 2007

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*ABSTRACT:* Central banks have embarked on a transition from relative secrecy to relative transparency over the last two decades. This has led researchers to investigate the ramifications of transparency on important economic outcomes. By and large, the results reported have been favorable, favorable with qualifications, or ambiguous. This paper examines the communications of officials from the Federal Reserve during 2007, the year between the end of the housing bubble and the beginning of the financial crisis. In contrast to previous findings, these communications are indicative of either deception, incompetence, or a combination of both.

*KEYWORDS:* Federal Reserve, transparency, monetary policy, policy objectives and coordination

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“There are several reasons to believe that this concern about burst bubbles may be overstated.”

– Fred Mishkin, Feb. 17, 2007

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## INTRODUCTION

Central banks have become more “transparent” over the last quarter-century. By communicating their actions, intentions, and philosophy they give the appearance of public-spiritedness and justify their independence from the political process. By examining this greater transparency with regards to monetary policy, economists have found that it has led capital markets and interest rates to react more efficiently and be more efficient.<sup>1</sup>

In contrast, the economic theory of regulation (Stigler, 1971) holds that regulators such as central banks will be “captured” and act in the private interests of the industries that they regulate. Evidence is presented here regarding the Federal Reserve’s role in regulation and financial oversight that supports this theory by showing that communications from the central bank have a tendency to support the Federal Reserve and the financial industry’s interests, rather than the public interest. The fact that the large banks were bailed out during the crisis confirms this conjecture about the nature of the relationship between the Federal Reserve and the financial industry.

This paper contends that central bank communications can indeed mislead market participants. Previous studies that rely on numerical market data have concluded that transparency has been generally beneficial. In contrast, public speeches by members of the FOMC on financial innovation and Federal Reserve oversight of financial institutions and financial products, such as mortgage-backed securities are examined here for their transparency. These communications are drawn from a critical period between the end of the housing bubble in 2006 and the financial crisis, which began in 2007. Rather than being transparent and helping markets

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<sup>1</sup> The drive for increased transparency began in the 1990s. In 1994 the Federal Open Market Committee (FOMC) started announcing its target for the federal funds rate. In 1999, the FOMC began announcing its “bias” for future changes in monetary policy as well as issuing more details statements when it was not changing rates. A few years later it began announcing FOMC votes after each meeting. In 2005, the FOMC began releasing the minutes of its meeting prior to the subsequent FOMC meeting. In 2007, the Fed has increased the frequency and content of its publicly-released forecasts. Similar trends towards central bank transparency have occurred at the Bank of England, European Central Bank, the Norges Bank, Sveriges Riksbank (the central bank of Sweden) and the Reserve Bank of New Zealand. (Blinder et al., 2008, p. 3)

equilibrate, these communications were effectively deceptive in an apparent attempt at maintain undo confidence in financial markets.

## CENTRAL BANK TRANSPARENCY

The issue of central bank transparency or lack thereof is important under a discretionary monetary regime. For example, Koppl (2002) shows that the central bank is a “big player” and market participants must expend resources and bear risk because the central banker has discretion and disproportionate impact on market outcomes. Likewise, Goodfriend (1999) in examining the role of the regional Federal Reserve banks, concludes that market expectations could be fractured if decision making over monetary policy were centralized in the hands of a “dictator” and that centralized decision making could be more easily captured by special interests. Crowe and Meade (2008) and McGregor (2007) have analyzed how much transparency has really changed and whether to expect more or less transparency in the future.

Prior to 1990, monetary policy was largely shrouded in mystery. Under the gold standard and in the Bretton Woods system, monetary policy was less arbitrary than today because it had a relatively fixed anchor. Because money had no anchor after Bretton Woods, policy makers felt a need for secrecy and a fear that lack of secrecy would undermine markets. Those fears gradually receded and were replaced with the notion that better communications by central bankers would help to manage expectations in financial markets and lead to improved economic results.

The Federal Open Market Committee (FOMC) began to announce its federal funds rate target in February of 1994. In May of 1999, the FOMC began publishing statements regarding its “bias” towards future rate changes. In 2002, it began to release the votes of the FOMC immediately after meetings. The Fed has continued its transition to greater transparency and more timely communication of its monetary policy. Forward-looking policy guidance was added in 2003. The release of FOMC minutes was shortened to three weeks after each meeting in 2005. Numerical forecasts with an extended three-year time horizon were added in 2007. Meeting transcripts for an entire year are now publicly released with a five-year lag. The financial crisis that began in 2008

has led the Fed to extend its transparency further into the future, e.g. rates will remain low for the foreseeable future.

Blinder (2008) reports that the central banks of England, New Zealand, Norway, Sweden, elsewhere in Europe, and other nations have adopted the philosophy of greater transparency and in many cases explicit inflation-targeting regimes. According to Blinder (2008, p. 3), "the view that monetary policy is, at least in part, about managing expectations is by now standard fare both in academia and in central banking circles. It is no exaggeration to call this a revolution in thinking."

There has been a great deal of research on this new paradigm of monetary policy and while better communication is generally lauded as a good thing, it is not yet considered a panacea. For example, there is the ultimate constraint that central banks will know more about their own views and actions than will the general public and financial markets. Therefore, there cannot be complete transparency. In addition, Bernanke (2004) admits that no system is known in which central banks can be completely self-constrained when changing conditions and surprises dictate deviations from previous central bank communications and inflation targets. Therefore central banks cannot provide 100 percent certainty about the information they share regarding the future.

The general appeal of transparency is that better communications by central banks help to manage or stabilize expectations and stable expectations help central bankers to implement more effective monetary policy, even though it may have less "influence" in the short run. Donald L. Kohn and Brian Sack (2004) contend that individuals place special authority on the communications of central banks based on the central banks' records of forecasting. While empirical studies support this view, it is not surprising, given the large amount of resources allocated by central banks to forecasting and by market participants to analyzing central bank communications.

Blinder (2008) shows that there is an extensive empirical literature that examines the impact of central bank communications on measurable movements in interest rates and events in stock markets. The general conclusion of these studies is that such central bank communications can and do positively impact these markets, but not necessarily as completely as central banks wish.

This paper does not argue with this conclusion. Rather, it relies on these types of results: central bank communications do impact behavior in a relatively effective manner. Additionally, this paper builds on the suggestion in the literature that central bank communications could also be welfare reducing, a minority view. For example, Amato, Morris, and Shin (2002) contend that central bank communications could move markets away from fundamentals if market participants give too much weight to central bank communications relative to market-generated data.

### **ARE CENTRAL BANKS CAPTURED?**

What are the implications of Amato, Morris, and Shin's (2002) contrarian stance? Most of the literature on transparency implicitly or explicitly assumes central bankers are motivated by concern for the public interest. This literature produces a great deal of evidence that this is indeed the case. However, if we were to re-examine this literature from a private-interest approach we might even find that Amato, Morris and Shin (2002) was not the exception, but the rule. Perhaps the evidence that transparency facilitates such things as stabilization of interest rates and inflation expectation could also be viewed as in the interest of central banks and money center banks as well as the public interest.

George Stigler (1971) presents an economic theory of regulation that suggests that special interests have an economic incentive to have agencies regulate their industries to create a cartel-like environment that will produce economic rents for members of the industry. Stigler's approach is closely aligned with the capture theory of regulation. This theory holds that interest groups with high stakes in both the form and the enforcement of a regulation or set of regulations will devote resources to capture the legislative process, commissions, and regulatory staffs. This allows the industry to control and benefit from the regulatory process. The outcomes are most often worse than if there were no regulation at all. Hamilton (2013) shows that when regulatory officials are not elected (as in the case of the central bank of the United States) and when democratically elected officials face insignificant competition, private-interest outcomes will dominate public-interest outcomes. More specifically Rothbard

(1984) has demonstrated that the Federal Reserve System was intended as and acts as a cartelizing device for large banks' interests. Broz (1997) argues that the Federal Reserve was a joint product consisting of a public good, i.e., a reduction in bank panics, and a private good, i.e., benefits to the large New York City banks, as suggested above.

An additional motivation for this research is an important paper by White (2005). He found that the Federal Reserve is highly influential in the business of publishing academic research in monetary economics. In his sample of the *Journal of Monetary Economics* and the *Journal of Money, Credit and Banking*, 80 percent and 75 percent of the articles had at least one coauthor with a Federal Reserve affiliation and 82 percent and 87 percent of the editorial board members had Federal Reserve affiliations. At the very least, this influence would tend to have a "crowding out" effect on research on alternative monetary regimes, such as the gold standard and free banking. White (2005, pp. 343–344) concludes that:

an academic economist who values the option to someday receive an offer from the Fed, either to become a staff economist, or a visiting scholar, faces a subtle disincentive to do regime-challenging research. To repeat Fetting's (1993) characterization of Milton Friedman's view: "if you want to advance in the field of monetary research... you would be disinclined to criticize the major employer in the field."

## CENTRAL BANK DECEPTION?

"Indeed, U.S. financial markets have proved to be notably robust during some significant recent shocks."

– Donald L. Kohn, Feb. 21, 2007

Thornton (2004) suggests that one should not listen to Federal Reserve chairman Alan Greenspan's testimony and speeches. Delete it from your mind like spam emails. Watch what he has done and what he is doing, but deeply discount anything you read about his testimony. Note that Greenspan's speeches and testimony as well other central bankers is often considered obfuscation rather than true deception.

Central banking is a confidence game. The Federal Reserve runs a monetary system where money has no traditional backing, such as gold or silver. It runs a banking system that has, until the housing bubble-financial crisis, had no reserves to back deposits, other than drawer money. The central bank certainly has its own tools to give us confidence in the system, such as the discount window, which serves as Federal Reserve role as a lender of last resort. Other institutions such as legal tender laws and deposit insurance also provide confidence by acting as security for the value of the dollar and insuring bank accounts against bank failure. Although central bankers would not accept the notion that central banking is a “confidence game,” they regularly speak of investors’ confidence, consumers’ confidence, policy expectations, and economic uncertainty.<sup>2</sup>

The Federal Reserve seeks to maintain our confidence in its system and to encourage people to not take proper precautions against the negative effects of its policies. Printing up money and lowering the value of dollar-denominated assets while simultaneously providing benefits to special interest groups is a deception that is a major part of the confidence game.

The basic focus here will be on the Federal Reserve’s mission to instill confidence in us about the economy while simultaneously instilling confidence in us about the abilities of the Fed itself. The first mission is easy to see because Federal Reserve officials are almost always publicly bullish and hardly ever publicly bearish about the economy. According to the central bank, the economy always looks good, if not great. If this message fails to have its intended effect, the central bank will proclaim that the economy is better than it appears and that there are signs of recovery and economic growth. If there are some problems, please do not worry, the Federal Reserve says: it will come to the rescue with truckloads of money, lower interest rates, and easy credit. If things were to get worse, *which they won’t*, the

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<sup>2</sup> A confidence game (also known as a *bunko*, *con*, *flimflam*, *hustle*, *scam*, *scheme*, or *swindle*) is defined as an attempt to defraud a person or group by gaining their confidence. The victim is known as the *mark*, the trickster is called a *confidence man*, *con man*, or *con artist*, and any accomplices are known as *shills*. Confidence men exploit human characteristics such as greed, vanity, honesty, compassion, credulity, and naïveté. The common factor is that the mark relies on the good faith of the con artist.

Federal Reserve would be able to respond with monetary weapons of mass stimulation. Of course this perspective is consistent with the viewpoint of mainstream economists. They see the business cycle as caused by psychological problems, random technological shocks, or market failures. In fact, the business cycle can be attributed to the divide between interest rates set by the Federal Reserve and those indicated by market forces.

The evidence presented here comes from public speeches by leading officials of the Federal Reserve during the year 2007. This is the period between the ending of the housing bubble in 2006 and the onset of the financial crisis, which began in earnest in 2008. Predictably, their testimony and speeches are highly nuanced and hedged. The quotes taken from these communications typically represent concluding or summary remarks. Note that this evidence is qualitative in nature rather than quantitative and therefore not of the species used by mainstream economists.

## **Ben Bernanke**

Let us begin at the beginning of 2007 with the chairman of the Fed, Ben Bernanke. The former economics professor from Princeton gave an address to the annual meeting of the American Economic Association. (Bernanke, 2007) Bernanke was the first chairman of the Fed from academia since Arthur Burns, and it was Burns who helped take us off the gold standard.

In addressing his fellow mainstream academic economists, Bernanke was unusually bold in describing the Federal Reserve's access to and ability to use data concerning financial markets. This knowledge and expertise includes the market for derivatives and securitized assets. He describes the Federal Reserve as a type of superhero for financial markets. In discussing the Federal Reserve's role as chief regulator of financial markets he makes powerful claims concerning the Federal Reserve's ability to identify risks, anticipate financial crises, and effectively respond to any financial challenge.

Many large banking organizations are sophisticated participants in financial markets, including the markets for derivatives and securitized assets. In monitoring and analyzing the activities of these banks, the Fed obtains valuable information about trends and current developments



in these markets. Together with the knowledge it obtains through its monetary policy and payments activity, information the Fed gains through its supervisory activities gives the Fed an exceptionally broad and deep understanding of developments in financial markets and financial institutions.

In its capacity as a bank supervisor, the Fed can obtain detailed information from these institutions about their operations and risk-management practices and can take action as needed to address risks and deficiencies. The Fed is also either the direct or umbrella supervisor of several large commercial banks that are critical to the payments system through their clearing and settlement activities. (Bernanke, 2007)

In other words, according to the Federal Reserve, it knows everything about financial markets. In truth, the banks and the Federal Reserve apparently had no idea about the looming dangers concerning derivatives, securitized assets, and risk management practices. But it gets worse:

In my view, however, the *greatest external benefits* of the Fed's supervisory activities are those related to the institution's role in preventing and managing financial crises.<sup>3</sup>

In other words, the Federal Reserve can prevent most crises and manage the ones that do occur. Given that we are more than seven years into this serious economic downturn, that banks are even bigger and more susceptible to systemic risk, and that the national debt and the Fed's balance sheet have exploded upward in size, his statement is clearly in doubt.

Finally, the wide scope of the Fed's activities in financial markets—including not only bank supervision and its roles in the payments system but also the interaction with primary dealers and the monitoring of capital markets associated with the making of monetary policy—*has given the Fed a uniquely broad expertise in evaluating and responding to emerging financial strains.* (Bernanke, 2007)

In other words, the Federal Reserve is an experienced, forward-looking preventer of financial crises. This is a strong claim given

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<sup>3</sup> See Thornton (2010). [https://mises.org/daily/4177/The-Federal-Reserve-as-a-Confidence-Game-What-They-Were-Saying-in-2007#\\_ftn1](https://mises.org/daily/4177/The-Federal-Reserve-as-a-Confidence-Game-What-They-Were-Saying-in-2007#_ftn1).

Bernanke's own abysmal record of forecasting near-term events during and after the housing bubble. As financial strains did emerge, it would be hard to judge Bernanke's evaluation and response as even marginally satisfactory unless one takes the perspective of the large banks and financial institutions.

Bernanke is infamous on the Internet because of the YouTube video that chronicles his rosy view of the developing crisis from 2005 to 2007. He denied in 2005 that there was a housing bubble. Bernanke in 2006 denied that housing prices could decrease substantially. He said that if they were to fall it would *not* affect the real economy and employment. He first denied and then tried to calm fears about the subprime-mortgage market. He stated in 2007 that he expected reasonable growth and strength in the economy, and that the problem in the subprime market (which had then become apparent) would not impact the overall mortgage market or the economy in general. In mid-2007 he declared the global economy strong and predicted a quick return to normal growth in the United States. Remember, Austrians were writing about the housing bubble, its cause, and the probable outcomes as early as 2003.<sup>4</sup>

Possibly the worst of Bernanke's statements occurred in 2006, near the zenith of the housing bubble and at a time when all the exotic mortgage manipulations were in their "prime." This was the era of the subprime mortgage, the interest-only mortgage, the no-documentation loan, and the heyday of mortgage-backed securities. The new Federal Reserve chairman admitted the possibility of "slower growth in house prices," but confidently declared that if this did happen he would just lower interest rates.

Bernanke also stated in 2006 that he believed that the mortgage market was more stable than in the past. He noted in particular that "our examiners tell us that lending standards are generally sound and are not comparable to the standards that contributed to broad problems in the banking industry two decades ago. In particular, real estate appraisal practices have improved."

Bernanke is considered a top mainstream economist with the best credentials and extensive service in academia and government.

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<sup>4</sup> See the compilation by MarcellusCMarcellus, "Ben Bernanke Was Wrong," at <https://www.youtube.com/watch?v=9QpD64GUoXw>.

The chairman of the Federal Reserve has enormous resources at his disposal including a virtually unlimited budget, thousands of economists and consultants, and every piece of economic data, including detailed information concerning every major financial firm. With those resources at his disposal he consistently issued wrong answers over an extended period of time. The plausible explanations for this pattern of misinformation include; 1) Modern mainstream economics is inadequate with respect to using monetary policy to control macroeconomic outcomes, 2) Monetary policy is something beyond the capabilities of bureaucratic management, or that 3) Bernanke was issuing statements that were in the private interests of either the Federal Reserve, the banking and nonbanking financial industries, or both. These three possibilities are not mutually exclusive.

## **Fred Mishkin**

Less than two weeks after Bernanke's address to the American Economic Association, fellow academic Fred Mishkin, a governor of the Federal Reserve Board, took the stage at the Forecaster's Club of New York. (Mishkin, 2007) Mishkin is a leading mainstream economist and expert on money and banking, and the author of the best-selling college textbook on money and banking. Mishkin addressed the group on the topic of enterprise risk management and mortgage lending.

He begins,

Over the past ten years, we have seen extraordinary run-ups in house prices ... but ... it is extremely hard to say whether they are above their fundamental value.... Nevertheless, when asset prices increase explosively, concern always arises that a bubble may be developing and that its bursting might lead to a sharp fall in prices that could severely damage the economy....

The issue here is the same one that applies to how central banks should respond to potential bubbles in asset prices in general: Because subsequent collapses of these asset prices might be highly damaging to the economy ... should the monetary authority try to prick, or at least slow the growth of, developing bubbles?

I view the answer as no. (Mishkin, 2007)

In other words, if the Federal Reserve is not worried enough to change policy and address bubbles, you should not be worried either. He continues:

There is no question that asset price bubbles have *potential* negative effects on the economy. The departure of asset prices from fundamentals can lead to *inappropriate* investments that *decrease the efficiency* of the economy. (Mishkin, 2007)

In other words, there are some *potential* problems with bubbles. But Mishkin has a theory that says there can be no such thing as significant bubbles.

If the central bank has no informational advantage, and if it knows that a bubble has developed, the market will know this too, and the bubble will burst. Thus, any bubble that could be identified with certainty by the central bank would be unlikely ever to develop much further. (Mishkin, 2007)

He then tells his listeners that in the unlikely event of a housing bubble, it really would not be a problem for several reasons:

Asset price crashes can sometimes lead to severe episodes of financial instability.... Yet there are several reasons to believe that this concern about burst bubbles may be overstated.

To begin with, the bursting of asset price bubbles often does not lead to financial instability....

There are even stronger reasons to believe that a bursting of a bubble in house prices is unlikely to produce financial instability. House prices are far less volatile than stock prices, outright declines after a run-up are not the norm, and declines that do occur are typically relatively small.... Hence, declines in home prices are far less likely to cause losses to financial institutions, default rates on residential mortgages typically are low, and recovery rates on foreclosures are high. Not surprisingly, declines in home prices generally have not led to financial instability. The financial instability that many countries experienced in the 1990s, including Japan, was caused by bad loans that resulted from declines in commercial property prices and not declines in home prices. (Mishkin, 2007)

Everything he just said turned out to be completely untrue. As the leading expert on these subjects, he should have known that all

of the statements in this quote were either not true or were at least far from certain. He clearly appears to be using this communication to quell rising fear and to instill confidence and it all turned out to be not true. But he continues to dig his hole deeper and his deception wider:

My discussion so far indicates that central banks should not put a special emphasis on prices of houses or other assets in the conduct of monetary policy. This does not mean that central banks should stand by idly when such prices climb steeply...

Large run-ups in prices of assets such as houses present serious challenges to central bankers. I have argued that central banks should not give a special role to house prices in the conduct of monetary policy but should respond to them only to the extent that they have foreseeable effects on inflation and employment. Nevertheless, central banks can take measures to prepare for possible sharp reversals in the prices of homes or other assets to ensure that they will not do serious harm to the economy. (Mishkin, 2007)

In other words, the Federal Reserve understands bubbles, but it is not going to stop a possible housing bubble. In fact, if prices did start to decline noticeably and present any danger to employment or to raise the specter of deflation, Mishkin says the Federal Reserve is prepared to protect us from the bursting of the bubble and prevent housing prices from falling. Mishkin was in effect issuing a blanket insurance policy on housing prices.

## **Donald Kohn**

Federal Reserve vice chairman Donald L. Kohn significantly downplayed the possibility of a crisis, but said:

In such a world [of financial crisis], it would be imprudent to rule out sharp movements in asset prices and deterioration in market liquidity that would test the resiliency of market infrastructure and financial institutions.

While these factors have stimulated interest in both crisis deterrence and crisis management, the development of financial markets has also increased the resiliency of the financial system. Indeed, U.S. financial markets have proved to be notably robust during some significant recent shocks. (Kohn, 2007)

He is in effect telling his listeners—mostly high-level employees in banking, finance and regulatory agencies—that financial markets are stable in the face of shocks, but despite this stability the Federal Reserve is working further to deter economic crisis and learning and doing more to be ready to manage future crises.

The Federal Reserve, in its roles as a central bank, a bank supervisor, and a participant in the payments system, has been working in various ways and with other supervisors to deter financial crises. As the central bank, we strive to foster economic stability. As a bank supervisor, we are working with others to improve risk management and market discipline. And in the payments and settlement area, we have been active in managing our risk and encouraging others to manage theirs. (Kohn, 2007)

In other words, the Federal Reserve will deter any crisis and is working with other regulators to prevent financial crises, to provide economic stability, improved risk management, and market discipline.

The first line of defense against financial crises is to try to prevent them. A number of our current efforts to encourage sound risk-taking practices and to enhance market discipline are a continuation of the response to the banking and thrift institution crises of the 1980s and early 1990s....

Identifying risk and encouraging management responses are also at the heart of our efforts to encourage enterprise wide risk-management practices at financial firms. Essential to those practices is the stress testing of portfolios for extreme, or “tail,” events. Stress testing per se is not new, but it has become much more important. The evolution of financial markets and instruments and the increased importance of market liquidity for managing risks have made risk managers in both the public and private sectors acutely aware of the need to ensure that financial firms’ risk-measurement and management systems are taking sufficient account of stresses that might not have been threatening ten or twenty years ago. (Kohn, 2007)

In other words, the Federal Reserve’s number-one job is to prevent “extreme” events. Kohn is essentially telling his audience that the Federal Reserve is aware of black swans and that the Federal Reserve tests financial firms so that if such an event were to take place financial markets could withstand extreme changes in the economy.

A second core reform that emerged from past crises was the need to limit the moral hazard of the safety net extended to insured depository institutions—a safety net that is required to help maintain financial stability. Moral hazard refers to the heightened incentive to take risk that can be created by an insurance system. Private insurance companies attempt to control moral hazard by, for example, charging risk-based premiums and imposing deductibles. In the public sector, things are often more complicated. (Kohn, 2007)

Well, he did get that one right. Things are more complicated in the public sector. The Federal Reserve's bureaucratic approach does need the element of deposit insurance, provided by the FDIC, to instill confidence in the system of fractional-reserve banking. However, the Federal Reserve's own record of bailouts over the period of the so-called Great Moderation created a moral hazard for financial firms that ended up overwhelming the deposit insurance system. And now for the *pièce de résistance*: "The systemic-risk exception has never been invoked, and efforts are currently underway to lower the chances that it ever will be." (Kohn, 2007)

This record of resisting the systemic-risk exception has now been shattered. What does that tell about the status of moral hazard in financial markets and what might transpire in the next crisis?

## **Randall Kroszner**

Fed governor Randall S. Kroszner was the Federal Reserve's number-one official in terms of regulation of financial markets. He was the point man in preventing things like systemic risk, but he considered all the new financial "innovation" and "engineering" to be a good thing:

Credit markets have been evolving very rapidly in recent years. New instruments for transferring credit risk have been introduced and loan markets have become more liquid.... Taken together, these changes have transformed the process through which credit demands are met and credit risks are allocated and managed.... I believe these developments generally have enhanced the efficiency and the stability of the credit markets and the broader financial system by making credit markets more transparent and liquid, by creating new instruments for unbundling and managing credit risks, and by *dispersing credit risks more broadly*....

The new instruments, markets, and participants I just described have brought some important benefits to credit markets. I will touch on three of these benefits: enhanced liquidity and transparency, the availability of new tools for managing credit risk, and a greater dispersion of credit risk. (Kroszner, 2007a)

What he then goes on to discuss are “recent developments” such as credit default swaps (CDS), of which the “fastest growing and most liquid” are credit-derivative indexes involving such things as packages of subprime residential mortgages. He says that “among the more complex credit derivatives, the credit index tranches stand out as an important development.”

He believes that, historically, secondary markets were illiquid and nontransparent because banks held their own loans and that this was a problem. Now because of these new financial vehicles liquidity has improved and transparency has improved. This promotes better risk management, as risk is measured and priced better because market participants have better tools to manage risk. The result has been a “wider dispersion of risk.”

On its face, a wider dispersion of credit risk would seem to enhance the stability of the financial system by reducing the likelihood that credit defaults will weaken any one financial institution or class of financial institutions. (Kroszner, 2007a)

According to Kroszner, yes, there are some concerns here, but most of these concerns are “based on questionable assumptions.” Yes, there is risk, but it is the risk that has been out there all along; now we can trade this risk among ourselves. There is “nothing fundamentally new to investors ... credit derivative indexes simply replicate the sort of credit exposures that have always existed.” Plus, remember that this risk is greatly diminished because lenders require borrowers to put up collateral.

What Kroszner seems to have failed to realize is that by allowing institutions to disperse their risk, the regulators encouraged and allowed for a huge increase in the aggregate amount of risk. When banks kept their own loans on their own books, they were careful to make prudent loans, but with nearly free money available from the Federal Reserve, they wanted to make more loans, and the only way to do that is to make riskier loans. They did not want to hold the risky loans, so they “dispersed” them.



Kroszner told his audience that the market already experienced a surprise in May of 2005, but that since that time much energy has been expended by market participants and the Federal Reserve to improve risk management.

We do not have to worry, Kroszner tells us, because Gerald Corrigan is in charge of making sure nothing goes wrong. Corrigan—a former president of the New York Federal Reserve and a managing director in the Office of the Chairman of Goldman Sachs—has been in charge of a private-sector group that controls “counterparty risk management policy” for the financial industry.

Cooperative initiatives, such as [this one led by Corrigan] can contribute greatly to ensuring that those challenges are met successfully by identifying effective risk-management practices and by stimulating collective action when it is necessary.... The recent success of such initiatives strengthens my confidence that future innovations in the market will serve to enhance market efficiency and stability, notwithstanding the challenges that inevitably accompany change. (Kroszner, 2007a)

Checking ahead, we find Kroszner still bullish later that same year.

Looking further ahead, the current stance of monetary policy should help the economy get through the rough patch during the next year, with growth then likely to return to its longer-run sustainable rate. As conditions in mortgage markets gradually normalize, home sales should pick up, and homebuilders are likely to make progress in reducing their inventory overhang. With the drag from the housing sector waning, the growth of employment and income should pick up and support somewhat larger increases in consumer spending. And as long as demand from domestic consumers and our export partners expand, increases in business investment would be expected to broadly keep pace with the rise in consumption. (Kroszner, 2007b)

Over the next year, the Dow would lose 6,000 points; by 2010 the amount of unemployment increased by seven million. Consumer confidence had hit a 27-year low, and sales of new homes hit the lowest level in a half a century—the lowest level in recorded history!

## CONCLUSION

We can see that the Federal Reserve plays a confidence game. Its officials’ public pronouncements, while heavily nuanced and

hedged, uniformly present the American people and the leading figures in banking and finance with a rosy scenario of the economy, the future, and the ability of the Federal Reserve to manage the market. Ben Bernanke and his successor, Janet Yellen have continued to spin a positive story of economic recovery dating back to the spring of 2008.

These are the people who said that there was no housing bubble, that there was no danger of financial crisis, and that a financial crisis would not impact the real economy. These are the same people who said they needed a multitrillion-dollar bailout of the financial industry, or else we would get severe trouble in the economy. They got their bailout, and we got the severe trouble anyway. Is it not time to bring this game, this confidence game, to an end for the sake of economic stability?

However, all this evidence does not rule out the other explanations for their behavior. They could be just incompetent; they could genuinely think they are acting in the public interest, or it might not be humanly possible to run such a monetary system and they were just hoping that unwarranted confidence could save all of us from a genuine disaster.

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