

# Our Overextended Fed

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In the past few weeks, the Federal Reserve has fundamentally redefined the role of a central bank in a market economy.

Almost one-half of our nation's central bank balance sheet -- more than \$400 billion -- is exposed to credit risk through new lending facilities. It has also entered an open-ended commitment to use its discount window to back stop major securities firms. Those efforts will influence the depth of the recession that the U.S. economy has likely already entered, and will leave a durable imprint on the financial landscape for many years to come.

We are amidst the worst financial crisis since the 1930s. The large complex financial institutions at the center of the global financial system need more capital. Until they get that capital, those firms will keep their risk-taking operations shuttered.

As a result, the market for securities using mortgage-related collateral has vanished. It also means that opportunities for new lending will be few and far between. Thus, we have entered one of those rare episodes in which balance-sheet constraints put a brake on spending. This is piled on top of an economy already reeling from the significant wealth loss associated with the decline in the prices of homes and equities and the retrenchment of builders who have realized that the run in residential construction was overdone.

The desire on the part of policy makers to draw a line defending the existing structure of the financial system is understandable. But one can wonder if the trenches the Federal Reserve has dug are this generation's Maginot Line -- ineffective in defense and costly in the long run.

The Federal Reserve put its balance sheet in harm's way to give assurance to Bear Stearns's creditors and extended that protection to the other primary dealers. In doing so, the Board of Governors of the Federal Reserve had to determine unanimously (since they only had five members at the time) that these were "unusual and exigent" circumstance and that failure to lend to Bear would have adverse consequences for the U.S. economy. The signaling aspect of that decision cannot help but have adverse consequences for investors' willingness to take on risk.

Moreover, the implicit declaration that a midsize investment bank was systematically important puts any firm at least as big as Bear in the cross-hairs of speculators. In coming days, how can the Federal Reserve turn away another like-sized entity, whether primary dealer or not, that is suddenly in the marketplace's disfavor for having used leverage to borrow at short-term maturities to fund longer-term obligations?

In such circumstances, the Federal Reserve's \$900 billion balance sheet will not look that big. And the Federal Reserve will have ceded control of its balance sheet to the needs of private-sector entities.

More seriously, the Federal Reserve's action can only be viewed as rewarding bad behavior. Remember that Bear opened this financial crisis when it revealed problems at its sponsored hedge funds last June. That it did not spend the next nine months resolving its problematic positions and getting sufficient capital did not prevent it from getting a "get out of jail free" card from the Federal Reserve.

The decision on Monday by executives at J.P. Morgan Chase to sweeten its takeover bid to \$10 per share showed how valuable that Federal Reserve intervention was to the owners of Bear Stearns.

Consider the alternative. Officials from the Federal Reserve could have commiserated with the mendicants from Bear and pointed to the door. The Federal Reserve could have then offered its balance sheet to any financial institution willing to assume the portfolio of risky obligations from the defunct Bear to ensure that the financial system continued to function smoothly. True, the Federal Reserve would be exposed to credit risk, as it is now. But bad behavior would be punished.

At the same time, showing its ingenuity in a different form, the Fed could have begun purchasing the debt of the government-sponsored enterprises and, more importantly, their mortgage-backed securities. The evident support to the prices of mortgage-related securities would have cushioned the market blow of Bear's failure. And Bear's failure would have provided a useful encouragement to those firms in the core of our financial system to get more capital.

The recent actions by the Federal Reserve are only buying time before that infusion of capital to those firms, which might come from the domestic private sector, from abroad, or ultimately from the government. The pity is that some of those actions taken in the heat of our ongoing crisis -- importantly including the extension of credit to an investment bank -- will have long-lasting consequences.

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