

**The World Economic Crisis and the Federal Reserve's Response to It:
August 2007-December 2008**

To be published in *Studies in Political Economy*

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September 2009

The world economy is clearly in the midst of a crisis as deep and profound as the Great Depression of the 1930s. The crisis began in 2006 in the US housing and related mortgage markets, but it soon spread to the rest of the US economy and then to the rest of the world. In August 2007, the turmoil moved from the securitized US mortgage markets to the interbank dollar funding market, causing it to freeze up. Worries about the extent and distribution of the mortgage-related losses had become so extensive that market participants no longer had faith in one another's credit-worthiness, and the market that provides US banks and other dollar-based financial institutions with their liquidity became illiquid as a result. An already very troubled financial system was imploding because the large commercial banks, investment houses and insurance companies that were at the heart of the US financial system could not borrow short-term from one another, and this was happening just when a loss of confidence was sending liquidity preferences soaring. Then, in September 2008, the entire US banking and financial system collapsed as a social financial system in a period of acute turmoil as violent and decisive as that of the banking crisis of 1931. From this point forward, what at first appeared as a US-based "subprime mortgage market crisis" revealed itself to be a world economic crisis of major proportions.¹

What happened between August 2007 and September 2008 that caused matters to come to a head in this way? The US financial system was wounded by the time the dollar funding market froze up in the third quarter of 2007. In the interim, however, the general macroeconomy had weakened, and this was

¹ This paper's primary sources are largely official and include the market overview sections of the *BIS Quarterly Review*, 2007-2008 (Basel, Bank for International Settlements (BIS), 2007-2009), the Federal Reserve Bank of New York's (FRBNY) annual reports on its "Domestic Open Market Operations" for 2007 and 2008 (New York, FRBNY, 2008 and 2009), the *Minutes of the FOMC* for 18 Sep 2007, 18 Mar 2008, 16 Sep 2008, 28-29 Oct 2008 and 15-16 Dec 2008 (Washington, Federal Reserve Board, 2007, 2008 and 2009) and the Board's "Monetary Policy Releases" and the FRBNY's "News: Markets" press releases for 2007 and 2008 made available on their two websites. It employs two data sources: the Board's statistical release H.3: "Aggregate Reserves of Depository Institutions and the Monetary Base" and statistical release H.4.1: "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks." Essential background reading on the crisis includes Dean Baker, "Midsummer Meltdown: Prospect for the Stock and Housing Markets," (Washington, Center for Economic and Policy Research, 2007), Charles Morris, *Trillion Dollar Meltdown: Easy Money, High Rollers and the Crest Credit Crash* (New York, Public Affairs, 2008) and Charles Kindleberger, *The World in Depression 1929-1939*, (Berkeley, University of California, 1974).

Descriptions of the various trading strategies that imploded in the crisis can be found in William Bartlett, *Mortgage-Backed Securities: Products, Analysis, Trading*, (New York, New York Institute of Finance, 1989), Satyajit Das, *Credit Derivatives: A Guide to Instruments and Applications* (New York, Wiley, 1998) and M. Anthony Wong, *Trading and Investing in Bond Options: Risk Management, Arbitrage, and Value Investing*, (New York, Wiley, 1991). See Darrell Duffe and Kenneth Singleton, *Credit Risk*, (Princeton, Princeton University Press, 2003) for an account of the theoretical underpinnings. These strategies assume that a risk-free security exists and are impossible to employ unless such a security exists in practice. Until August 2007, such a risk-free security was found in the term interest rate swap markets. The best book on the money markets remains Marcia Stigum's *The Money Market*, (New York, McGraw-Hill, 2007).

pulling asset prices down. A classic debt deflation was underway, with falling asset, real estate and (beginning in 2008) commodity prices feeding one another in a downward spiral. The crisis, accordingly, spread from the interbank market outwards while simultaneously exploding globally. Investors everywhere were scrambling to reduce their leverage, meet rising margin calls, raise capital and otherwise reduce their losses and exposures, but it was already difficult if not impossible for the major US financial institutions to flee their risky and losing investments to the safety of “money” because a safe, private sector money had ceased to exist. Then, the September 2008 US banking crisis itself – the breakdown of the international banking system based on the hegemony of the major US investment banks, commercial banks and insurance companies – amplified the turmoil, sending a severe contractionary shock through the world economy. The ensuing economic slowdown has been and continues to be international in its scope and characterized by falling income, output and employment across the globe.

Today’s crisis has a precise cause. Its origin is the inability, or rather the incapacity, of US financial capital to continue playing the role it played since at least the early 1980s in the circulation and control of a large part of the world’s aggregate social capital. The underlying reasons for the economic crisis – its linkage to problems in the US housing market and the provision of workers’ wage goods more generally, the importance of neoliberal “deregulation” and the US-led “derivatives revolution” in making the US financial system so unstable, why it manifested itself as a credit-market/money-market crisis and how and why the financialization of the US and world economies made both vulnerable to a US financial crisis – are beyond the scope of this paper to cover. The basic facts of the matter are not in dispute, however: today’s global economic crisis has a financial origin and an origin in the United States at least in the sense that the US banking and financial crisis that surfaced in August 2007 and came to a head in September 2008 was so severe the only direction the world economy could go afterwards was down. The US financial system stopped “intermediating between savers and investors,” and this disruption of the circulation of US interest-bearing capital – whatever its ultimate causes – blocked the circulation of productive capital across the globe, making US financial capital *politically* responsible for a world economic crisis.

In August 2007, the US financial system began to unravel; in September 2008, the circuit of US financial capital came to a halt, precipitating a major economic downturn. Assuming that the crisis unfolded in this way, a) how did the US state in the form of the Federal Reserve respond to the crisis? b) What were the economics of the US state’s response to the crisis? c) How should one understand this response politically? And d) what were the effects of the US state’s emergency response to the crisis on its banking and financial market regulations?

The response of the US state to the financial crisis

The response of the US state, of the Federal Reserve in particular, was decidedly “interventionist.” The US monetary authorities responded with a swift and large reduction in their official interest rates, and by the end of 2008, the Federal Reserve’s overnight federal funds target rate, at just above 0.0%, would be close to what Federal Reserve Chairman Ben Bernanke has called its “zero lower bound,” meaning, since nominal interest rates can only be positive, further interest rate reductions were impossible.² But the Federal Reserve’s efforts to stimulate the economy through lower interest rates were accompanied by two different but related developments that together implied an abandonment of the central bank’s traditional monetary policy practices, including the targeting of the federal funds rate. One, the Federal Reserve responded to the crisis by reorganizing itself as a financial institution, that is, by changing the way in which it provided credit to the financial system, to whom and on what terms. Recognizing that US interest rates were already low ahead of the crisis and that the breakdown of the interbank market could not be solved by a simple reduction in interest rates, it became a direct *lender* to a wide variety of financial institutions and not just to commercial banks or within the United States, thereby taking on the active management of the United States’ global credit and liquidity risks. And two, after holding the total size of its balance sheet constant for more than a year, in September 2008, to counter the contractionary shock that the events of that month were sending through the world economy, the Federal Reserve used the ability to lend that it had developed in the interim to engineer the largest increases in bank reserves in US history, an increase in reserves more than necessary to push the federal funds rate to zero and which US banks absorbed as *excess* reserves.³

² Around the turn of the century, there was policy debate about whether it is possible and desirable to provide stimulus to an economy when short-term nominal interest rates are just above zero and there is concern about deflation. These conditions existed in Japan at the time, and the Bank of Japan was finding it difficult to stimulate its depressed economy as a result. In his contribution to the debate, then-Governor Bernanke, writing together with several other US monetary researchers, explored the effectiveness of an alternative set of policy tools to complement the Fed’s continued use of the federal funds rate as its operational target should it find itself constrained, like the Bank of Japan, by its “zero lower bound:” Ben Bernanke and Vincent Reinhart “Conducting Monetary Policy at Very Low Interest Rates,” *American Economic Review*, 94, 2, pp. 85-90 and Ben Bernanke, Vincent Reinhart and Brian Sack, “Monetary Policy Alternatives at the Zero Bound: An Empirical Assessment,” *Brookings Papers on Economic Activity*, 2004, 2, pp. 1-78. Bernanke suggested, in particular, that policy makers consider three different policies: a) supplying more reserves than is necessary to push short-term nominal interest rates to zero (“quantitative easing”), b) adjusting the maturity and composition of a central bank’s assets to affect the term structure of interest rates if not the relative prices of broad asset classes (money, bonds, mortgages) holding the total supply of central bank credit constant and c) clear and repeated public statements of its intention to continue easing.

³ The Federal Reserve is a financial institution with its own assets and liabilities, and like any financial institution, its assets must equal its liabilities. One can depict the central bank’s balance sheet as follows:

The Federal Reserve's response to the crisis was not superstructural but material. The US central bank changed the way in which it interacted economically with the US financial system, and by changing its material connection with US interest-bearing capital in this way, it changed the US financial system, giving US interest-bearing capital a new and different kind of unity, a political unity embodied in its new operating procedures. During the 17-month period under review, moreover, the Federal Reserve was the only institution of the US state to have a coherent response to the crisis. The response of the US Treasury Department, the other major federal institution with similar responsibilities, was weak and even incompetent by comparison, no doubt due in large part to the timing of the crisis, coming as it did towards the end of the discredited Bush administration and just ahead of Obama's election as President in November 2008. To fill in the gap, the Federal Reserve assumed responsibility for every aspect of the US state's response to the crisis, effectively subordinating the US Treasury under its leadership as it did so during the interregnum between Presidencies.

It is certainly too early to tell how the economic crisis will end or what the new monetary policy regime that the Federal Reserve has begun creating will finally look like. It also not clear at this point when and to what extent the central bank will reduce the US money supply back to more normal levels. Two matters are certain at this point, however: a) the monetary policy that the Federal Reserve created in response to the crisis is a new and different kind of monetary policy, and b) the US state, under the leadership of the Federal Reserve, has already embarked on a major reform of the international financial

Assets: factors supplying reserve funds	Liabilities: factors absorbing reserve funds
US Treasury and federal agency securities held outright	Currency in circulation
Repurchase agreements	Bank reserves
Loans to US banks	US Treasury balances at Reserve Banks
Drawings on foreign exchange swap lines with foreign central banks	Foreign official balances at Reserve Banks
Seized assets	Other non-reserve deposits
Other assets	Other liabilities

The reserve liabilities of the Federal Reserve are assets of the banks that hold them. By law, US banks must hold a certain amount of their assets at a Reserve Bank in the form of bank reserves (or cash) to "backup" their demand deposits. These are "required" reserves. Banks can hold more reserves at a Reserve Bank than necessary to meet their reserve requirements. By definition, these are "excess" reserves. The Board of Governor's H.4.1 and H.3 statistics are the relevant data, and they show a) little change in the total size of the Federal Reserve's assets from early August 2007 to early September 2008 but a significant change in the composition of its assets, b) little change in both the size and the compositions of its liabilities, including its liabilities to US depository institutions in the form of bank reserves, over the same period of time and c) massive increases in both the size of its assets and its reserve liabilities from mid-September 2008 to late-December 2008 but little change in banks' required reserves.

system to establish a new and different kind of unity between itself and US financial capital, a new regulatory regime whose first expressions were the practices adopted by the Federal Reserve from August 2007 to December 2008.

The Fed's response to the crisis

Prior to the emergency, open market operations (OMOs) in the US Treasury market were the Fed's principal policy tools. Only banks maintained reserve accounts at the Fed and only US banks could borrow from the Fed's primary discount window. The Federal Reserve held US Treasury securities on the asset side of its balance sheet (its portfolio of loans, foreign exchange and other assets was tiny by comparison). And the Federal Reserve used its OMOs in the US Treasury market to target the overnight federal funds rate, the assumption being that monetary policy affects the economy through its effects on financial institutions' cost of funds. After August 2007, the Fed began to behave differently. It began advancing its own credit against collateral, and not just to US commercial banks, against US government bonds or for interest-rate purposes. Then, in September 2008, it flooded the US financial system with its own zero-interest rate, but essentially riskless liquidity.

In December 2007, it established two new lending facilities – a Term Auction Facility (TAF), under which it lent US banks federal funds for one-month (rather than overnight) through regularly scheduled auctions, and a system of foreign exchange swap lines with foreign central banks, under which it gave its partner central banks access to the dollars that they then lent to their own troubled banks – and these two facilities quickly became the principal means by which the US central bank created new credit. Meanwhile, behind the scene, the Fed adjusted its portfolio of US Treasury securities to accommodate its new reliance on lending. As it increased the amount of credit created through the TAF and swap lines, it reduced its holdings of US Treasuries by a similar amount, thus keeping the total size of the Federal Reserve's portfolio of loans and securities as well as the size of its liabilities to depository institutions in the form of bank reserves roughly constant. In response to acute instability that overtook the US financial markets in March 2008, it established a program under which it began lending primary dealers US Treasury securities against a wide variety of collateral (including private-label mortgage-backed securities), seized \$30 billion in non-performing mortgage-related credit securities from Bear-Stearns on the 14th (facilitating its forced purchase by JPMorgan Chase two days later) and gave primary dealers and thus investment banks access to its discount window – all the while being careful to sterilize any effects

that these actions might have on the supply of central bank credit through reverse OMOs in the US Treasury market.⁴

The Federal Reserve's initial response to the crisis was thus a radical one. Between December 2007 and March 2008, the Federal Reserve transformed itself from being a participant in the US Treasury market into a direct lender, replacing US Treasuries with less liquid and credit worthy loans on the asset side of its balance sheet. It extended term and overnight Federal Reserve credit to US banks and nonbanks alike in keeping with the 1999 repeal of Glass-Steagall and dollar-credit to foreign central banks, not for exchange rate purposes, but to maintain the liquidity of the offshore as well as the domestic dollar funding markets. And it absorbed a large quantity of distressed assets, increasing its risks incalculably. But it did not supply any new monies, engaging in a swap of its good and liquid credit for the private sector's bad and frozen credit instead. The policy was simple. The Federal Reserve took measures to bring the US money market back to life, assuming that the US financial system as a whole had enough if not the right kind of liquidity in the right places, and as it was increasing its lending, it accepted increasingly less credit-worthy securities as collateral, all the while reducing its holdings of "safe" US Treasuries to keep the money supply constant. This was not an interest rate policy. The Fed was assuming responsibility for US interest-bearing capital's liquidity and credit risks in a set of policies which have since then come to be called "toxic waste removal" policies.

The increase in the stock of high-powered state money that came in September 2008 was an emergency measure, driven by events that were occurring on the ground in a confused, rapidly changing and fluid situation that included the US Treasury's takeover of Fannie Mae and Freddie Mac, Lehman Brothers' bankruptcy on the 15th, the transformation of the two remaining "bulge bracket" US investment banks (Goldman Sachs and Morgan Stanley) into bank holding companies and the creation (at least on paper) of the US Treasury's \$700 billion Troubled Assets Relief Program (TARP) as well as a rapid weakening of the underlying real economy both in the United States and elsewhere. The increase was also not operationally neutral. As it was increasing the money supply, the Fed was organizing itself again in a second wave of reform that did not alter as much as it consolidated and built on the steps taken earlier, which included its takeover of the multinational insurance company American International Group (AIG) on 16 September 2008, a program under which it began purchasing asset-backed commercial paper (ABCP) from money market mutual funds and a decision to start paying interest on

⁴ A limited liability corporation (LLC) that has the FRBNY as its sole benefactor holds the "toxic waste" that the Federal Reserve seized from Bear Stearns. BlackRock Financial Management manages these assets. "Primary dealers" are those financial institutions that have a direct dealing relationship with the FRBNY. Most primary dealers are securities firms.

bank reserves.⁵ More than necessary to bring the federal funds rate to zero, the increase meant a change in the Fed's response to the crisis from a simple asset swap to a policy that Bernanke has called a "quantitative easing." But here too, the process was one of consolidation rather than repudiation. The increase was accomplished using the TAF, the dollar swap lines with foreign central bankers and the new ABCP support facility – all products of the crisis – and its effects on the Federal Reserve's credit and liquidity risks were as immense as its sheer size.

Effect on the Fed's balance sheet and the money supply

The cumulative effects of all of these developments on the composition of the Federal Reserve's assets and thus on its risk exposures are astonishing. On 1 August 2007, 96% of the Federal Reserve's portfolio of loans and securities existed in the form of US Treasury securities held outright or through repurchase agreements.⁶ Its credit and liquidity risks were minimal. At yearend 2008, 18% of its credit was held in this way, while 9%, 28%, 26% and 15% of Federal Reserve credit existed in the form of discount borrowing, borrowing through the TAF, drawings on the foreign exchange swap lines and credit created through the ABCP support program, respectively. In the wake of the September 2008 "Lehman Brothers" crisis, therefore, 77% of its money-creating assets consisted of loans that hitherto might have been supplied by the private sector but which the Fed chose to make for emergency reasons. Another 3% of the Federal Reserve's assets consisted of the mortgage securities and credit derivatives it seized from Bear Stearns and AIG, assets that no one in the private sector would willingly hold. At the end of 2008, therefore, the Federal Reserve's credit and liquidity risks were considerable. As a matter of policy, it a) became a lender to a number of troubled, clearly undercapitalized and possibly insolvent financial institutions, lending a total of \$1,730 billion to US interest-bearing capital and b) assumed legal ownership of \$73 billion worth of the worst of the "toxic waste" the US financial system had produced, and it would face a significant "embarrassment" should a financial institution fail with a large advance from the Federal Reserve on its books.

The behaviour of the money supply is equally remarkable. For a little more than a year into the crisis, the Federal Reserve made only modest changes in both the size of its portfolio of loans and securities and the supply of bank reserves. On 1 August 2007, it held \$856 billion in its portfolio of loans

⁵ The toxic waste that the Federal Reserve seized from AIG and the ABCP that it has purchased from money market mutual funds are also held by LLCs that have the FRBNY as their sole benefactor. BlackRock manages the assets of first LLC; PIMCO manages the portfolio of ABCP.

⁶ Federal Reserve statistical release H.4.1; as percent of "Reserve Bank credit."

and securities and the reserve supply was \$42 billion.⁷ On 10 September 2008, the values were \$907 and \$47 billion, respectively.⁸ Then the explosion came. By 5 November 2008, the Federal Reserve's portfolio of loans and securities more than doubled to \$2,058 billion, and the supply of bank reserves jumped nearly tenfold to \$416 billion. At year end 2008, they were \$2,259 and \$852 billion, respectively, both record highs.⁹

Between 10 September and 5 November 2008, banks' excess reserves increased from \$2 to \$364 billion. They were \$799 billion at the end of 2008. Banks' excess reserves had averaged \$817 million from January 1959 to August 2008.¹⁰ US interest-bearing capital ended 2008 awash in idle state money.

The economic modus operandi of the Federal Reserve's response to the crisis

Judged in terms of its success in preventing what at first appeared as a US "subprime mortgage market" crisis from intensifying and then exploding into a global economic slowdown, the Federal Reserve's response to the crisis was a clear failure. Conditions in the interbank market only worsened over time, and when the Fed flooded the US banking system with unprecedented quantities of reserves in September 2008, banks held them as idle funds at the Fed rather than investing them, the circuit of US interest-bearing capital having come to a halt by then. But it is wrong to conclude from this that the Federal Reserve failed completely or that it failed in every way. The Federal Reserve is an institution of the US state with immense political as well as economic powers. Its decisive invention into the US financial system affected the crisis in significant ways, creating order out of what would have otherwise been chaos. The central bank brought *stability* to US interest-bearing capital during its time of crisis by a) giving the US financial system a safe monetary base into which it could retreat and b) bringing an increasingly large part of the US financial system under its supervision and regulatory control.

The US financial crisis and the global economic contraction that it precipitated were not haphazard events. They occurred because very specific imbalances had built up between the US financial

⁷ Assets: Federal Reserve statistical release H.4.1; reserves: Federal Reserve statistical release H.3. On 1 Aug 2007, the other liabilities of the Federal Reserve included \$814 billion in currency and \$4 billion in US Treasury deposits.

⁸ On 10 Sep 2008, the Fed's other liabilities included \$814 billion in currency and \$5 billion in US Treasury deposits.

⁹ On 5 Nov 2008 and 31 Dec 2008, currency in circulation was \$864 billion and \$890 billion, respectively. For the same dates, the US Treasury's deposits were \$578 billion and \$365 billion. The size of the US Treasury's deposits at the Fed in the last few months of 2008 reflects the activities taken under the TARP. Remember that the Fed, in addition to being the bank at which US private banks' hold their reserve deposits, is also the bank through which the US Treasury conducts most of its operations.

¹⁰ On 1 Aug 2007, 10 Sept 2008, 5 Nov 2008, and 31 Dec 2008, required reserves were \$40, \$45, \$52 and \$54 billion, respectively.

system and the underlying macroeconomy – imbalances between stocks of financial assets and liabilities, on the one hand, and flows of national income, on the other – and given the severity, complexity and location of the financial asset/income flow imbalances involved, once started, there was probably very little that the Federal Reserve could have done to stop the crisis until it had run its course.¹¹ But – and this is essential – the Fed shaped the course of the crisis in significant ways, intervening decisively at its key turning points, for example, averting Bear Stearns’ bankruptcy in March 2008 but not Lehman Brothers’ bankruptcy later that fall. The policy was not to prevent the US financial system from failing – that proved to be impossible – but rather to make it fail in a particular way. As Marx would put it, the “Protestant” US financial system, having lost its faith in itself due to all the bad debt, was collapsing in a *disorderly* manner back into the “dogmatic” safety of its “Catholic” monetary base. The crisis was so intense, in other words, that the US financial system did not have a monetary base into which it could collapse. The private money markets were in disarray, and this was both effect and cause of the crisis. For a year, the Fed’s efforts focused on trying to get the interbank market going again, holding the quantity of its total credit constant. Then, in September 2008, after failing in these efforts, the Fed flooded the economy with massive amounts of its own liquidity, finally allowing the US financial system to dissolve into its monetary base, but into a monetary base made up almost entirely of unused state money.

For such a policy to work as a stabilizing, order-creating strategy, the Federal Reserve had to accomplish another goal, which the very same policy seems at first to make impossible: it had to maintain the soundness of its money not just against every other kind of money but absolutely. A fundamental premise of US financial hegemony, the premise that the dollar is the international currency, was at stake.

The Fed’s credit and liquidity risks increased over time. It took responsibility for US money capital’s liquidity and credit risks in the only way possible: by taking on these risks itself. Having assumed responsibility for the US financial system in this way, the problem was to manage its own risks in such a way as to bring order and stability to the US financial system. Private sector risk-free money no longer existed. The Federal Reserve gave the US financial system a risk-free state security as an

¹¹ There was more than a little irony in this. Financial crises and the ensuing economic slowdowns have been recurrent features of neoliberal global capitalism since its inception in the early 1980s. Indeed, under neoliberalism as a global regulatory regime, they came to have a particular “equilibrating” function which was to remove the imbalances that periodically built up between the international financial system and its global macroeconomic monetary base – this was how the contradictions of a financialized global capitalism expressed themselves – only in the previous financial/economic crises the contradictions were located in the periphery rather than the center of the world economy, in markets other than in the money market/credit market center of the world economy’s hegemonic financial center and the authorities succeeded in containing them, that is, in preventing them from damaging the world economy’s US center.

alternative security into which it could collapse, and to do this, it had to manage its risks not just carefully but in a particular way.

Hence, one should not confuse the Fed's success in giving the US banking system a solid monetary base into which it could safely dissolve with generosity. Any borrowing from the Fed came with its set of imposing conditions, including but not limited to those pertaining to which kind of collateral to accept and at what price. The discipline over US interest-bearing capital that the Federal Reserve's switch to lending allowed it to exercise also expressed itself as an unwillingness to lend, as when it refused to make an emergency loan to Lehman Brothers, allowing it to fail in a disorderly manner because it did not have the necessary collateral. The Federal Reserve may well keep large amounts of the toxic waste that it took from Bear Stearns and AIG on its books for years, but as a *minimal* principle, its lending policies assumed that its loans would be paid back and on its own essentially political terms. Not subject to the law of value in the same way a private capital is, the Fed – as an institution of the capitalist state with the coercive powers of the law behind it – necessarily imposed a capitalist logic on its individual capitalist borrowers – to protect their general, collective interests.

The Federal Reserve did not and probably could not prevent the crisis from worsening over time, but it did bring order to the US financial system as it was failing by providing its banking system with a “riskless” security into which it could collapse, where a “riskless” security – a security whose value is the same in “all possible worlds” – is how the universal equivalent is operationally defined in today's financialized global economy, with its emphasis on risk management and risk taking. Not a private sector security, this was a *politically* riskless security, that is, a security that is *economically* riskless because sanctioned by the Federal Reserve as an institution of the capitalist state. To maintain its own credit worthiness in this way, the policy necessarily involved a *disciplining* of US interest-bearing capital.

The Federal Reserve's material unity with and relative autonomy from US interest-bearing capital

The Federal Reserve stabilized the US financial system by allowing it to collapse into itself as the source of politically secure high-powered money, substituting its “sound” state money for the private sector's “unsound” money throughout the entire process, being careful to protect financial capital's collective interests against any disruption that any particular financial capital may have caused as it did so. How was such political economic alchemy possible?

Central banks are peculiar institutions, caught up as they are in a very specific set of contradictions. As institutions of the state, they exhibit a characteristic relative autonomy vis-à-vis the individual private financial capitals they supervise and regulate, an autonomy that expresses itself in the first instance in central banks' well-known secrecy and “independence.” But as financial institutions,

central banks participate in the financial markets alongside these same individual interest-bearing capitals as financial capitals themselves, and for this reason, in each and every central bank a necessary unity is established between the state and the individual capitals with which it conducts its operations.¹²

Monetary policy codifies and shapes this mixture of political autonomy and unmediated economic unity between the private sector and the state, and any change in money policy necessarily involves a change in this autonomy and unity and thus in the central bank's regulations and operating procedures.

Since central banks are in fact state institutions with their own independence and autonomy vis-à-vis the private sector, monetary policy is always articulated with the state's overall political role in maintaining social cohesion, ultimately in the maintenance of simple "law and order." This is what states "do." It is their function to act as the cohesive factor in society. In a society that is divided into classes, this means that monetary policy cannot be understood apart from the state's more general political role to organize the dominant classes politically and to disorganize the dominated classes politically. This means, further, that monetary policy is always articulated structurally with the state's overarching political, ideological and repressive roles in the field of class struggle, and thus in the class struggle not only between the dominant and dominated classes, but also between the various factions within the dominant classes. Monetary policy thus plays an essential role in maintaining class exploitation and domination and in organizing the balance of power within the ruling class itself, but it does so through the *immediate* economic unity that it establishes between the state, whose monetary policy it is, and interest-bearing capital. This is why central banks are concerned with the value of their currency not just against the currency of other central banks or relative to the credit of the private sector, but absolutely. Political class interests, the political unity of their relationships with their interest-bearing capitals, are at stake. This is also why central banks necessarily exercise a disciplining function vis-à-vis the individual capitals they regulate and whose political class interests they organize. *Their* unity, the political unity of these disparate individual financial capitals, exists in their unity with their state and thus as an autonomous,

¹² David Harvey, *Limits to Capital*, (New York, Verso, 1999) describes this unity in the following way:

A part of the state apparatus is entirely caught up in the circulation process of interest-bearing capital. There is an aspect, and only *an* aspect, of the state which cannot be considered even *relatively* autonomous of capital because is necessarily constructed in the image of the motion of capital itself. The administrators of this aspect of the state apparatus manage the circulation of interest-bearing capital and function as 'the executive committee of bourgeoisie' no matter what their political allegiance. A necessary unity is thereby established between a part of the state apparatus and the money capitalists, industrialists and financiers who similarly participate in the circulation of interest-bearing capital. From the outside it appears as if a section of the state colludes directly with industrial and financial interests. A new definition of finance capital comes to the fore: one in which all three interests are unified (p. 322).

independent factor. In the case of US interest-bearing capital during its time of crisis, its political unity existed, not in itself, but in the Federal Reserve's risk-free credit. It existed in the "dollar" as, what Marx has called, "world money."

The Federal Reserve's decision to reorganize itself as it did in response to the crisis and then to increase the money supply were never decisions concerning merely technical operating procedures, for monetary policy is never a politically neutral technical function imposed by the necessities of a politically neutral economy. Nor can the Fed's behaviour be understood apart from the US state's other responsibilities, whether repressive or ideological. One cannot separate the global economic slowdown and the key role that the Federal Reserve has played in shaping it, therefore, from such matters as the United States' continuing military involvement in Iraq, Afghanistan and much of the rest of the world, the utter squalor of a large part of the US population even ahead of the crisis, the intellectual and the moral poverty of American capitalism's daily culture and intellectual life or the challenges to American leadership coming from Europe, China and elsewhere. But the Federal Reserve's political responsibilities are defined by its unity with interest-bearing capital, which means, given the depth of the economic crisis and the paralysis in the rest of the federal government, its immediate political responsibilities were both immense and narrowly focused.

Here is how the Federal Reserve's political economic alchemy worked. As a central bank it was both "inside" and "outside" the financial system that it was reorganizing, materially united with US and foreign interest-bearing capital through its operations as a financial capital itself, on the one hand, and subject not to the logic of individual capitalist competition but to the political organizing logic of an autonomous capitalist state, on the other. The Federal Reserve was successful in giving its (and hence the world's thoroughly dollarized) financial system a risk-free security into which it could collapse, but not because of the quality of the loans that it made to the private sector. These were intentionally "bad" loans. The Fed had this capacity because of the "faith" that US and foreign capital continued to have in the global political power of US capital. This faith was not subjective. It lay in the objective political power of US financial capital as it existed materially in the form of the Federal Reserve as an institution of the state, and as Poulantzas wrote, state "institutions and apparatuses do not 'possess' their own 'powers,' but simply express and crystallize class powers."¹³ The US state in the form of the Federal Reserve really did "rescue" American capitalism during its time of crisis: it gave the US and the international financial system a political center.

¹³ Nikos Poulantzas, *Classes in Contemporary Capitalism*, (New York: Verso, 1978), p. 70.

The “new” Federal Reserve and the regulation of US interest-bearing capital

It is tempting to say that the Federal Reserve nationalized a large part of the US banking and financial system – if not the system as a whole, then certainly its short-term money markets. But it is wrong to characterize what happened in this way, not at least in a politically meaningful sense of the term “nationalization.” In the emergency, the Fed assumed responsibility for certain activities that the private sector was no longer able to perform. In December 2007, US banks were incapable of supplying short-term credit to one another, so the Fed took over in their place with the TAF and dollar swap lines. In the spring and fall of 2008, the private sector could not function normally as long as it held Bear Stearns and AIG’s toxic waste, so the Fed stepped in to make these assets disappear. And to counter the turmoil that the September 2008 banking crisis left in its wake, the Fed flooded the US economy with its own liquidity. But the Fed’s efforts stopped at this point. It acted to stabilize the US financial markets during an emergency, but did nothing more. In no instances did it seek to allocate capital, and in no instances did it take over the control of a capital.¹⁴ The Federal Reserve did play a crucial role in shaping and reshaping the US financial system, but concerning matters of capital ownership, its role was limited to that of engineering mergers and acquisitions. As an autonomous financial institution of great economic power and as an autonomous institution of a state with the force of law behind it, it held itself equally distant from every individual capital, paying attention to each only to the degree that systemic issues were involved.

The unity that the US state in the form of a “new” Federal Reserve has with interest-bearing capital is different from the unity that existed just prior to the crisis, shaped as it was by an ideological commitment to “deregulation” – to the “freeing” of financial markets from the state. That unity was deliberately scattered and disorganized, the assumption being that this way of regulating the financial system would make it more “efficient”, that is, more profitable. Thus, while Bank of America and Citigroup came under the jurisdiction of the Fed, Bear Stearns and Lehman Brothers reported to the Security and Exchange Commission (SEC), and the Office of Thrift Supervision regulated AIG’s London CDS shop. And while some financial products and markets, such as mortgages and loans for small businesses, were regulated legally, other products and markets - credit default swaps, for example - were not. This does not mean that there was no order to the how the US state organized the US financial system just ahead of the crisis, however. The system was a coherent, well-defined regulatory regime.

¹⁴ The Federal Reserve assumed legal ownership of the assets that it seized from Bear-Stearns and AIG but not economic control. These assets functioned as collateral to secure the emergency loans that it made to these two firms and, to repeat, these assets are managed and therefore, controlled by the private sector.

The *principles* of neoliberal financial market deregulation were outlined most clearly in the Basel capital accord with its associated “Three Pillars” of minimal capital requirements, supervisory review of capital adequacy and public disclosure.¹⁵ Banks were understood financially as speculative “risk takers” and required to set a certain amount of their capital aside as a form of self-insurance, their regulation (form of unity with the state) strangely privatized. In this regime, a) banks and bank holding companies were allowed, even encouraged, to use their own risk models and management systems to determine their own appropriate levels of risk capital, b) the regulators, including those at the Federal Reserve, discharged their responsibilities once they determined that the private sector’s risk models and management systems were “state of the art” and c) any enforcement was left to the private sector, which punished banks with low capital ratios by refusing to fund them. The market discipline that this system has produced since the onset of the crisis was severe: banks in trouble, that is, banks with falling capital and risky and losing investments, were capital-starved, forcing central banks everywhere to “intervene” to rescue them. The failure of this regime was also complete: the crisis began when the private sector’s risk models and hence its risk management systems broke down, that is, when market participants realized they could not price the credit derivatives that Basel had encouraged them to use. That investment banks and insurance companies were not covered under the capital accords does not matter. Because credit derivatives allowed commercial banks to save on their required capital, the capital accords subsidized their development, creating a demand that the investment banks and some insurance companies, most notably AIG, were eager to provide.

A crisis in a monetary policy regime does not mean its end, however. In a financial crisis, macroeconomic banking and financial market stability is something that a regulator must impose, which is why the US authorities stepped into the breach to assume direct responsibility for the US financial system’s aggregate credit and liquidity risks, violating and therefore changing the rules of the regulatory game they had worked so hard to create as they did so. But one must be careful not to conclude more than this. Not only do the Basel capital requirements remain legally in force in the United States, the scope of their application has in fact been strengthened as a consequence of the crisis. Since all internationally active US banks and bank holding companies are by US law subject to the Basel regulations, a greater share of the United States’ financial capital than before is now subject to the Basel rules due to the demise of the major US investment banks and their transformation into or purchase by banks and bank holding companies. The end of US investment banking as it existed prior to the crisis has another implication: the Federal Reserve, working in conjunction with the US Treasury and the FDIC, has

¹⁵ See the Basel Committee on Banking Supervision, *Overview of the New Basel Capital Accord*, (Basel, BIS, 2003).

also assumed de facto responsibility for every aspect and dimension of the US banking and financial system. No sector, market or type of institution is beyond the Fed's jurisdiction and regulatory control. Measures may be taken at some future date to change the legal framework within which the Fed now operates, but in all likelihood such reforms will only ratify and rationalize the control that the Federal Reserve has come to exercise over the entirety of the US financial system. Today, there are few if any regulatory "lapses." US interest-bearing capital has essentially one regulator: its central bank.¹⁶

The Federal Reserve's new lending practices do not mark an end the regulatory regime of neoliberalism, therefore, but rather its transformation from something like its classical to its neoclassical phase, where the term "neoclassical" indicates that the new regime can be understood only as an imitation and refinement of its immediate predecessor with its faith in markets, privatization, mathematical finance and "independent" central banks. a) The Fed's largest new credit facility, the TAF, is an auction. The authorities set the maturity and quantity of credit to be auctioned off, and the private sector, through a competitive bidding process, sets the interest rate. b) The Federal Reserve took Bear Stearns and AIG's toxic waste off the hands of US capital by transferring this waste to itself, then immediately returned the management of these assets to the private sector, thus following a practice characteristic of the Basel accords in which its own operations are privatized. c) The obvious failures of the credit derivatives revolution notwithstanding, mathematical models still play a role in US monetary policy. The value of the bad assets that the Federal Reserve now holds is not determined by any market but by the solutions in their private sector money managers' asset-pricing models. And d) a central bank as "old fashioned" as the Federal Reserve has become, that is, a central bank that is primarily a lender, is a completely autonomous central bank. Lending against collateral is something that the Federal Reserve can do entirely on its own. By increasing its "instrumental independence," lending increased the Federal Reserve's economic and political power: its ability to influence and regulate private capital.

The autonomy of the Federal Reserve as an institution of the state vis-à-vis other institutions of the US state, especially with regard to its more representative institutions, is immense. Everything that it did in response to the crisis was legal under existing legislation except for the decision to pay interest on bank reserves. It did not have to ask for new legislation to do what it did in every other detail, and in this one instance, new legislation was needed only to speed up the policy change. In many cases, the US monetary authorities simply had to change certain operational rules that they had imposed on themselves. This was how the TAF was created. In other instances, including in particular its seizures of the worst of

¹⁶ Goldman Sachs, for example, continues to exist as an independent capital, but it is no longer an investment bank. It is rather a bank holding company, and as such, is subject to the Basel rules and no longer regulated by the SEC but by the Fed. The same is true of Merrill-Lynch due to its purchase by Bank of America.

the private sector's bad assets and the measures taken to support the commercial paper market, the Federal Reserve acted under emergency powers given to it by the legislation that created it.

Its emergency powers under section 13(3) of the 1913 Federal Reserve are sweeping.¹⁷ In an emergency, a Federal Reserve Bank can advance its own credit to *any* individual or legal entity in the United States should the US monetary authorities determine that that individual or legal entity is unable to obtain "adequate" funding from *any* bank. The only other requirement is that the loan is secured to the "satisfaction" of the Federal Reserve Bank involved, implying that it and it alone can determine the terms of its advances, including in particular what kind of collateral it will accept and at what price. Not only are these emergency powers completely flexible, nothing that a Federal Reserve Bank does under section 13(3) is subject to outside review. Standing at the intersection of the private sector and the state, during an emergency, monetary policy also stands at a zone of indistinction between the law and lawless force. What is particularly important about the Fed's exercise of its emergency measures in this regard is who did and did not obtain assistance: Bear Stearns and AIG, but not Lehman Brothers or a home owner in default on his or her mortgage. The Federal Reserve's disciplinary "misdeeds" are sins of omission.

The Federal Reserve's independence and autonomy helps explain why nothing that it did between August 2007 and December 2008 received the attention given the US Treasury Department when, in the initial draft of the legislation that created the TARP, the Treasury Secretary attempted to give himself powers similar to those that the Federal Reserve Board Chairman was exercising daily. The offending paragraph of the initial draft was this, offensive only because of its candour:

Decisions by the Secretary pursuant under the authority of this Act are non-reviewable and committed to agency discretion, and may not be reviewed by any court of law or any administrative agency.¹⁸

¹⁷ Section 13(3) reads as follows:

In unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of not less than five members, may authorize any Federal [R]eserve [B]ank, during such periods as the said board may determine, at rates established in accordance with the provisions of section 14, subdivision (d), of this Act, to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are endorsed or otherwise secured to the satisfaction of the Federal [R]eserve [B]ank: *Provided*, That before discounting any such note, draft, or bill of exchange for an individual, partnership, or corporation the Federal [R]eserve [B]ank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions. All such discounts for individuals, partnerships, or corporations shall be subject to such limitations, restrictions, and regulations as the Board of Governors of the Federal Reserve System may prescribe. (Federal Reserve Act, Section 13, "Powers of Federal Reserve Banks," Subsection 3, "Discounts for Individuals, Partnerships, and Corporations," (Washington, Board of Governors of the Federal Reserve, 2008), webpage.)

¹⁸ "Text of Draft Proposal for Bailout Plan," *New York Times*, 21 Sep 2008.

The conclusion: not only does the Federal Reserve have sweeping powers, during the crisis it was also quite literally beyond reproach. Politically, therefore, far from constituting a nationalization of the US banking system, the Federal Reserve's assumption of certain activities that had hitherto been handled privately was in fact nationalization's opposite: a further privatization of the US state precisely in the sense that its activities were not subject to democratic scrutiny, not even the very limited public scrutiny of a liberal republic. Politically and socially, the unity that monetary policy establishes between interest-bearing capital and the state is normally invisible, and any change in this unity that the Federal Reserve makes entirely on its own, no matter how dramatic, is normally equally invisible. Throughout the crisis, the financial press duly reported what the Fed had done, but that was the end of the public discussion. During the emergency, there was an organized consensus to be silent about the Fed.

Conclusion: the Federal Reserve's response to the crisis in perspective

Liberal criticism of the Federal Reserve's behaviour since the advent of the crisis focuses on its failure to prevent the crisis from getting worse. In the least, it is argued, the Federal Reserve should have engaged in a quantitative easing earlier. But central banks are very conservative institutions, and when they exercise their lender-of-last resort responsibilities, they are not necessarily generous. The Federal Reserve's intervention into the US economy in response to the crisis was massive and decisive. It gave shelter to its interest-bearing capital by providing it with ample quantities of order-creating liquidity, thereby avoiding an acute political crisis in which the hegemony of American capitalism would be thrown into doubt. Having accomplished this, its one primary goal, it did little more.

In the midst of the Great Depression of the 1930s, Keynes famously asked: "Why would anyone outside a lunatic asylum wish to use money as a store of wealth," for "it is a recognized characteristic of money as a store of wealth that it is barren; whereas practically every other form of wealth yields some interest or profit." His answer was this:

Because, partly on reasonable and partly on instinctive grounds, our desire to hold Money as a store of wealth is a barometer of the degree of our distrust of our own calculations and conventions concerning the future. Even tho[ugh] this feeling about Money is itself conventional or instinctive, it operates, so to speak, at a deeper level of our motivation. It takes charge at the moments when the higher, more precarious conventions have weakened. The possession of actual money lulls our disquietude; and the premium which we require to make us part with money is the measure of the degree of our disquietude.¹⁹

Central bankers have the same "feeling" about money as the bankers, industrialists and financiers who similarly participate in the circulation of interest-bearing capital, but this common feeling causes them to respond to the crisis in very different ways. The bankers, industrialists and financiers, caring for their

¹⁹ "The General theory of Employment," in *The General Theory and After: Part II, Defence and Development*, D. Moggridge, editor, (New York, Cambridge University Press), p. 111.

individual interests, scramble in search of “liquidity.” The central bankers, concerned about the stability of the financial system as a whole, act according to other principles which operate “at a deeper level of [their] motivation” at moments when their “higher, more precarious conventions have weakened.” What are these principles?

Public statements by Federal Reserve officials about their policies must be read closely, given the care they take in making them. Hence, it is noteworthy when in a speech on the “Federal Reserve Policies in the Financial Crisis,” Chairman Bernanke made the following candid statement about why he was not able to save Lehman Brothers:

In the absence of an appropriate, comprehensive legal or regulatory framework, the Federal Reserve and the Treasury dealt with the cases of Bear Stearns and AIG using the tools available. To avoid the failure of Bear Stearns, we facilitated the purchase of Bear Stearns by JPMorgan Chase by means of a Federal Reserve loan, backed by assets of Bear Stearns and a partial guarantee from JPMorgan. In the case of AIG, we judged that emergency Federal Reserve credit would be adequately secured by AIG's assets. However, neither route proved feasible in the case of the investment bank Lehman Brothers. No buyer for the firm was forthcoming, and the available collateral fell well short of the amount needed to secure a Federal Reserve loan sufficient to pay off the firm's counterparties and continue operations. The firm's failure was thus unavoidable, given the legal constraints, and the Federal Reserve and the Treasury had no choice but to try instead to mitigate the fallout from that event.²⁰

In the absence of a buyer, Lehman Brothers failed because it could not obtain a loan from the Fed, a loan denied because it did not have the necessary collateral. The Federal Reserve, acting as a bank with its own credit standards and acting to maintain its own credit worthiness, denied the firm a loan. During the crisis, the Federal Reserve stepped in to actively manage the US financial system's credit and liquidity risks, but it did so in a capitalist manner, as a defence of property.

Bernanke as an individual may have had certain personal feelings about the suffering that the crisis was causing, and in his public statements, he has made reference to peoples' suffering to deflect any criticism that might be forthcoming. But as a central banker he has no recognition that social relations are involved. There is not even the recognition of use-values, only the abstraction of the commodity form in its most reified, alienated form of interest-bearing capital. During the crisis, the Federal Reserve stepped in to fill certain gaps that had appeared in the abstract commodity space of financial capital, but once this space had been spanned, it let the circulation of US interest-bearing capital resume its abstract and empty course – on the condition that the value of its risk-free state money was preserved. As institutions of the state, central banks have capacities that give them nearly sovereign powers. But the immediate unity that they have with interest-bearing capital constrains them to exercise this sovereignty in a particular way: as a defence of interest-bearing capital. This need to maintain the soundness of the US banking system

²⁰ Text of speech given at the Greater Austin Chamber of Commerce, Austin, Texas, 1 Dec, 2008 (Washington: Board of Governors of the Federal Reserve System, website).

explains the Fed's flexibility as well as its stringency. The rest – the consequences of this defence of interest-bearing capital's collective property on society and its "lesser" members – is collateral damage.

How then should one characterize the Federal Reserve's response to the crisis? The political economy was quite simple. It responded to the crisis as a lender-of-last-resort precisely in the way that Walter Bagehot, the man who coined this description of a central bank's proper behaviour, argued it should when he said:

What is wanted and what is necessary to stop a panic is to diffuse the impression, that though money may be dear, still money is to be had. If people could be really convinced that they could have money if they wait a day or two, and that utter ruin is not coming, most likely they would cease to run in such a mad way for money. Either shut the [central] Bank at once, and say it will not lend more than it commonly lends, or lend freely, boldly, and so that the public may feel you mean to go on lending. To lend a great deal, and yet not give the public confidence that you will lend sufficiently and effectually, is the worst of all policies.²¹

For the first full year of the crisis, the Fed did not lend as it had "commonly" lent prior to the crisis, but it did not follow the "worst of all policies" either, which is to "lend a great deal, and yet not give the public confidence that you will lend sufficiently and effectually." Then, beginning in September 2008, it lent "freely, boldly," all the while assuring the public that it would go on lending. The Federal Reserve, from the point of view of capital, exercised its lender-of-last resort duties sensibly and responsibly. At the end of 2008, the Federal Reserve had clearly diffused the impression that money was dear and could not be had – as long as one was a financial capital in trouble and as long as the dollar maintained its dominance internationally.

²¹ *Lombard Street: A Description of the Money Market*, (New York, Wiley, 1999), pp. 64-65.