Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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After my latest opinion piece appeared in *Barron's* on Thursday, I was stunned by the virulence with which *Barron's* readers -- not exactly a bunch of Democratic Socialists -- agreed with me not because of my reasoning, but because they believe the Fed in general and Jay Powell in particular are engaged in a sweeping conspiracy on behalf of the wealthiest global capitalists. The new controversy over Reserve Bank president stock holdings only adds fuel to this fire. Are Federal Reserve Banks forever? Their history suggests maybe not.

Reserve Banks are creatures of 1913, created in concert with the Federal Reserve Board in Washington as part of the awkward compromise that persuaded those who feared a dominant federal banking powerhouse that the central bank would have roots outside the largest cities and thus be beyond the reach of New York's powerful bankers.

This balancing act is in fact one reason the Board is headquartered in Washington, not New York, and also why the New York Fed is the most powerful among nominal equals when it comes to its fellow Reserve Banks. The fundamental anachronism of the System is evident in its geographic footprint -- a heavy concentration of Reserve banks up to Kansas City and St. Louis and then not a single Reserve Bank for all of the mountain and western states but the lone edifice still standing apart in San Francisco.

The ethics rules now at issue due to recent revelations are also artifacts of not just the Reserve Bank construct as it was over a century ago, but also of the limited central-bank role the Fed only fully abandoned after the 2008 crisis. The U.S. central bank became ever more powerful in the 1980s and 1990s thanks to the combination of two mega-authoritative chairs and the Fed's then-new dominance of the nation's payment system and growing market financialization in concert with increasing economic inequality. However, it still largely stuck to its monetary-policy, regulatory, and payment-system knitting.

Now, of course, the Fed is the be-all and end-all of virtually every aspect of U.S. finance and thus of the national and even international economy. It sets policies that do a lot more than lend as a last resort, instead picking winners and losers even deep into the bowels of the corporate-bond market. Indeed, it's so powerful that, as a new BIS study demonstrates, all it has to do is say it's going to rescue corporate bonds for bid-ask spreads across the global market to rise ever higher regardless of real, widely-recognized default risk.

Once it might have been acceptable for Fed officials to own lots of stocks and bonds as long as none was issued by the banks that directly executed monetary policy and were also regulated by the central banks. Similarly, once it might have made sense for the Board to have regional outposts to save its officials from arduous cross-country journeys to supervise their charges and to obtain on-the-ground insights in an age of uncertain economic data and telecommunications barriers.

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Now, of course, none of this makes sense. Indeed, the Reserve-Bank rationale was dubious as long ago as the 1980s, when the then-chairman of the House Banking Committee, Henry Gonzalez, targeted the Reserve Banks as easy prey in his broader campaign to punish the Fed for Paul Volcker's austerity policies. The 1913 rationale was wearing thin by then so the Fed came up with another, more persuasive one: it needed regional Reserve Banks to run the payment system when the 1980 law finally gave it full power. And so matters have rested other than occasional efforts to move a Reserve Bank or two out west or to mandate Congressional confirmation of presidential appointees to head Reserve Banks.

The fact is, though, that Reserve Banks aren't really necessary even for the payment system, which -- with a nod to contingency planning -- could be run as easily out of Jersey City as it's run now from the twelve Reserve Banks. Open-market operations in New York along with on-the-ground contacts with the money market might make sense along with ongoing outreach across the country to small-town bankers and business leaders, but Zoom works too. The real reason we have Reserve Banks is because we've long had Reserve Banks and, other than Mr. Gonzalez, Congressional leaders on all sides of the aisle have been reluctant to directly challenge high-profile, high-power Fed chairmen and the financial system sure to side with them to retain critical friends in this very high place.

Might that change now? As I said, the anger expressed by my Barron's commentators is at fever pitch, and they aren't alone; I've noticed a sharp uptick in conspiratorial tirades against the Fed each time I write about it in the *New York Times*, *Financial Times*, or other media outside the inner sanctums. These readers are largely of the libertarian, free-market type but they are often joined by progressives who stand side by side with them against a central bank thought to act only for big money, not small savers and middle-class households. One might think that it's only extremists at each end of the wide U.S. political spectrum who distrust the Fed, but a central-bank distrust is a deep-rooted, wide-spread U.S. tradition evident not just in how long it took to create a U.S. central bank, but how threatened its charter has been ever since.

The Fed is attuned to its danger to some extent, although its recent spate of racial-equity conferences, employment-equity talk, and climate-change worries may be attributable as much to the change at the White House as to a real understanding of the political coalition brewing against its institutional might. The furor over Reserve Bank president investments was also quickly met with promises for new, passive-investing rules, but this too may not be enough. The complexities of recent Fed commitments to think about labor participation rates when it comes to racial equity may blunt some criticism on key policy questions. However, alleged conspiracies based on assertions that top Fed officials profited at the expense of what's left of the middle class are very, very easy to understand when most Americans are very, very angry about economic inequality. Henry Gonzalez's campaign simply to end the U.S. central bank is no more, but his populist anger is at least as deep and wide-ranging at each end of the 2021 political spectrum. Reform of the Reserve Banks may thus prove inevitable if only because the Board needs twelve sacrificial lambs to save itself.