Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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There's no question that the 2008 crisis was a bit of an embarrassment to everyone in charge no matter what all their memoirs since have said. However, the actual global financial cataclysm was nothing to U.S. voters compared to the torrent of furious protest sparked by Treasury's maladroit decision to allow top executives at AIG to keep munificent pay raises even though many of them presided over and profited by actions that prompted well over $100 billion in taxpayer bailouts. So it is with the Fed. The looming battle over its billions to big finance companies is, as I detailed last week, a serious structural challenge. But the combination of continuing official trading conflicts and new revelations about closed-door meetings is a lot easier to understand and thus a political killer with immediate consequences for Fed governance when Congress gets around to thinking about things other than itself.

Elizabeth Warren's already on it. Many will follow her lead not only because they often do, but also because this time she's mostly right. Even if she weren't, most people will understand why she was upset by Fed "insider" trading and now by a whole lot of insider talking.

That the St. Louis Fed only says that it needs to "rethink" its policy just throws salt in this gaping political wound. Saying also that the Bank's president went without compensation to discuss monetary policy behind doors controlled by one of the giant companies it supervises doesn't come close to countering the fact that these closed-door meetings have happened before and might indeed happen again following a bit of a ponder when it pleases the St. Louis Fed. Just as the Kansas City Fed was deaf to why its secretive payment-access decisions raised hackles, so the St. Louis Fed thinks a bit of hand-waving will allay lasting damage. It won't.

Members on both sides of the aisle will have none of this. As *Bloomberg's* editorial last week made clear, the Federal Reserve needs not only to ensure that its investment ethics standards are robust – Sen. Brown and others think not. It must also polish up the sanctions against closed-door meetings that advantage a financial company and its clients – one might have thought it would have already done so, but apparently not. And, in both cases, the Fed must not only have good ethics rules, but also meaningful monitoring and effective, transparent enforcement when it comes to FOMC members, Reserve Bank presidents, and the Board of Governors.

And the Fed needs to go farther to make transparency a default choice, not an occasional option when the masses get restive. It must do this by quickly addressing the many other ways it is unduly insular. Why, for example, won't it web stream the critical Jackson Hole meetings for those not privileged with an invitation to this mountain eyrie? The Fed is so cloistered that it won't even put the papers presented at these sessions on the web even though all contain academic or central-bank research intended subsequently for public discourse. This minor opacity compared to all the conflicts evident in recent revelations, but it speaks volumes about the privileges the central bank thinks attendant to even the most prosaic utterances. This reinforces the bonhomie of the chosen

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few and any financial institution favored with an audience, but it's ghastly governance and still worse political-risk management.

In the 1980s, a best-selling, policy-crafting book about the Fed was entitled, "Secrets of the Temple." This book exposed the Fed to considerable political risk because it came out right as Paul Volcker's anti-inflation fight plunged the nation into painful recessions. The Fed should have learned from that, but clearly hasn't. Even as its policies provoke pain in all but the most affluent households and panic among all the vulnerable politicians, the Fed has become even more insular.

As central bankers are forced to acknowledge each time they testify, Fed independence is only as strong as Congress's willingness to grant it. Congress not unreasonably demands the information it needs to hold the Fed accountable and constituents will rightly demand answers as Fed policies offend both their sensibilities and bank accounts. One remaining strength of the U.S. system is that, more often than not, institutions that fail to reform themselves are overhauled by Congress and/or the President. Having friends in very high places seems to have dulled the Fed's understanding of its political risk, but public officials are all political and will always save themselves even if doing so requires throwing friends to the wolves. Monetary-policy independence cannot be effectively defended in the face of institutional indifference to the power this independence affords and the vital importance of using it transparently to advance what is generally seen as the public good even if it's inconvenient to one's trading positions or limits the number of posh lunches on the calendar.