



# *Policy Note*

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## DEBT RELIEF AND THE FED'S MONEY-CREATION POWER

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### Introduction

Monetary policy is running out of gas. Six years ago, in the heat of crisis, the Federal Reserve's response was awesome. The Fed created trillions of dollars and flooded the system with easy money—enough to stabilize financial markets and rescue wounded banks. It brought short-term interest rates down to near zero and long-term mortgage rates to bargain-basement levels. It provided a huge backstop for the dysfunctional housing sector, buying \$1.25 trillion in mortgage-backed securities, nearly one-fourth of the market.

Flooding Wall Street with money saved the banks, but it didn't work for the real economy, where most Americans live and toil. And official Washington now appears to have opted for an unspoken policy of complacency. The president talks up the limp economic recovery as good times, even if he's careful to say they're not good enough. The best you can say for Congress is that it stopped making things worse. The only positive light—Federal Reserve chair Ben Bernanke's deluge of easy money—is flickering, as conservative critics hector him to back off. The trouble with Bernanke's policy is that it hasn't worked, not if the goal is a vibrant economy with abundant jobs. And his recent hint that he might consider ending the Fed's bond purchases provoked a minipanic on Wall Street—a clear enough sign of the recovery's weakness.

The Fed knows (even if politicians do not) the danger of sliding into a liquidity trap, which would utterly disarm its monetary tools. So the Fed wants Congress and the White House to borrow and spend more because, when the private sector is stalled and afraid to act, only the federal govern-

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ment can step in and provide the needed jump start. And back in January 2012, the central bank promoted a white paper on housing, proposing, ever so gingerly, the heretical remedy of debt forgiveness for the millions of homeowners facing foreclosure (Federal Reserve 2012).

Despite being a longstanding critic of the Federal Reserve, I found myself feeling sympathy and a measure of admiration for Bernanke's willingness to stand up for unorthodox ideas and switch sides on the sensitive matter of debt reduction for failing homeowners. For many years, I have assailed the institution's unaccountable power and antidemocratic qualities, its incestuous relations with powerful banks and investment houses. Those flaws and contradictions remain unreformed, yet I now think the country needs a stronger Fed—a central bank not afraid to use its awesome powers to help the real economy more directly. One of the ways it can do this is by revisiting—and extending—its bold ideas on debt relief. By harnessing the power of money creation, the Fed can help clear away the overhang of mortgage and student debt holding back the economic recovery.

### **The Federal Reserve Turns Left**

People ask, How come the Federal Reserve can dispense trillions to save Wall Street banks but won't do the same to rescue the real economy? Good question, and they deserve a better answer than the legalisms provided by the Fed. At this troubled hour, the Federal Reserve should find the nerve to abandon failed paradigms and use its powers to serve a broader conception of the public interest.

The Fed belatedly turned its attention to the foreclosure crisis when it realized that the housing sector, clogged with millions of failed mortgages and vacant houses, was a big part of why Bernanke's monetary policy failed. Housing, of course, is an issue that belongs to the fiscal side of government, but the Fed can help out because its "dual mandate" in law requires monetary policy to support both maximum employment and stable money.

Though it seemed out of character for the austere central bank, in January 2012 the Fed staged its version of a media blitz on behalf of troubled homeowners. In the span of seven days, two governors from the Federal Reserve Board in Washington and three presidents from the 12 regional Federal Reserve Banks delivered strong speeches on how to stop the bleeding and revive housing. They asked the elected politicians to consider a

broad campaign to reduce the principal owed by homeowners who are underwater, owing more on their mortgages than their homes are worth. Most of them can't sell and can't keep up with their payments, and are thus doomed to foreclosure.

All this was explained in the white paper Bernanke sent to Capitol Hill, which outlined why cleaning up the housing mess was necessary for a "quicker and more vigorous recovery" (Federal Reserve 2012, 2). The white paper was hedged with lots of qualifiers, but it read like a handbook for recovery. A prime mover behind the initiative was William Dudley, president of the New York Fed. Dudley suggested \$15 billion in bridge loans to tide over unemployed homeowners. He urged Fannie Mae and Freddie Mac, the two government-sponsored enterprises (GSEs) now in conservatorship, to loosen their tightfisted control over mortgages and reduce outstanding balances on delinquent loans—which most likely will never be repaid anyway.

A sense of moral resonance runs through the white paper. Fairness, it turns out, is an economic variable. So are the social consequences of doing nothing. The foreclosure mess, the Fed noted, hurts innocent bystanders when their neighborhoods are ruined by other people's failures. Towns burdened by lots of empty houses lose property-tax revenue needed to sustain public services. The foreclosure process piles up "deadweight losses" in which nobody wins.

Mortgage relief, on the other hand, in effect redistributes income and wealth from creditors to debtors. "Modifying an existing mortgage—by extending the term, reducing the interest rate, or reducing principal—can be a mechanism for distributing some of a homeowner's loss (for example, from falling house prices or reduced income) to lenders, guarantors, investors, and, in some cases, taxpayers," the Fed document explained (17). Both the lender and the borrower can gain from reducing the size of an underwater mortgage: "Because foreclosures are so costly, some loan modifications can benefit all parties concerned, even if the borrower is making reduced payments" (17–18).

Refinancing at a lower rate and reducing the principal allows a family to keep its home with the promise of regaining equity as they pay down the more affordable mortgage. The modification can also restore the loan as a profitable investment for lenders, who will gain a greater return than they would if they had let the mortgage slide into foreclosure. Writing it down acknowledges that the original debt was never going to be repaid anyway. The lender suffers an accounting "loss" on the forgiven debt, but in real terms earns back more. The same logic

can apply to the economy as a whole, the Fed explained. The short-term costs of adjustment are up front for lenders, but the long-term benefits will be much greater for the overall economy if clearing away bad debt helps strengthen the recovery.

### **Debt Reduction for Failing Mortgages**

Here is a modest example of what the Fed could do to shake up the system. It could announce its intention to buy only new mortgage-backed securities that have been subjected to the process of refinancing and modification to establish positive equity and more realistic valuations. The mere announcement would cast a cloud over the existing stock of GSE mortgages and probably trigger a wave of market-driven mortgage adjustments. The Fed, in effect, would not only provide a model for debt write-downs generally but also help create the market for them. The Fed's presence would assure people that the process does not threaten the banking system. For distressed homeowners, it would amount to redistribution of income and wealth—sharing the costs of the financial catastrophe among other players instead of dumping all the pain on borrowers.

Stephen Roach, a Morgan Stanley economist and lecturer at the Yale University School of Management, thinks the executive branch can engineer dramatic debt reduction with or without the approval of Congress. Fannie and Freddie together hold something like \$1.5 trillion in housing loans or mortgage-backed securities. The Federal Reserve has nearly another trillion on its balance sheet. As owners, they could unilaterally grant new, more realistic terms to stressed borrowers. “Government can do this by simply telling Fannie Mae and Freddie Mac to take a write-down on their outstanding loans,” Roach explains. “Then the government can put pressure on the banks to do the same thing. The banks will resist, but they have to go along if the government is forceful enough.”<sup>1</sup>

The Fed can likewise become a major influence for debt reduction, Roach says. Conservative traditionalists would naturally be appalled if the Fed directly aided the real economy of consumers and producers, but that objection was nullified by the financial crisis, when the central bank pumped hundreds of billions of dollars into nonbank corporations like AIG and General Electric.

Joseph Stiglitz, a Nobel Memorial Prize-winning economist at Columbia University, and Mark Zandi, chief economist at Moody's Analytics, have proposed an excellent use for Fed-

created money: funding a massive refinancing of home mortgages, which would cut monthly payments dramatically and free personal income for consumption (Stiglitz and Zandi 2012). A plan proposed by Oregon Senator Jeff Merkley, they explain, could boost disposable income for some 20 million families with underwater mortgages, including those not backed by Fannie Mae and Freddie Mac. A “government-financed trust” would buy up the refinanced mortgages, thus giving private lenders the capital to make more loans. Several federal agencies could handle this, but Zandi told me that using the Federal Reserve would be the most efficient way. “The biggest impediment is the banking system,” Zandi said. “The pipeline for origination of lending has shrunk—a lot of midsize banks and mortgage companies got out—so the big banks now account for even more of the volume. They manage the flow by raising their eligibility standards. That's why they are making so much money.” The Federal Reserve could change that, Zandi said, but he added, “I think the Fed would never go down this path unless the national economy is sliding back into recession.”<sup>2</sup>

### **Using the Fed's Money Power to Tackle Student Debt**

Senator Elizabeth Warren has introduced what I would call a seismic proposition, one very likely to disturb the sleep of complacent politicians. Why, she asks, should the Federal Reserve lend money to banks at an interest rate of less than 1 percent when the government intends to charge students 6.8 percent interest on their college loans? The senator posted an amusing billboard on her official website: WANT TO BORROW MONEY FROM THE GOVERNMENT? DON T BE A STUDENT. BE A BANK.

Warren has proposed legislation—her very first bill—to correct this anomaly. Instead of doubling the student loan rate from 3.4 to 6.8 percent, as the government did in July, she wants it reduced to the same rate that banks are charged at the Fed's discount window: 0.75 percent. In addition, Warren wants the Fed to pay for this modest debt reduction, just as it did for the Wall Street bailouts. “Every time the US government makes a low-cost loan to someone, it's investing in them,” the senator explained in an interview. “The US government does that every single day through the Federal Reserve. It invests in the largest financial institutions in this country. We should be willing to make that same kind of investment in our kids who are trying to get an education.”<sup>3</sup>

This comparison should embarrass Washington: as Warren observed, the government actually makes money on its student loan business. It will collect \$51 billion this year, according to the Congressional Budget Office. “In other words,” she said, “our kids have become a profit center, while the big banks walk away with the subsidy.” Try explaining that to the young people drowning in a trillion dollars of debt.

Conventional experts sputter that banks are different from students. “Yeah, I know that,” Warren countered wearily. That’s her point: why should students be treated as less important than banks? “There’s a nice parallel here,” she said. “In fact, it gives us a chance to explore just what the values are that underlie whom the government helps.” The senator hopes her measure will inspire a national debate about values and public investment. “Of course we need a financial system,” Warren said. “But we also need young people to get educated. We also need infrastructure. We also need research. Those are all investments. I want us to have a bigger conversation. As a country, where should our investments be? Because right now, in my view, we are starving the wrong groups.”

What rattles conservative central bankers and monetary economists is Warren’s assertion that the Federal Reserve should pay the costs of the student loan rate reduction out of the money it creates. The central bank’s unique advantage is that its dispersal of money does not count as government expenditure. The Fed’s new money is the nation’s “pure credit” because it belongs to everyone and to no one in particular. “If Federal Reserve loans are subsidies, it doesn’t show up in the federal budget,” Warren explained. “They just do it. Every day and ‘off book.’ There’s no offset to make up for it. Nobody says, ‘Well, we need to find a tax loophole somewhere to make up for it.’ If we are willing to harness that [money-creation power] for the big banks, we should be willing to put it into service for our students, because both are building the future.”

To lessen the controversy, Warren limited her proposal: the interest rate reduction would last only one year, forcing Congress to return to the problem and seek systemic solutions for the debt overhang and the rising cost of college. Her bill gives no relief to students and graduates who, she acknowledges, are already “being crushed” by debt. (Senator Sherrod Brown has introduced a parallel bill to reduce rates on existing loans.) “It’s a down payment on trying to give hardworking people a real chance,” Warren said. “Let’s get a foot in the door with this piece. We’ve got to win this thing in pieces.”

Others are urging more dramatic interventions: using Fed financing for directed lending and debt relief in the real economy. Though it’s not widely known, the question of such unorthodox Fed interventions has been a recurring subject among policy elites in a shadow debate on monetary policy. Walker F. Todd (2013), former legal adviser at the Cleveland and New York Federal Reserve Banks, suggests the Fed could underwrite a significant reduction of the \$1 trillion in student loan debt by drawing down the banking system’s swollen backlog of reserves, estimated at \$1.8 trillion. Others have proposed lending to help the small-business sector, now starved for credit by reluctant bankers. Still others envision the Fed as the backstop for a nationwide infrastructure investment program (see Greider 2013b).

The shadow debate among economists and policy thinkers is not secret, but it’s not exactly public, either. Since Fed officials have been largely silent about unorthodox alternatives of late, the major media don’t bother to report the political implications. Public ignorance is a useful tool of the governing classes.

### **It’s Time for Debt Relief**

Forgiving the debtors is the right thing to do, because the bankers have already been forgiven. The largest banks were, in effect, relieved of any guilt—for their crimes of systemic fraud or for causing the financial breakdown—when the government bailed them out, no questions asked. The Obama administration followed up with a very forgiving regulatory policy that basically looked the other way and ignored the fictional claims on bank balance sheets. Instead of forcing honest accounting and rigorous reform, the administration adopted a strategy of soft-hearted regulation that banking insiders call “extend and pretend”: extend the failed loans and pretend that the loans will be paid off, even when you know many of them won’t. The phrase originated during the third world debt crisis in the 1980s, when the Federal Reserve rescued the same big banks from insolvency, the result of their reckless lending in Latin America.

This time, the government’s rationale for rescuing bankers first was that the economy cannot recover until the financial system is healed. The premise did not prove out: banks revived, at least partially, but not the economy. The same rationale applies, more logically, to failing homeowners and those struggling under the burden of student debt. A heavy blanket of bad debt is smothering economic activity. Until the debt is lifted from financial balance sheets, the economy is unlikely to regain

its normal energies. So debt reduction is not just a moral imperative; it's also an economic necessity.

The largest and most powerful banks are standing in the way of this solution. Bankers and other creditors would have to take a big hit if they were forced to write down the debt owed by borrowers. The banks would have to report reduced capital, and their revenue would decline if homeowners were allowed to make smaller monthly payments. This could threaten the solvency of some very large banks—those that have been exaggerating their financial condition, as many market analysts and shareholders suspect. That risk presumably explains why the Treasury Department and various housing agencies are trying to dodge the growing demands for debt forgiveness. Fannie Mae and Freddie Mac, which guarantee roughly 70 percent of all mortgages and are now virtually owned by the government, have flatly rejected the idea, and so have the Federal Housing Administration and the Veterans Administration.

## Conclusion

The Federal Reserve should act to deliver debt relief because nobody else will. That sounds unfair, since the Fed has already taken heavy flak for poaching beyond its traditional domain. Further experiment will enrage right-wing critics, but the central bank is running out of options. Monetary policymakers say they face formidable legal limits, but the Fed still has enormous leverage. I believe what Wall Street financiers tell me: the Fed can usually find a way to accomplish what it really wants to do. In this case, it can break the political impasse and goad other parties into taking action. That does not require it to violate the Federal Reserve Act. It does require reinterpretation of the vaguely defined “dual mandate,” which has always been heavily biased in favor of Wall Street finance over the real economy. If stagnation drags on for years, tearing up society and destabilizing politics, demands for more radical action will swell and eventually overwhelm the old restraints.

If this country ever gets back to a time when real questions are asked about democracy and our unrealized aspirations, both the public and politicians will have to talk about the Federal Reserve and its “money power.” I have a hunch current events are educating citizens and their elected representatives toward that day. It no longer makes sense to keep fiscal and monetary policy separate, pulling the economy in opposite directions. The present crisis suggests that monetary tools should be coordi-

nated with the fiscal side. How this could be done in a democratic way is a tough question, but it cannot be answered until the people and their representatives are educated far beyond their current primitive level of understanding.

The other promising challenge is, can we convince ourselves that money created by government really belongs to the people? Could it be used—judiciously—to finance long-term public projects, like infrastructure and high-speed rail? The government as employer of last resort? Make your own list of what the nation needs. Imagine if the highest-priority projects were financed with the new money mysteriously created by the mighty Federal Reserve. That would be a future worth arguing over.

## Notes

1. Quoted in Greider 2011.
2. Quoted in Greider 2012b.
3. All Warren quotes in this and subsequent paragraphs, see Greider 2013a.

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