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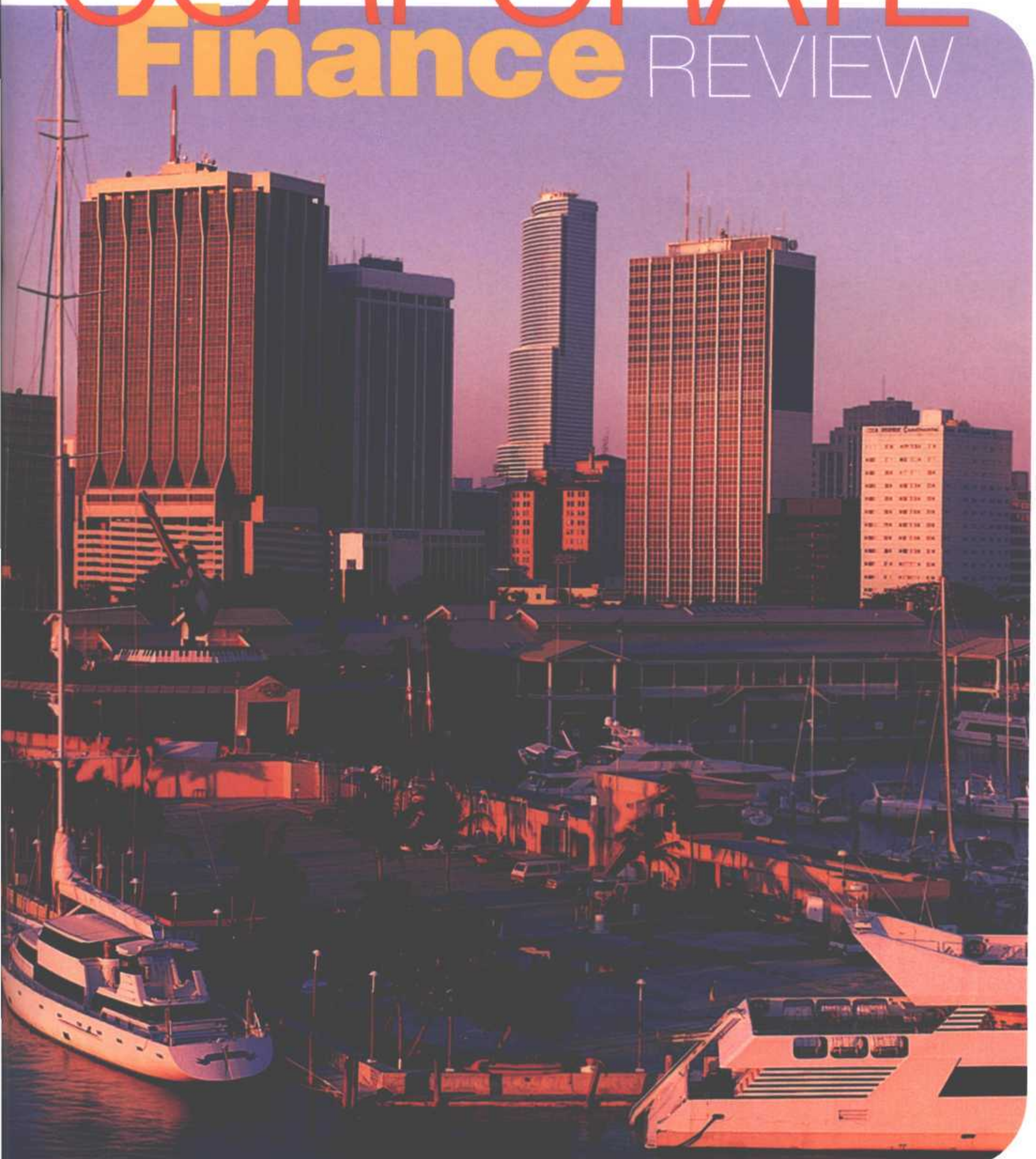

In Their Own Words:
What We Learn About Corporate Ethical Lapses

Disasters, Vulnerability, and Governmental Response

Hawala: How Terrorists Move Funds Globally

AMERICA'S FEDERAL RESERVE BANKS: MUCH MORE INFLUENCE ON YOUR PROFESSIONAL AND PERSONAL LIFE THAN YOU MIGHT IMAGINE

Pop quiz: What is the Federal Reserve System? Oh yes, it is the organization that sets key bank interest rates, "controls" inflation, and has something to do with regulation of the United States banking industry . . . *right?* In March 2006, at one of his public press conferences, President George W. Bush suffered a senior moment (that all of us have experienced one time or another) when he failed to recall the name of "the Fed" in answering a question from the audience, saying only that it wasn't his Administration but an "independent organization" that sets interest rates that in turn decide outcomes on home mortgage rates. (He couldn't recall the name of the Federal Reserve Bank for a brief moment.)

The minor flub was good for a laugh at President Bush's expense, but there is a point to this: Many Americans don't understand what the Federal Reserve System ("the Fed") is all about . . . and what short- and long-term effects the "bank" has on their professional, business, and personal lives. The Fed is much more than the keeper of the prime rate or overnight bank-lending discount rate. The Fed's policy tools include "open market" operations, setting the bank discount rate, and establishing banking reserve requirements.

The president was mostly right: The Fed is an independent outfit ... a number of outfits, it turns out. The United States of America was among the last of the industrialized nations to create an official central bank in 1912 (known as the Federal Reserve System) after the banking panic of 1907 created a groundswell of support at both the "grasstops" and "grassroots" levels for federal government intervention in the nation's often chaotic banking affairs. (The banking scare of 1907 was preceded by the panic of 1893, which was preceded by the panic of 1884, which was preceded by the 1873 banking crash, etc. Bank "crashes" occurred about every ten years after the American Civil War. The Federal Reserve System was adopted to prevent and/or deal with recurring future crises in the banking system.)

When the Federal Reserve System was established, the nation's economy was quite different from that of the current economy. Agriculture and manufacturing were the mainstays of the national economy. Regional banks that reflected the influence of their respective regions were established in capital cities. There is one bank in St. Louis and another not so far away in Kansas City—these reflect the importance of early-20th-century trading and capital outposts for agriculture. Others similarly situated were the Minneapolis and Chicago banks. Today, these four midwest banks have broadened their perspectives to include the information economy and high-tech America, but all remain strongly anchored in agri-business. Each regional bank serves as an important "sentinel" for its regional economic activities and as a "canary in the coal mine" for bringing important views and perspectives to national deliberations of the system.

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Even as we near the 100th anniversary of the venerable institution, the Fed can be a mystery to many Americans, even at times to those who daily toil in corporate finance and the capital markets.

For some of us it can be like one of the mysterious beasts of mythology that breaks into view every now and then — through such sightings as reported in headlines like the following: "The Federal Reserve Bank Today Cranked Up Interest Rates for the Fifth Time in a Year ..."

The visible chairman—Alan Greenspan

The almost mythical status achieved by the recently retired chairman of the system — the honorable Alan Greenspan — coincided with the emergence of several all-financial-news-all-the-time programs on American cable television systems (delivered by MSNBC, CNNfn, CNBC, Fox News, Bloomberg Television, and other networks). The broadcasters reveled in footage of the chairman over the course of his eighteen years of service, usually pictured toting his briefcase to the scheduled Federal Open Market Committee (FOMC) meetings where key interest rates would be set. The heft of the totem briefcase became a signal for confidence or anxiety on Chairman Greenspan's part as he strode the walkway to the "temple" that is the Fed's Washington, DC headquarters. Wall Street followers were even said to be watching the briefcase very carefully to know what direction to start trading debt or equity! Such is the mystical power of the Fed. But what about the system's real powers?

ONE OF THE MOST VISIBLE EFFECTS OF THE FEDERAL RESERVE IS THE DECISION MAKING OF THE FOMC, WHICH SETS TARGET LEVELS FOR INTEREST RATES.

What does the Federal Reserve really do—and why should financial executives in any professional pursuit care about the "bank"? To begin our exploration of the Fed, note that there are actually twelve independent Federal Reserve Banks in addition to the system's headquarters located in the nation's capital.[1] Each regional bank operates somewhat independently, even as the Federal Reserve System itself attempts to operate independently of government.

Among the most important activities of the various banks are the research efforts of economists and others employed by the twelve regional banks, supplemented frequently by input from leading academics, economists, monetary technicians, and capital markets experts who participate in Federal-Reserve-sponsored or -conducted workshops, seminars, and symposia. The frequent speeches by various Federal Reserve Bank CEOs and presidents also provide philosophical and practical frameworks — and send signals — for anticipating Fed policies and action steps.

Federal Open Market Committee

At the system level, one of the most visible effects of the Federal Reserve is the decision making of the FOMC, which sets target levels for interest rates. A number of regional bank CEOs and presidents sit on this committee and provide advice and counsel from their respective regions, reflecting the fact that the United States is not a single economy but is made up of several regional economies.

The FOMC consists of seven governors of the national board, the president of the Federal Reserve Bank of New York, and four of the eleven remaining regional bank presidents (serving on a rotating basis). All twelve regional bank heads attend every meeting, contribute to the discussion, and provide forecasts that are then summarized in congressional testimony. "FOMC forecasts" are the summary of forecasts collected from this body and include input from nonvoting regional bank heads. The practice of providing February and July forecasts to the US Congress began in the hyperinflation year of 1979.

As William Gavin, vice president and economist of the St. Louis Federal Reserve Bank, explained in May 2003, the FOMC can be reluctant to commit publicly to an inflation target because there can be a wide range of differences of opinion among the FOMC members.[2] On his watch, Chairman Greenspan is credited with moving the Fed toward greater transparency about both decision making and background information that influenced FOMC decisions.

The key rate that is set—targeted—by the FOMC is the market rate paid for balances held at the Fed by banks and other institutions when those balances are traded; these balances are part of the banking system's reserves and are used to effect payments and meet statutory reserve requirements. As Daniel Thornton of the Federal Reserve Bank of St. Louis pointed out in August 2003, the Fed has used the open market rate since the 1980s to achieve objectives mainly by buying and selling government securities, increasing and decreasing supply and demand.[3] (To reduce the funds rate the Fed must increase the supply of reserves.)

Addressing uncertainty in the financial system

The FOMC attempts to remove uncertainty (and to provide certainty) in the capital markets for the vital banking industry as well as for "non-bank" participants. Chairman Alan Greenspan noted in 2003 that "[uncertainty is not just an important feature of the monetary policy landscape; it is the defining characteristic of that landscape."[4] His position has been that central banks such as the Fed are driven to a risk-management approach to policymaking.

Similar to corporate finance executives' attempts at divining the immediate future and adopting strategies and tactics to deal with uncertain outcomes, in Chairman Greenspan's view it is the mission of Fed policymakers to "reach a judgment about the probabilities, costs, and benefits of the various possible outcomes under alternative choices for policy."[5] While numerous economic models are used by bank economists, there is still a significant level of "uncertainty" in the US and world economies.

2006: year of transition at the Fed

Alan Greenspan ended eighteen years of service as chairman of the Board of Governors of the Federal Reserve System, and on February 1, veteran economist and Princeton University academic Ben Bernanke succeeded him. According to Janet Yellen, president/CEO of the Federal Reserve Bank of San Francisco, Chairman Greenspan had skillfully managed monetary policy during his tenure. The US economy has been extraordinarily stable— and frequently it has been the stabilizing force for other nations. The nation experienced just two mild (and short) economic recessions and weathered a series of storms.

The Greenspan legacy

Two important legacies were established by Chairman Greenspan, Ms. Yellen suggested: The Fed adopted a more predictable approach to policy making and placed a growing emphasis on open communication and transparency. The two traditional mandates for the Fed—keeping inflation low and stable and promoting maximum sustainable employment—were consistently followed, at times with aggressive intervention to address any increase (real or perceived) in inflation. Core price inflation mostly trended down in the Greenspan era, often approaching one percent (in effect, for government and business, a "zero" inflation rate).

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In 1994, just before stock market equity prices took off like a rocket (the Dow Jones Index rose 6,000 points in six years), Chairman Greenspan's Fed raised funds rates in response to early indicators suggesting that labor and product markers) demand exceeded capacity. Just months earlier, when the unemployment rate had been rising (after the late-1980s real estate bust, thrift failures, the tightening of bank credit standards, and the start of recession in many regions), the Fed intervened and eased credit policy to stimulate growth.

These actions, suggested Ms. Yellen, enhanced the ability of financial markets and corporations to anticipate the Federal Reserve's response to economic developments and to respond independently in advance of the Fed's movements.

And consumer confidence steadily strengthened as public confidence grew in the Fed's ability to "control" and promote economic stability—and the Fed stated its firm commitment to rein in inflation. It helped that in 1994 the system began a practice of issuing press releases after FOMC meetings to announce changes in the federal funds target rate (something we now take for granted). Before, it could take days, weeks, and at times months to ascertain correctly the Fed's policy on rates.

So the key to understanding the power of the Greenspan legacy, suggests Ms. Yellen, is to link the system's disciplined approach to policy combined with more communication on the approach and policies adopted—this has strengthened the public's confidence in the Fed and anchored inflation expectations to price stability.

The New York Fed—watching canaries in financial coal mines

The Federal Reserve Bank of New York is a key monitor and watchdog of the capital markets, which are generally considered to be located in or around the city of New York. (The New York Fed occupies a literal fortress with several-feet-thick stone walls located just a few steps from Wall and Broad streets, home of the New York Stock Exchange trading floors.)

Recovery after September 11, 2001 was relatively rapid for most of New York's capital market players, and the New York bank and Fed system was credited with quick response and stabilization of the capital markets.

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But some concerns remained and New York bank researchers at the end of 2005 were addressing the issue of rising US international liabilities and the effects on capital markets. Years of maintaining large current account deficits have saddled the United States with the world's largest stock of international liabilities, approaching $2.5 trillion (or 22% of the US GDP) at the start of 2005. That's the bad news. The good news, New York bank research shows, is that the nation earned $36 billion *more* on its own collective foreign assets than it paid out to service its foreign liabilities. Here are some important data that have been of value to policymakers (and should be of interest to corporate finance managers with global operations).

The US has been earning a higher rate of return on its large stock of international assets. Some surprising findings by the New York Fed may be excellent points to make around the water cooler in your office as the negative media headlines trumpet our "deficit" economy:

- There is barely any gap at all in rates-of-return on assets and liabilities for equities, debt securities, and bank claims.
- There is a substantial gap in returns on foreign direct investments (FDI): US companies operating abroad are far more profitable than foreign firms operating in the US.

The good news must be tempered with two realities, however:

- Net investment income will not remain positive for much longer, given the continuing buildup in net foreign liabilities (all those billions we borrow from China and other countries).
- Any rise in US and/or global interest rates will bring forward that time when the US will have to begin making net income payments.

The following are two important results with serious implications for your business:

- A shift to growing net income payments means the US trade deficit would have to narrow in order to stabilize the current account deficit (the monthly headline-making statistic).
- The shrinking of the trade deficit would mean that the US economy couldn't continue to consume more than it produces.

The New York research team noted that the large, ongoing current account deficits of the United States were leading to a steady buildup of US net liabilities to the rest of the world, and the consequences have been masked to date by the superior rate of return that the US earns on FDI assets. (We've been helped by the recent drop in global interest rates as well.)

But this situation is not sustainable, and for a country that imports far more than it exports, there is a day of reckoning—and if the balance tips against the US in the near future, the "adjustments" necessary will be very challenging for business, government, and consumers.

This is the kind of research available free to corporate managers seeking data or trend lines or windows into the Fed's thinking. (Consider the twelve banks your own "think tanks" on various aspects of finance, monetary policy, key financial trends, productivity, and dozens of other key issues that affect your business.)

The Fed is not omnipotent, however

Given the collective brainpower and experience of the Fed staff, impressive results are becoming "the expected." But as Professor Geoffrey Miller — law professor and director of the Center for the Study of Central Banks at New York University— commented in May 2001, as central banks emerged from their relative obscurity, they began to be perceived as one of the most powerful institutions in the world — politically, socially, economically— and as forces for cultural and historical change. Not so fast, counsels the professor. Central banks are *not* omnipotent; they do not control the business cycle nor ensure an endless cycle of prosperity.

Professor Miller's extensive research showed that central bank tools of monetary policy can sometimes be too broad to deal effectively with sector phenomena, and that bank intervention (such as the Bank of Japan's actions in recent years) may be limited in such areas of concern as the stock market and real estate market. A second "myth" that has grown up around central banks is that their only monetary function has to do with price stabilization. Stability is not the only goal of the Fed or other central banks.

The "power" given to the independent central bank would appear to be counterintuitive to what most government officials — especially politicians — would want to do. But doing so works to their interest: "Politicians recognize the value of offering a credible commitment to not give in to the temptation to undo political deals by creating inflation," Professor Miller explained, and they can merrily maximize short-term campaign contributions by giving up power to the central bank. Long-term "deals" are more credible because they will not be threatened by inflation and do not have to resort to highly unpopular gimmicks such as price indexing or public sector price control schemes.

The effect is to have a central bank like the Federal Reserve, or the Bundesbank of Germany or Bank of Japan, operate both *within and without* the nation's respective political and economic systems. (No wonder many citizens of those countries are in the dark about what their central bankers are up to!)

Four months before the September 11, 2001 terrorist attacks in the United States, Professor Miller observed that one of the most important functions of the central bank is to help a nation address a crisis such as a threat to national security. In these times, the bankers may decide to fund the response through inflation rather than the slower, more desirable means of raising taxes. That is what the Federal Reserve did just weeks after 9/11: pump money into the banking and capital markets systems.

For the future: a warning

The various Fed banks regularly conduct seminars, workshops, and symposia that attract stellar talent in economics and other fields. In February 2005, the San Francisco Federal Reserve Bank's Center for Pacific Basin Studies and the University of California at Berkeley's Clausen Center for International Economics conducted a seminar on Asian development. Conference participants discussed the current international exchange rate system, the sustainability of global trade imbalances— especially that of the United States — and what imbalances mean for emerging markets.

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Professor Maurice Obstfeld of the University of California discussed the likelihood that the US might soon face an emerging markets style of "sudden stop" crisis. He questioned the sustainability of US current account imbalances, which reached a record monthly high of $68.5 billion in January 2006 and suggested that a large depreciation of the US dollar was very likely.

A number of scholars debated the importance of China's maintaining its peg to the dollar for the renminbi and the "free-float" of China's currency and revaluing to the dollar or other currencies. (Five months later, in July 2005, the Chinese government announced it was revaluing against the US dollar and would be "flexible" in the future.

IT IS TOO SOON TO DEFINE "THE BERNANKE FED," BUT IT MAY BE COMFORTING TO FINANCE EXECUTIVES TO KNOW THAT THE NEW HELMSMAN IS A LEADER WHO WILL NOT IGNORE THE LESSONS OF THE PAST.

China, as of March 2006, has almost $850 billion in reserves.)

An important consensus was reached concerning whether the current system was sustainable as the US current account deficit continued to grow. Near-term, the answer seems to be yes, but three to ten years hence, several scholars argue, the system will be unsustainable and Asian countries may decide not to finance the deficit by purchasing more US securities.

But, we have the Federal Reserve System to address extreme volatility in currency and bank reserves and to meet the "shocks" of key capital markets systems.

Chairman Ben S. Bernanke—looking to the future... and lessons of the past

On February 1, 2006, Princeton economist Ben Bernanke became the Chair of the Federal Reserve System. He has served as a member of the Board of Governors of the US Federal Reserve System and is a widely published author. (He was appointed to the Board for a fourteen-year term ending January 31,2020, and a four-year term as Chairman, expiring January 31, 2010.)

Chairman Bernanke has long studied the effects of the Great Depression of the 1930s on the US and global economies, a time in which there was unemployment for one in four heads of household, large numbers of bank failures, currency speculation, price depression, and other catastrophic events.

In his book entitled *Essays on the Great Depression,* published in 2000, Mr. Bernanke noted, "[T]hroughout my academic career, I have returned many times to the study of the vertiginous economic decline of the 1930s .... there is . . . much to learn from the Depression about the workings of the economy."[6]

Further, he wrote, "Those who doubt that there is much connection between the economy of the 1930s and the supercharged, information-age economy of the twenty-first century are invited to look at the current [year 2000] economic headlines — about high unemployment, failing banks, volatile financial markets, currency crises, and even deflation. The issues raised by the Depression, and its lessons, are still relevant today."[7]

Chairman Bernanke's original research published in 1983 explored the macroeconomic implications of financial crises, which then received broader attention as the East Asian financial crises occurred a few years later. He has served in various Federal Reserve System capacities since the late 1980s and was a member of the Board of Governors from 2002 to 2005.

It is too soon to define "the Bernanke Fed," but it may be comforting to finance executives to know that the new helmsman is a leader who will not ignore the lessons of the past; indeed, the lessons of history appear to continue to be important guideposts for current Federal Reserve System decision making. •

NOTES

1 The regional Federal Reserve Banks are located in the following cities: Boston, New York, Philadelphia, Richmond, Atlanta, Dallas, Kansas City, St. Louis, Chicago, Cleveland, Minneapolis, and San Francisco.

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3 D.L. Thornton, "Alternative Policy Weapons?" (August 2003), published by the Federal Reserve Bank of St. Louis. Available online at http://research.stlouisfed.org/publications/mt/20030801/cover.pdf.

4 Alan Greenspan's remarks on the importance of monetary policymaking are quoted from a speech delivered at a symposium sponsored by the Kansas City Federal Reserve Bank at Jackson Hole, Wyoming, 2003. The speech is available online at http://www.federalreserve.gov/boarddocs/Speeches/2003/20030829/default.htm.

5 Ibid.

6 B.S. Bernanke, *Essays on the Great Depression* (Princeton University Press, 2000): preface.

7 Ibid.

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