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Fallout from a Bailout

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Resident scholar Vincent R. Reinhart outlines how the Federal Reserve bailout of Bear Stearns tarnished the Fed's reputation, changed its relationship to nonbank lenders, and increased the likelihood of government intervention and regulation. He expects these changes to have long-term adverse consequences.

The Senate Banking Committee approved legislation on May 20 that would empower the Federal Housing Administration to provide relief to mortgage borrowers teetering on the brink of default. The House has already passed similar legislation. Only two months ago, mortgage aid was viewed as unlikely, but the odds now favor it becoming law. For this change of fortune, the legislation's chief sponsors, Senator Chris Dodd (D-Conn.) and Representative Barney Frank (D-Mass.), should thank one person in particular: Federal Reserve chairman Ben Bernanke.

Politicians seeking to expand the role of government to help ease problems in the mortgage market face an inconvenient fact: most Americans own their homes outright, meet their mortgage payments, or are renters. As a consequence, mortgage relief never polls well. When people are asked whether they think government aid should be given to households failing to meet their mortgage obligations, a majority routinely says no. The average American, meeting the struggle to live within his or her means, bridles at the notion that those who are overextended should be helped.

The Federal Reserve's decision in March to lend to the investment bank Bear Stearns changed this debate forever. Fed officials took the unprecedented action of extending the agency's safety net beyond the banking system. Presumably, they were balancing the risk that other failures would be triggered should Bear, the nation's fifth-largest investment bank, default on its obligations against the precedent of such lending.

It is probably impossible for anyone who was not in the room during those negotiations to accurately assess that balancing act. Still, there is one certainty: that decision to solve the problem immediately at hand will have long-term consequences. In particular, the Fed's action tipped the political balance toward providing direct subsidies to households having trouble meeting their mortgage payments.

The bailout of Bear's creditors has allowed the political question to be reframed. Now voters can be asked more than whether federal aid should be given to overextended homeowners. Consider a question such as: "Given that the government has provided funds to an investment bank, do you think government aid should also be given to households failing to meet their mortgage obligations?" The word "also" describes an expansion of government and a redistribution of income as an exercise in fairness. In effect, greater unfairness among households in offering debt relief to some now seems insignificant when compared with the unfairness wrought by the Fed between the financial sector and households.

Another casualty of the Bear bailout is the Federal Reserve's reputation. The Fed has dealt with financial crises before. A key component in

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its response to past crises was that it entered each episode with open, but empty, hands. It would provide liquidity to the market as a whole, or even to banks, but it drew a firm line against lending to other institutions. That posture gave the Fed special status as an honest broker.

Pages from this central banking playbook include the encouragement of depositories to lend after the default of Penn Central in the commercial paper market in 1970, the provision of reserves after the stock market crash in 1987, and the good offices given to the private-sector creditors of Long-Term Capital Management in 1998 to work toward a mutually beneficially solution that did not involve taxpayer funds.

What will happen the next time top officers of key investment banks are thrown together to discuss a failing institution? Those titans of finance, not a charitable lot by profession, will no doubt ask: where is the government's contribution? While it was seventy years before the Fed lent in earnest to a nonbank firm for the first time, they will know that this does not mean that it will be seventy years until the next time. They will hold back, and hold out, until taxpayers' funds are at risk.

The world has changed because of a few snap decisions made one weekend in March. We do not yet have an adequate understanding of what happened and why. But we can be sure that the Fed's action will be used to argue for more spending and more regulation.