REUTERS/JIM YOUNG

COZYING UP TO BIG INVESTORS AT CLUB FED

SHOULD THE FEDERAL RESERVE PARCEL OUT DETAILS THAT CAN MOVE MARKETS?

SEPTEMBER 2010

REUTERS™

SPECIAL REPORT

THE TIES THAT BIND AT THE FEDERAL RESERVE

The U.S. central bank is not known for its communication skills. But when it comes to former Fed officials, the information can flow quite freely. Big investors are also privy to some of its secrets. Is it proper for the Federal Reserve to parcel out details that can move global markets?

EAGLE EYED: The U.S. Federal Reserve Building is pictured in Washington, December 15, 2009. **REUTERS/HYUNGWON KANG**

BY KRISTINA COOKE, PEDRO DA COSTA AND EMILY FLITTER
NEW YORK/WASHINGTON, September 30

TO the outside world, the Federal Reserve is an impenetrable fortress. But former employees and big investors are privy to some of its secrets -- and that access can be lucrative.

On Aug. 19, just nine days after the U.S. central bank surprised financial markets by deciding to buy more bonds to support a flagging economy, former Fed governor Larry Meyer sent a note to clients of his consulting firm with a breakdown of the policy-setting meeting.

The minutes from that same gathering of the powerful Federal Open Market Committee, or FOMC, are made available to the public -- but only after a three-week lag. So Meyer's clients were provided with a glimpse into what the Fed was thinking well ahead of other investors.

"THE RULES WHEN I WAS THERE WERE YOU DON'T TALK TO ANYBODY ABOUT ANYTHING THAT COULD BE USED FOR COMMERCIAL PURPOSES."

THE MAN: Federal Reserve Board Chairman Ben Bernanke testifies on Capitol Hill in Washington, Sept. 2, 2010. **REUTERS/MOLLY RILEY**

His note cited the views of "most members" and "many members" as he detailed increasingly sharp divisions among the officials who determine the nation's monetary policy.

The inside scoop, which explained how rising mortgage prepayments had prompted renewed central bank action, was simply too detailed to have come from anywhere but the Fed.

A respected economist, Meyer charges clients around $75,000 for his product, which includes a popular forecasting service. He frequently shares his research with reporters, though he kept this note out of the public eye. Reuters obtained a copy from a market source. Meyer declined to comment for this story, as did the Federal Reserve.

By necessity, the Fed spends a considerable amount of time talking to investment managers, bank economists and market strategists. Doing so helps it gather intelligence about the market and the economy that is invaluable in informing the bank's decisions on borrowing costs and lending programs.

But a Reuters investigation has found that the information flow sometimes goes both ways as Fed officials let their guard down with former colleagues and other close private sector contacts.

This selective dissemination of information gives big investors a competitive edge in the market. In the past, Fed officials themselves have privately expressed discomfort about the cozy ties between the central bank and consultants to big investors, though their concerns have largely fallen on deaf ears.

No one is accusing Meyer and his firm, Macroeconomic Advisers -- or any other purveyors of Fed insights for that matter -- of wrongdoing. They are not prohibited from sharing such information with their hedge fund and money manager clients.

"THE FACT IS THAT GOVERNMENT TODAY IS DRIVING THE MARKETS MORE THAN ANY TIME IN RECENT HISTORY."

SAFE HAVEN: A security officer patrols the front of the U.S. Federal Reserve building in Washington, June 24, 2009. **REUTERS/JIM YOUNG**

Haag Sherman, chief investment officer of Salient Partners, a Houston-based money management firm that oversees around $8 billion in assets, says even the slightest hint of the possible direction of policy can give investors a huge leg up.

"The fact is that government today is driving the markets more than any time in recent history and having insight into near-term and long-term plans provides a money manager with a significant competitive advantage," Sherman said.

Markets have been particularly sensitive to Fed policy in recent months as renewed weakness in the economy sparked widespread speculation that the central bank would try to ease borrowing conditions further, probably by ramping up its purchases of U.S. government bonds.

But critics question whether it is proper for Fed officials to parcel out details that have the potential to move markets around the world, especially with the government's involvement in the economy being so pronounced.

"It's certainly not what Fed officials should be doing," said Alice Rivlin, a former Fed governor and now a fellow at the Brookings Institute think tank. "The rules when I was there were you don't talk to anybody about anything that could be used for commercial purposes."

In an effort to counter concerns about close ties between business and government, U.S. President Barack Obama issued an "ethics pledge" that forbids appointees of his administration from contacting the agencies they worked under for at least two years after leaving.

But such measures are tough to enforce. And in the case of the Fed's Washington-based board, governors are allowed to transition directly into a banking sector job immediately after they leave the central bank, though they must first serve out a rather lengthy 14-year term, which many do not.

"COLOR" IN GRAY AREA

Against the backdrop of today's shaky recovery and the Fed's efforts to provide ongoing support to growth, information about what central bank officials agree or disagree on can be even more valuable than usual.

By adding to the over $1.7 trillion in such purchases undertaken in response to the financial crisis so far, the Federal Reserve would be providing further incentives for banks to lend and consumers to borrow -- despite the fact that official interest rates are already effectively at zero.

In his note, Meyer said many Fed officials hadn't found out about the pace of mortgage prepayments -- which meant the central bank's support for the economy was ebbing -- until just before the Aug. 10 meeting.

"For a few members, it was too late to affect their decisions; for others it was a very important factor, even the most influential factor," wrote Meyer. "Shouldn't the FOMC at least have a neutral balance sheet policy given the weaker outlook? This was obvious to the doves, persuasive to the center, but not the hawks."

Fed-watching, of course, has long been a cottage industry, albeit a fairly wealthy one. Investors are constantly looking for clues about what officials may or may not be thinking, parsing their language much like Kremlinologists of yore. And markets can jump at the first whiff of a change in tone.

For example, five days after Meyer's note, the Wall Street Journal published a more detailed account of the divisions on the Fed's policy-setting committee. The newspaper report was credited with moving bond yields 0.20 percentage point, a relatively steep decrease.

"THE REVOLVING DOOR BETWEEN THE FED AND THE PRIVATE FINANCIAL SECTOR IS QUITE SIGNIFICANT."

Small wonder that large funds are willing to shell out tens of thousands of dollars a year to receive "color" -- as investors refer to the useful tidbits that plugged-in consultants supply.

The precise number of former Federal Reserve employees tapping their network of old colleagues can't be determined, but by most accounts they are a sizable group.

"The revolving door between the Fed and the private financial sector is quite significant," said Timothy Canova, professor of international economic law at Chapman University School of Law in Orange, California.

There is no required registration process for economic and monetary policy consultants, former Fed lawyers say.

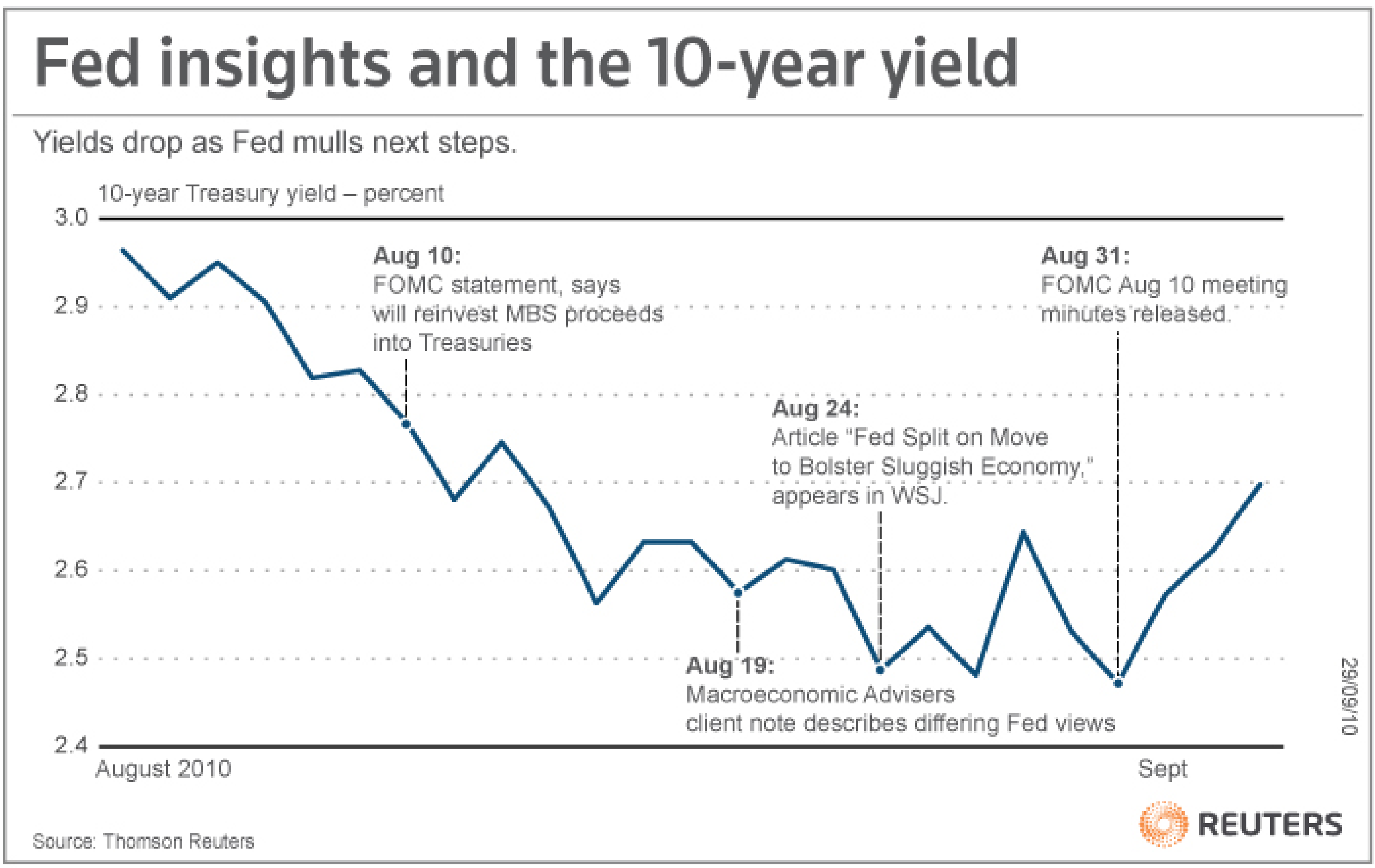
Some especially high-profile former Fed officials now have their own shops, too: Former Fed Chairman Alan Greenspan's Greenspan Associates offers policy consulting to Pimco, the world's biggest bond fund.

"THREE BIG FEDDIES"

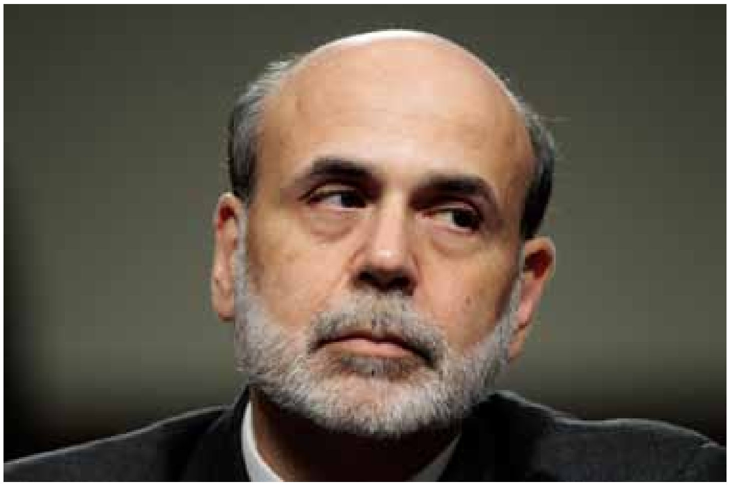
Though rarer, access is sometimes also bestowed upon outsiders. Paul Markowski, a China expert who counts hedge funds and foreign central banks among his consulting clients, has never worked at the Fed but says his relationships with officials there date back to the 1960s. For him, he says, it's a question of knowing the individuals on the committee well enough to understand their sometimes cryptic signals.

"You have to establish a relationship over time. If you go and see someone once or twice you are not going to be able to read what they are saying to you properly," he said. "They look at me, for one, as someone who has deep relations with the financial markets. It's a two-way street."

On the same day as the Fed's eventful August meeting, Markowski wrote to his clients: "While I thought they could hold off doing what they did, a senior Fed official told me that after measuring the risk of doing nothing they had little to lose and more to gain."



Reuters graphic/Stephen Culp



POKER FACE: Fed Chairman Ben Bernanke testifies before the Senate Banking, Housing and Urban Affairs Committee on Capitol Hill July 21, 2010. **REUTERS/MOLLY RILEY**

On Friday, Sept. 24, three days after the Sept. 21 meeting, he described a string of conversations with "three big Feddies."

Earlier in the year, just a day after the April 27-28 gathering, Markowski offered clients the type of material that, if true, went beyond anything even the minutes from the meeting would offer three weeks later:

"I had two interesting phone conversations with senior Fed officials -- one last night and another this morning. What I heard was that going into the meeting the staff were split 50:50 as to the recommendation on rates; there were 6 members who favored some change in the asset sales issue and 3-4 who favored changing (the Fed's commitment to keep rates low for an extended period), with another 1-3 suggesting putting the change off to the next meeting."

QUID PRO QUO

Of course, speaking to one or two officials at the central bank does not necessarily provide the full story, especially at a time when policymakers diverge on key issues such as the outlook for the economy and appropriate policy actions.

Niche analysts may also have a vested interest in exaggerating the extent of their access -- it makes their offering all the more enticing.

Some investors point out that markets are inherently volatile, and inklings into the broad contours of policy do not necessarily translate into an obvious short-term trading strategy.

"Having this information from the Fed would be beneficial only if you understood what the effects of what the Fed is doing might be," said Joseph Calhoun, strategist at Alhambra Investments in Miami.

Even those who seem to be in the know are not always right: both Meyer and Markowski called the Aug. 10 meeting wrong, thinking the Fed would hold pat when it in fact chose to provide additional stimulus.

But Canova, the Chapman law professor, says the immediate investment value of the information is not the main issue. For him, the backroom exchanges are part of a bigger problem of financial industry influence over economic decision-making.

"This is one of many quid pro quos in a system of opaque subsidies," Canova said. "It seems to me naive to think private investors would routinely share proprietary information without any legal obligation or subpoena unless they were getting some tangible benefits in return."

A DIFFERENT COMMUNICATIONS CHALLENGE

Over the past two decades, the Fed has become much more transparent than it once was. In the 1990s, it began releasing the results of its interest rate decisions and minutes of its policy meetings, as well as transcripts of those gatherings with a five-year lag.

Yet as institutions go, the Fed is hardly a paragon of openness. Chairman Ben Bernanke seldom speaks to the press on the record. When he does, it is often during well-orchestrated, pre-vetted events. During the financial crisis, Fed lending to troubled financial institutions, including the infamous rescues of AIG and Bear Stearns, was done hurriedly and behind closed doors, fostering public suspicion and political ire.

"THIS IS ONE OF MANY QUID PRO QUOS IN A SYSTEM OF OPAQUE SUBSIDIES."

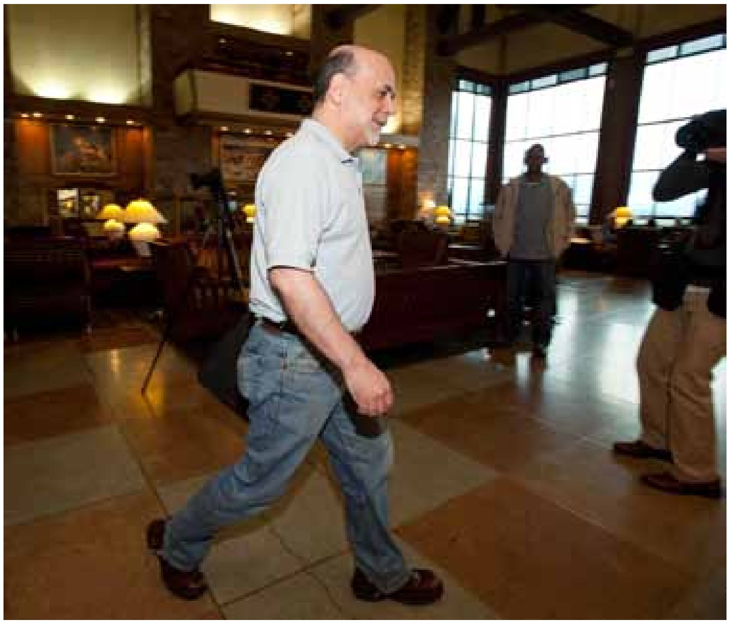
The Fed's opaque communications structure makes it easy for markets to misinterpret the rather terse policy statements released after each meeting, adding to the demand for kernels of wisdom about their decisions.

The pitfalls of the Fed's communication strategy were highlighted by the Aug. 10 meeting. Just a few weeks earlier, Bernanke had spent the bulk of his testimony to Congress discussing the central bank's eventual exit from its ultra-accomodative policies. And the Fed had done little to explain to markets the link between the economic outlook and the size of its balance sheet.

For many investors, therefore, the policy pivot on Aug. 10 -- the decision to buy more bonds -- came out of the blue. Markets broadly took the Fed's move as a significant shift towards more support for the economy. Some market participants also interpreted it as a sign the Fed was more worried about the economy than it was letting on.

When its policymakers are on the same page, the Fed often has no trouble making its position known following its FOMC meetings. But when policymakers disagree, as has been the case recently, the cacophony of voices can merely confuse markets.

That may be one reason Fed officials feel the need to help investors better understand the public statements they make.



BUSINESS CASUAL: Fed Chairman Ben Bernanke enters the Jackson Hole Economic Symposium in Grand Teton National Park August 28, 2010. **REUTERS/PRICE CHAMBERS**

Other central banks around the world try to avoid such risks by taking a different approach. Some strip away some of the mystery around policy by stipulating a specific inflation target. The European Central Bank holds a press conference after its key meetings that gives its president, Jean-Claude Trichet, a chance to explain the reasoning behind its actions in a public forum.

"If Bernanke can't stop the leaks he ought to have a full press conference after the meeting. It's inappropriate for certain people to gain an advantage on information from the Fed," said Ernest Patrikis, a former No. 2 official at the Federal Reserve Bank of New York and now a partner at law firm White & Case.

CLUB FED

For the U.S. Federal Reserve, the willingness to share market-sensitive information may reflect the institution's history and culture. Critics have long argued that the central bank has been too close to the financial industry.

The Fed was established in 1913, in part as a response to the panic of 1907, by bankers who wanted a lender of last resort to help prevent frequent runs on the nation's financial institutions.

Bankers still serve on boards of directors of regional Fed banks and former Fed staffers are hotly sought after on Wall Street and in the investment community.

Meyer founded his consulting firm, then called Laurence H. Meyer and Associates Ltd, before joining the Fed in 1996. When he left the Fed in 2002, he returned to his firm, now called Macroeconomic Advisers.

Another example is Susan Bies, who retired from the Fed's board in 2007, and took a job on the board of Bank of America in 2009. A number of chief economists at top U.S. banks at some point have also held staff positions at the Fed.

Going the other way, William Dudley, head of the powerful New York Federal Reserve Bank, was the chief economist at Goldman Sachs and a partner at the firm.

Critics say this revolving door structure makes it difficult for Fed staffers to be disciplined in not inadvertently revealing too much in conversations with old colleagues and friends.

Fed board staffers who retire even get to keep their pass for the central bank's building, which boasts fitness facilities, a barber and a dining room.

Though their identification badges designate their "retired" status, they are not restricted to where they can go once inside the building -- even if they now work in the private sector.

Nowhere is the sense of cliquish old-world camaraderie more evident than at the Fed's annual gathering for world central bankers in Jackson Hole, Wyoming. Receiving an invitation to the exclusive event is no small feat, and economists take pains to get themselves on the short list. Being there means face time with Fed officials in an informal setting -- and more importantly, a stamp of legitimacy that is difficult to put a price tag on.

This year's conference, held in late August, featured not only panels on monetary policy and a string of speeches from leading central bankers and academics, but also an unusual evening excursion to watch a horse-whisperer tame a wild stallion.

"Too often, the Federal Reserve believes that rules do not apply to them," said Sherman at Salient Partners. "If we allow some to have access, then how are we different than those that follow 'crony capitalism' in the Third World?"

COVER PHOTO: The U.S. Federal Reserve is reflected in a car as a security officer patrols the front of the building in Washington, June 24, 2009 2010. **REUTERS/JIM YOUNG**

FOR MORE INFORMATION CONTACT:
Jim Impoco, Enterprise Editor, Americas
+1 646 223 8923
jim.impoco@thomsonreuters.com

Claudia Parsons, Deputy Enterprise Editor
+1 646 223 6282
claudia.parsons@thomsonreuters.com

Kristina Cooke
+1 646 223 6154
kristina.cooke@thomsonreuters.com