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Why the Federal Reserve is Irrelevant

Alan Greenspan isn't the "Maestro." He's Oz.

By John P. Hussman, Ph.D.
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The Federal Reserve is irrelevant. We don't just mean ineffective, though that is certainly likely to be true here. Rather, because of a change in the application of reserve requirements over the past decade, Fed actions have virtually zero impact on lending activity in the U.S. banking system.

The main job of the Federal Reserve is to determine the mix of government liabilities held by the public. When the Fed "eases monetary policy" or "cuts interest rates", it accomplishes this as follows. The Fed goes into the open market, buys a bunch of Treasury securities from banks (who have drawers full of them), and pays for them by creating new bank reserves.

Pull a dollar bill out of your wallet. Look at the very top line on the front. It says "Federal Reserve Note." That dollar bill is essentially a liability of the Federal Reserve. The Fed also has a corresponding asset - the Treasury securities it buys.

When the Fed "cuts interest rates", what it is really doing is replacing one government liability held by the public - Treasury securities - with another government liability: currency and bank reserves (monetary base). That's all the Fed does. It determines the mix - but not the total amount – of government liabilities held by the public. Since the operations of the Fed are executed by buying or selling securities on the open market, the group at the Fed responsible for these decisions is called the Federal Open Market Committee, or FOMC.

Banks are required to hold reserves as a percentage of all *checking accounts* outstanding. These reserves prevent overdrafts, and provide for day-to-day withdrawals of currency and the like. On any given day, some banks will have a reserve shortfall, while others will have excess reserves. These excess bank reserves are lent back and forth between banks on an overnight basis, at an interest rate known as the Federal Funds Rate.

Essentially, the Fed lowers the Federal Funds rate by purchasing Treasuries from banks and increasing the "monetary base" - bank reserves plus currency in circulation. The only thing that the Fed can control with certainty is the monetary base. Alternately, it can *try* to control the Federal Funds rate (and passively adjust the monetary base by whatever amount is required to keep Fed Funds on target). However, the Fed cannot control the Federal Funds rate with certainty. For example, if inflationary pressures were high and interest rates were moving up, the Fed could not predictably lower the Fed Funds rate by easing monetary policy. Not surprisingly, central banks always target money growth, not interest rates, when inflation is high. That's why Volcker targeted money supply, while Greenspan targets interest rates. But ultimately, the only thing that the Fed can directly control is the monetary base.

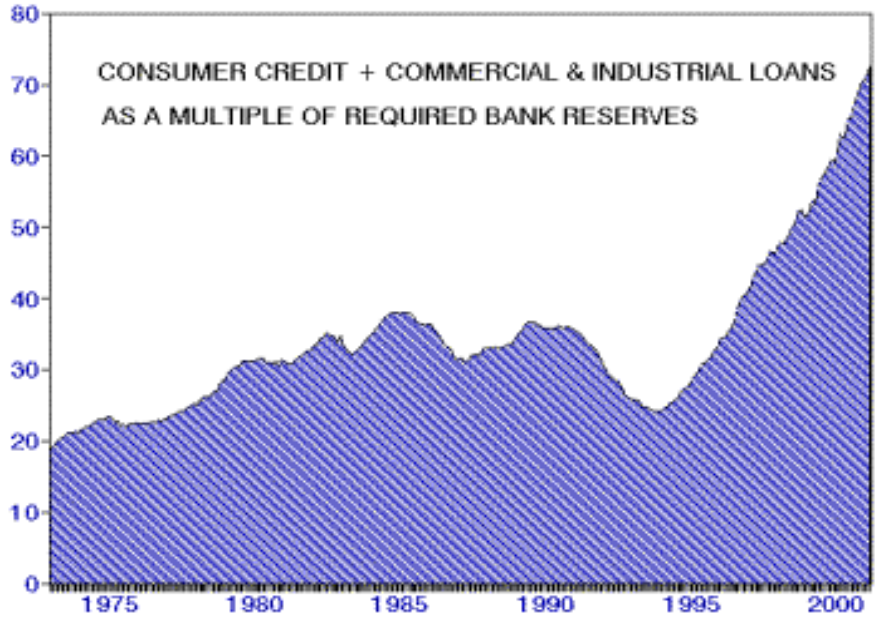
The "money multiplier" loses its magic

Alright. So when the Fed is easing, it increases the monetary base by purchasing Treasuries on the open market. When the Fed is tightening, it reduces the monetary base by selling Treasuries on the open market. Now that we're clear on what the Fed does, let's take a look at why it is irrelevant.

Activist monetary policy is based on the assumption that there is a predictable relationship between bank reserves and bank lending. The operative notion of easy money is that the Fed creates new bank reserves, and banks lend them out. These loans get spent, and the proceeds get deposited at other banks as new checking accounts. Whatever is not required to be held as reserves is then lent out again, and through the magic of the "money multiplier", loans and bank deposits go up by many times the initial injection of reserves.

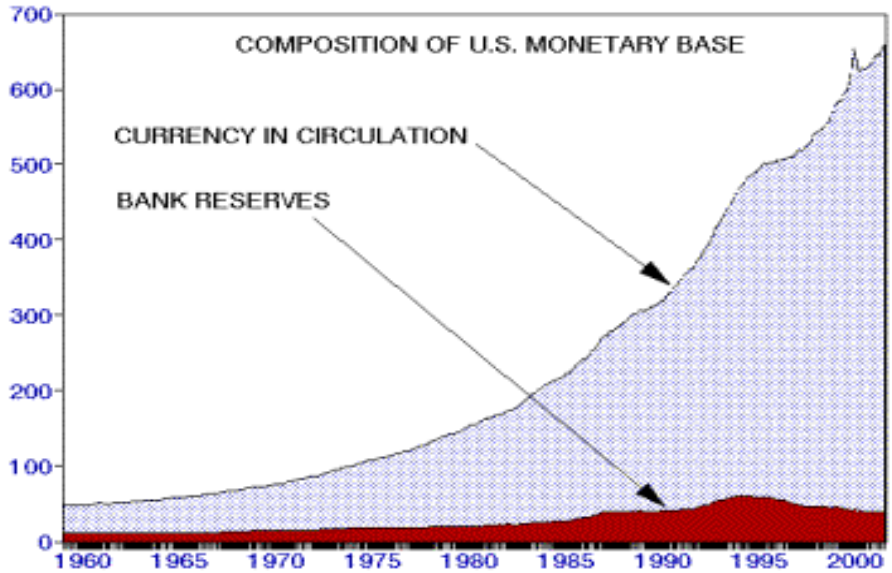
That's the theory. But a change came in the 1970s with the emergence of money market funds, which require no reserve requirements. Then in the early 1990s, reserve requirements were dropped to zero on savings deposits, CDs, and Eurocurrency deposits. **At present, reserve requirements apply only to "transactions deposits" - essentially checking accounts. The vast majority of funding sources used by banks to create loans have nothing - *nothing* - to do with bank reserves.**

These days, commercial and industrial loans are financed by issuing large denomination CDs. Money market deposits are largely used to lend to corporations who issue short term commercial paper. Consumer loans are also made using savings deposits which are not subject to reserve requirements. These loans can bunched into securities and sold to somebody else, taking them off of the bank's books.



The point is simple. Commercial, industrial and consumer loans no longer have any link to bank reserves. Since 1995, the volume of such loans has exploded, while bank reserves have actually *declined* . Look at the one monetary aggregate that the Fed can directly control - the monetary base. Every bit of increase since January 1994 is accounted for by currency in circulation, *not* bank reserves.

Over the past year, the Fed has eased very aggressively, buying about $32 billion in Treasuries, with a corresponding $32 billion increase in the monetary base. Now look closer. Total bank reserves actually *declined* by $1 billion while currency in circulation has increased by $33 billion.



Alan Greenspan isn't the "Maestro". He's Oz - working behind the curtains, leaning into the microphone, pressing buttons that blow smoke and fire, but not really having much power at all. Scarecrow already *has* a brain. For the past several years, commercial and industrial loans and consumer credit exploded quite simply because rabidly eager borrowers

were able to find rabidly eager lenders. And now, both forms of credit (as well as commercial paper issuance) are declining because borrowers are saturated with debt and lenders are increasingly skittish of credit risk.

The Fed certainly played an important *psychological* role in recent years, and *certainly* has a role to play during bank runs and other crises where the demand for monetary base soars. But the rest of the time, open market operations are almost completely sterile. In recent years, the irrelevance of open market operations has also been argued (for slightly different reasons) by academic economists renown for their work in the theory of “rational expectations”, including Thomas Sargent and John Muth.

Inflation follows unproductive government spending

One might respond that even if the Fed doesn't affect credit, surely changes in the monetary base affect inflation. But if you look at the statistical evidence, the relationship between monetary growth and inflation is very weak. Instead, our research indicates that *inflation is primarily the result of growth in unproductive forms of government spending* (basically defense spending, entitlements and other expenditures that fail to stimulate the supply of goods). The evidence both from the U.S. and other countries clearly demonstrates this relationship.

As Milton Friedman has noted, the burden of government is not measured by how much it taxes, but by how much it *spends* . The impact is particularly severe when growth in entitlements is high and growth in productivity is low. This is why inflation exploded after the late 60's, and why it came down after the early 1980's. This is why the Germans suffered hyperinflation after World War I when its government decided to keep paying workers who had gone on strike.

Always and everywhere, rapid inflation is produced by excessive creation of government liabilities without a corresponding increase in the amount of goods produced by the economy. The *Fed* doesn't control this. It doesn't even matter much what form the liabilities take. If the Germans had decided to issue bonds to striking workers instead of money, bond prices would have been driven to ridiculously low levels, driving interest rates to extremely high levels, creating an unwillingness to hold non-interest bearing money, resulting in a rapid deterioration in the value of money, and hyperinflation just the same.

Except for the Federal Funds rate, the Fed does not determine short-term interest rates. Most of the time, it simply follows them. Statistically, the Federal Funds rate consistently lags market interest rates such as Treasury bill yields. Indeed, changes in market rates have far more predictive power to forecast the Federal Funds rate than vice versa.

The main exception is the Prime Rate. Changes in the Prime Rate follow changes in the Federal Funds rate largely because 1) competition forces equality of lending rates; 2) the Fed Funds rate tracks other short term rates, and; 3) changing Prime in unison at any other time than a discrete Fed move would be considered evidence of collusion among banks.

So don't place too much faith in the Federal Reserve. Again, in a banking panic, where the demand for the monetary base soars, the Fed is *essential* . But here and now, the Fed is, and probably will be, hopelessly ineffective.

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