

BULL AND BEAR BULLETIN

Is the Federal Reserve Board Promoting Instability?

The Federal Reserve System was created by Congress in 1913 to promote financial stability in the United States. Over time, the Federal Reserve's role has expanded in response to multiple economic and financial catastrophes. Today, as stated in the ninth edition of *The Federal Reserve System: Purpose and Functions*, the Federal Reserve has four primary responsibilities: conducting the nation's monetary policy by influencing the monetary and credit expansion in the pursuit of maximum employment, price stability and moderate long term rates, supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking sector to protect the credit rights of consumers, maintaining the stability of the financial system and containing systematic risk that may arise in financial markets and providing financial services to depository institutions, the US government and foreign officials.

While each responsibility of the Federal Reserve possesses its own unique benefit to our society, the first responsibility may be the most important as it relates to the perpetual prosperity of our country. The ability to control a country's monetary policy and influence credit expansion has a profound influence upon, as highlighted by the Federal Reserve, the level of unemployment, inflation and interest rates. These three variables tend to have the utmost impact on each citizen's daily life and his/her respective prosperity.

To manage monetary policy, the Federal Reserve has three primary tools at its disposal: setting interest rates on overnight loans to banks, called the discount rate, determining the amount of money banks must hold in reserve with the Federal Reserve and the ability to purchase and to sell U.S. Treasury and federal agency obligations in the open market. The Federal Reserve Board's standard response to an economic contraction and/or financial crisis has been to utilize these three tools to reaccelerate the level of credit expansion and money supply in the economy in an attempt to return the economy to the previous growth trend.

In order to promote credit expansion and its overwhelming benefit to the growth of the U.S. economy, the Federal Reserve may lower the level of reserves that banks must hold with the Federal Reserve and/or lower the discount rate at which banks may borrow from the Federal Reserve. The lower reserve requirement and the lower discount lending rate provide banking institutions with additional money to lend to their customers, expanding the level of credit in society and subsequently driving additional economic activity. Since its inception, the Federal Reserve has used this tactic to counter economic slow downs and to restore economic prosperity. While the Federal Reserve's tactics have worked in the past, we discussed several months ago how this approach has become less efficient with every deployment.

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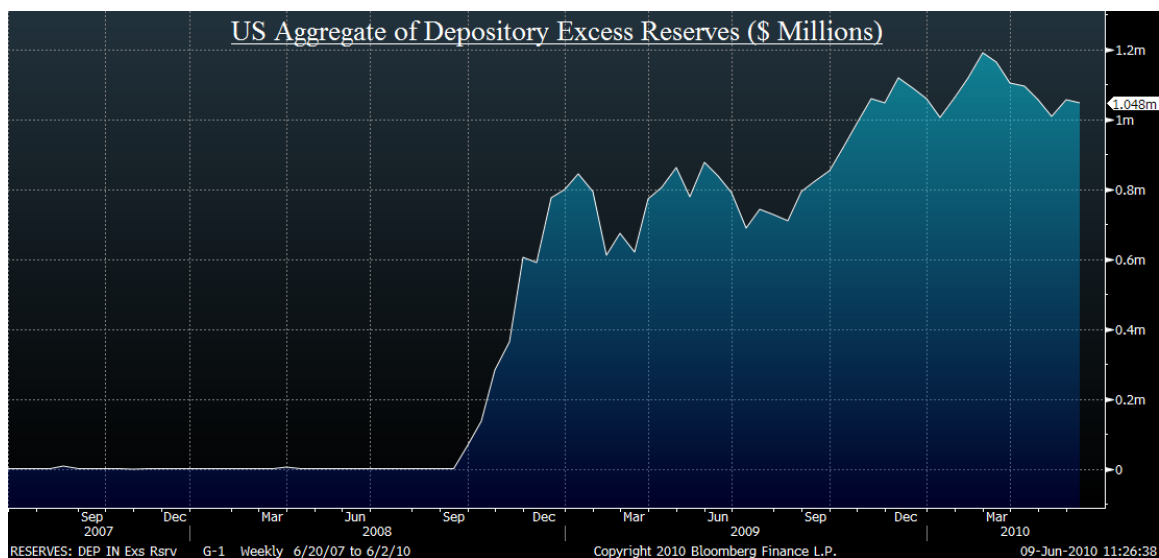
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Despite the growing inefficiency, it still remains intuitive that the Federal Reserve actions remain prudent given the financial crisis we have witnessed over the past three years. But is the current unprecedented sub-1.0% interest rate policy truly the best course of action for the long term stability of the United States? The truth may be that the Federal Reserve is limiting the level of credit expansion, while simultaneously risking greater long term instability via the transformation of private debt into public debt, the promotion of recklessly low interest rates and by pushing banks away from the traditional deposit lending business model.

By allowing banks to borrow from the Federal Reserve discount window at extremely low rates, paying interest on both required reserve deposits and excess reserve deposits (those monies held in reserve at a Federal Reserve bank above the required level), the Federal Reserve Board has provided banks with a financial incentive to maintain additional reserves and to grow their own internal investment portfolios. As proof, the excess reserves held at the Federal Reserve have swelled from roughly \$2 billion to over \$1 trillion (Chart 1). With the Federal Reserve paying 0.25% on excess reserves, depository institutions are earning a collective \$2.5 billion annually. Furthermore, by borrowing cheap and investing in risk free U.S. Treasury obligations, banks are also capable of earning a profit on their investment portfolios with minimal risk. While the profitable arbitrage environment has allowed banks to improve their earnings and financial stability, it has replaced the traditional deposits and lending operations that promote credit expansion within our economy.



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Outside of the traditional monetary policies of the Federal Reserve is the government's use of mortgage agency conservatorships. In an attempt to reaccelerate the housing market and to protect the banking industry from additional loan losses, the government has allowed Fannie Mae, Freddie Mac, FHA and other similar government lending agencies to become the holder of last resort. In 2009, government mortgage agencies held a significant majority of the newly issued U.S. mortgages. By receiving origination fees on new mortgages and subsequently selling the mortgages to a government mortgage agency, banks earn an additional risk free profit. The kicker of the situation is that the government has contributed hundreds of billions of dollars of taxpayer money into the government agencies to offset their massive losses and to ensure their continued existence, despite creating a further incentive for banks to avoid the traditional deposit lending model.

If the Federal Reserve wants to maintain its primary goal to promote credit expansion and price stability, it needs to end the free lunch for the banking industry. By increasing the interest rate on bank borrowings, eliminating interest earned by banks on excess reserves and winding down the government mortgage agencies, the Federal Reserve would be acting in a manner to force lending institutions back to the normal risk assumed and less profitable deposit-lending business model.

Some analysts and banking institutions may argue that the outcome to such a policy change would lead to higher interest rates on loans and tighter lending standards, thereby, limiting the amount of credit expansion even further. They are probably right, but only in the short term. I would ask them if the level of lending in the years proceeding the recent recession was truly healthy for the long term benefit of our country and the stability of the banking sector? Is a return to that environment what we so desperately seek? While credit expansion would contract in the short term, it would certainly return to a more normalized and sustainable level, a level that would promote greater long term financial stability, credit expansion and economic prosperity.

Although interest rates on loans would increase from the current level, gone would be the days of banks earning a profit while passing the risk to taxpayers. Gone would be the days of irrational lending practices. Gone would be the days of society's over indebtedness. Gone would be the days of retirees' earnings returns below inflation on their fixed income investments and savings.

So, while the Federal Reserve Board continues its attempt to reaccelerate credit expansion to a level that was artificially high and beyond a normalized range, ushering in greater financial instability, it should begin to ask itself if its policy has brought Main Street and the economy any true long term benefit. It may find that the only benefit has been to the financial sector and a failure to achieve its primary goals of long term prosperity through sustainable employment, price stability and credit expansion.