Déjà vu, Yogi & The Fed

Why are we watching and guessing when the Fed will begin to raise interest rates and when it really does not matter? Monetary Policy is not only about interest rates. Earlier in the week a golf buddy of mine(Dennis Lockhart, Atlanta Fed President) gave a speech in NYC suggesting that the Fed will probably begin to raise rates in 2015. The stock market reacted negatively to the wrong point once again. Too funny since Liquidity drives growth more than interest rates as my research has shown.

Monetary Policy is effective when the Fed adds or subtracts reserves from the banking system; which either increases or decreases “aggregate demand” better known as “Total Spending.” Quantitative Easing (QE) began when Bernake, Paulson and Geitner determined that the market liquidity for Mortgage Backed Securities was frozen, dysfunctional and basically broken. They thought about bring Bill Gross in to resume trading but could not figure out how to actually restore the market to normal trading levels. Please refer to “Stress Test” by Timothy Geitner for the rest of the story. Mark- to- market accounting rules were making a bad situation even worse. So they infused massive amounts of liquidity into the banks as a daring show of force and commitment from the Fed and Treasury. That led to charges of Moral Hazard and too Big to Fail arguments. We all remember those days quite vividly. My point is that QE was not designed as a stimulus as claimed by the Government soon thereafter. What happened to QE 1-3 and the excess reserves created thereby is what this article is about. The economy did not tank once tapering began because the “excess reserves” created by QE never found their way into the system. So where did they go? The Fed “printed money” in exchange for bonds. Who sold those bonds to the Fed? The banks did, holding the payment from the Fed in “excess reserves.” The Fed Balance sheet grew by 26% per year to $4.2 Trillion. Thus far the Fed has shown Zero inclination to reduce that number. Therefore, whether the Fed raises interest rates by 25 bps really won’t mean much. The supply of money as measured by M2 (total bank deposits) has only grown 6.6% per year (vs. 26% for the Fed’s Balance Sheet) since late 2008. As long as reserves remain the same, the Fed’s interest rate lever is nullified. When we see a drop in liquidity, then a rate hike could be meaningful. Had the Fed raised rates last week, it would have agreed by doing so, to pay more to the banks for their excess reserves not to lend. The Fed receives interest on its $4.2 Trillion in bonds some of which it pays to banks(25bps today) on the cash reserves they hold. The difference between the two or “spread” generated a profit for the Fed in 2014 of $100 Billion which it paid to Treasury. A 25bps increase in the Fed Funds Rate would reduce this profit by $7 Billion and the banks would get that $7 Billion. So which government official wants to pay the banks $7 Billion more at the expense of the Taxpayers? Where is the incentive? And if we look ahead to a target rate of 2 or 3%, there would be a $7 Billion “check” from taxpayers at every 25bps bus stop or $28 Billion for every 1% rise in rates. In this election cycle which politician will campaign based on a policy to pay more to Wall Street? Who would dare reward the villain from the 2007/2008 crisis in such a manner. Although government policies such as requiring Fannie and Freddie to buy sub-prime mortgages certainly had a lot to do with the recession and collapse of housing. But government has chosen to place all of the blame on Wall Street greed while ignoring the role of government in creating the crisis.

So once again we are looking at the wrong data and reacting badly. We lost Yogi Berra this week, my first favorite player and as he once said: ”Its Dej Vu all over again.” Or Y 2K or the Sequester, or Greece or Syria or China or the election. Market Volatility has emerged once again but for the wrong reason. We should focus on what really might make a difference but we rarely do. The agenda of the media driving for revenue growth(think CNN and the Republican debates) and politicians in an election year and one can see why we are looking at the short, more simplistic issue of the Fed rate hike rather than the more complex matter of the Fed bloated balance sheet and the incentive for the banks to sit on excess reserves while collecting billions from the taxpayers. The Fed does not have secret information that no one else has. So follow the money, focus on changes in liquidity(excess reserves) not just the prospect of the first Fed rate hike since December 2008. We will miss you Yogi, thanks for the 4 memories of your wisdom. Bob Green 9/23/2015