January 1, 2014

QE—The Experiment of the Federal Reserve

After 100 years, the Federal Reserve System remains an enigma within the United States. This is in spite of a clear mission statement that articulates:

The mission of the Board is to foster the stability, integrity, and efficiency of the nation's monetary, financial, and payment systems so as to promote optimal macroeconomic performance.[1]

The Strategic Goals of the Fed are to:

1. conducting monetary policy that promotes the achievement of the Federal Reserve's statutory objectives of maximum employment and stable prices
2. promoting a safe, sound, competitive, and accessible banking system and financial stability
3. developing regulations, policies, and programs designed to inform and protect consumers, to enforce federal consumer protection laws, to strengthen market competition, and to promote access to banking services in historically underserved markets
4. fostering the integrity, efficiency, and accessibility of U.S. payment and settlement systems
5. providing oversight of the Reserve Banks
6. fostering the integrity, efficiency, and effectiveness of Board programs

Since the founding of the Federal Reserve System in 1913, the United States has experienced a number of economic boom and bust periods. The economic boom of the "Roaring Twenties" and the subsequent "Great Depression" of the 1930's is expressed in Liaquat Ahamed's 2010 Pulitzer Prize-winning book *Lords of Finance: The Bankers Who Broke the World.*[2] Ahamed describes how the laissez-faire, free-for-all economic policies of the Fed of the 1920's produced a wild and upward economy and stock market rise, followed by a stock market collapse in 1929. It was the Fed's restrictive monetary policies (Quantitative Tightening or QT) which may have contributed to the duration and severity the economic Great Depression of the 1930's. Having a change of heart, the current Fed decided to deal with the Great Recession (2007-2009) by utilizing Quantitative Easing (QE) to avert a full-blown financial crisis. On February 1, 2006, Congress appointed Ben Bernanke as Chairman of the Federal Reserve System. It was a stroke of luck because he was a student of the Great Depression and was highly respected for his knowledge of how monetary policy (QT) contributed to the Great Depression.

At the height of the economic crisis, the Fed Chairman Bernanke and U.S. Treasury Secretary Hank Paulson orchestrated the insolvency and acquisition of investment banker and brokerage firm Bear Stearns, along with the $150 billion dollar bail out of insurance giant AIG. A $540 billion loan to money market funds was necessary to stop a global run on the banks. Wachovia

[1] http://www.federalreserve.gov/publications/gpra/files/2010-gpra-performance-report.htm#2
[2] http://www.amazon.com/Lords-Finance-Bankers-Broke-World/dp/0143116800/ref=la_B001KD0PL0_1_1?s=books&ie=UTF8&qid=1390319828&sr=1-1

Bank and Merrill Lynch were forced to be acquired, as were Washington Mutual and many other smaller banking institutions. Goldman Sachs was forced to convert from an investment bank to a FDIC-insured bank in order to prevent insolvency.

Once the immediate financial crisis was contained, interest rate policy and Quantitative Easing (QE) became the primary tools used by the Fed to stabilize the fragile economy. Interest rates have been held artificially low for over 5 years as the Fed endeavors to stimulate economic growth through low cost borrowing and thereby reduce unemployment. QE is the Federal Reserve's program of purchasing bonds from its member banks to increase the money supply. In the past, the Fed purchased mortgage backed securities (MBS) and U.S. Treasury notes, and issues credit to the banks' reserves to buy bonds. This is known as open market operations.

Prior to the 2008-09 recessions, the Fed held between $700-800 billion of Treasury notes on its balance sheet. As a result of QE the Fed balance sheet has nearly quadrupled (**Chart 1**). It is by far the most massive economic stimulus program in world history. It is believed that increasing the money supply will reduce the borrowing costs for households, businesses and the U.S. Treasury, spurring GDP growth and employment.

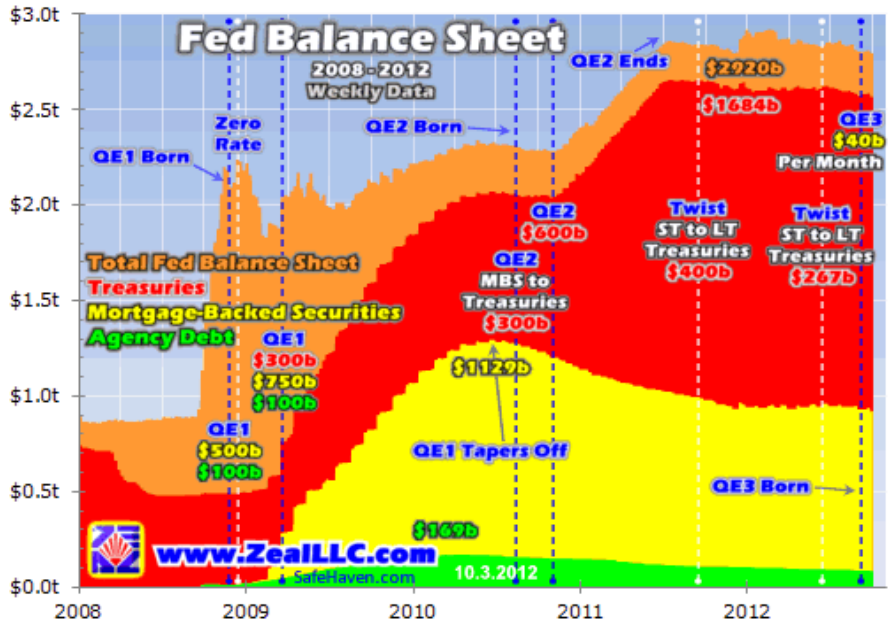

Chart 1. Fed Balance Sheet.
Source: SafeHaven.com

The economy has shown a 10% GDP growth since the 2007-2009 Great Recession according to noted economist Gary Shilling, averaging 2.3% annually. Since the post WW II era, real growth averaged 3.4%. To what degree the economy may have grown without Fed intervention or what impact the Fed policy has had, is immeasurable. In a recent speech, Bernanke reiterated the positive effects on the economy from Fed's commitment to hold down interest rates and its asset purchases, they are "somewhat less certain about the magnitude of the effects on financial conditions and the economy of changes in the pace of purchases or in the accumulated stock of assets on the Fed's balance sheet."[3]

Shilling noted that "The Fed is well aware that other than pushing up stock prices, its asset-buying program is having little impact on the economy." In the third quarter (of 2013), "S&P 500 profit margins at 9.6% were a record high but revenues rose only 2.7% from a year earlier." "This reflects the productivity-enhancing investments American businesses have been using to propel profit margins and the bottom line in an era when sales volume has been weak and pricing

[3] http://www.businessinsider.com/gary-shilling-deleveraging-2013-12

power absent." Certainly, Fed policy has had a significant, yet unverifiable influence on financial assets and the economy. Shilling adds, "Driven by the zeal for yield due to low interest rates and the rise in stock prices that has elevated the S&P 500 more than 160% from its March 2009 low, a degree of speculation has returned to equities."[3]

For investors who "fought the Fed," misunderstood Fed economic policy, or failed to act upon the Fed's actions (benefiting financial assets), investment returns have likely been sub-par. The uncertainty of the consequences of the Fed actions kept many investors out of the equity markets entirely, or they maintained limited equity exposure. For those investors who fully participated with the Fed, their investment returns have likely been most satisfactory.

The stock market peak of October 2007 witnessed the beginning of the greatest economic crisis in modern world history, second only to that of the Great Depression of the 1930's. The response of the global central bankers, lead by U.S. Fed Chairman Ben Bernanke, will likely go down in history as one of the most brilliant displays of central bank economic intervention and creativity, unparalleled in financial history.

The Fed policy under Chairman Greenspan of reducing regulations, an easy monetary policy, low interest rates, high margin borrowing, coupled with Wall Street's issuance, then collapse, of over-leveraged and high-risk Collateralized Debt Obligations (CDO's) and Collateralized Mortgage Obligations (CMO's), contributed significantly to the crisis.

The 100-year history of the Federal Reserve System is one of both success and failure. Certainly the Fed has been a major factor in influencing economic policy in the most recent financial crisis and also during the Great Depression. The mandate to promote a safe, sound, competitive, and accessible banking system and stable financial markets has been a mixed bag at times. Without question, the Federal Reserve has navigated well through the recent crisis, benefitting the U.S. as well as the global community. It is unknowable what might have transpired for the global economy in 2008, had the central bank's economic interventionist policies failed to produce the desired results. Could the economic crisis have become even greater and more severe than that of the 1930's? Perhaps of equal interest is what will be the long–term economic consequences of the massive debt created by the monetary stimulation advanced by the Federal Reserve? Time will tell.

- Roger L. Johnson