Tea Leaf

…weekly since 1976

Your guide to understanding today's economy and financial markets

September 30, 2009

view previous issues

The Fed's Overseer

Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

"The Federal Reserve should be abolished," writes Ron Paul, "because it is immoral, unconstitutional, impractical, promotes bad economics, and undermines liberty."

Congressman Ron Paul (R-Texas) ran for President in 2008. He is highly likely to run again in 2012. He has a fervent, but small, following of highly conservative people. At the risk of upsetting some of my readers, I see him as a nice man with highly flawed political views.

He has a new book out entitled "*End the Fed*." In a perhaps nicer-than-it-should-have-been USA TODAY book discussion, the reviewer noted some of Paul's basic desires, without taking him to task on any of them…

…no such luck here

Paul notes that the central bank (the Fed) "can create trillions of dollars and distribute them to its cronies without congressional oversight." He notes that the Fed's monetary policy benefits bankers, rather than the common man.

He suggests that with the dismantling of the Fed, rationality would be restored to monetary policy. With limits on the printing of money, inflation would halt, the dollar would keep is value, and banks and governments would spend within their means.

…where to begin

First up…a basic point of agreement with Paul and other critics of the Fed. The Federal Reserve DOES have the ability to create money out of thin air. However, such a process has NOTHING to do with a printing press.

The Fed can create, or destroy, "money" through a process called "open market operations." This action involves the buying or selling of securities from select money center banks and brokerage firms to increase or decrease bank reserves. However, with this ability to "create money" comes an extremely high level of responsibility to do so prudently.

They Don't Get It

What Paul and other Fed critics don't understand is that the Federal Reserve has an overseer…something or someone IT has to answer to. That something is the American bond market.

Earlier in my career I was a bond portfolio manager for a commercial bank. I have spent the past 12 years as an economic advisor to one of the largest and oldest bond sales and bond trading operations in the nation.

I fully respect the power of the bond market to force the Fed to act responsibly and to keep inflation pressures under control. Veteran (meaning old) players and observers of the bond market like me remember a time when the Fed did not act responsibly.

Another Time

During the early 1970s, Fed Chairman Arthur Burns arguably kept money growth too aggressive in an attempt to help Richard Nixon gain re-election in November 1972. This result, combined with a quadrupling of oil prices in the mid-1970s, contributed to greater and greater inflation pressures as the decade rolled on.

President Jimmy Carter's disastrous appointment of corporate executive G. William Miller to replace Burns as Fed Chairman in March 1978 was a case of "the emperor having no clothes." Miller had absolutely no background in monetary policy and was viewed as a Carter puppet from day one.

Inflation pressures continued to move higher and higher, averaging nearly 11.0% annually during 1978-1981. Bond prices fell sharply as long-term interest rates moved much higher to reflect higher inflation expectations. Bond portfolio losses were enormous and widespread.

The U.S. dollar was getting hammered around the world. President Carter was forced only 17 months later to replace Miller with Paul Volcker, a very highly regarded monetary expert.

jeff thredgold, CSP
ECONOMIC FUTURIST

THREDGOLD ECONOMIC ASSOCIATES

The TEA Company
A Professional Speaking and Economic Consulting Company
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
801-614-0403
www.thredgold.com

Volcker was a game changer. He soon pushed the Fed's key short-term interest rate (the federal funds rate) to as high as 19.5%. The prime lending rate was 21.5%. Fixed-rate mortgages, if you could get one, were 15% or higher. The U.S. economy soon dropped like a rock, with what was at the time the most serious recession since the Great Depression.

The Good News?

Within 24 months Volcker broke the inflation paranoia…broke the inflation psychology that ruled the economy. Bond portfolio managers, who suffered enormous portfolio losses, collectively said "never again."

Bond market pressure upon the Fed since a generation ago to act responsibly has largely been effective, with the Consumer Price Index (the CPI) rising at an average annual rate of 3.0% since 1982…and only 2.4% annually since 1997.

In fact, the CPI has actually declined 1.5% during the most recent 12-month period. A small contained rise in annual inflation is beneficial to allow for expanding business activity and a growing population.

The Fed Today

During the past two years, the Fed, along with the U.S. Treasury, has taken unprecedented steps to address the most serious threat to the U.S. and global economies since the Great Depression. The atmosphere in financial markets 12-24 months ago was truly scary.

The Fed's key rate has been at a target level of 0.00% - 0.25% since last December, a record low. The Fed's Open Market Committee suggested last week that the rate could stay at this low level for "an extended period."

At the same time, the Fed has more than doubled the size of its balance sheet—all with newly created "money"—to aggressively buy more than a $1 trillion of U.S. Treasury and mortgage-backed securities as a means of keeping long-term mortgage rates low, thereby helping the nation's housing market to stabilize.

To many Fed critics, this massive expansion of money creation, combined with mind-boggling budget deficits, will lead to a huge increase in inflation in coming years. This is not the consensus view.

Federal Reserve Chairman Ben Bernanke

The Fed will face major challenges during 2010-2012 to keep inflation pressures under control. The Fed's necessary moves to "exit" its unprecedented stimulus will likely lead both short-term and long-term interest rates somewhat higher next year as the Fed stops buying securities…and begins to sell them in an orderly fashion to shrink its balance sheet to more normal levels.

Congressional and media criticism of the Fed will be brutal. This is why the recent reappointment of Fed Chair Ben Bernanke to another four-year term by the President was so important.

What If?

IF bond investors were currently convinced that the Fed was not going to be "responsible" in reversing its unprecedented actions of the past two years, long-term interest rates would reflect those fears, with rates having risen sharply. Instead, 10-year U.S. Treasury note yields today are at a 6-month low of 3.31%. Thirty-year U.S. Treasury bonds are at 4.05%. Thirty-year fixed-rate mortgages for conventional loans averaged 5.04% the past two weeks.

Why are long-term interest rates so low? Because the Fed enjoys the inflation-fighting credibility it has painfully gained during the past 30 years. In my view, the Fed remains the most credible institution in the nation's capital…

…the emperor has clothes

…the bond market won't have it any other way

Jeff

"TEA"ser

When I was a boy the Dead Sea was only sick.

—George Burns

jeff thredgold, CSP
ECONOMIC FUTURIST

THREDGOLD ECONOMIC ASSOCIATES

To receive the *Tea Leaf* free via email, sign up at
www.thredgold.com

Thredgold Economic Associates
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
www.thredgold.com

Graphics and layout by Kendall Oliphant
Research assistance by Shawn Thredgold