Congress can help the Fed

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President-elect Donald Trump noted that "we have a very false economy," due to the Fed "keeping the rates down." He is right. Yet, the question remains how to exit from this policy while avoiding catastrophe in the bond market and building a safer monetary policy framework for the future. Here, Congress can help.

Over the last eight years, monetary mischief restrained the economy, by 1) denting the return on investment for retirees and others willing to save for the future; 2) encouraging business to use cheap money to buy back their own stock rather than invest in plant, equipment, and people; and 3) damaging liquidity in financial markets for institutions and individuals.

Worse, the Fed created a bond bubble of epic proportion (see Figure 1).

Never before – at least back to 1880 – has the US Treasury 10-year bond been this richly valued. In fact, the bubble has now spread through the world – due to the Fed's role at the center of the international monetary system, along with copycat behavior by other central banks racing to cut rates and cheapen their respective currencies to boost their international competitiveness.

If bond prices unravel in an unpredictable and jarring fashion, the financial crisis in 2008 will seem small by comparison.

The solution is for the new House and Senate to require the Fed to play by rules assigned by Congress. The Federal Reserve Act states in the monetary policy objectives section (2a) that:

> The Fed "**shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential** to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." In other words, the Fed must closely monitor the money supply and growth in credit throughout the economy.

The Fed has lost sight of its charge to maintain growth of the monetary and credit aggregates. Instead, its focus has been on employment and inflation.

Instead, the Federal Reserve produced the largest quantity of money since its founding in 1913. Money created by the Fed or "state money" surged by nearly 400% in the six years ending in August 2014. This money printing experiment was twice the size of the second-largest six year expansion, which ended in 1944 and helped the US exit the Great Depression and fund a World War.

In contrast, money created by the private sector or "bank money" increased a scant 9% over the same six year period, as measured by an indicator we track at the Center for Financial Stability called Divisia M4.

Had two types of money been on the Fed's dashboard, QE3 never would have happened. Treasury 10-year bond yields would likely have bottomed at 2.5% rather than 1.4%. Lastly, the Fed's balance sheet would have been a stunning $1.4 trillion lower than the $3.8 trillion it is today!

"Bank money" drives growth. Today, bank money includes the service value of traditional commercial bank products such as deposits as well as shadow banking services such as commercial paper, money market funds, and repurchase agreements. So, it is essential that the Fed monitor the levels of this money as a signal of the efficacy of its policy.

The gigantic gap between "state" and "bank" money growth during the Fed's Quantitative Easing (QE) exercises is startling. It should have prompted Fed officials to conclude that 1) the monetary transmission mechanism was clogged and 2) no amount of additional QE would have spurred growth.

Quite simply, the financial sector failed to respond to Fed policy, due to regulatory overload and monetary policy uncertainty.

Sadly, the explosion of "state money" was largely channeled into speculative purchases of US Treasury bonds and risk-seeking trading strategies - not the kind of business investments that would have fostered growth. In fact, Fed purchases of Treasury bonds to implement its QE catalyzed and then further fueled the bond bubble we confront today.

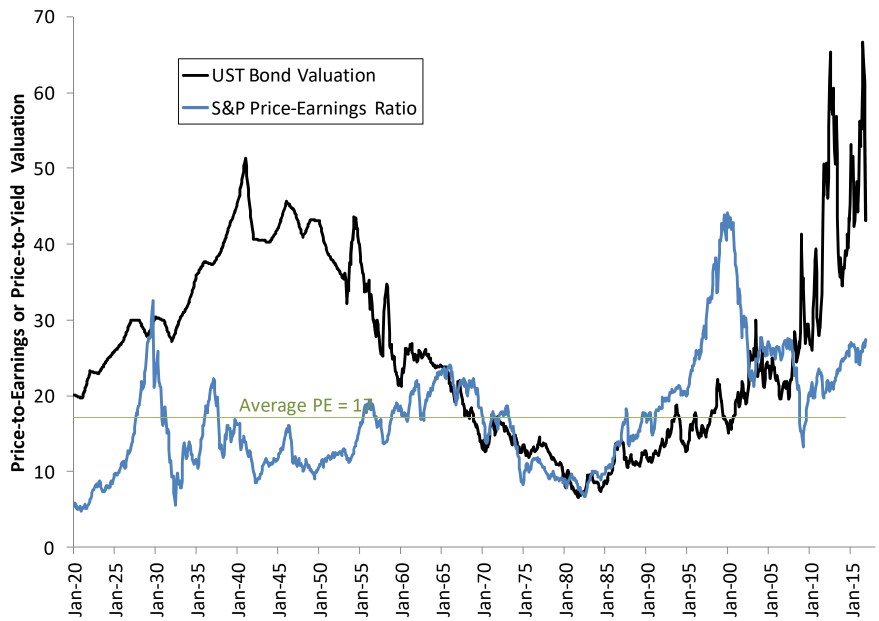
By the time the Fed contemplated its third round of QE, "bank" money growth was rapidly heading toward 6.8% on a year-to-year basis. QE3 never should have happened!

Today, a steady advance of "bank money" since the beginning of the year to 5.8% suggests either the economy is springing back to life, inflation is moving higher, or some combination of the two (see Figure 2). Unchecked, a further advance in factors driving bank money higher can readily trigger a massive bond market correction.

Now is the time for the Fed to purposefully diffuse the sovereign debt bubble it helped create. The Fed needs to integrate state and bank money into the policy discourse, including its own reports to Congress and the public. The Fed must respond to the recent swell in bank money and set a clear path for the normalization of rates and reduction of its bloated balance sheet.

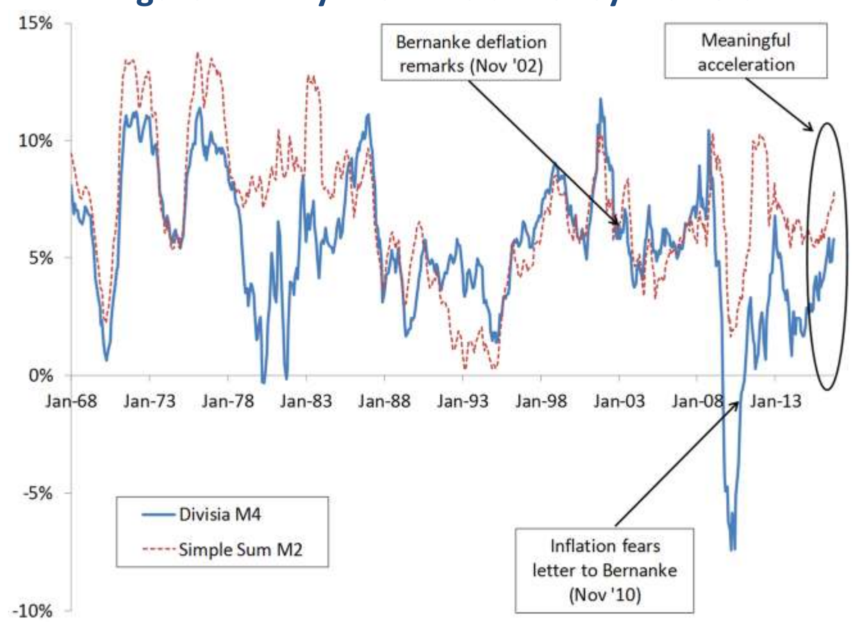
The Fed can start to fix the "false economy" by putting money back on its dashboard.

Figure 1. Unwind of Epic Market Distortions



Source: Robert Shiller (Yale University), Bloomberg LP, and Center for Financial Stability.

Figure 2. Why CFS Divisia Money Matters



Source: Federal Reserve and Center for Financial Stability.

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