The Fed's Car Is Missing a Transmission

The problem with QE, particularly QE3

The big discussion is quantitative easing. The Federal Reserve has put in place not one, not two, but now three rounds of stimulus that involve creating money and putting it into the financial sector. The first round ($1.25 trillion purchase of Mortgage-Backed Securities) was meant to ease the pain at banks. It worked, but it did not rejuvenate overall economic activity. The second round ($600 billion purchase of US Treasuries) was meant to spur overall economic activity. It did not work. The third round ($40 billion monthly purchase of Agency Mortgage-Backed Securities, which are FNMA, FHLMC, and FHA bonds and are referred to as AMBS) is aimed at boosting the overall economy because QE2 did not work. QE3 will fail. The simple reason is that you can't get "there" from "here."

The Fed is trying to increase consumer demand by purchasing bonds that are related to the financing of homes. The linkage between the Fed's activities and its stated goals (buying bonds and driving up the economy) is called the transmission mechanism, and it does not exist. The tortured chain that the Fed and Fed supporters point to goes like this:

- The Fed buys AMBS, thereby driving down the cost of mortgage financing, so
- Those who are considering buying homes have a lower cost, and
- Those who can refinance under FNMA and FHLMC can do so at a lower cost.
- This leads to consumers buying more homes (driven by lower mortgage rates), which
- Leads to home prices moving higher, so
- Homeowners feel richer and they spend more money.

- This also leads to a huge influx of refi's, which
- Leads to consumers having lower payments, therefore
- Homeowners have more to spend and therefore spend more money.

- An additional benefit is the increase in home buying leads to more homebuilding, which
- Leads to greater employment in the housing sector,
- Bringing back those middle class jobs that were lost.

- On the purchase side, those who sold AMBS to the Fed now have cash, so
- They go on a buying spree and purchase "risky assets," which means
- Companies selling their stock or issuing bonds have more buyers.

- Along the way the debasement of the currency through new money printing results in a rising stock market as does the old AMBS owners buying stock, which leads to
- Consumers who also own stocks feel richer, so
- Consumers spend more.

Here's the problem. It doesn't work like this. If these things were true - lower interest rates lead to more home buying, which leads to higher home prices and more jobs; while at the same time higher stock prices lead to increased consumption – wouldn't this series of events already have happened? If the transmission mechanism is lowering the cost of a mortgage, does that mean that the average 30-year fixed rate of 3.7% before QE3 was too high? If spurring consumption can be done through a higher S&P500, does that mean that the index at 1,450 before QE3 was too low? Obviously the last two questions are rhetorical. Mortgage rates are at historical lows and the stock indices are nearing record highs in the face of declining economic activity, stubbornly high unemployment, and a great risk of stagflation as incomes fall. The interesting part is that the Fed Chairman and board members know all of this. When Chairman Bernanke was pressed on this point at the press conference on 9/13 after the Fed meeting, he struggled to explain how buying AMBS transmits to gains in employment. The transcript of the question from the Reuters reporter and then the Chairman's answer are below:

> **PEDRO DA COSTA: Pedro da Costa from Reuters**: *My question is I want to go back to the transmission mechanism because speaking to people on the sidelines of Jackson Hole conference that seemed to be the concern about the remarks that you made is that they could clearly see the effect on rates and they could see the effect on the stock market but they couldn't see how that had helped the economy. So I think there's a fear that over time, this has been a policy that's helping Wall Street but not doing that much for Main Street. So could you describe in some detail how does it really differ from trickle-down economics where you just pumped money into the banks and hope that they lend?*
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> **CHAIRMAN BERNANKE:** *Well we are--this is a Main Street policy because what we are about here is trying to get jobs going. We are trying to create more employment. We are trying to meet our maximum employment mandate, so that is the objective. Our tools involve, I mean the tools we have, involve affecting financial asset prices and that's--those are the tools of monetary policy. There are a number of different channels, mortgage rates, I mentioned, other interest rates, corporate bond rates, but also the prices of various assets, like for example, the prices of homes. So the extent that home prices begin to rise, consumers will feel wealthier, they'll feel more disposed to spend. If house prices are rising, people may be more willing to buy homes because they think that they'll, you know, make a better return on that purchase. So house prices is one vehicle. Stock prices, many people own stocks directly or indirectly. The issue here is whether or not improving asset prices generally will make people more willing to spend. One of the main concerns that firms have is there is not enough demand, there's not enough people coming and demanding their products. And if people feel that their financial situation is better because their 401(k) looks better for whatever reason, their house is worth more, they are more willing to go out and spend and that's going to provide the demand that firms need in order to be willing to hire and to invest.*

Imagine that this situation was about a car. It might have gone something like this:

> **Reporter**: *Mr. Chairman, you control fuel, and you keep putting more fuel in the tank. However, the added fuel has not caused the car to go anywhere. It has created more energy for the engine, which is revving higher, but*

so far the car is not gear and the wheels are not engaged. At this point the fuel tank seems to be full to overflowing. How can more fuel engage the wheels?

Chairman: *Our job and our goal is to move the vehicle to the next town. It takes fuel to move a vehicle. When we added fuel before it allowed the engine to rev higher, but we did not get to our destination, in fact we aren't moving. If we keep adding fuel on top of the fuel we've already put in the tank, then the driver might notice the fuel gauge shows FULL, he might hear the engine rev even louder, and then he might potentially be motivated to put the car in drive.*

The Not-So-Secret Secret

The Fed cannot make anyone spend. The Fed cannot make anyone borrow. The Fed cannot cause a general rise in employment. The Federal Reserve oversees monetary policy. As such, they have monetary tools at their disposal. Which means the only people the Fed can affect are those that hold monetary instruments. The Fed uses its power to drain value from all dollars outstanding by creating more of them, and then transfers that wealth to people and institutions that already have financial assets by purchasing intangibles from them. This is the only course of action the Fed can take. They can buy stuff that sits on a balance sheet, not in a driveway, on a plot of land, or on a shelf. The Fed Chairman and Board of Governors must then hope – and hope is the right word – that this tremendous influx of cash to the previous holders of financial assets will find its way into the broader economy through debt. The reason that debt is the channel is because the holders of these financial securities will not just give the money away to the average consumer…but they will lend it.

Choice Is the Problem. What If We Don't Borrow?

The unspoken fatal flaw in this entire relationship is the choice of consumers. What if we as consumers choose not to borrow? What if we instead choose to repair and build our personal balance sheets? It renders the entire action of the Fed useless, at least from the stand point of their stated goal. This is what we have discussed forever. Consumers can and do choose. Given our research, our view is that the Boomers are well passed the stage of life that calls for more borrowing, so the Fed is essentially pushing on a rope. It simply won't work because of the choice that consumers have made so far and will make in the future.

QE3 Will Have Effects

While the Fed's QE3 won't meet its intended goal, it will cause some things to happen. Those who own AMBS just received a pop in value. Typically these types of securities aren't held by individual investors, they are held by pension funds, insurance companies, and sovereign wealth funds. In fact, back in 2008 it was a big controversy that the US government guaranteed FNMA and FHLMC bonds at 100% because one of the large holders of these bonds was the Chinese government. At the same time the US government let the common stock and preferred stock of these two companies go to zero. These two classes of securities were mostly held domestically.

Another outcome is a gift to banks. The Federal Reserve does not have a brokerage account. Instead, when the Fed wants to buy something it does so through one of the big banks that are members of the Fed, those who hold funds there as national banks are required to do. So when the Fed wants to buy $40 billion per month of AMBS, it asks the member banks to make an offering. Now obviously these banks are not sitting around with all of these securities on their own books. So these banks go into the marketplace and get offerings from the holders of these securities, then offer them back to the Fed. Along the way the banks make a commission on the transaction. So the Fed just guaranteed that it will pay commission on $40 billion per month in securities transactions for the foreseeable future. That's good business…if you are a really big bank.

There is one part of this equation in which the Fed touches all of us. This entire sequence of events is made possible by taking value from those who hold and use US dollars. Whenever the Fed creates a new dollar, that dollar only has value by taking a little bit from all the other dollars already in existence. This is how the Fed debases or lowers the value of the US dollar every time it creates new money.

Now, this point is hotly debated. Many people point to inflation and say, "Look, at 1.7% CPI we don't have runaway inflation, so the Fed is NOT causing a problem!" In response to this we simply point out two things. First, income is not matching inflation. In fact, income continues to fall in inflation-adjusted terms. This means that workers are losing ground in their standard of living. There is no way to sugar-coat or explain this away. When a consumer pays more for food, energy, healthcare, and education, but makes the same or less income, then that consumer is worse off. Period. Second, when the US government calculates inflation it counts shelter as roughly 30% of the measurement. This makes no sense. It grossly distorts the experience of the average consumer. Who changes their shelter, or housing, on a monthly or even annual basis? For most consumers this is set for at least a multi-year period, so a change either direction in the cost of shelter as measured by the government is not a big factor in the average consumer's life. However, the change in prices at the pump and the grocery store are felt every week and even several times a week. These are the things we should give more weight when measuring inflation.

So if wages are falling, but prices are moving higher, then the average consumer is being squeezed. This is exactly where we are today, and the further down the asset and income scale a person is, the worse the situation becomes. It was just reported that the median household income in the US is down to $50,200. This is household income, meaning all income earned by those living there, and it is median, so 50% of America is below this number and 50% above. Of those households that earn less than $50,200 per year, how many own stocks that are driven higher by QE programs? Not many. How many buy food and energy? All of them. You get the picture.

In short, the Fed is crushing the poorest Americans in an effort to boost the broader economy because the Fed must use the only tools it has – interest rates and money supply – and the program isn't working. What's the response? Do more of the same. As I recall, this is the definition of insanity.

Sincerely,

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