Encima Global

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Full Punch Bowl

The New York Times front page story likened today's wide-spread criticism of Fed asset purchases to the mid-1930s arguments against fiscal and monetary stimulus. There's a huge difference. In the 1930s, banks and corporations weren't sitting on idle trillions. There were no excess reserves. The dollar was strong and commodity prices were low and collapsing. Farmers were decimated. There was a clear shortage of money. Tax increases were piled on top of that, helping create a second depression in 1937.

At some point, the Fed has to grapple with the evidence that monetary policy is already plenty loose – trillions of idle cash, near zero rates for the government and big corporations, weak dollar, high commodity prices, growth in monetary base, rising TIPS-based inflation expectations, foreign inflation, foreign rate hikes, ISM prices-paid. Today's sluggish growth is not a problem of tight money – it's bad Washington policies on the dollar, deficit spending, regulatory uncertainty and tax increase threats.

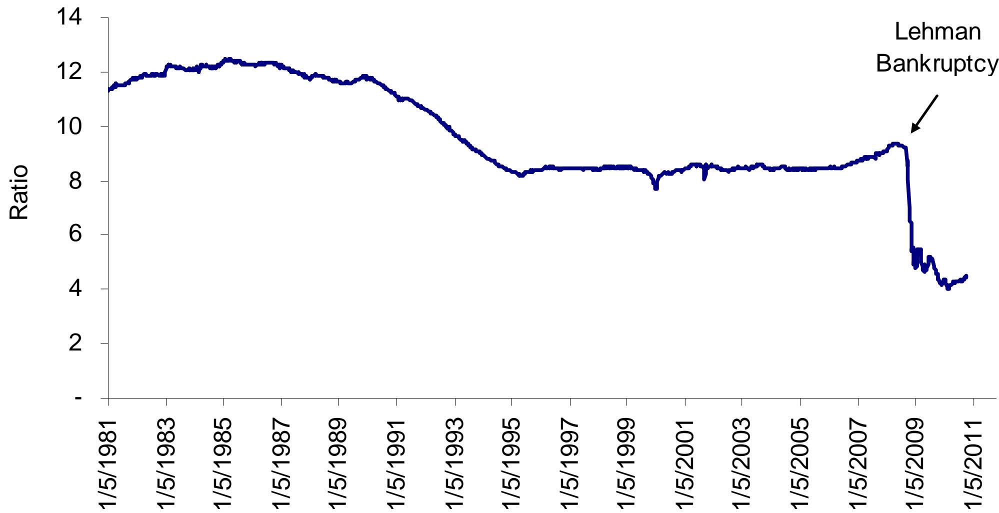
Fed Chairman Ben Bernanke's Washington Post op-ed today presented an expansive demand-side view of the Fed's role in stimulating economic growth. "The FOMC decided this week that, with unemployment high and inflation very low, further support to the economy is needed. With short-term interest rates already about as low as they can go, the FOMC agreed to deliver that support by purchasing additional longer-term securities…Higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending. Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."

In his Post editorial, Chairman Bernanke again made no mention of small businesses or how diverting credit to bond issuers would help small businesses hire. We emphasize the disconnect between the Fed buying Treasury bonds and job creation. In the old days, the Fed used to "inject reserves," meaning they would buy Treasury bills from a bank (or do the equivalent through repo operations). Tbill yields would go down, the Fed's assets would go up, and "excess reserves" would go up in the Fed's liabilities. This was stimulative because the commercial bank would earn zero on the reserves so it would quickly try to lend the money often to a small business, the start of the money multiplier effect. Most of the money would stay in the small business's checking account at a bank, requiring more reserves to be held at the fed. The bank would change the label on its reserves at the Fed from "excess" to "required". The bank would continue lending until the "excess reserves" caused by the Fed's purchase of Tbills became "required reserves."

In the past, the Fed would have "created money" to the extent that M2 rose due to multiple loans made from the original Tbill purchases. The Fed didn't create more money by itself -- it

facilitated the money multiplier effect through which banks create M2 out of M0. That's not happening now.

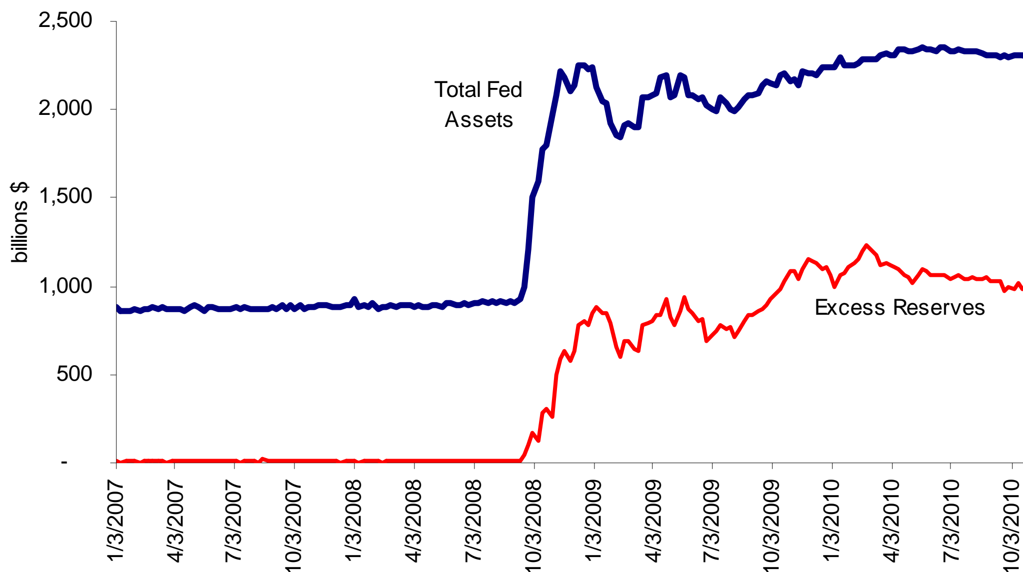
M2 / M0 (last obs. October 18, 2010)



Source: Federal Reserve; Encima Global

There's no money multiplier going on now – excess reserves have gone up almost as much as Fed total assets, meaning there's no throughput. **The Fed's impact instead is a zero-sum game in which it drives down the yield on Treasury notes and corporate equivalents at the expense of less credit availability to smaller businesses (the vast majority that aren't big enough to issue bonds.)**

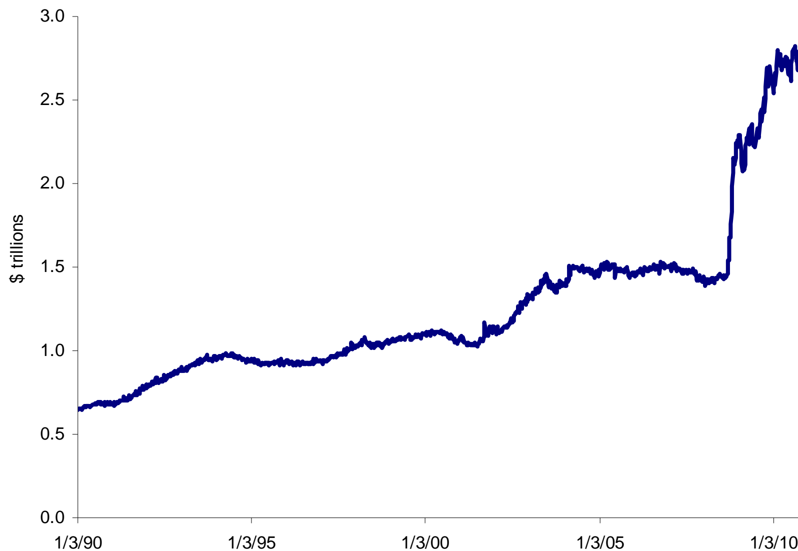
Fed Assets and Excess Reserves (last obs. sales October 27, 2010)



Source: Federal Reserve Board; Encima Global

- Since the Fed is paying above-market rates to the banks for excess reserves, the banks are increasing their safe loans to Treasury and the Fed (currently $1 trillion in excess reserves alone)…

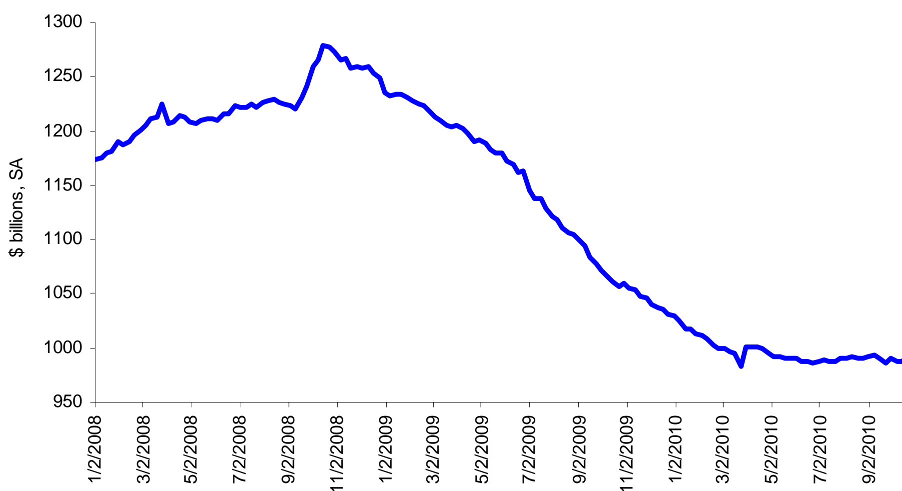
Idle Assets At Banks: Cash Assets plus Treasury and Agency Securities (last obs. October 20, 2010)



Source: Federal Reserve; Encima Global

- … rather than extending cmrcl and ind'l loans through new customers and roll overs.

C&I Loans (last obs. October 20, 2010)



Source: Federal Reserve; Encima Global

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