

Abolish the FOMC

By David Stockman, from Zerohedge, 11 August 2016

The approximate hour Janet Yellen spends wandering in circles and spewing double talk during her post-meeting pressers is time well spent. **When the painful ordeal of her semi-coherent babbling is finally over, she has essentially proved that the Fed is attempting an impossible task.**

And better still, that the FOMC should be abolished.

The alternative is real simple. It's called price discovery on the free market; it's the **essence of capitalism.**

After all, the hot shot traders who operate in the canyons of Wall Street could readily balance the market for overnight funds. They would do so by varying the discount rate on short-term money.

That is, they would push the rate upwards when funds were short, thereby calling-in liquidity from other markets and discouraging demand, especially from carry trade speculators. By contrast, when surplus funds got piled too high, they would push the discount rate downward, thereby discouraging supply and inciting demand.

Under such a free market regime, the discount rate might well be highly mobile, moving from 1% to 10% and back to 1%, for example, as markets cleared in response to changing short-term balances. So what?

Likewise, the world is full of long-term savers like pension funds, insurance companies, bond funds and direct household investors on the supply side, and a long parade of sovereign, corporate and household borrowers on the demand side.

Through an endless process of auction, arbitrage and allocation, the yield curve would find its proper shape and levels. And like in the case of a free market in money, the yield curve of the debt market would undulate, twist, turn and otherwise morph in response to changing factors with respect to supply of savings and demands for debt capital.

It goes without saying that under such a regime, savers would be rewarded with high rates when demands for business investment, household borrowings and government debt issuance were large. At the same time, financial punters, business speculators, household high-livers and deficit-spending politicians alike would find their enthusiasm severely dented by high and rising yields when the supply of savings was short.

What would be the harm, it must be asked, in letting economic agents in their tens of millions bid for savings in order to find the right price of debt capital at any given time? Why concentrate the task among 12 people who, as Janet Yellen's endless babbling so thoroughly demonstrates, can't possibly figure it out, anyway?

There are three reasons given as to why capitalism's monumental and crucial tasks of setting the price of money and debt cannot be trusted to the free market. But all of them are wrong; all of them are a variation of the giant Keynesian error that capitalism self-destructively tends toward entropy absent the ministrations of the state, and especially its central banking branch.

The three cardinal errors of which we speak are the claim that 1) debt is the keystone to prosperity, 2) the business cycle is inherently unstable and bleeds the economy of growth and wealth and 3) active central bank intervention is needed to stop bank runs and financial crises from spiraling into catastrophe.

The “Financial Contagion” Myth And The False Case For Activist Central Banking

Let’s start with the third claim. It’s the fear of financial contagion and catastrophe of the type which allegedly arose in September 2008 that is the bogeyman which ultimately undergirds the current cult of Keynesian central banking.

Yet we didn’t really need Ben Bernanke and his self-proclaimed courage to print—and wildly and excessively so, as it happened.

Recall that the Fed’s balance sheet was about \$900 billion before the Lehman meltdown, and it had taken 94 years to get there. The Bernanke Fed printed another \$900 billion in just seven weeks after Lehman and \$1.3 trillion more before Christmas eve that year.

In the process, any crony capitalist within shouting distance of the canyons of Wall Street got bailed out with ultra-cheap credit from the Fed’s alphabet soup of bailout lines.

Among these was the \$600 billion AAA balance sheet at General Electric where CEO Jeff Imelt’s bonus would have been jeopardized by spiking interest costs on his imprudently issued \$90 billion in short-term commercial paper.

Ben had the courage save Imelt’s bonus by funding him at less than 4% for no good reason whatsoever. General Electric could have readily raised the funds through a dilutive issue of common stock or long-term debt.

He also had the courage to fund Morgan Stanley to the tune of \$100 billion in cheap advances and guarantees. That gift kept this insolvent Wall Street gambling outfit alive long enough for CEO John Mack to jet down to Washington where he got short-sellers outlawed and collected a \$10 billion TARP bailout—and all in less than two weeks!

Well, there is a better answer and it requires no FOMC, Ben Bernanke or specious courage to rescue crony capitalist bandits like John Mack and Jeff Imelt.

It is called mobilizing the discount rate. Implementation only takes green eyeshades.

Yes, just a small number of competent accountants.

Indeed, no Harvard, Princeton or even University of Chicago PhDs need apply.

For all the false jawing about Walter Bagehot’s rules for stopping a financial crisis, a mobilized discount rate, not a hyperactive FOMC running around with hair afire and monetary fire hoses spraying randomly, is actually what the great English financial thinker had in mind.

To wit, Bagehot actually said that during a crisis central banks should supply funds freely at a **penalty spread** over a **market rate** of interest secured by **sound collateral**.

You don’t need macroeconomic modelers with PhDs in econo-algebra to do that. You need accountants who can drill deep into balance sheets and examine the collateral; and then clerks who can query the market rate of interest, add say 300-400 basis points of penalty spread, and hit the send button to eligible banks which have posted approved collateral.

Indeed, this was the sum and substance of the Fed’s original design by Carter Glass, the great financial statesman who authored it. That’s why he had 12 Reserve Banks domiciled in the different economic regions of the country and an essentially honorific but powerless board in Washington DC.

As we indicated above, the latter had no remit to target macroeconomic variables. It was not charged with managing, countering, flattening, or abolishing the business cycle. It could not even own government debt, and 91.7% (11/12) of its operations were to be conducted in the 11 regional banks away from Wall Street.

In short, the purpose of the Fed was actually to be a classic lender of last resort. Carter Glass called it a “banker’s bank”. Its job was liquefying the banking system on a decentralized basis, not monetary central planning or Keynesian macro-economic management.

Accordingly, the balance sheet of the Federal Reserve System was not intended to be a proactive instrument of national economic policy. It was to passively reflect the ebb and flow of industry and commerce. The expansion and contraction of banking system liquidity needs would follow from the free enterprise of business and labor throughout the nation, not the whims, guesstimates, confusions, and blather of a 12-person FOMC.

Needless to say, under the mobilized discount rate regime and Banker’s Bank that Carter Glass intended, **the outcomes during the 2008 financial crisis would have been far different.**

Bear Stearns was not a commercial bank, and would not have been eligible for the discount window. It would have been liquidated, as it should have been, with no harm done except to the speculators who had imprudently purchased its commercial paper, debt and equity securities.

Likewise, Morgan Stanley was insolvent and its doors would have been closed on September 25, 2008. That is, long before John Mack could have gotten the short-sellers of his worthless stock banned or collected his \$10 billion gift from Hank Paulson.

In short, the world would have little noted nor long remembered the chapter 11 filing of what was (and still is) a notorious gambling house. Likewise, GE would have paid a 10% or even 20% interest rate for its commercial paper refunding, thereby dinging its earnings by a quarter or two and Jeff Imelt’s’ bonus that year.

So what?

In a word, what happened in the run-up to the great financial crisis and its aftermath never would have occurred under a mobilized discount rate regime conducted by a Banker’s Bank. Funding costs in the money markets would have soared, causing speculators who had invested long and illiquid and borrowed cheap and overnight to be carried out on their shields.

The Crisis of 1907—The Proper Way To Quell A Speculative Blow-Off

That’s exactly what happened during the great financial panic of 1907 when interest rates soared to 20% and even 60% of some days of extreme money market stress.

As it happened, the market cleared out the speculators and hopelessly insolvent, like the copper kings and real estate punters of the day.

At the same time, JP Morgan and his syndicate of bankers with their own capital on the line, re-liquefied the solvent supplicants who came to Morgan’s library on Madison Avenue—but only after their green eyeshades had spent long nights proving up solid collateral for liquidity loans from the Morgan syndicate.

By 1910 American capitalism was again booming. No Fed. No Bernanke. No harm done.

So in 2008, the money markets would have cleared, and any temporary expansion of the Fed’s balance sheet would have immediately shrunk once the crisis was over, and the discount loans were repaid. And, yes, at 10%, 20% or even 50% and a penalty spread to boot, they would have been paid off real fast.

That’s what a real lender of last resort would look like. Janet Yellen’s crony capitalist flop house is its very opposite.

As to the second proposition—that debt is the keystone to prosperity—that was true in a bad sort of way, but not anymore. That's because debt does not ultimately expand economic activity and wealth; it just pulls it forward in time, leaving the future to reckon with the morning after.

The chart below tells the story in a nutshell. Prior to 1970 the ratio of total debt in the US—government, household, business and financial—was about **1.5X** national income or GDP. Other than a modest fluctuation in the early 1930s when the denominator (GDP) collapsed during the Great Depression, the nation's aggregate leverage ratio oscillated around this golden mean through boom and bust, war and peace.

More importantly, immense output growth, technological progress, capital investment and living standard gains were made during that period without any permanent change in the **1.5X** leverage ratio. For a century, American capitalism thrived without stealing growth and prosperity from the future through the Keynesian parlor trick of ratcheting up the national leverage ratio.

Once the Fed was liberated from the yoke of Bretton Woods and the redeemability of dollars for gold by Nixon's folly at Camp David in August 1971, however, financial history broke into an altogether new channel.

What happened was a rolling national LBO. As shown in the chart below, total debt outstanding soared from **\$1.6** trillion to **\$64** trillion or by **40X**. By contrast, nominal GDP expanded by only **16X**.

Accordingly, the nation's leverage ratio soared from its historical groove around **1.5X** to **3.5X**. That's massive; it's two extra turns of debt on national income. At the old pre-1971 ratio, which had been proved by a century of prosperity, total debt outstanding today would be only **\$27 trillion**.

To wit, the American economy is now lugging around about \$35 trillion of extra debt. Yet the results are unequivocal. The trend rate of real GDP growth has been heading steadily lower since the 1960s. More debt ultimately means less growth, not more.