THOUGHTS FROM THE FRONTLINE

Time to Rethink the Fed

By John Mauldin | February 5, 2022

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> "In many important ways, the financial crash of 2008 had never ended. It was a long crash that crippled the economy for years. The problems that caused it went almost entirely unsolved. And this financial crash was compounded by a long crash in the strength of America's democratic institutions. When America relied on the Federal Reserve to address its economic problems, it relied on a deeply flawed tool. All the Fed's money only widened the distance between America's winners and losers and laid the foundation for more instability. This fragile financial system was wrecked by the pandemic and in response the Fed created yet more new money, amplifying the earlier distortions."
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> —Christopher Leonard, *The Lords of Easy Money* (2022) (h/t Michael Lewitt)

One of the hardest leadership challenges is knowing when to change plans. Is what you *could* do better than what you *are* doing? Certainty is impossible.

At some point, though, good leaders recognize their plans aren't going well and start looking for better ones. I believe the Federal Reserve is there. I don't mean the Fed's current policy dilemma. I mean the Fed itself; its very existence, structure, and goals. **They need a complete restructuring, because the Fed isn't accomplishing what we all need it to. Worse, it is causing problems we could do without.**

I believe Fed officials are largely responsible for the cycles of bubbles, booms, and busts over the last 30 years. Further, they share some of the blame (clearly not all) for the growing divisions and tribalism in our society. Much of it springs from the wealth disparity they aided and abetted.

I've talked before about how the Fed has painted itself into a corner. All the options are bad and getting worse. The reasons it is in this position are no mystery. Indeed, this is all inherent in the Federal Reserve system's design. **It is trying to do things it shouldn't be attempting.** The only real solution is a wholesale redesign and reconstruction. What we have today isn't working and the time has come to amend the Federal Reserve Act and change its purposes and authorities.

I realize these are bold words. I fully acknowledge the gravity of what I'm proposing here. And I am totally open to ideas of what a new and better Fed would look like. I know any transition from here to there will be tricky, too.

It also will take time. I do not expect anything to happen of any substance until we get to The Great Reset, where we will be forced to think and do many things now unthinkable in the current environment. In the meantime, I fully expect the current Federal Reserve will increasingly inject itself into the economy and make things worse. Its leaders will do so with the best of intentions, because they believe their own dogma. In their view, this is just what they do.

We need to have this conversation and it has to start somewhere. So today I'll start it.

Who Needs Central Banks?

We should first ask why the Federal Reserve (or any other central bank) is even necessary. Answering that leads quickly to much deeper questions, like what is "money" and who should create/control its value. Many libertarians and Austrian-school economists argue governments should have no role at all.

I probably would've been sympathetic to that in the late 19th century and early 20th century. I will now no longer argue for the Fed's full dissolution. We need central banks with limited capabilities, just like young children need training wheels. My goal is to improve the present system and reduce its harmful side effects.

Modern central banking is fairly new. Until the 19th century private banks commonly issued their own currency notes, sometimes linked to gold but not always. Wars and political machinations created instability, with periodic panics and bank runs. Banking was not a "system" as we know it today. Banks did their own thing, and if yours had trouble it was your problem, too.

Let's stop here and make an important distinction. Today we associate central banks with "fiat money" without independent backing like gold. That's not always the case. You can have both a gold standard and a central bank at the same time. A central bank standing behind individual banks helps maintain stability, thereby promoting the confidence that attracts deposits. This would be important even in a 100% reserve system.

In the 1870s the Bank of England pioneered the "lender of last resort" concept. British writer Walter Bagehot (a co-founder of *The Economist* magazine) famously summarized the central banks' job as averting panic by "lending freely, to solvent firms, against good collateral, and at high rates."

That isn't what today's Federal Reserve does. In particular, it doesn't follow the "high rates" part of Bagehot's advice. This, I think, is key to many of our problems.

A Benchmark for Everything

As lender of last resort, a central bank stands ready to always loan a commercial bank enough cash to repay depositors. This doesn't always mean the bank is in trouble. Money flows in and out every day and sometimes gets unbalanced. In the US, "federal funds" are available overnight to fill these gaps, for which banks pay interest at the federal funds rate, the amount of which is set by the Federal Open Market Committee (FOMC).

This rate has grown far beyond the limited purpose of simply enhancing bank liquidity. It has become the benchmark for everything. The entire global economy now hinges on a price subjectively determined by a committee of a) politically appointed Governors and b) regional Fed presidents selected by boards who represent their region's commercial banks. Unlike other prices, it isn't a function of supply and demand. The rate can be as high or as low as the committee wants. The FOMC members set the rate at whatever they think will achieve what they believe are good economic goals. But that has economic consequences.

It all seems so logical when they explain it. But the reality is that we have been through multiple bubbles brought about by ever-lower interest rates in an effort to avoid recessions and improve employment (laudable goals to be sure) and in recent years a new tool: quantitative easing (QE).

The Federal Reserve Act gives the Fed a "dual mandate." It is required to promote both full employment and price stability. Unfortunately, its monetary policy tools have at best a distant influence on employment. Creating the conditions that let businesses create jobs is really a fiscal and regulatory function. Congress and the president should be doing that part. The Fed should focus on price stability.

Fed proponents point to a correlation between Federal Reserve efforts and unemployment. I would argue that this is correlation without causation. Jobs are created when entrepreneurs recognize business opportunities and need workers to achieve them. As we will see, artificially low interest rates actually hinder job formation.

As for price stability, the Fed defines "stability" as inflation averaging 2% yearly. That's not stability. A 2% inflation rate will, over a typical worker's lifetime, consume a large part of the buying power of their savings and leave them anything but "stable."

Moreover, the Fed hasn't produced consistent price stability despite its many tools. Inflation was well below target for most of the last decade (based on the Fed's own benchmarks, though consumers certainly saw higher inflation in their living costs). Now inflation is far above their target. The Fed's choice to keep rates low and continue massive QE is having serious side effects.

This Can't Continue

As you know, there are interest rates and "real" interest rates (nominal interest rates minus the inflation rate), which account for the fact the currency with which a borrower repays may have changed value before repayment was due. The Fed is now taking this to extremes, as former Morgan Stanley Asia chair Stephen Roach explained in a recent *Project Syndicate* piece. Quoting (emphasis mine):

> "Consider the math: The inflation rate as measured by the Consumer Price Index reached 7% in December 2021. With the nominal federal funds rate effectively at zero, that translates into a real funds rate (the preferred metric for assessing the efficacy of monetary policy) of -7%.
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> "That is a record low.
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> **"Only twice before in modern history, in early 1975 and again in mid-1980, did the Fed allow the real funds rate to plunge to -5%. Those two instances bookended the Great Inflation, when, over a five-year-plus period, the CPI rose at an 8.6% average annual rate.**
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> "Of course, no one thinks we are facing a sequel. I have been worried about inflation for longer than most, but even I don't entertain that possibility. Most forecasters expect inflation to moderate over the course of this year. As supply-chain bottlenecks ease and markets become more balanced, that is a reasonable presumption.
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> "But only to a point. The forward-looking Fed still faces a critical tactical question: **What federal funds rate should it target to address the most likely inflation rate 12–18 months from now?**
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> **"No one has a clue, including the Fed and the financial markets."**

A -7% real interest rate is simply bizarre. It means anyone who can borrow at the fed funds rate, or close to it, is effectively being paid to take on more debt. And not just paid but paid *well*, plus whatever return they can generate with the borrowed money. This is partly why so many asset prices are so bubble-like today.

Now, real rates may moderate somewhat in 2022 as inflation eases and/or the Fed raises rates. But even the most hawkish scenarios would only bring it back to the 0% range, which is still not normal.

Negative rates were increasingly normal even before the current inflation. I wrote a long letter about it back in August 2016: Six Ways NIRP Is Economically Negative. I showed how the Fed and other central banks were ignoring even their demigod, Lord John Maynard Keynes. Following a long Keynes quote I said this:

> To paraphrase, Keynes is saying here that a lower interest rate won't help employment (i.e., stimulate demand for labor) if the interest rate is set too low. Interest rates must account for the various costs he outlines. The lender must make enough to offset taxes and "cover his risk and uncertainty." Zero won't do it, and negative certainly won't.
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> The footnote in the second paragraph is important, too. Keynes refers to "the nineteenth-century saying, quoted by Bagehot, that 'John Bull can stand many things, but he cannot stand 2 per cent.'"
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> Is Keynes saying 2% is some kind of interest rate floor? Not necessarily, but he says there is a floor, and it's obviously somewhere above zero. Cutting rates gets less effective as you get closer to zero. At some point it becomes counterproductive.
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> The Bagehot that Keynes mentions is Walter Bagehot, 19th-century British economist and journalist. His father-in-law, James Wilson, founded *The Economist* magazine that still exists today. Bagehot was its editor from 1860–1877. (Incidentally, if you want to sound very British and sophisticated, mention Bagehot and pronounce it as they do, "badge-it." I don't know where they get that from the spelling of his name. That's an even more unlikely pronunciation than the one they apply to Worcestershire.)
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> Bagehot wrote an influential 1873 book called *Lombard Street: A Description of the Money Market*. In it he describes the "lender of last resort" function the Bank of England provided, a model embraced by the Fed and other central banks. He said that when necessary, the BoE should lend freely, at a high rate of interest, with good collateral.
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> Sound familiar? It was to Keynes, clearly, since he cited it in the General Theory. Yet today's central bankers follow only the "lend freely" part of this advice. Bagehot said last-resort loans should impose a "heavy fine on unreasonable timidity" and deter borrowing by institutions that did not really need to borrow. Propping up the shareholders of banks by lending low-interest money essentially paid for by the public when management has made bad decisions is not what Bagehot meant when he said that the Bank of England should lend freely.
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> How did the Fed act in 2008? In exact opposition to Bagehot's rule. They sprayed money in all directions, charged practically nothing for it, and accepted almost anything as collateral. Not surprisingly, the banks took to this largesse like bees to honey. Taking it away from them has proved very difficult. We now find ourselves in an era of speculation about what will happen when interest rates are raised.

A few months after that letter, the Fed embarked on a two-year tightening phase that took rates about two percentage points higher. Even that small, slow change was more than markets could handle. The Fed gave up and resumed cutting in mid-2019. Then COVID hit and here we are, in a mess with no good way out.

This can't continue. The Federal Reserve and its peers need to get back to boring, Bagehot-style central banking and stop trying to micromanage the entire economy. The mere attempt generates yet more problems. The free (or better than free) money environment they've created makes every other challenge worse.

How Then Should We Change the Fed?

So what can we do? I think we abolish the dual mandate and have the Fed focus squarely on inflation. That will be easier if full employment isn't on their plate, too. As noted above, the link between low interest rates and employment is tenuous, if it exists at all.

Further, 2% inflation should be seen as high. The Fed should be leaning into inflation (tightening monetary policy) at 2% inflation and ease policy when inflation is at 1% or lower. Period. It goes without saying that we need better inflation tracking tools, too.

The Federal Reserve should not be this all-powerful "manager" of the economy. The Fed has taken on a third unwritten mandate, that of "financial stability," which really means stock market stability. The low rates that keep the stock market happy also financialized the entire economy. It is now cheaper to buy your competition than to actually compete. Private equity has evolved the way it has because low rates make it possible to buy good businesses, add cheap leverage, and over time generally produce well-above-market returns. None of it is available to the bottom 80% of the population, meaning the rich get richer. The financialization of the economy has been one of the greatest ills brought about by a loose monetary policy.

Jeremy Grantham said in his recent piece:

> "Perhaps the most important longer-term negative of these three bubbles, compressed into 25 years, has been a sustained pressure increasing inequality: to participate in the upside of an asset bubble you need to own some assets and the poorer quarter of the public owns almost nothing. The top 1%, in contrast, own more than one-third of all assets. And we can measure the rapid increase in inequality since 1997, which has left the U.S. as the least equal of all rich countries and, even more shockingly, with the lowest level of economic mobility, even worse than that of the U.K., at whom we used to laugh a few decades back for its social and economic rigidity.
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> "This increase in inequality directly subtracts from broad-based consumption because, on the margin, rich people getting richer will spend little to nothing of the increment where the poorest quartile would spend almost all of it. So, here we are again. This time with world-record stimulus from the housing bust days, followed up by ineffably massive stimulus for COVID. (Some of it of course necessary—just how much to be revealed at a later date.) But everything has consequences and the consequences this time may or may not include some intractable inflation."

The economy can manage itself (with a few rules, of course). We just need stable money, a stable economic environment, and an honest, reliable banking system. A great deal of the Fed's activity has nothing to do with what should be its core mission. As bureaucracies do, it has grown too powerful and invented new reasons to justify its existence.

That's not any one person's fault, nor is it a partisan political thing. Getting us into this mess was a long-term bipartisan comedy of well-intentioned errors. Finding a solution is more important than pinning blame. We have to start somewhere and now is the time.

A few final thoughts:

1. As I keep saying, we will eventually come to a financial reckoning I call The Great Reset. It will require us to rationalize debt, reduce government spending, and increase taxes. Otherwise we will fall into very difficult economic times. Not the end of the world, but still difficult.

2. The Fed will continue doing what it does, up to the moment of actual crisis, helping bring it about, and then offer to put out the fire it helped create. Failure to reform the Fed will let it continue to create bubbles and distort the economy.

3. Starting this conversation now will help us have proposals ready when the time is right. There are others far more knowledgeable than I am who can provide better ideas and insight. I am simply observing a pattern that has developed over 25 years of loose monetary policy beginning with the Greenspan Fed, which is responsible for many ills.

This is a serendipitous time to begin this discussion, with pushback against authorities across the spectrum "speaking down" to the hoi polloi. We live in a time of dueling experts, with one group of experts wanting to censor others or drown out alternative, competing ideas.

The Fed is part of that system, led by a group of people who believe they know better how to manage a $20 trillion economy than businesses and consumers themselves. They have created all sorts of unintended consequences, none of which they assume responsibility for, because their theories tell them that what they are doing is correct and those consequences are caused by something else. They are like Plato's philosopher kings. "Trust us, we know how to run your lives."

The Federal Reserve is just one of many institutions that need rethinking. But while we do it, let's make sure we take care of the Fed. We need a properly managed Fed for crises like we saw in early 2020, but it must have limits.

Planning to Travel, Not Sure When

I know Shane and I need to get to Cleveland for long-postponed checkups. Perhaps a trip to Boston and certainly one to New York. Also Austin if I can. It's all up in the air.

Some of you know that my daughter Amanda (one of the twins in Tulsa) had a serious stroke last year. We were lucky her husband was home and got her to the hospital within minutes. Otherwise we could've lost her. She's been doing intense therapy and is recovering nicely due to the very professional care she gets.

Amanda asked me to tell my readers about an American Heart Association program to spread awareness on heart disease and strokes in women, which are far too common and often go untreated. Learn more at Go Red for Women. There are many more cases like Amanda's and we don't want to lose any of them.

If/when we reorganize the Fed, I see the need for a new 12-step program. "Hello, my name is John, and I'm a former Fed watcher." I have a lot of friends who would happily join.

With that, I will hit the send button and wish you a great week. Don't forget to follow me on Twitter!

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