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ECONOMIC RESEARCH REPORT
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The Fed's Massive Power Grab

Take your pick of these two jobs. You get to manage a $4+ trillion bond portfolio and have omnipotent control over banks and other financial institutions. Or, you can manage an $800 billion portfolio, control the level of the federal funds rate and manage some regulatory issues. Is this really a hard choice? Well, it certainly doesn't seem to be for the Federal Reserve.

The Fed has seamlessly morphed from an institution that occasionally intervened in financial markets to a monster that apparently wants to control a great deal of the US financial system. Federal Reserve Board Chair, Janet Yellen, and her fellow central bankers, with virtually no pushback from Congress, are in the process of adopting an entirely new economic management technique called "macroprudential regulation."

The definition of macroprudential regulation is hard to pin down. In short, it means managing systemic risks. This is done by regulating specific financial system behavior in an attempt to avoid cascading economic problems. The idea is that the Fed can reduce the risks of financial instability for the economy as a whole by regulating certain behaviors.

In practice, what this really means is that the Fed wants to run a monetary policy that it believes is appropriate for the economy as a whole – to keep unemployment low. But, if this overall monetary policy causes too much financial risk, the Fed wants to micro-manage that risk by deeming it a macro-risk. At its root, this is hypocritical.

Everyone knows that when the Fed holds rates too low, this encourages some investors to leverage up more than they would otherwise. For example, in 2004-05, the Fed held the federal funds rate at 1% which helped cause a bubble in housing. But, rather than raising rates at that point, the Fed wants to have the right to regulate home lending activity. It could do this in any number of ways, by raising the capital required by banks to make home loans or possibly putting a limit directly on certain types of loans. That's macroprudential regulation.

In effect – and the Fed has argued this – the Fed blames banks for bubbles, not its strategy of holding interest rates artificially low. This is central planning to the second degree. The Fed wants to set rates first and then police the impact of those rates as if these decisions are not related.

This is a very dangerous precedent and it moves the US away from the free market while continuing to concentrate the power in the hands of the Fed. In a true free market, monetary policy should not be used to manage the economy. Rather, monetary policy should have one goal – to keep the value of the currency stable.

Unfortunately, as is true with all government institutions, the Fed is always looking to expand its influence and power. Remember when Rahm Emmanuel said, "never let a crisis go to waste."? The Fed has taken this to heart. In the thirty years, between 1977 and 2007, its balance sheet (the monetary base) averaged 5.4% of US GDP. Today, it's 22.4%. Never, in the history of the United States, outside of the military in World War II, has one government institution been so dominant.

And, under Janet Yellen, the Fed is making a steady, insistent and disciplined argument that growing the Fed's power is necessary for economic stability. The Fed wants to keep its balance sheet large, hold interest rates low, and regulate banking activities. From a distance this behavior looks awfully like that of the Bank of China.

The alternative would be for the Fed to shrink its balance sheet, hold interest rates where economic fundamentals and the Taylor Rule suggest they should be, and have faith that the free market will police excessively risky behavior. But, the US has entered a new era of doubt about free markets.

This was pre-ordained when Congress passed the Troubled Asset Relief Plan (TARP) in October 2008 – a $700 billion slush fund for the government that was sold as a way to save the world from Wall Street. As President Bush later said, "[We] abandoned free market principles to save the free market system."

But, by violating free market principles, politicians created conditions which allowed the Fed to justify regulation of the economy in new and broadly expansive ways. Republicans were always the defenders of free markets, but TARP signaled a new era. Now, because the GOP won't say TARP was a mistake, it has no effective argument against the Fed grabbing more power.

What this means for the economy is that flawed economic models, combined with the very visible hand of regulation, are distorting economic activity and leading the US toward more politicized control of financial markets. What could keep the Fed from lowering capital requirements on clean energy and raising them on fossil fuels? After all, many argue that fossil fuels are destabilizing.

But even more dangerous is that the Fed will hold rates down at artificially low levels for long periods of time in order to bring unemployment back down, all the while believing it can control the risks of easy money by using macroprudential regulation tools.

There are many reasons to disagree with this policy, but the most important is that artificially low rates distort decision making. High-return businesses will lever up unnecessarily and probably show up as bubbles. But some low-return enterprises will wrongly assume that borrowing to expand is still profitable. If resources flow too heavily to low return businesses, the economy will be less efficient and have more danger of inflation.

When rates eventually rise, both these behaviors will be tested and perhaps crack. Rather than trying to figure out where dangerous leverage is being employed, the Fed should put rates at the correct level and keep the whole boom-bust process from happening in the first place.

Congress needs to push back hard against macroprudential regulation, but it's highly doubtful they will because they don't understand it. The Fed is expanding its mandate in massive and unprecedented ways. Who is going to stand up and say stop?

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