

The Fed: Under Attack

Brian S. Wesbury – Chief Economist
Robert Stein, CFA – Dep. Chief Economist
Strider Elass – Economist

Never before has the Federal Reserve been so large and so actively involved in the US financial system. The Fed's balance sheet (at \$4.4 trillion) is now 25% of GDP – four times larger than its 1952-2007 average.

Meanwhile, the Fed's regulatory role in the banking system has grown, too. Smaller community banks have been squeezed by rules intended to make very large banks less likely to fail. Only in Washington, DC could they draw up rules designed to limit the big banks and end up making it easier for them to compete against the small banks.

The massive expansion in Fed power is a direct result of government's response to the Panic of 2008. The Troubled Asset Relief Plan (TARP) implicitly blamed the panic on the banking system and made government the savior. President Bush told [CNN](#) in December 2008 "I have abandoned free market principles to save the free market system." This created an environment of regulatory overreach that is finally being noticed by Congress.

In fact, we have never seen so much attention being paid to Fed decisions and activity. Senate Banking Committee Chairman Richard Shelby (R-Alabama) is suggesting a law to bind monetary policy to a policy rule, like the Taylor Rule, which would make the likelihood and direction of the Fed's policy changes much more predictable and transparent. If the Fed had followed the Taylor Rule in 2003-04, it would have never lowered interest rates to 1% and the US might have avoided the housing bubble altogether.

Another Senate idea, this one from a bipartisan duo of David Vitter (R-LA) and Elizabeth Warren (D-MA), would decentralize authority at the Fed by making sure all the Senate-appointed governors had their own staff. Vitter and Warren

would also make it tougher for the Fed to bailout banks and require a recorded vote on large fines for banks.

Yet another idea, this one from former Dallas Fed Bank President Richard Fisher, would end the New York Fed's permanent seat on the committee that sets monetary policy. At present, the other Fed bank presidents rotate their membership every year while the NY president never loses his seat. So Fisher's proposal would be a demotion for the bank president perceived most responsive to Wall Street and the biggest banks.

In addition, Congress is now investigating whether the Fed, including Janet Yellen herself, leaked valuable information about future decisions on monetary policy to Medley Global Advisors, a forecasting firm that trades in access, or at least the perception of access, to key political decision-makers.

And if the Fed thinks it's getting lots of attention now, just wait a few years when short-term interest rates are higher. Last year, the Fed turned over close to \$100 billion in interest earnings to the US Treasury Department. But when short rates go up, the Fed will be paying banks money that it used to pay the Treasury, just so the banks won't lend their excess reserves.

Perhaps the worst part of all this is that it might call future policy decisions into question. For example, what if the Fed raises rates in June? We think that policy action is justified by economic fundamentals. But some investors might think Yellen was just trying to appease GOP lawmakers. So even making the "right" call can cause problems.

Free market supporters should be careful about casually trading on the independence of the Fed. But it's easy to see why Congress is so focused – the larger and more active the Fed gets, the more attention it attracts.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-13 / 7:30 am	Retail Sales – Apr	+0.2%	+0.3%		+0.9%
7:30 am	Retail Sales Ex-Auto – Apr	+0.5%	+0.7%		+0.4%
7:30 am	Import Prices – Apr	+0.3%	+0.8%		-0.3%
7:30 am	Export Prices – Apr	0.0%	0.0%		+0.1%
9:00 am	Business Inventories – Mar	+0.2%	+0.1%		+0.3%
5-14 / 7:30 am	Initial Claims – May 9	273K	276K		265K
7:30 am	PPI – Apr	+0.1%	-0.1%		+0.2%
7:30 am	“Core” PPI – Apr	+0.1%	0.0%		+0.2%
5-15 / 7:30 am	Empire State Mfg Survey – May	5.0	4.5		-1.2
8:15 am	Industrial Production – Apr	0.0%	-0.1%		-0.6%
8:15 am	Capacity Utilization – Apr	78.3%	78.2%		78.4%
9:00 am	U. Mich Consumer Sentiment- May	95.7	96.4		95.9