BY JOHN A. ALLISON

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President's Message

The Federal Reserve's Unsound Policies

The Federal Reserve is increasing the long-term risk in our financial system through both its monetary and regulatory policies. It is simultaneously redistributing wealth from moderate-income savers to high-income households and laying the foundation for another housing bubble.

From 1914 until 2007 the Fed's balance sheet grew to $900 billion. Since 2007 the balance sheet has exploded to $3.2 trillion and is growing $80 billion per month. The Fed's capital ratio is currently 1.3 percent, while the average capital ratio of the largest banks is 8.0 percent. The Fed fails its own stress test and should be forced to shrink by its own standards. The risk in the financial system is not large banks, but the Fed itself.

The Fed's balance sheet has been radically expanded to hold down interest rates by buying Treasury and Freddie/Fannie bonds. This has significantly expanded the lending capacity of banks. Increasing the level of bank reserves has the same effect as "printing money." If the economy starts to grow, either inflation will increase as money velocity accelerates or the Fed will have to withdraw the excess reserves, which will result in rapidly rising interest rates and major losses for bond holders. If the Fed does not shrink its balance sheet, the economy could be stuck in very slow growth as the government consumes an increasing share of the economy, as has happened in Japan.

Since the U.S. dollar is the world's reserve currency, these actions have created a global currency trade war. This currency trade war causes misallocation of capital and lowers the global standard of living just like a trade war based on raising tariffs. Instead of production being driven by real competitive advantages and efficiencies, fluctuating currency values are causing a sub-optimization of resources. Every country wants the "cheapest" currency to make its export industries more competitive.

The only reason the U.S. dollar has held its relative value is its status as the reserve currency. This allows the Fed and Congress to get away with printing money and incurring massive debt that the market would not otherwise permit. Unfortunately, having the world's reserve currency creates a huge temptation to overleverage and create an unsustainable level of debt. Someday the rest of the world may wake up and realize the United States is in poor financial condition—the emperor has no clothes.

Current Fed regulatory policy is also increasing the risk in the banking system. All large banks are being forced to use the same regulatory-driven mathematical risk management models. This means that all the major banks will have a strong incentive to take the same type of risk, which significantly increases the overall risk in the financial system.

The significant expansion of the monetary base (printing money) is surely creating misinvestments in the economy. The combination of easy money, low long-term interest rates, and very liberal lending standards by the Federal Housing Administration could be igniting another housing bubble, while we are still trying to recover from the last one. These combined government policies are encouraging consumption (housing is consumption) when the U.S. economy has a negative real savings rate, when government deficits (including unfunded liabilities) are considered. The lack of real savings and capital will reduce our long-term ability to grow the economy.

By holding interest rates below what the market would create, the Fed is punishing moderate-income savers, especially older individuals. Retired individuals with low to moderate net worth should not be making risky investments. However, the Fed has forced down interest rates so that low-risk investments have negative real returns. This means that many older individuals who hoped to live on their interest income are having to consume their principle, which threatens their standard of living. On the other hand the extra liquidity created by the Fed is driving higher returns in risky investments, typically owned by high-net-worth individuals.

The primary beneficiary of the Fed's low interest rate strategy is the U.S. government, the world's largest debtor. The federal government's annual deficit is at least $250 billion less than it would be if interest rates were normalized. It appears that the real purpose of the Fed is to obtain favorable financing for the U.S. government, at the expense of private savers.

The good news is that the United States is experiencing an economic recovery. However, it is the slowest recovery in our history, and we still have three million fewer jobs than in 2007. If markets had been allowed to correct, if the Fed had maintained sound money, and if fiscal and regulatory policies were rational, our growth rate would be significantly faster and the U.S. government's financial position much sounder. At Cato we are working hard to encourage less regulation, lower taxes, less debt, and sound money.