

INADVERTENT TIGHTENING: IGNORING THE IMPACT ON BANKS

Fed's recent decision will tighten money supply

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There is a tendency in recent years to assume that the monetary policy prerogatives of the Federal Reserve stop at the doors of the Federal Reserve--i.e., that only the Fed creates or destroys money supply and only the Fed adjusts interest

rates.

This myopic view is unfortunately incorrect. The banking system also creates money and destroys it by making and eliminating loans. Moreover, global fund flows have a significant impact on interest rates.

It is also not well understood that the actions of bank regulators, not associated with monetary or interest rate policy, have an impact on both due to the impact that these regulators have on banks. Thus, discussions of monetary and interest rate policy that ignore the actions of the banking industry tend to be misleading.

This became evident again today [June 20] when commentators suggested that the actions of the Federal Reserve today will have little or no impact on money supply and a limited impact on interest rates. This is not true. By flattening the yield curve further while maintaining the size of the Federal Reserve Balance sheet, the Fed is actually tightening money supply.

Explanation

When the Fed prints money to buy Treasuries it injects cash into the economy. Ultimately the cash that has been created becomes a deposit in the banking system. If the banks lend the money to households and businesses, they create deposits or more money and it stimulates economic activity. If the banks redeposit the funds they have received back into the Federal Reserve then there is no economic stimulus.

The evidence over the past few years is very clear. The banks have not loaned the money that they have received as a consequence of the Federal Reserve's QE1 and QE2 programs. The banks redeposited these funds and more back into the Fed. This can be seen because bank deposits at the Fed have risen from an average of \$8 billion to \$12 billion four years ago to \$1,512 billion today.

In this same time frame, bank loans contracted by \$557 billion.

The money the Fed created never reached the economy. In fact, 100% of the funds were taken by the Fed and loaned to the United States government or its associated institutions.

Why?

The banks did not loan the money, in part, because the demand for funds contracted in the economy. However, there was a series of additional reasons why the banks did not lend the money that were associated with regulatory policy:

- Capital requirements were increased.
- Liquidity requirements were increased.
- Risk weightings were put in place that penalized banks for lending to the business sector.

- Regulations were created and put-backs developed by the GSEs that sharply inhibited mortgage origination in the private sector.
- Interest rate policies were instituted that reduced the profits from lending.
- Incentives were put in place to lend to the government and its associated entities.

Current policy

Today the Federal Reserve enunciated three conditions that are likely to further inhibit bank lending and, therefore, tighten money supply:

- First, the Fed raised questions concerning the sustainability of economic growth.

This will inhibit bank lending since banks are reluctant to lend into a weakening economy.

- Second, the Fed then indicated that it would buy securities with maturities of 6 to 30 years and sell securities with maturities less than 3 years.

This flattens the yield curve, making bank loans significantly less profitable, again taking away the incentive to lend.

- Third, the Fed gave no indication that it would expand the size of its balance sheet by buying and selling securities.

This means that the Fed is not going to print any additional funds to attempt to stimulate economic growth.

Thus, the net result of what the Fed announced today is to put further deterrents on bank lending without offering any new funding source. It effectively tightened the money supply.

Analysis

Personally, I agree with the policy of not printing more money to stimulate growth. It does not work and the vast majority of monetary economists would argue it never worked.

I strongly disagree with the policies that deter bank lending. This does slow economic growth. Rather than inhibiting bank actions, the Fed and the other bank regulatory authorities should be incenting banks to lend to households and businesses. This is easily accomplished. Simply reverse the draconian strictures placed on the industry's activities. Failure to do so is to condemn the economy to sub-par performance.

