

How the Fed Inadvertently Promotes Financial Collapse

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The bankruptcy of a major brokerage firm is simply the latest indication of serious, unprecedented strains in the financial area. Although the economy's trouble began in the housing area, it has since spread throughout the entire financial system.

While the Fed is being given high marks for "rescuing" the financial system from collapse, the Fed itself is primarily responsible for much of the current strains in the system. The Fed's main job is to create the right amount of money to stabilize economic conditions. When it creates too much money, spending soars. Eventually, inflation increases. When the Fed fails to create enough money, spending slows and the economy enters a recession.

While many have criticized the Fed for creating too much money, the opposite has been the case. The Fed has inadvertently adopted an overly restrictive policy that has hastened the spread of bankruptcies and financial failure. By lending money to banks and investment companies in return for its own securities, the Fed is exchanging one type of asset for another. This action can be helpful, but it's no substitute for increasing the total amount of liquidity in the system.

There are two reasons that some mistakenly believe that Fed policy has been expansive. First, the rise in gold prices and the decline in the value of the dollar are often signs that there is a surplus of dollars. However, the same rise in gold prices and collapse in the dollar can also be signs of insufficient money and imminent financial collapse.

When the Fed first began to adopt a more restrictive policy in 2005, gold prices stopped rising and the value of the dollar increased by 10%. It was only after the Fed adopted a progressively more restrictive policy that gold prices soared and the dollar collapsed.

A second reason some believe that Fed policy is expansive is due to the sharp decline in interest rates in recent months. However, interest rates are a poor guide to whether monetary policy is expansive or restrictive. During the Depression of the 1930s interest rates fell to zero at a time the money supply fell by a third.

While there is no one perfect guide to monetary policy, it is often helpful to look at something called "high-powered" money to determine the extent to which the Fed is adding or subtracting funds to the system. High-powered money (also known as the monetary base) consists of bank reserves plus currency.

Bank reserves represent the first step in the process of creating money. Reserves are created when the Fed purchases government debt. It pays for the debt by crediting banks with new deposits at the Fed. These deposits are bank reserves.

In the early part of the decade (2001-05), the Fed increased bank reserves at an annual rate of 5% a year. The money supply often grows by a few percentage points more than the growth in reserves. By 2005-07, this relatively rapid growth in high-powered money produced a relatively rapid increase in spending of 6%-7% a year. It was that relatively rapid pace of spending that led to the recent jump in inflation.

Beginning in 2005 the Fed adopted a more restrictive policy. That policy produced a decline in bank reserves of roughly 3% from early 2005 to the end of 2006. In response to this restraint, the spending pace in the economy slowed to 5% in 2007.

When financial problems began to surface last August, the Fed initially responded by increasing bank reserves by several billion dollars. This was the correct response. Unfortunately, the Fed reversed course in September and for the past six months has taken all of those reserves back out of the system.

There is a typical 6-9 month lag between adopting an expansive monetary policy and seeing its effects on the economy. By delaying a move to a more expansive policy the Fed has prolonged the current recession and placed further strains on the financial system.

While it is too late to avoid a recession this year, the Fed can still mitigate its damage by shifting to a more expansive policy. To make sure it adopts such a policy, the Fed should avoid setting a specific interest rate target. Instead, it should focus on increasing the amount of high-powered money, particularly bank reserves.