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FED SHADOW

Easing -- As in Appeasing

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Donald Luskin

Gold soars as the Fed resists politicization by giving politicians the easy money they want.

New regulation of financial services seemed several months ago like a fairly harmless exercise in rearranging bureaucratic deckchairs (see "Regulation Road" June 18, 2009). But that was when the depths of the credit crisis were still in recent memory, and politicians were reluctant to upset already destabilized financial markets. Now, more than eight months on from March's panic bottom in stocks, the Congress is more willing to take the risk of acting on aggressive regulatory initiatives -- just as we feared it would (see "Wolf in the Fold" May 18, 2009).

Some initiatives now in motion have potentially significant anti-growth implications for the financial sector, which would inevitably spill over in the entire economy. Particularly dangerous is the Kanjorski Amendment to the House Financial Services Committee's proposed Financial Stability Improvement Act. It would empower the federal government to arbitrarily, and effectively without judicial appeal, break up any financial firm determined to pose a systemic threat, even if that firm were under no financial stress. Like antitrust enforcement, it would impose a limit on how successful a firm can become, a limit to be determined and enforced subjectively, which is to say, politically. As this and other financial regulation policy initiatives have surfaced, the S&P 500 financial sector is off 7.3% from its highs six weeks ago, while overall stocks made new recovery highs last week.

Update to strategic view

US FINANCIAL STOCKS: The financial sector is now strong enough for Congress to dare to impose draconian regulations. We reiterate our view that the sector is only a recovery story, not a growth story.

GOLD, US RESOURCE STOCKS, COMMODITIES, HIGH YIELD BONDS, US DOLLAR: The Fed's powers and independence are under attack, and it is fighting back by appeasing the politicians who threaten it by continuing extreme policy accommodation. Inflation-driven and liquidity-driven assets will continue to show relative strength versus growth-driven assets, and the dollar will continue to weaken.

US STOCKS: Stocks are being dragged along only by the excess liquidity symbolized in gold's new all-time highs -- not by natural growth expectations.

[see Investment Strategy Dashboard]

But of more immediate concern are other initiatives threaten the independence and the internal stability of the Fed. Long term, if implemented, we believe that they would very likely degrade the Fed's ability to conduct sensible monetary policy. By systematically raising uncertainty about what is arguably the single most critical policy domain, this would discourage entrepreneurial risk-bearing and negatively impact growth prospects and returns to capital. Short term, while

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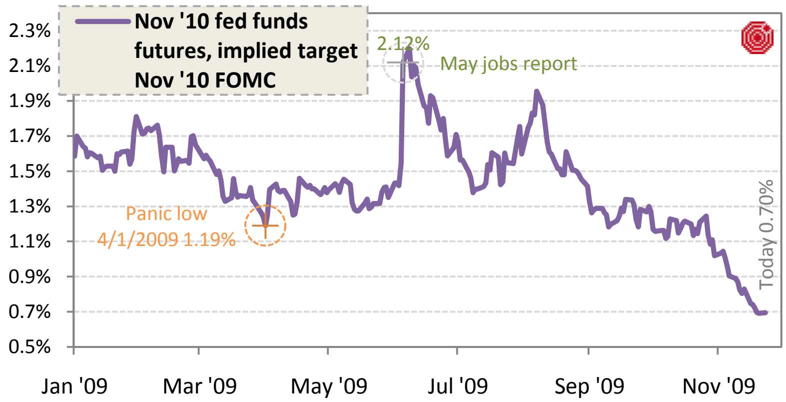

these initiatives are still in play, they pose a significant inflation threat. They motivate the Fed to persist in and intensify its policy posture of extreme easiness, so as not to give Congress the excuse to exert power over it on the grounds that it is not doing its utmost to promote recovery. We think this is a large part of the reason why fed funds futures are now showing the lowest-ever probability for rate hikes a year in the future (see the chart at left), and why inflation-sensitive gold has moved aggressively to new all-time highs.

- The Restoring American Financial Stability Act proposed by the Senate Banking Committee's chairman Chris Dodd (D-CT) would strip the Fed of its bank regulatory powers, ceding them to a new Financial Institutions Regulatory Administration (FIRA). In our idea of a perfect world, this wouldn't matter much, because the Fed wouldn't carry out policy by targeting interest rates, reserves or other elements of the banking system. But in the real world in which the Fed does target these things, monetary policy is probably made more effective by information the Fed obtains uniquely from its position as banking regulator. But it is certain that the Fed, like any bureaucracy, will wish to resist this diminution of its scope. If it must do so by appeasing Dodd with easy monetary policy, then it probably will.

- Dodd's proposal would limit the Fed's emergency lending powers under Section 13(3) of the Federal Reserve Act to "financial utilities" or "activities," not individual companies, and subjugate them to the approval of a newly created Agency for Financial Stability. If this had been effect in 2008, it would have ruled out the Fed's enabling JPMorgan's absorption of Bear Stearns, and its support of AIG. Such emergencies would be handled instead by the FDIC under a new resolution authority, with the costs allocated to surviving financial firms. Good idea or not, again, the Fed will seek to appease Dodd in order to resist this.

Key documents
Dodd discussion draft **Frank discussion draft** **Kanjorski amendment** **Paul/Grayson amendment**
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- Dodd's proposal would have the chairman of every regional Federal Reserve Bank appointed by the President of the United States, and their boards of directors appointed by the Federal Reserve Board in Washington. This would effectively lodge all power with the Board of Governors in Washington, neutering the regional reserve banks and upsetting a time-tested system of checks and balances through diversified decision-making authority. As one would expect, the presidents of the regional reserve banks strongly oppose this. The St. Louis Fed's James Bullard has called this is a “blatant politicization." Yet he, one of the most aggressive policy hawks, has begun to appease by suddenly becoming more dovish. Bullard said last week that the funds rate could stay at zero until 2012, and that the Fed's mortgage-backed securities buy program should stay in place beyond its planned wind-down next spring.

- In the House Financial Services Committee, Barney Frank's (D-MA) proposed Financial Stability Improvement Act includes an amendment by Ron Paul (R-TX) and Alan Grayson (D-FL) that would give the Government Accountability Office the power to audit the Fed. The Fed is bitterly opposed, arguing that it would breach the confidentiality necessary for monetary policy and the lender-of-last-resort function to operate effectively.

In addition, Dodd has scheduled hearings for Ben Bernanke's confirmation for a second term as Fed chair on December 3, the same day as the White House's "jobs summit." Dodd told an interviewer last week that confirmation of Bernanke was "not necessarily" a foregone conclusion, even though he had expressed support for him when he was renominated by President Obama in August. All this political theater seems calculated to remind Bernanke of the role the Fed is expected to play in promoting recovery at any cost -- and Dodd's own doubtful chances of re-election next year.

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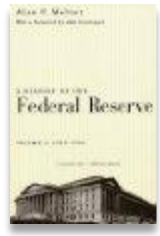
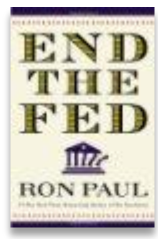


A History of the Federal Reserve, Volume 1: 1913-1951 by Allen H. Meltzer, University of Chicago Press, 2004



End the Fed by Ron Paul, Grand Central, 2009

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Bernanke doesn't need much reminding. The Fed is already locked on easy, in the apparently sincere belief -- as expressed in the last FOMC meeting -- that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." The political threats facing the Fed only make matters worse. If they materialize, we face living with a politicized central bank likely to repeat the inflationary sins of the Arthur Burns era (see "Gold's Most Immemorial Year" October 19, 2009). If they don't, it's because the Fed successfully appeased the politicians by staying ultra-accommodative, and inflating their way to re-election. No matter how you cut it, with inflation-sensitive gold already at all-time highs, all the liquidity-driven markets -- like commodities, oil, corporate bonds, emerging markets and resource stocks -- are going higher.

BOTTOM LINE: The financial sector is now strong enough for Congress to dare to impose draconian regulations. We reiterate our view that the sector is only a recovery story, not a growth story. The Fed's powers and independence are under attack, and it is fighting back by appeasing the politicians who threaten it by continuing extreme policy accommodation. Inflation-driven and liquidity-driven assets will continue to show relative strength versus growth-driven assets, and the dollar will continue to weaken. Stocks are being dragged along only by the excess liquidity symbolized in gold's new all-time highs -- not by natural growth expectations.