

# US Fed: The Ultimate Cleanup Sponge

## July 2009

### Green Shoots

This piece would no doubt disappoint readers, if we failed to comment on the “green-shoots” that have been observed among the ashes of economic collapse. Conversely, we would be presumptive to attempt a fresh point of view on the subject. Instead, here are a couple of apparently unanswered questions and related observations:

- **Are the green shoots we see actually growing, or have the surrounding ashes merely been compacted?** Massive government spending is clearly providing needed soil, but not fertilizer. Recently positive quarter-on-quarter corporate and bank bottom lines are heavily influenced by one-time belt-tightening; sales have shrunk dramatically (and, in many cases, still are). If the recovery-corner has been turned, then the next leg must be yet-to-appear bank lending and corporate revenue growth.
- **Can the US return to economic growth, amid continuing job destruction and the resulting consumer fright among those still employed?** Many have reminded us, including the President, that unemployment stats are lagging indicators of general economic health. That said, almost 15 million un-employed and a larger number of under-employed are understandably neither watching statistics nor spending money. Indeed, for them, ‘hope’ is acutely intangible, notwithstanding the possible green-shoot fact that the value of their home may have stopped declining. Moreover, a huge portion of those still employed have packed-in their spending on all but a minimum amount of necessities. [Please see the graph and our final paragraph in this piece.]

### Feder-nomics

It would be difficult to over-estimate the impact of the Federal Reserve Bank’s engineering work on the US economy, both at present and over the foreseeable future (particularly if the Obama Administration succeeds in enhancing the Fed’s authority).

About one year ago, the Fed took charge of the mess which had suddenly crushed the elaborate network of trust and credit that turns the wheels of commerce in the developed-market world. The situation’s dynamics were

not unlike a thousand-car, rush hour pileup on a fogbound California expressway.

Among US Government entities, the Fed is unique: (a) It isn’t a department or agency, (b) it requires no annual funding, no Congressional budget approval/very little oversight, (c) its mission is extremely broad and, consequently, (d) its activities are mostly non-transparent.

You may have read references to the Fed’s “balance sheet blowout”, or similar terms. Here are **selected items** from the Fed’s end of June 2009 and 08 balance sheets, plus other currently key items (**dollar amounts in billions**):

	7-2-2009	7-2-2008	Change (% of 7/2008 Total Assets)
<b>ASSETS:</b>			
US Treasury Securities	\$663	\$479	+20%
Fannie/Freddie/Ginnie debt paper	462*	0	+50%
Other agency debt paper	98	0	+10%
Commercial paper	115	0	+12%
<b>TOTAL ASSETS</b>	<b>\$2,045</b>	<b>\$ 923</b>	<b>+122%</b>
<b>LIABILITIES**:</b>			
Currency in circulation	\$ 911	\$ 827	+9%
Deposits with Fed Banks, other than reserves	284	12	+9%
Reserve balances held at Fed Reserve Banks	722	-7	+79%
<b>MEMORANDUM ITEMS:</b>			
Custody holdings for foreign accounts: US Treasury securities	\$1,960	\$1,374	
*Add'l net commitments to purchase mortgage-backed securities	\$ 139	\$ 0	+15%

\*\* Changes in these 3 items account for essentially the net change in all Fed assets and represent the Fed’s “printing of money” activity from July 2, 2008 to July 2, 2009.

Context: At the end of 1Q 2009, the annual rate of US Gross Domestic Product stood at \$14 trillion; the Fed’s 12-month “absorption” was therefore equivalent to about 8% of GDP.

The Fed's balance sheet has historically been quite simple; the numbers were not eye-popping. Until now, we have not seen it bloated with massive purchases of long term US Government-backed debt. But suddenly the Fed owns, among other things, a half-trillion-dollar, proverbial boatload of mortgage-backed paper that is "guaranteed" by the financially exhausted quasi-agencies known as Fannie Mae and Freddie Mac.

Meanwhile, the US Congress was busy with its budgeting process, an annual kabuki ritual that, this fiscal year, paints a nightmare for the finance-gnomes down at the Treasury. Not only is the federal budget in its accustomed deficit mode, but its size is unprecedented....and it is growing by proportions not seen since the Great Depression/World War II, if then. Deficits, of course require borrowed money....new Treasury debt. But, who will buy all those T-puppies and what interest rate will they demand? Simple answer: two endlessly well-heeled investors who have an agenda other than earning a good interest rate, i.e., the US Fed and The People's Bank of China.

### **So, where's the sleight of hand?**

The Fed's massive money-printing enterprise, of course means that there are significantly more US dollars in existence today than a year ago. We and others conclude that the Fed's money-pump is laying a warm, fuzzy bed for future price-inflation, through de-valuation of the dollar, versus currencies of countries, mostly Asian, whose central banks are not manufacturing money. [Money is a commodity; its value is established by forces of supply and demand; an over-supply of dollars will naturally push up the price of things valued in dollars.]

### **'Not so fast', says the Fed**

The simple money supply/inflation logic laid out in the preceding paragraph has not failed to appear on macroeconomist (Dr.) Ben Bernanke's radar screen. In fact, he has written considerably on the money-creation-versus-inflation topic. In 2003, as an academic, he preached to Japan's central bank (BOJ) about what they should do at the time to restore healthy economic growth to their country, mired as it was/is in a naggingly persistent recession.

Here is our synopsis of how Dr. Bernanke's 2003 Japan-formula seems to fit with his 2008-09 depression-avoidance tactics in the US:

- Treasury will, and should kick-start the economy with expansive deficit-spending (funded by new debt issuance).
- Central bank should buy up the excess amounts of new treasury debt; this will
  - ✓ prevent an abnormal market supply of treasury debt, and
  - ✓ avoid "crowding out" of new corporate debt, which will
  - ✓ maintain stable, low interest rates, until recovery is underway, BUT this will also
  - ✓ create a surge in money supply.
- Central Bank should announce a target to reflate the economy (so that the marketplace will not treat this as a temporary move).
- As inflation takes hold, via healthy expansion of *nominal* GDP (even though the *real* economy may not be growing), Central Bank should
  - ✓ gradually ratchet-up short term interest rates, as it normally does, and also, if necessary,
  - ✓ sell its accumulated bonds, which, in turn, will put downward pressure on both long term market interest rates and general price inflation.

There you have it. But, beware: Bernanke further said "....Of course, one can never get something for nothing; .....increased monetization of government debt [substitution of newly issued money for debt] simply amounts to replacing other forms of taxes with an inflation tax."

### **'Not to worry' (about inflationary impact of Fed's actions), says Bernanke**

As it happens, this paper is being completed as Mr. Bernanke was undergoing his semi-annual monetary policy grilling before the US Senate Banking Committee. This time, on the same day he trudged up to Capitol Hill, he pre-empted his testimony, via a Wall Street Journal op-ed piece titled The Fed's Exit Policy. Two essential elements were *not mentioned*, we noted: (1) setting and announcing a re-flation target rate and (2) his 'inflation-tax' theory.

Mr. Bernanke is now brandishing a new tool which he believes will be seminal in the expected battle to tame future inflation of goods and services prices: the Fed is now permitted to pay interest (at a rate set by it) on commercial banks' reserve deposits. The explanation of this is multi-layered and won't be attempted here.

### **What gives at the US Treasury?**

In case you missed it: A period of crisis-upon-crisis, weekend fix-it meetings in New York during the summer of 2008 turned into a fully

formed tidal wave by late September. The US Treasury Secretary assembled Congressional leaders and, according to reports, gave an economic assessment so dire that it "...sucked the air out of the room". He handed them an emergency next-step: 3-page draft legislation authorizing the Treasury to buy \$700 billion of "toxic" investments held by financial institutions deemed too big to fail.

Following a wave of market-destroying political fireworks (by both parties) on the floor of the US House, Congress passed emergency legislation known as Troubled Assets Relief Program (TARP). A month later, however and with little explanation, the Secretary announced that TARP money would not, after all, be used for de-tox purchases of troubled assets.

So, how has TARP money actually been spent? At June 30, 2009, Treasury had "invested" \$203 billion in some 650 financial institutions (including some buys of toxic assets). In June, the first permitted \$70 billion of repayments were collected from a few of those borrowers. The net TARP figure is now \$133 billion.

Other prominent disbursements and commitments which total about \$400 billion....

- AIG Insurance Co: \$70 billion (Treasury's addition to the Fed's earlier \$124 billion bailout) ;
- BankAmerica and Citigroup: \$45 billion;
- GM/Chrysler and auto suppliers: \$30 billion;
- "Making Home Affordable Program": \$50 billion;
- "Small Business and Community Lending Initiative": \$15 billion;
- "Public-Private Investment Program" (PPIP): \$100 billion;
- "TALF" Program (supplemental commitment): \$80 billion.

Note: the PPIP program does not appear to have gained acceptance; it remains to be seen whether very much of this commitment will actually be spent.

Fiscal 2008's federal deficit was a mere \$459 billion, whereas *this year* (September 30) *will be 4 times that amount* (more than \$1.8 trillion). The Treasury is also responsible for the \$787 billion 'stimulus' bill passed by Congress in February 2009 (not to be confused with \$700 billion TARP money). More than 1/3 of this figure is designated for "middle class income tax relief" .....an interesting target, because citizens and other US residents who are presumably most in need of economic stimulus are those who have lost their jobs and, hence, are not burdened with income taxes.

Stimulus distributions are targeted for all 50 states, as you would expect. But \$3.8 billion will also go to 9 US territories... including not only Puerto Rico, but also Micronesia and Palau (?), among others. Thus far (July 10), \$183 billion of projects had been slated for funding, but only a relatively puny \$64 billion had been doled out.

### US Personal Saving and Debt-Growth Rates are Healthy Again – Too bad

The graph below, if not saying all, says most of what's important about consumer-level economic activity in the US. Only 2 years ago, households were flipping their houses on sub-prime mortgages, ATM-style, using the cash-out money for down payments on the biggest luxury SUVs, boats, trips, etc. Folks were just generally feeling and acting rich, because, in addition to enjoying so many creature comforts, they had *secure jobs* that, besides a paycheck, provided a 401k account which dependably added new wealth on every quarterly report.

But now, even those who have kept their jobs are hunkered down. People who still have "Disposable Personal Income" are not spending it. Instead, they are tightening belts and using cash flow to: (a) pay off credit cards and (b) put as much as possible into savings, for protection against the day when the Grim Reaper visits them, as he already has in their neighborhood. On such a massive scale, this scenario is the stuff that feeds deep economic recessions.

