THOUGHTS FROM THE FRONTLINE

ME

Still Rethinking the Fed

By John Mauldin | April 22, 2023

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Back before clocks went digital, you could say "a stopped clock is right twice a day" and even youngsters would know what you meant. A mechanism could be nonfunctional but occasionally correct.

So it is with the Federal Reserve and its leaders. They make many mistakes but sometimes get it right. They are doing so now, in my view, by prioritizing inflation control ahead of growth. This doesn't excuse the past mistakes, though—especially since they helped create this inflation.

This week I'm traveling and unable to write a full letter, so I'm instead going to revisit a theme I have written about in the past and is still very appropriate today. The most recent was last year in *Time to Rethink the Fed*. Judging by the number of comments, it was one of the most engaging letters in recent memory. I wrote it as inflation was proving non-transitory but before the Russia attack on Ukraine spiked energy prices and put inflation on overdrive.

In hindsight, my opinions have not changed much but I do have a few additional insights.

Time to Rethink the Fed

One of the hardest leadership challenges is knowing when to change plans. Is what you *could* do better than what you *are* doing? Certainty is impossible.

At some point, though, good leaders recognize their plans aren't going well and start looking for better ones. I believed back in early 2022 that the Federal Reserve was there. I don't mean the Fed's policy dilemma, then and now. I mean the Fed itself; its very existence, structure, and goals. **They need a complete restructuring, because the Fed isn't accomplishing what we all need it to. Worse, it is causing problems we could do without.**

I believe Fed officials are largely responsible for the cycles of bubbles, booms, and busts over the last 30 years. Furthermore, they share some of the blame (clearly not all) for the growing divisions and tribalism in our society. Much of it springs from the wealth disparity they aided and abetted.

I've talked before about how the Fed has painted itself into a corner. All the options are bad and getting worse. The reasons it is in this position are no mystery. Indeed, this is all inherent in the Federal Reserve system's design. **It is trying to do things it shouldn't be attempting.** The only real solution is a wholesale redesign and reconstruction. What we have today isn't working and the time has come to amend the Federal Reserve Act and change its purposes and authorities.

I realize these are bold words. I fully acknowledge the gravity of what I'm proposing here. And I am totally open to ideas of what a new and better Fed would look like. I know any transition from here to there will be tricky, too.

It also will take time. I do not expect anything to happen of any substance until we get to The Great Reset, where we will be forced to think and do many things now unthinkable in the current environment. In the meantime, I fully expected back in 2022 and still believe the current Federal Reserve will increasingly inject itself into the economy and make things worse. Its leaders will do so with the best of intentions, because they believe their own dogma. In their view, this is just what they do.

We need to have this conversation and it has to start somewhere. So today I'll start it.

Who Needs Central Banks?

We should first ask why the Federal Reserve (or any other central bank) is even necessary. Answering that leads quickly to much deeper questions, like what is "money" and who should create/control its value. Many libertarians and Austrian-school economists argue governments should have no role at all.

I probably would've been sympathetic to that in the late 19th century and early 20th century. I will now no longer argue for the Fed's full dissolution. We need central banks with limited capabilities, just like young children need training wheels. My goal is to improve the present system and reduce its harmful side effects.

Modern central banking is fairly new. Until the 19th century, private banks commonly issued their own currency notes, sometimes linked to gold but not always. Wars and political machinations created instability, with periodic panics and bank runs. Banking was not a "system" as we know it today. Banks did their own thing, and if yours had trouble it was your problem, too.

Let's stop here and make an important distinction. Today we associate central banks with "fiat money" without independent backing like gold. That's not always the case. You can have both a gold standard and a central bank at the same time. A central bank standing behind individual banks helps maintain stability, thereby promoting the confidence that attracts deposits. This would be important even in a 100% reserve system.

In the 1870s the Bank of England pioneered the "lender of last resort" concept. British writer Walter Bagehot (a co-founder of *The Economist* magazine) famously summarized the central banks' job as averting panic by "lending freely, to solvent firms, against good collateral, and at high rates."

That isn't what today's Federal Reserve does. In particular, it doesn't follow the "high rates" part of Bagehot's advice. This, I think, is key to many of our problems.

A Benchmark for Everything

As lender of last resort, a central bank stands ready to always loan a commercial bank enough cash to repay depositors. This doesn't always mean the bank is in trouble. Money flows in and out every day and sometimes gets unbalanced. In the US, "federal funds" are available overnight to fill these gaps, for which banks pay interest at the federal funds rate, the amount of which is set by the Federal Open Market Committee (FOMC).

This rate has grown far beyond the limited purpose of simply enhancing bank liquidity. It has become the benchmark for everything. The entire global economy now hinges on a price subjectively determined by a committee of a) politically appointed governors and b) regional Fed presidents selected by boards that represent their region's commercial banks. Unlike other prices, it isn't a function of supply and demand. The rate can be as high or as low as the committee wants. The FOMC members set the rate at whatever they think will achieve what they believe are good economic goals. But that has economic consequences.

It all seems so logical when they explain it. But the reality is that we have been through multiple bubbles brought about by ever-lower interest rates in an effort to avoid recessions and improve employment (laudable goals to be sure) and in recent years a new tool: quantitative easing (QE).

The Federal Reserve Act gives the Fed a "dual mandate." It is required to promote both full employment and price stability. Unfortunately, its monetary policy tools have at best a distant influence on employment. Creating the conditions that let businesses create jobs is really a fiscal and regulatory function. Congress and the president should be doing that part. The Fed should focus on price stability.

Fed proponents point to a correlation between Federal Reserve efforts and unemployment. I would argue that this is correlation without causation. Jobs are created when entrepreneurs recognize business opportunities and need workers to achieve them. As we will see, artificially low interest rates actually hinder job formation.

As for price stability, the Fed defines “stability” as inflation averaging 2% yearly. That’s not stability. A 2% inflation rate will, over a typical worker’s lifetime, consume a large part of their savings and leave them anything but “stable.” It means you lose half your buying power in 36 years. Worse, 3% inflation means half your buying power disappears in a mere 24 years.

Moreover, the Fed hasn’t produced consistent price stability despite its many tools. Inflation was well below target for most of the last decade (based on the Fed’s own benchmarks, though consumers certainly saw higher inflation in their living costs). Now inflation is far above their target. The Fed’s choice to keep rates low and continue massive QE is having serious long-term side effects.

This Can’t Continue

As you know, there are interest rates and “real” interest rates (nominal interest rates minus the inflation rate), which account for the fact the currency with which a borrower repays may have changed value before repayment was due. The Fed is now taking this to extremes, as former Morgan Stanley Asia Chairman Stephen Roach explained in this early 2022 *Project Syndicate* piece. Quoting (emphasis mine):

> “Consider the math: The inflation rate as measured by the Consumer Price Index reached 7% in December 2021. With the nominal federal funds rate effectively at zero, that translates into a real funds rate (the preferred metric for assessing the efficacy of monetary policy) of -7%.
>
> “That is a record low.
>
> **“Only twice before in modern history, in early 1975 and again in mid-1980, did the Fed allow the real funds rate to plunge to -5%. Those two instances bookended the Great Inflation, when, over a five-year-plus period, the CPI rose at an 8.6% average annual rate.**
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> “Of course, no one thinks we are facing a sequel. I have been worried about inflation for longer than most, but even I don’t entertain that possibility. Most forecasters expect inflation to moderate over the course of this year. As supply-chain bottlenecks ease and markets become more balanced, that is a reasonable presumption.
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> “But only to a point. The forward-looking Fed still faces a critical tactical question: **What federal funds rate should it target to address the most likely inflation rate 12–18 months from now?**
>
> **“No one has a clue, including the Fed and the financial markets.”**

A -7% real interest rate is simply bizarre. It means anyone who can borrow at the fed funds rate, or close to it, is effectively being paid to take on more debt. And not just paid but paid *well*, plus whatever return they can generate with the borrowed money. This is partly why so many asset prices are so bubble-like today.

Now, real rates may moderate somewhat in 2022 as inflation eases and/or the Fed raises rates. But even the most hawkish scenarios would only bring it back to the 0% range, (and we certainly aren't there yet) which is still not normal.

Negative rates were increasingly normal even before the current inflation. I wrote a long letter about it back in August 2016: Six Ways NIRP Is Economically Negative. I showed how the Fed and other central banks were ignoring even their demigod, Lord John Maynard Keynes. Following a long Keynes quote I said this:

> To paraphrase, Keynes is saying here that a lower interest rate won't help employment (i.e., stimulate demand for labor) if the interest rate is set too low. Interest rates must account for the various costs he outlines. The lender must make enough to offset taxes and "cover his risk and uncertainty." Zero won't do it, and negative certainly won't.
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> The footnote in the second paragraph is important, too. Keynes refers to "the nineteenth-century saying, quoted by Bagehot, that 'John Bull can stand many things, but he cannot stand 2 per cent.'"
>
> Is Keynes saying 2% is some kind of interest rate floor? Not necessarily, but he says there is a floor, and it's obviously somewhere above zero. Cutting rates gets less effective as you get closer to zero. At some point it becomes counterproductive.
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> The Bagehot that Keynes mentions is Walter Bagehot, 19th-century British economist and journalist. His father-in-law, James Wilson, founded *The Economist* magazine that still exists today. Bagehot was its editor from 1860–1877. (Incidentally, if you want to sound very British and sophisticated, mention Bagehot and pronounce it as they do, "badge-it." I don't know where they get that from the spelling of his name. That's an even more unlikely pronunciation than the one they apply to Worcestershire.)
>
> Bagehot wrote an influential 1873 book called *Lombard Street: A Description of the Money Market*. In it he describes the "lender of last resort" function the Bank of England provided, a model embraced by the Fed and other central banks. He said that when necessary, the BoE should lend freely, at a high rate of interest, with good collateral.
>
> Sound familiar? It was to Keynes, clearly, since he cited it in the General Theory. Yet today's central bankers follow only the "lend freely" part of this advice. Bagehot said last-resort loans should impose a "heavy fine on unreasonable timidity" and deter borrowing by institutions that did not really need to borrow. Propping up the shareholders of banks by lending low-interest money essentially paid for by the public when management has made bad decisions is not what Bagehot meant when he said that the Bank of England should lend freely.

> How did the Fed act in 2008? In exact opposition to Bagehot's rule. They sprayed money in all directions, charged practically nothing for it, and accepted almost anything as collateral. Not surprisingly, the banks took to this largesse like bees to honey. Taking it away from them has proved very difficult. We now find ourselves in an era of speculation about what will happen when interest rates are raised.

A few months after that letter, the Fed embarked on a two-year tightening phase that took rates about two percentage points higher. Even that small, slow change was more than markets could handle. The Fed gave up and resumed cutting in mid-2019. Then COVID hit and here we are, in a mess with no good way out.

I assume and the markets agree with me that the Fed will raise rates another 25 basis points in May. That will take fed fund rates up to 5¼%. And while inflation is coming down, real rates are still below zero. Between now and the June meeting the Fed will get two CPI reports and two unemployment reports. They will be very data dependent as they go into the June meeting. Barring some surprise in those reports, I think the Fed goes on hold for a very long time. The rate cuts that the market thinks will happen this year aren't in my crystal ball.

Obviously, this is creating market turmoil and some pressures on mismanaged banks. This can't continue. The Federal Reserve and its peers need to get back to boring, Bagehot-style central banking and stop trying to micromanage the entire economy. The mere attempt generates yet more problems. The free (or better than free) money environment they created makes every other challenge worse. Now we are paying the price. Would the market naturally price interest rates at 5.25%? We will never actually know, but my suspicion is "doubtful." Yet given where inflation is, I don't believe the Fed has a choice other than to maintain rates high enough to choke off inflation.

Full disclosure and a minor retraction: I wrote well over a year ago that I thought the Fed would raise rates to over 5% and we would get to 5% unemployment before they stopped. We have clearly made the 5% fed funds rate but I think they and pretty much everybody else has been surprised at the strength of the labor market. I now think they will stop way before unemployment reaches even 4.5%. But actually cutting rates? At minimum, we will need to see a 2% handle on inflation (that means the first number in the inflation number is a 2, in market slang called a 2 handle).

How Then Should We Change the Fed?

So what can we do? I think we should abolish the dual mandate and have the Fed focus squarely on inflation. That will be easier if full employment isn't on their plate, too. As noted above, the link between low interest rates and employment is tenuous, if it exists at all.

Furthermore, 2% inflation should be seen as high. The Fed should be leaning into inflation (tightening monetary policy) at 2% inflation and only ease policy when inflation is at 1% or lower. Period. It goes without saying that we need better inflation tracking tools, too.

The Federal Reserve should not be this all-powerful "manager" of the economy. The Fed has taken on a third unwritten mandate, that of "financial stability," which really means stock market stability. The low rates that keep the stock market happy also financialized the entire economy. It is now cheaper to buy your competition than to actually compete. Private equity has evolved the way it has because low rates make it possible to buy good businesses, add cheap leverage, and over time generally produce well-above-market returns. None of it is available to the bottom 80% of the population, meaning the rich get richer. The financialization of the economy has been one of the greatest ills brought about by a loose monetary policy.

The economy can manage itself (with a few rules, of course). We just need stable money, a stable economic environment, and an honest, reliable banking system. A great deal of the Fed's activity has nothing to do with what should be its core mission. As bureaucracies do, it has grown too powerful and invented new reasons to justify its existence.

That's not any one person's fault, nor is it a partisan political thing. Getting us into this mess was a long-term bipartisan comedy of well-intentioned errors. Finding a solution is more important than pinning blame. We have to start somewhere and now is the time.

(End 2022 walk down memory lane)

Updated Thoughts

Reaction to that letter was overwhelmingly positive. The main criticism was that I had described the problem but not proposed any solution. That was intentional. I wanted to start a conversation and, hopefully, encourage those with expertise to offer their ideas.

(The war that started soon afterward delayed that conversation, but we'll pick up the ball in several sessions of next month's online Strategic Investment Conference. Our faculty includes experts with many perspectives. You should definitely join us. Click here to learn how.)

For my part, I think Bagehot had it right 150 years ago. We need central banks, but their role is to keep the banking system stable, not control the economy. They should lend freely, at high rates, with good collateral. Do that and I think other things will mostly take care of themselves.

You might say, "Not in a million years." And it's true the Fed is a powerful, entrenched institution that won't change easily. But it's also true we are approaching a time when, according to Neil Howe and George Friedman, some of society's most powerful institutions will collapse and be rebuilt. The Fed could be one of them.

If you and I can't reform the Fed, maybe the Fourth Turning will.

We have finalized the faculty for the Strategic Investment Conference. This is clearly the best conference that we have done in the last 19 years. Click here, scroll down and look at the speakers. There are some famous names you know but I guarantee you that some of the most interesting and surprising panels will be names that you don't know of today but will become information fixtures in your future. We have a broad array of cutting-edge technology leaders, lots of financial and economic experts, fascinating geopolitical analysts, and sessions designed to give us a handle on the changing social environment not just in the US but the world.

You can view SIC in real time, absorb it on your own schedule, listen to it on your walks or biking, or read the transcripts. Regular attendees will tell you that this is the single best economic conference of the year anywhere. And 2023 will be our best in 19 years. You really want to join us.

Austin, Colorado, Tulsa, and Home

I am in Austin tonight for the first time in about five or six years. My friend and reader Norbert Wagnick served as my driver and tour guide as we drove through a downtown that I simply did not recognize. People kept telling me it had changed but it's hard to grasp how much it's changed in just five years.

This is already proving to be a fun trip. I had dinner with Lacy and JK Hunt and George and Meredith Friedman. Lacy and I went over his speech material for the upcoming SIC. I've been reading and listening to everything Lacy says for almost 20 years. This will be his most substantive and important speech ever. Just wow! Don't miss it!

I also get to see longtime friend and Mauldin Economics associate Patrick Watson for lunch, dinner with Joe Lonsdale, more meetings lined up on Saturday, and then The Cicero Institute dinner Saturday night. The next morning I'm off to Colorado Springs to see my new grandson Odin (and Chad and Danielle) and then the next day to see three of my kids (Abigail, Amanda, and Henry) and five grandkids. I saw Melissa and Tiffani in Dallas.

I am not complaining, but I am as busy now as I have ever been in my life. That's good because I'm enjoying it immensely. It is time to hit the send button and wish you a great week! And don't procrastinate! Sign up for the conference right now!

You're as frustrated as ever with the Fed analyst,

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