The Fed is Putting Free Markets at Risk

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For those who believe that capital markets should be free from undue government interference, the Fed's adoption of expansive programs raises the question of whether it has gone too far.

The Fed has taken unprecedented action to bolster the economy and prop-up the financial markets in the face of the COVID-19 pandemic. In addition to lowering short-term interest rates to zero, reducing the interest rate that banks can borrow from the Fed and cutting bank reserve requirements, it has again implemented asset-purchase programs, known as quantitative easing (QE). However, unlike the first QE programs adopted during the 2008 financial crisis, today's QE is far more expansive in the amount of money that can be spent and the type of assets that can be purchased.

The Fed's purpose

In considering the question I raised at the outset, it is helpful to examine the Fed's purpose. The original and still primary purpose of the Fed, or any central bank, is to manage the stability of the fractional reserve banking system by acting as a lender-of-last resort to commercial banks. Because commercial banks are permitted to lend out more money than they are required to hold in reserve to cover deposit withdrawals (i.e., fractional reserve banking), a central bank is needed to back-stop the deposits of commercial banks in case they experience financial difficulty and a subsequent run by depositors. Through the central bank's discount window and other direct lending programs, commercial banks can borrow from the Fed any time they need additional liquidity. It is primarily through these means that the Fed acts as lender-of-last resort to maintain the stability of the banking system.

With the enactment of the Full Employment and Balanced Growth Act of 1978, Congress expanded the Fed's purpose to include the creation of monetary policy that promotes long-term economic growth, maximum employment and stable consumer prices. Those purposes were not part of the Fed's original mandate, and arose primarily due to the United States' adoption of a fiat money system and its subsequent battle with stagflation. Under a fiat money system, the value of the dollar is determined not based on a specific exchange rate tied to the value of an underlying scarce asset such as gold, but rather, purely on its supply and demand in the world markets. This decoupling of the dollar from an asset-based exchange rate made it possible for the federal government to engage in unlimited money creation. However, unconstrained money creation can lead to uncontrolled inflation. In order to curtail the inflationary effects of a fiat money system and its impact on the broader economy, the Fed was specifically tasked with the role of managing the price of money through its power to set short-term interest rates.

Under its evolving mandate, the Fed has assumed the broader purposes of maintaining the stability of the financial system and the entire economy. One of the ways that it has chosen to do this during times of crisis is through QE. However, if pursued without constraint, these programs can lead to inappropriate government interference in private markets and the degradation of our free market system.

Quantitative easing and the Fed's new role as buyer-of-last-resort

The origins of QE began during the 2008 financial crisis when the Fed first used it as a means to preserve liquidity in the banking systems and to stabilize the economy. In its simplest form, QE involves the Fed's purchase of Treasury bonds and other government-guaranteed debt from commercial banks in order to pump money into the banking system. The primary goal of QE is to shore-up the financial position of commercial banks in order to stabilize the banking system during times of stress. It also provides commercial banks with additional liquidity so that they can make more loans to consumers and businesses with the objective of jump-starting economic growth.

However, QE also creates substantial artificial demand for the assets being purchased. Under the basic law of supply and demand, Fed-driven securities buying causes a corresponding increase in asset prices. Therefore, when the Fed launches a QE program to buy Treasury bonds and/or agency debt, the effect is not only to create liquidity in the financial system but also to increase the demand and market price for such debt as well as lowering its interest yield. In fact, any QE or central bank asset-purchase program will lead to greater liquidity, more demand and higher market prices for the assets being purchased. This is one of the reasons why QE was viewed as being so controversial when it was first implemented in 2008.

QE programs also indirectly affect the price of financial markets by increasing money flows to commercial banks and other financial institutions who use this additional liquidity to buy financial assets for their own account. For example, when the Fed buys Treasury bonds and agency debt from commercial banks in exchange for dollars, this increases the amount of cash on each bank's balance sheet. Not all of this cash is used to fund capital reserves or to make additional loans. Rather, a substantial portion of this additional liquidity is used by the banks to buy publicly traded stocks and bonds for their own account. Again, under the law of supply and demand, this increase in capital into publicly traded stocks, bonds and other financial assets causes prices in the markets to increase. QE programs cause artificial price increases in financial markets, which can lead to destabilizing valuation bubbles over the long-term.

The COVID-19 crisis and the Fed's adoption of unprecedented QE

The precedent of QE established during the 2008 financial crisis has been taken to new heights. On March 15, the Fed announced that, in addition to other monetary action, it would institute a QE program to purchase $500 billion in Treasury securities and $200 billion agency mortgage backed-securities in order to support the smooth functioning of the market for these securities.

Then, on March 17, the Fed announced that it would act to support the commercial-paper market through the creation of a special purpose vehicle (SPV) to purchase unsecured and asset-backed commercial paper directly from eligible companies. Under this program, known as the Commercial Paper Funding Facility, the Fed explicitly stated that it was acting to support the non-government backed commercial-paper debt market.

However, the *coup de grâce* occurred on March 23 when the Fed announced a new plan of virtually unlimited QE. Under this plan, which was further expanded on April 9, the Fed established or expanded several credit facilities to purchase multiple types of non-government guaranteed assets ("risk assets"). Unlike the first QE programs created in 2008, this QE has no dollar limit and authorized the Fed to purchase an even wider variety of assets, including risk assets such as investment-and non-investment-grade corporate bonds, publicly traded corporate bond exchange traded funds (ETFs) and a myriad of asset-backed securities. The explicit purpose for those credit facilities was to prop up the markets for those financial assets.

Evidence of this can be seen in the Fed's March 23 announcement, where it stated that one of the justifications for its expanded QE program was "to promote the stability of the financial system." In other words, the Fed announced that it would intervene in these non-government-backed debt markets to support demand and prices by acting as buyer-of-last-resort with the goal of stabilizing the financial system. Through this new, expanded QE, the Fed now has unprecedented power to interfere in the non-government backed securities markets – leaving only stocks and stock-index ETFs as the only risk assets yet to fall under the Fed's purchasing power.

But why does the Fed feel compelled to use such expansive QE programs? Leaving aside potential political reasons, the answer lies in the fact that the Fed's traditional monetary policy tools have been exhausted. An example of this can be seen in the Fed's decision to keep short-term interest rates at historically low levels over the past decade. By keeping interest rates at such low levels for so long, the Fed is now unable to lower rates in the face of an economic crisis. As a result, the Fed is forced to adopt more unconventional methods, such as expanded QE, to facilitate the stability of the financial markets and promote economic growth.

The Fed's creative basis for acting as buyer-of-last-resort

Although Congress has not provided the Fed with the explicit authority to engage in asset-purchase programs such as QE, the Fed claims that it has the ability to do so under its expanded interpretation of Section 13(3) of the Federal Reserve Act.

Under Section 13(3), Congress authorized the Fed to provide emergency *lending* to commercial banks and systemically important non-bank companies in order to promote the stability of the financial system. It was enacted in 1932 as part of Depression-era legislation designed to respond to a series of bank failures and financial weakness among several economically important companies such as railroads. The original version of Section 13(3) gave the Fed the power to provide emergency loans to Federal Reserve member banks and economically important companies in exchange for short-term commercial paper or other securities eligible for discount under the Federal Reserve Act. Given the potential dangers associate with this authority, the Fed adopted a narrow interpretation of Section 13(3) by limiting its scope to only Federal Reserve member banks.

However, in response to the stock market crash of 1987 and the need to promote the liquidity of broker-dealers in its aftermath, Congress, in 1991, expanded the scope of Section 13(3) to expressly include non-member banks. It also expanded the type of assets that could be acquired by the Fed in exchange for emergency lending beyond government-backed securities and commercial paper.

During the 2008 financial crisis, Section 13(3) was frequently used by the Fed to inject liquidity into the financial system. For example, it was the principal source of legal authority for the Fed's creation of the Troubled Asset Relief Program (TARP) and its bailout of American International Group, as well as the establishment of other credit facilities such as the Term Asset-Backed Lending Facility. However, Congress felt that the Fed's expanded use of Section 13(3) to bailout individual companies was beyond the Act's intended purpose. Thus, under the Dodd-Frank Act, Congress limited the Fed's use of Section 13(3) to only emergency credit facilities for programs with "broad-based eligibility." It also prohibited the Fed from establishing any Section 13(3) program without the prior approval of the Treasury Secretary.

On its face, Section 13(3) permits the Fed to create only emergency*lending* programs – not asset-purchase programs. However, through the use of shell entities known as Special Purpose Vehicles (SPVs), the Fed, with the help of the Treasury Department, has come up with a way to game the language of Section 13(3) to permit it to engage in indirect asset purchases on a wide scale. An example of this creative structure is as follows:

- The Fed establishes a credit facility to provide liquidity to a specific market such as the market for investment-grade corporate bonds, junk bonds or a myriad of other securities.
- The Treasury Secretary formally approves the establishment of the Fed's credit facility (as required by Section 13(3)).
- The structure of the credit facility involves the creation of a SPV and initial funding of the SPV by the Treasury Department in exchange for an equity stake in the SPV. The source of the Treasury Department's equity investment in the SPV is usually its Exchange Stabilization Fund.
- The Fed then provides a loan to the SPV so that it can purchase certain types of financial assets in the primary and secondary markets.
- In exchange for the loan, the SPV pledges the assets that it purchases as security for the loan.

The Primary Market Corporate Credit Facility ("PMCCF") and Secondary Market Corporate Credit Facility ("SMCCF") are prime examples of the Fed's use of this structure. These credit facilities were established on March 23 as part of the Fed's expanded QE program and were enlarged on April 9. They involve the creation of SPVs whose sole purpose is to purchase investment-grade and non-investment-grade corporate bonds and corporate bond ETFs in the primary and secondary markets. The SPVs will receive aggregate equity funding of at least $75 billion from the Treasury Department through its Exchange Stabilization Fund. The Federal Reserve Bank of New York will then lend the SPVs a total of $750 billion to facilitate their purchase of the corporate bonds and corporate bond ETFs. In exchange for the loan, the SPVs will pledge the securities that they purchase as collateral.

As can be seen through these credit facilities, the Fed has taken the position that it has the authority to engage in indirect asset purchases by making a loan to a shell entity (SPV), whose sole purpose is to purchase certain securities in the primary and secondary markets. In effect, what the Fed and Treasury Department have done is to create a convoluted corporate structure that complies with the literal language of Section 13(3) even though it violates the Act's intended purpose by expanding the Fed's power well beyond that of just making emergency loans to banks and systemically important operating companies.

A dangerous game

Despite the Fed's stated good intentions, its expanded use of QE programs, including the creation of credit facilities similar to the PMCCF and SMCCF, is a dangerous form of government interference in private markets and a serious threat to our free-market system.

By purchasing corporate bonds and other risk assets in the primary and secondary markets, the Fed assumes the perilous role of determining corporate winners and losers. Not only is such action well beyond the Fed's original purpose, it also is a serious entanglement of the federal government in the private sector. These programs also create substantial artificial demand for the assets being purchased and provide an implicit promise by the federal government to support market prices in times of crisis. This dangerous combination causes substantial price distortions within the capital markets as a result of skewed investor perceptions of risk and return. Over time, such government interference will to lead to an erosion of investor confidence in the fair and efficient operation of our capital markets and risks nationalizing our free market system.

Evidence of these distortions can be seen in the widening gap between financial asset prices and their fundamental values.

Since the Fed started to expand its balance sheet at the end of 2008 with its adoption of the first QE programs, the stock market has increased in value by over 275% and the yield for intermediate-term US government bonds has declined from 3.04% to 0.65%, thanks, in part, to the additional liquidity and demand injected into these markets by the Fed. Moreover, historically high stock valuation ratios and historically low bond yields says that there is a fundamental mispricing of risk in the capital markets.

Investors are more concerned with Fed policy than actual market fundamentals. For example, the recent rally in the stock and junk bond markets began on March 23, the same day that the Fed announced its expanded QE program. Those markets are up more than 27% and 14%, respectively. If investors want to know why the stock and junk bond markets continue to rise despite new and grave economic reports every week, it's because of the Fed's commitment to inject massive amounts of new money into the capital markets through its aggressive monetary policies, including its new program of expanded QE.

Conclusion

The Fed's intervention in risk asset markets as a buyer-of-last-resort is antithetical to free market capitalism and the Fed's original purpose as lender-of-last-resort. Such action places the Fed in the perilous role of selecting corporate winners and losers and constitutes an inappropriate interference of the federal government in the private sector. It also compromises the fair and efficient pricing of financial assets and risks nationalizing our capital markets.

To prevent such market distortions, the Fed should not adopt a policy of sustained monetary easing, so that it will have sufficient tools to address economic crises without having to resort to asset purchase programs such as QE. In addition, Congress should rein in the Fed's power to engage in asset-purchase programs by clarifying that Section 13(3) of the Federal Revere Act can only be used to provide emergency loans to commercial banks and other systemically important operating companies – not loans to intermediate shell companies or SPVs for the purpose of engaging in disguised asset purchases.

Those measures would eliminate the Fed's need to rely on QE and would end the Treasury Department's and the Fed's Devil's bargain of funding indirect asset purchases through its creative interpretation of the law.

What's at stake is the integrity of our financial markets.

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