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Are We in Another Financial Bubble

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In The movie All The President's Men a source of reporter Bob Woodward nicknamed "Deep Throat" informs him that to solve the mystery of Watergate he needs to follow the money. To understand how the stock market can almost triple in value during a period of mediocre economic growth (2008-2015), we must do the same.

The Fed and Commercial Banks

The Federal Reserve System—a.k.a. the Federal Reserve and, informally, the Fed—is the central banking system of the United States.

It is where banks deposit their money. Those deposits, called reserves, are how banks pay other banks.

Say, for instance, that your bank is Wells Fargo, and you write a check for $2,500 to your car mechanic, who happens to bank at Citi. Wells deducts $2,500 from your checking account. Then they transfer $2,500 from their reserve account at the Fed to Citi's reserve account. Citi then increases the mechanic's checking account by $2,500. No actual cash moves —just a series of interlocking IOUs all done electronically.

Before the 2008 financial crisis, banks did not keep a lot of reserves because, if some banks were short of reserves, they could always borrow them from other banks. But when the housing market crashed, some banks were afraid that other banks were insolvent. So the healthier ones stopped lending them their reserves, and the payment processing system described here was in jeopardy.

TARP

Through its Troubled Asset Relief Program (TARP) the federal government authorized $700 billion to the financial system.[1] By backstopping the banks, the government prevented the reserve payment processing system from freezing. Had the government not acted, the economy would have ground to a standstill, and a depression would have most likely followed.

The Fed also slashed the federal funds rate, that minimum interest rate at

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which the Fed hoped banks would borrow reserves from other banks. This rate eventually became zero, but the economy still languished.

Quantitative Easing

Enter quantitative easing (QE). Starting in late 2008, with a touch of a keyboard the Fed created trillions of dollars to buy bonds. The banks that sold bonds to the Fed ended up with reserves, but reserves are used only among banks, so very little of that money made it into the economy. To push new money into the economy, the Fed also bought bonds from such nonbanks as pension plans and asset managers.

By "**new money**," I mean money added to the economy without money being yanked from someone else's account. Usually, when someone sells an asset, the buyer's bank account is reduced by the price paid for that asset. For example, if I sell you a bond for $10,000, your bank account will drop by $10,000. But with QE, the Fed created the money, so the pension plan or asset manager received the money without anyone's bank account dropping. That means additional money and purchasing power enters the economy.

Some of this new money did bankroll the oil and gas shale boom, but a lot of it was used to purchase existing stocks and high-yield bonds. Those purchases pushed up the prices of those financial assets, but buying existing financial assets does very little to help Main Street.

Commercial Banks

Commercial banks also create "new money" when lending. For example, say you go to your bank for a $100,000 home equity loan. The bank reviews your credit and decides to give

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you a loan, and with a click of a mouse, credits your account $100,000. No one's bank account is reduced by $100,000. The $100,000 is new money, which creates new purchasing power for the economy.

Because banks create money out of thin air, they favor lending for the purchase of existing assets rather than lending to new investment or the creation of new assets. That way, the existing assets can act as collateral, so if the borrower fails to pay the loan, the bank has an asset they can sell.

Post-housing crisis, the one area in which bank lending is surging is to hedge funds and private equity firms. [2] However, like QE, most of that new money goes to buy existing assets such as stocks and high-yield bonds.

Stock Buybacks

Companies spend on plants, equipment, products, buyouts of other companies, debt payment, or buybacks of their stock. However, only spending on plants, equipment, and products transmits directly into economic growth.

For the past ten to fifteen years, stock buybacks have been the preferred method of spending, as they reduce the amount of outstanding stock that boasts the earnings per share, making companies appear to be more profitable.

Today, many executive salaries are paid in stock, and their level of stock compensation depends on earnings per share.

In 2013, the companies in Standard & Poor’s 500 spent a total of $477 billion on stock buybacks. Moreover, they bought that stock after the stock market had increased over 100%.[3]

Companies don’t use “**new money**” for buybacks, but the money they use is no longer available to fund new plants, equipment, products etc.

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Money and Bubbles

The Fed used to do what Deep Throat had recommended. They followed the money, harnessing their powers as a regulator to get new money created by banks into new investments—research, infrastructure, plant and equipment, etc.—and limit the amount of new money that went into existing assets.

But then the Fed began to focus less on where the new money went and more on its cost—i.e., the fed funds rate—to try to control the new money. Commercial banks know best policy. And now much of the money created by banks goes into buying existing assets. Corporations have also gotten into the act with their massive stock buyback programs. As a result, economic growth is generated only when assets rise, as the so-called "wealth effect," i.e., house or stock price increases propel people to spend on other things. (The wealth effect is more pronounced with housing because more people own homes than stocks.)

When most new money did go into the new investments mentioned here, housing and stock prices also went up—but they were the beneficiaries, not the drivers, of economic growth. More people benefited when new investment fueled economic growth. Plus. there were fewer financial bubbles.

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[1] U.S. Department of the Treasury http://www.treasury.gov/initiatives/financial-stability/ TARP-Programs/ Pages/default.aspx#

[2] Gregory Zuckerman, Banks' Loans to Funds Are Back at Levels Before Crisis, http:// www.wsj.com/articles SB10001424052748703535104574646710848896566, Jan 10, 2010

[3] Pearlstein, Steven. “Corporations can’t stop gobbling up their own stock.” The Washington Post, May 10, 2014. Retrieved from http:// www.washingtonpost.com/ business/corporations-cant-stop-gobbling-up-their-own- stock/2014/05/09/83c8ddb0- d6e6-11e3-aae8-c2d44bd79778_story.html