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In This Issue

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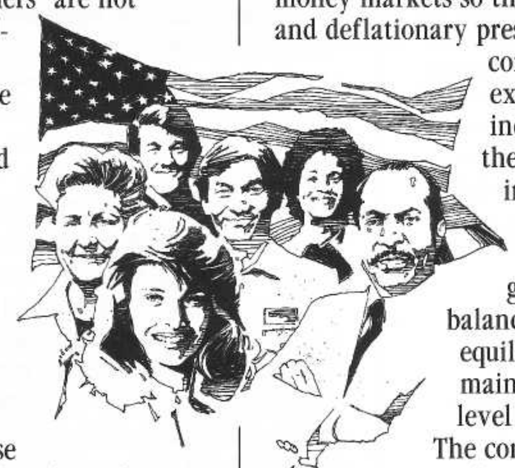
The Impact and Influence of the Federal Reserve System on the U.S. Economy **An Essay - Part I**

Bob Pelletier has resumed his sabbatical from writing the CSI Technical Journal while he devotes more of his energies to engineering and implementing CSI's forthcoming data delivery system. This article is a slightly modified reprint from the June, 1995 issue. It is the first installment in a two-part series on the Federal Reserve.

The enormous economic power wielded by the U.S. Federal Reserve System has a very great impact on the lives of every American. Even our overseas trading partners are not exempt from its mind-boggling influence. Knowledge of how the Federal Reserve operates has supported the efforts of many successful traders. This first installment of our series about the Federal Reserve Board explores two economic views that have influenced this country. Through these views we hope to explain how the Federal Reserve System works. Next month we will dig into the mechanics and consequences of controlling U.S. monetary policy by the Federal Reserve and we will address the political connection of this arm of government.



The basic responsibility of the U.S. Federal Reserve System is to control the credit and the supply of money in the Federal Reserve System. This includes just about every money depository institution in the United States.

The Federal Reserve System was created with the passage of the Federal Reserve Act of 1913. The Act created twelve Federal Reserve Banks distributed around the country which are supervised by the Federal Reserve Board and the Federal Open Market Committee (FOMC). The intent of the legislation was to give the Federal Reserve Board in Washington the authority to stabilize the credit and money markets so that inflationary and deflationary pressures could be controlled. The express objectives included stabilizing the dollar, maintaining high employment, fostering economic growth, achieving balance of payments equilibrium and maintaining a rising level of consumption. The concept of "consumption," not production, is explicitly quoted from *The Federal Reserve System: Purposes and Functions*, fifth edition published by the Federal Reserve Board, 1965, p. 1.

The Fiscalists and the Monetarists

The emphasis on consumption, rather than production, is a fiscal view, as opposed to the now-practiced monetarist view. The fiscal view was advanced by John Maynard Keynes, a British economist known for his economic theory circa 1919. His theory involved controlling the economy with tax rates and government spending. The monetarists, on the other hand, control the economy by manipulating the money supply and rates of credit.

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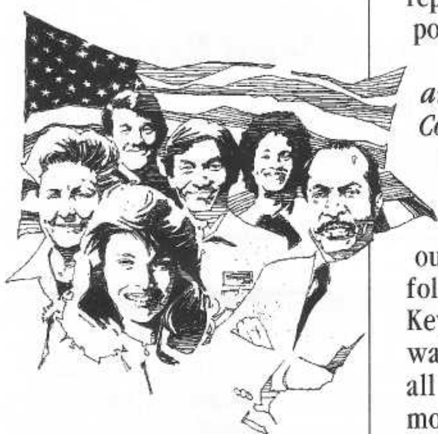

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The Impact and Influence ...
(continued from page 1)

Keynes' theory has had its trials as applied to the American economy, but the latter view on monetary control represents the flavor of the official policy which is adopted today.

Keynes authored *Indian Currency and Finance* and *The Economic Consequences of Peace*, which were very popular works in their day.

Keynes' view that peace is a deterrent to prosperity has outlasted him. My recollection following World War II was that the Keynesian "beware of peace" position was well entrenched in the minds of all well-educated people. My own money and banking professors of the '50s believed that only through "prudent fiscal policy" could we avoid another depression. I don't think I'm being unkind or inaccurate when I recall my professors saying, "We can always tax our way out of a jam or start a war somewhere to keep the economy on track."

Keynes, in attempting to apply his own economic theory to the currency markets, made substantial profits speculating on the strength of the dollar versus European currencies. However, in 1920 he suffered bankruptcy when speculating on a bearish posture for the German Mark. After replenishing his capital and reputation through his writings, he successfully speculated in commodities, accumulating over one-half million pounds. In spite of his later wealth, he was known for offering his guests meager meals and sending them away hungry. In one report, he paid native boys in Algiers such a pittance for shining his shoes that he was stoned in return. His reaction: "I will not be a party to debasing the currency."

Milton Friedman advanced the monetarist view that the quantity of money, prices, national income, and velocity of money interact to keep our economy in check. Mr. Friedman was born in 1912, some 22 years after John Maynard Keynes and one year after the enactment of the Federal Reserve Act. He was short in stature (five feet five inches), but a giant in his contribution to economic theory.

He was not the first to advance monetaristic views concerning the supply of money, but he was an avid lecturer and probably the most consistent advocate of monetary policy. He believed that control of the money supply, not government fiscal policy, should be the primary means to manage the economy. He also believed that an insufficient money supply was the major contributor to the Great Depression.

Banks, the Money Supply & the Fed

Banks represent one mechanism through which the U.S. government exercises the monetarists view espoused by Friedman. To a large extent, the banks themselves implement Fed-directed changes in the nation's money supply. Increases in the money supply are facilitated by commercial banks when they loan money or purchase securities. The Federal Reserve regulates the amount of money a bank can loan by requiring the bank to maintain a percentage of its assets on deposit at the commercial bank's regional Federal Reserve Bank. This percentage is known as the *reserve requirement*. If a commercial bank, for example, has \$1000 on deposit in the Federal Reserve Bank and the Federal Reserve is currently imposing a reserve requirement percentage of 10%, then the bank can grant loans totaling \$1000/.10 or \$10,000 and effect a \$10,000 increase in the nation's money supply.

If the Federal Reserve wants to increase the money supply, it might buy U.S. Government Securities (T. Notes, for example) on the open market with a check drawn on the U.S. government. (The only cost to this transaction is the ink used to write the check because the money is created out of thin air.) When the seller of the securities deposits the government check in his commercial bank, the bank's deposits (reserves) at the commercial bank's Federal Reserve Regional Bank increase. With these increased reserves, the commercial bank can now increase the money supply (at a multiple of 10 times the amount of the government check using the above example) by making new loans based upon the increased reserves from the seller's deposit.

In reverse sequence, the Federal Reserve can decrease the money supply and commercial bank reserves by simply selling government securities out of its own inventory. The check received from the buyer that is drawn on a commercial bank is paid by the commercial bank. This transaction serves to decrease the commercial bank's reserves and the commercial bank is then forced to trim its loan portfolio by calling in loans. In lieu of calling in a portion of their loan portfolio, other alternatives for the commercial bank would be to borrow excess reserves from some other commercial bank at the Fed Funds rate or to borrow the necessary funds at the Federal Reserve discount window.

This latter alternative, although less expensive for the borrower, is taken by the Fed as a sign that the borrower is overextended. Therefore, to keep the Fed from imposing an audit, banks usually get their needed funds from other banks who are operating below the Federal Reserve's reserve requirement. Such loan transactions are usually temporary measures by banks which keep them from having to abruptly disturb their loan portfolios.

The Fed is not responsible for the spread between the prime rate and the federal funds rate (the interest rate commercial banks charge each other) or the spread between the prime rate and the federal discount rate (the rate of interest charged by the Federal Reserve District Banks of commercial banks). But this spread represents the minimum gross total margin a bank earns for arranging a loan to a favored business. The spread represents an enormously lucrative opportunity for banks in general. It is no wonder that current Federal Reserve Chairman, Alan Greenspan, is known to be a close friend to the banker.

The rate banks charge, if you think about it, is realistically a form of government sanctioned price fixing. A major bank, noting a Fed sanctioned discount rate hike, will announce a change in their prime rate. Other banks in the U. S. will then follow suit by imposing the exact same rate change on their books.

Obviously, banks are insulated from any illegalities for price fixing. General Electric and Westinghouse management officials spent considerable time in jail for fixing the prices of heavy electrical equipment in the early 1960s. It is difficult to understand how banks all over the U.S. can not be cited for price fixing when nearly every commercial bank in the country can adopt a fixed pricing policy for loans pegged to an arbitrarily large spread above the federal discount rate.

This Technical Journal's introductory installment hints at the enormous power and influence exerted on each of us by the Federal Reserve. I hope that we have helped to heighten your awareness of the Federal Reserve Board and the repercussions of its actions. Next month's installment delves into flaws in the Federal Reserve's procedures for money management and suggests a solution to the overall problem.

A bibliography will follow the next installment. ✦

Bob Pelletier

"It is difficult to understand how banks all over the U.S. can not be cited for price fixing when nearly every commercial bank in the country can adopt a fixed pricing policy for loans pegged to an arbitrarily large spread above the federal discount rate."

Ask Customer Service

Each month in this column, the CSI Customer Service staff addresses a topic of interest to many of our subscribers. This month, they'll field questions about using data from different sources with CSI software.

Please help us keep in contact with you! Forward your e-mail address to bookkeeping@csidata.com so we can update our records.

Thanks

Q. *My hard drive holds data from several vendors and I wonder if I can use it with QuickTrieve.® Can QuickTrieve process or help me manage data from other sources?*

A. Although we certainly can't vouch for the integrity of data from other sources, chances are good that if it is properly stored in CSI format, QuickTrieve can process and update it. You can tell CSI format data by the structure of your directories. A CSI-format data directory has a master file (QMASTER) and up to 120 data files (ending in .dta). QuickTrieve can automatically find and make available all compatible files through option <J> *Edit master path* from the main menu. Simply select <F8> *Scan drive*, then select your drive and the *Quick-Trieve* format for the search. All directories with CSI-format data will be added to your master path list, which you may save by pressing <F10>.

Q. *What about writing data in non-CSI format with QuickTrieve?*

A. The MetaStock (CompuTrac) format is supported for direct updates and for conversion to and from the CSI format. ASCII files are supported through conversions only. The drive-scan procedure described above can be modified to add existing directories with MetaStock format files to your master path list.

Q. *Should I merge data from other sources with my CSI data?*

A. This may be possible, but we recommend against doing so for the following reasons:

1) Data integrity may be compromised by possible voids, omissions and errors.

2) In many cases the free data supplied with your subscription represents an easier and more economical means of feeding your analysis software.

3) The conversion and copying processes can be tedious and time-consuming.

Q. *I plan to use Unfair Advantage® when it becomes available. I understand it includes historical data. What should I do with the history data I already have?*

A. Unfair Advantage holds a full commodity data base on your hard drive, so other data will likely be unnecessary during your license term. We recommend archiving your existing history by copying it or backing it up for storage on floppy disks.

Q. *With Unfair Advantage's license agreement, will I actually OWN the data I receive?*

A. No. Unfair Advantage's license agreement gives you permission to use the data for the period of your subscription. Please be aware that after termination of your agreement, you will lose access to the data supplied through Unfair Advantage. By licensing the data you'll have low-cost access to a data base you probably couldn't afford to buy.

Q. *A huge data base is only as useful as your analysis software. What studies will be included with Unfair Advantage?*

A. The current pre-release version offers highly compressed bar charts, trend lines, moving averages and the like, but we would like to add more. If there are particular studies you would enjoy, please fax your suggestions to (561) 392-7761 or E-mail them to techsupport@csidata.com. Be prepared to send back-up reference materials in case they are needed. ✦