Bernanke cannot take his foot off the gas pedal

On May 22, Fed Chairman Ben Bernanke stated, in testimony before Congress, that the Fed may taper its bond-buying program, known as Quantitative Easing (QE), in coming months. This remark was further qualified by Federal Reserve Governor Jeremy Stein on June 28 that tapering could begin in September and be completed by "around mid-2014." [1]

But, can the Fed realistically taper back on QE? Unlikely. Here is why …

Policy Objectives

The Fed wants to get the US economy back on track. Broadly, this means solid GDP growth and an acceptable unemployment rate.

Its primary policy mechanisms are the interest rate and the inflation rate. Its primary tool is the money supply.

To manage its current policy objectives, the Fed implemented QE. This program applies downward pressure on interest rates, consistent with Fed targets, and provides liquidity to the market by creating and circulating new dollars. Under the current QE program, each month the Fed buys $45 billion of U.S. government debt and $40 billion of mortgage securities. To date, through three rounds of QE, the Fed has bought and holds more than $2.5 trillion in US Government Treasury bonds.

In a December 2012 meeting, Federal Reserve policymakers indicated that it would continue this highly interventionist activity as long as: [2]

- unemployment remains above 6.5%;
- inflation between one and two years ahead is projected to be no more than 0.5% above 2%, and;
- longer-term inflation expectations continue to be "well anchored".

But, has it worked?

Economic growth continues to be anemic. GDP growth in the first quarter was 1.8% (annualized), revised downward by the Bureau of Economic Analysis from 2.8 percent. In comparison, the US economy's long-term average growth rate is in the range of 3 percent.

Unemployment persists at 7.6% (per the April jobs report). Projections for the unemployment rate anticipate it will not hit the 6.5% target before 2014. [3]

Missed Inflation Targets

The Fed drives to an inflation target of 2%. The inflation target is positive because the Fed believes that "some" inflation is good for growth. It is also good for future payments on present debt, as future "inflated" dollars would be less costly to pay back than current dollars. Hence, US government debt benefits from inflation.

The Fed wants interest rates to be below the rate of inflation to give consumers and businesses an incentive to borrow and spend, generating jobs. The underlying narrative being that borrowing and spending today will cost you less than spending tomorrow. Hence, inflation must be positive, as interest rates can't be lower than zero.[4]

Inflation is controlled by managing the money supply. The Adjusted Monetary Base (BASE) is the sum of currency in circulation outside Federal Reserve Banks and the U.S. Treasury, plus deposits held by depository institutions at Federal Reserve Banks. It is completely under the control of the Fed. Since September 2008, the BASE has increased 265%, from $850B to $3,192B.

M2 is a category within the money supply that includes M1 in addition to all time-related deposits, savings deposits, and non-institutional money-market funds. M2 is used to measure inflation. Over the last decade, M2 increased 76%. However, M2V, the velocity of the money supply, has been declining since 2008. [5] This indicates that money is circulating at a decreasing rate, down nearly 25% from the end of 2008, suggesting continually slowing economic activity.

This is underscored by the fact that, despite an aggressive increase in the money supply, which would be expected to encourage inflation, the Personal Consumption Expenditures (PCE) price index has fallen to a 3-1/2 year low of 1%, against the 2% target. [6]

The fox in the henhouse is that recent research shows that, since August 2008, 81.5% of the stimulus has not been circulating in the economy, but sits idle as excess reserves, held on account at the Fed for commercial banks. Excess reserves held by the Fed currently amount to $1.9 trillion. In effect, the Fed loans money to these banks at 0%, but then allows the banks to keep the money on account while receiving from the Fed 0.25% interest — money for nothing. The remaining 18.5% of the stimulus circulates or is held as *required* reserves on banks' deposit accounts. [7]

The inability of the Fed to increase inflation with such an aggressive expansion of the money supply suggests the US economy could well have entered into a *deflationary* state were it not for QE.

Upward Pressure on Interest Rates

In December 2008, the Fed cut interbank interest rates to zero. Since then, the target rate for overnight lending between banks has been kept at 0% to 0.25% percent.

Following Bernanke's comments, market fear that the stimulus provided by QE might slow or come to an end erupted in US Treasuries being dumped. Yields on 10-year notes were driven to 2.57% in late June, from 1.6% in May, a 1% nominal increase but a 61% change. The market reaction appears to have caught the Fed by surprise, and there are fears that the Fed is losing control of interest rates. [8]

The potential easing of QE highlights another challenge. The US continues to run a substantial budget deficit, currently projected by the Congressional Budget Office to be $642 billion in 2013. The deficit is financed through debt, funded by the selling of Treasury bonds. If investors are dumping Treasuries and do not want to hold them, who will purchase newly-issued debt *at rates which fulfill the Fed's policy objectives*?

The Fed is the government's lender of last resort. If the Fed does not step in to prop up the market for Treasuries, the interest rate will reset to a level which remunerates risk — a level clearly above what the Fed is offering. But soaring interest rates would rattle the still fragile global economy. [9] In its recently published annual report, the Bank for International Settlements (BIS) projects that if Treasury yields rose 3%, holders of Treasury bonds could lose more than $1 trillion. [10]

MOAR QE

The Fed has little choice but to continue QE until such a time as the US economy shows marked improvement, or when private and public sector buyers of U.S. debt materialize. At present, there is no room for the Fed to maneuver without shocking the global economic system.

Terry Atkinson, July 3, 2013

References:

[1] *Federal Reserve website, Comments on Monetary Policy, June 28, http://www.federalreserve.gov/newsevents/speech/stein20130628a.htm*

[2] *Federal Reserve website, Press release, December 12, 2012, http://www.federalreserve.gov/newsevents/press/monetary/20121212a.htm*

[3] *Fed Sees Unemployment as Low as 6.5% Threshold by End-2014, Bloomberg, June 19, http://www.bloomberg.com/news/2013-06-19/fed-sees-u-s-jobless-rate-as-low-as-6-5-threshold-by-end-2014.html*

[4] *Why the Fed Worries if Inflation is Too Low, Business Week, May 1, http://www.businessweek.com/articles/2013-05-01/why-the-fed-worries-inflation-is-too-low*

[5] *FRED, Federal Reserve Bank of St Louis, http://research.stlouisfed.org/*

[6] *Fed's credibility tested as inflation drifts below target, Reuters, May 8, http://www.reuters.com/article/2013/05/08/us-usa-fed-inflation-idUSBRE94704L20130508*

[7] *Massive Misconceptions About Where the Bernanke Fed's Money Explosion Went, Huffington Post, June 26, http://www.huffingtonpost.com/robert-auerbach/massive-misconceptions-ab_b_3490373.html*

[8] *Bernanke's First Mistake: Losing Control Of The Market As Rates Spiked, Can He Get It Back?, Forbes, July 1, http://www.forbes.com/sites/afontevecchia/2013/07/01/bernankes-first-mistake-losing-control-of-the-market-as-rates-spiked-can-he-get-it-back/*

[9] *High bond yields flash warning of fresh financial crisis, National Post, June 24, http://business.financialpost.com/2013/06/24/high-bond-yields-flash-warning-of-fresh-financial-crisis/*

[10] *Bondholders would lose more than $1 trillion if yields spike – BIS, Reuters, June 23, http://www.reuters.com/article/2013/06/23/economy-global-bis-idUSL3N0EW3EZ20130623*