Fed plan to reverse QE is fraught with danger

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Fed

Fed Chief Janet Yellen is in a very difficult position dealing with the Trump White House

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The US Federal Reserve has taken an almighty gamble by brushing aside deflationary warnings from the bond market and raising interest rates into a blizzard of weak data.

It has taken an even bigger gamble by choosing to reverse quantitative easing when there is no need to do so, and to proceed in the face of very influential counter-advice from top economists.

Under this double-barrelled tightening, the Fed will start selling its $4.4 trillion bond portfolio before interest rates have returned to anything like normal levels, and before it has built up a safety buffer against a fresh shock.

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This could prove one of the most fateful decisions of modern economic history. Whether or not the Fed has judged this correctly will shape the future of capitalism, and with it the prospects for Western liberal democracy.

The Fed aims to begin shrinking the balance sheet as soon as September, or by the end of the year at the latest. The process will be gradual. It starts at $10bn a month and rises in steps each quarter until reaching $50bn a month.

The Fed's chairman, Janet Yellen presented this as a dull technical issue, saying that the unwinding of QE will be like "watching paint dry". In reality it is fraught with hazard.

No modern central bank has ever tried to reverse QE of this kind and scale. The withdrawal of dollar liquidity will be felt across Asia and Latin America, and through the global financial system.

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Prof Danny Blanchflower, Dartmouth College

Prof Danny Blanchflower, a former member of the Bank of England's Monetary Policy Committee now at Dartmouth College in the US, said: "This is a huge mistake. They have no idea how to unwind it.

"Commentators like to think there is a deep underlying plan, but when we first went into QE we had no idea what the effects would be or how much to do. This was beyond anything in the textbooks. It was suck it and see economics."

Former Fed chairman Ben Bernanke wrote a cautionary article for the Brookings Institution advising his former colleagues - mindful of Fed etiquette - to steer well clear of this nitroglycerin.

He told them to leave QE alone until "the short-term interest rate is well away from zero". The Fed should let the economy "grow into" the $4.4 trillion portfolio over time. He adduced a long list of arguments for why a big balance sheet makes the financial system safer.

"He was basically saying, 'Never shrink the balance sheet. Just don't touch this issue. There be dragons."

Federal Reserve Chair Janet Yellen, right, poses with her predecessor Ben Bernanke

Federal Reserve Chair Janet Yellen, right, poses with her predecessor Ben Bernanke CREDIT: AP

It typically takes about 500 basis points of Fed cuts to fight bad recessions. It was even worse after the Lehman crash in 2008. The Fed ran out of ammunition after 475 points and had to flood the system with liquidity through QE. The total was, in synthetic terms, 850 points of loosening.

As matters now stand, the Fed has just 100 basis points of cuts to play with in a crisis. Prof Blanchflower said: “We should be getting as far away as possible from the zero-lower-bound [zero rates] before selling off any assets, otherwise we are going to have a disaster.”

What makes this so sensitive is that the window for QE in the future is closing. The two new Fed members floated by the Trump administration, Randal Quarles and Marvin Goodfriend, are both staunch conservatives hostile to QE. The bar will be higher. This means the Fed may have to fight the next downturn with little in the arsenal.

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One ex-Fed official said: “It is going to be pretty unpleasant if we hit a crisis with only four rate cuts to play with and no QE. The whole universe of asset prices is built on the assumption there will always be a ‘Fed put’ and bond yields will never be allowed to rise.”

Professor Tim Congdon, founder of the Institute of International Monetary Research, said quantitative tightening would compound the monetary squeeze just as big banks were already having to boost their loss-absorbing capital to 16pc of risk-weighted assets under the Basel rules.

The two effects will both dampen money creation, he said: “If the Fed really goes ahead with this, there will be trouble three to six months later. The US economy could tank in 2018.”

Expert views conflict. Manmohan Singh, a senior economist at the International Monetary Fund, said asset sales could actually prove to be a stimulus, since they would free up “good” collateral, allowing for more money creation. However, the Fed has not clarified what its assumptions are.

The question is why Janet Yellen has chosen to play down warnings from Mr Bernanke and the analysis by the Fed's own staff of the risks. Fed insiders say that what changed everything is the arrival of Donald Trump. The worry is that he will take a leaf out of the Nixon playbook and try to turn the institution into a sort of Reichsbank to buy his debt on demand.

"They want to get out of the balance sheet business altogether. They have seen the ghost of William McChesney Martin (1960s Fed chairman) and don't want to get caught in the hands of a bureaucratic bully," said one source close to the Yellen circle.

Events may intrude before asset sales even begin. Markets think the deflationary forces are so powerful that the Fed will have to abandon any form of monetary tightening before long.

Fed

William McChesney Martin was pressured by President Lyndon Johnson when he tried to take away the punch bowl. President Nixon later found a more amenable Fed chief CREDIT: US FEDERAL RESERVE

Yields on 10-year US Treasuries are down almost 50 points since March, to 2.15pc. The Trump "reflation trade" has been washed out of credit markets. Ten-year break-even Treasury inflation-protected securities, or TIPS, used to track inflation expectations, are at 169 basis points from a 2017 high of 208.

Michael Darda, chief economist at MKM Partners, said it was too early to tell whether the Fed has misjudged, but Mrs Yellen must move with extreme care. "It does make me nervous to see the yield curve collapse in this manner. They need to be ready to call off additional tightening soon," he said.

The Fed is flying in fog. There is still a possibility that Mr Trump will succeed in pushing big tax cuts through Congress, injecting fiscal stimulus and igniting a boom on Wall Street. Nobody knows what will happen in the fevered committee rooms of scandal-ridden Washington.

Lars Christensen, founder of Markets & Money Advisory and a senior fellow at the Adam Smith Institute, said the Fed should back off immediately: "This was a clear monetary policy mistake. The Fed should be easing. If it continues down this road it is likely to lead to an outright US recession." Mr Christensen said Mrs Yellen was clinging to a 1970s Keynesian view of the world in which inflation is essentially the product of a tight labour market.

The Fed’s working assumption is that inflation must soon take off given that unemployment has dropped through the so-called “NAIRU” floor, short for non-accelerating inflation rate of unemployment, to a 16-year low of 4.3pc. The counter-argument is that globalisation has entirely changed the mechanics of the US labour market.

The US employment participation rate is still stuck at 60pc, below its pre-Lehman peak of 63pc. This suggests that the US is up to 8m jobs short. It may be the more relevant indicator.

Markets are entering a treacherous phase. Patrick Perret-Green from AdMacro said it was time for investors to batten down the hatches. “The world’s central bank balance sheet is close to shrinking. The implications for highly valued risk assets are obvious. Our message is clear. Sell credit, sell duration, sell risk,” he said.

If it is any comfort, Evercore ISI, the Washington-based investment banking advisory firm, says the Fed will come to the rescue yet as always if need be. The Fed Put still exists. What has changed is the trigger point.

Janet Yellen will blink only once the S&P 500 index of US equities has dropped by 5pc to 10pc. Whether it will be too late by then is anybody’s guess.