The Fed Sets Another Trap

By Stephen S. Roach *Thu, Jan 8, 2015*

"The Fed's incrementalism of 2004-2006 was a policy blunder of epic proportions… The Fed seems poised to make a similar – and possibly even more serious – misstep in the current environment," writes the former chairman of Morgan Stanley Asia.

America's Federal Reserve is headed down a familiar – and highly dangerous – path. Steeped in denial of its past mistakes, the Fed is pursuing the same incremental approach that helped set the stage for the financial crisis of 2008-2009. The consequences could be similarly catastrophic.

Consider the December meeting of the Federal Open Market Committee (FOMC), where discussions of raising the benchmark federal funds rate were couched in adjectives, rather than explicit actions.

In line with prior forward guidance that the policy rate would be kept near zero for a "considerable" amount of time after the Fed stopped purchasing long-term assets in October, the FOMC declared that it can now afford to be "patient" in waiting for the right conditions to raise the rate. Add to that Fed Chair Janet Yellen's declaration that at least a couple more FOMC meetings would need to take place before any such "lift-off" occurs, and the Fed seems to be telegraphing a protracted journey on the road to policy normalization.

This bears an eerie resemblance to the script of 2004-2006, when the Fed's incremental approach led to the near-fatal mistake of condoning mounting excesses in financial markets and the real economy. After pushing the federal funds rate to a 45-year low of 1% following the collapse of the equity bubble of the early 2000s, the Fed delayed policy normalization for an inordinately long period. And when it finally began to raise the benchmark rate, it did so excruciatingly slowly.

In the 24 months from June 2004, the FOMC raised the federal funds rate from 1% to 5.25% in 17 increments of 25 basis points each. Meanwhile, housing and credit bubbles were rapidly expanding, fueling excessive household consumption, a sharp drop in personal savings, and a record current-account deficit – imbalances that set the stage for the meltdown that was soon to follow.

The Fed, of course, has absolved itself of any blame in setting up the US and the global economy for the Great Crisis. It was not monetary policy's fault, argued both former Fed Chairmen Alan Greenspan and Ben Bernanke; if anything, they insisted, a lack of regulatory oversight was the culprit.

This argument has proved convincing in policy and political circles, leading officials to focus on a new approach centered on so-called macro-prudential tools, including capital requirements and leverage ratios, to curb excessive risk-taking by banks. While this approach has some merit, it is incomplete, as it fails to address the egregious mispricing of risk brought about by an overly accommodative monetary policy and the historically low interest rates that it generated. In this sense, the Fed's incrementalism of 2004-2006 was a policy blunder of epic proportions.

The Fed seems poised to make a similar – and possibly even more serious – misstep in the current environment. For starters, given ongoing concerns about post-crisis vulnerabilities and deflation risk, today's Fed seems likely to find any excuse to prolong its incremental normalization, taking a slower pace than it adopted a decade ago.

More important, the Fed's $4.5 trillion balance sheet has since grown more than fivefold. Though the Fed has stopped purchasing new assets, it has shown no inclination to scale back its outsize holdings. Meanwhile it has passed the quantitative-easing baton to the Bank of Japan and the European Central Bank, both of which will create even more liquidity at a time of record-low interest rates.

In these days of froth, the persistence of extraordinary policy accommodation in a financial system flooded with liquidity poses a great danger. Indeed, that could well be the lesson of recent equity- and currency-market volatility and, of course, plummeting oil prices. With so much dry kindling, it will not take much to spark the next conflagration.

Central banking has lost its way. Trapped in a post-crisis quagmire of zero interest rates and swollen balance sheets, the world's major central banks do not have an effective strategy for regaining control over financial markets or the real economies that they are supposed to manage. Policy levers – both benchmark interest rates and central banks' balance sheets – remain at their emergency settings, even though the emergency ended long ago.

While this approach has succeeded in boosting financial markets, it has failed to cure bruised and battered developed economies, which remain mired in subpar recoveries and plagued with deflationary risks. Moreover, the longer central banks promote financial-market froth, the more dependent their economies become on these precarious markets and the weaker the incentives for politicians and fiscal authorities to address the need for balance-sheet repair and structural reform.

A new approach is needed. Central banks should normalize crisis-induced policies as soon as possible. Financial markets will, of course, object loudly. But what do independent central banks stand for if they are not prepared to face up to the markets and make the tough and disciplined choices that responsible economic stewardship demands?

The unprecedented financial engineering by central banks over the last six years has been decisive in setting asset prices in major markets worldwide. But now it is time for the Fed and its counterparts elsewhere to abandon financial engineering and begin marshaling the tools they will need to cope with the inevitable next crisis. With zero interest rates and outsize balance sheets, that is exactly what they are lacking.

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