The Fed Trap

By Stephen S. Roach *Thu, Oct 2, 2014*

The Fed's assumption that the so-called "wealth effect"—when asset appreciation spurs real economic activity—will hasten a true post-crisis recovery isn't producing the desired results, writes the former Morgan Stanley chief economist.

As the US Federal Reserve attempts to exit from its unconventional monetary policy, it is grappling with the disparity between the policy's success in preventing economic disaster and its failure to foster a robust recovery.

To the extent that this disconnect has led to mounting financial-market excesses, the exit will be all the more problematic for markets—and for America's market-fixated monetary authority.

The Fed's current quandary is rooted in a radical change in the art and practice of central banking. Conventional monetary policies, designed to fulfill the Fed's dual mandate of price stability and full employment, are ill-equipped to cope with the systemic risks of asset and credit bubbles, to say nothing of the balance-sheet recessions that ensue after such bubbles burst.

This became painfully apparent in recent years, as central banks, confronted by the global financial crisis of 2008-2009, turned to unconventional policies—in particular, massive liquidity injections through quantitative easing (QE).

The theory behind this move—as espoused by Ben Bernanke, first as an academic, then as a Fed governor, and eventually as Fed Chairman—is that operating on the quantity dimension of the credit cycle is the functional equivalent of acting on the price side of the equation.

That supposition liberated the Fed from fear of the dreaded "zero bound" that it was approaching in 2003-2004, when, in response to the collapse of the equity bubble, it lowered its benchmark policy rate to 1%. If the Fed ran out of basis points, the argument went, it would still have plenty of tools at its disposal for supporting and guiding the real economy.

But this argument's intellectual foundations—first laid out in a 2002 paper by 13 members of the Fed's Washington, DC, research staff—are shaky, at best.

The paper's seemingly innocuous title, "Preventing Deflation: Lessons from Japan's

Experience in the 1990s," makes the fundamental assertion that Japan's struggles were rooted in a serious policy blunder: the Bank of Japan's failure to recognize soon enough and act strongly enough on the peril of incipient deflation.

(Not coincidentally, this view coincided with a similar conclusion professed by Bernanke in a scathing attack on the BOJ in the late 1990s.) The implication was clear: substantial monetary and fiscal stimulus is critical for economies that risk approaching the zero bound.

Any doubt as to what form that "substantial stimulus" might take were dispelled a few months later, when then Fed-Governor Bernanke delivered a speech stressing the need for a central bank to deploy unconventional measures to mitigate deflationary risks in an economy that was approaching the zero bound. Such measures could include buying up public debt, providing subsidized credit to banks, targeting longer-term interest rates, or even intervening to reduce the dollar's value in foreign-exchange markets.

A few years later, the global financial crisis erupted, and these statements, once idle conjecture, became the basis for an urgent action plan. But one vital caveat was lost in the commotion: What works during a crisis will not necessarily provide sufficient traction for the post-crisis recovery—especially if the crisis has left the real economy mired in a balance-sheet recession.

Indeed, given that such recessions clog the monetary-policy transmission mechanism, neither conventional interest-rate adjustments nor unconventional liquidity injections have much impact in the wake of a crisis, when deleveraging and balance-sheet repair are urgent.

That is certainly the case in the US today. QE may have been a resounding success in some ways—namely, arresting the riskiest phase of the crisis. But it did little to revive household consumption, which accounts for about 70% of the US economy. In fact, since early 2008, annualized growth in real consumer expenditure has averaged a mere 1.3%–the most anemic period of consumption growth on record.

This is corroborated by a glaring shortfall in the "GDP dividend" from Fed liquidity injections. Though $3.6 trillion of incremental liquidity has been added to the Fed's balance sheet since late 2008, nominal GDP was up by just $2.5 trillion from the third quarter of 2008 to the second quarter of this year.

As John Maynard Keynes famously pointed out after the Great Depression, when an economy is locked in a "liquidity trap," with low interest rates unable to induce investment or consumption, attempting to use monetary policy to spur demand is like pushing on a string.

This approach also has serious financial-market consequences. Having more than doubled since its crisis-induced trough, the US equity market—not to mention its amply rewarded upper-income shareholders—has been the principal beneficiary of the Fed's unconventional policy gambit. The same is true for a variety of once-risky fixed-income instruments—from high-yield corporate "junk" bonds to sovereign debt in crisis-torn Europe.

The operative view in central-banking circles has been that the so-called "wealth effect"—when asset appreciation spurs real economic activity—would square the circle for a lagging post-crisis recovery. The persistently anemic recovery and its attendant headwinds in the US labor market belie this assumption.

Nonetheless, the Fed remains fixated on financial-market feedback—and thus ensnared in a potentially deadly trap. Fearful of market disruptions, the Fed has embraced a slow-motion exit from QE. By splitting hairs over the meaning of the words "considerable time" in describing the expected timeline for policy normalization, Fed Chair Janet Yellen is falling into the same trap. Such a fruitless debate borrows a page from the Bernanke-Greenspan incremental normalization script of 2004-2006. Sadly, we know all too well how that story ended.

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