The Perils of Fed Gradualism

By Stephen S. Roach *Wed, Dec 23, 2015*

Our guest columnist wants interest rates to rise faster. 'A steeper normalization path would produce an outcry,' he writes. 'But that would be far preferable to another devastating crisis.'

By now, it's an all-too-familiar drill. After an extended period of extraordinary monetary accommodation, the US Federal Reserve has begun the long march back to normalization. It has now taken the first step toward returning its benchmark policy interest rate—the federal funds rate—to a level that imparts neither stimulus nor restraint to the US economy.

A majority of financial market participants applaud this strategy. In fact, it is a dangerous mistake. The Fed is borrowing a page from the script of its last normalization campaign—the incremental rate hikes of 2004-2006 that followed the extraordinary accommodation of 2001-2003.

Just as that earlier gradualism set the stage for a devastating financial crisis and a horrific recession in 2008-2009, there is mounting risk of yet another accident on what promises to be an even longer road to normalization.

The problem arises because the Fed, like other major central banks, has now become a creature of financial markets rather than a steward of the real economy. This transformation has been under way since the late 1980s, when monetary discipline broke the back of inflation and the Fed was faced with new challenges.

The challenges of the post-inflation era came to a head during Alan Greenspan's 18-and-a-half-year tenure as Fed Chair. The stock-market crash of October 19, 1987—occurring only 69 days after Greenspan had been sworn in—provided a hint of what was to come. In response to a one-day 23% plunge in US equity prices, the Fed moved aggressively to support the brokerage system and purchase government securities.

In retrospect, this was the template for what became known as the "Greenspan put"—massive Fed liquidity injections aimed at stemming financial-market disruptions in the aftermath of a crisis. As the markets were battered repeatedly in the years to follow—from the savings-and-loan crisis (late 1980s) and the Gulf War (1990-1991) to the Asian Financial

Crisis (1997-1998) and terrorist attacks (September 11, 2001)—the Greenspan put became an essential element of the Fed's market-driven tactics.

This approach took on added significance in the late 1990s, when Greenspan became enamored of the so-called wealth effects that could be extracted from surging equity markets. In an era of weak income generation and seemingly chronic current-account deficits, there was pressure to uncover new sources of economic growth.

But when the sharp run-up in equity prices turned into a bubble that subsequently burst with a vengeance in 2000, the Fed moved aggressively to avoid a Japan-like outcome—a prolonged period of asset deflation that might trigger a lasting balance-sheet recession.

At that point, the die was cast. No longer was the Fed responding just to idiosyncratic crises and the market disruptions they spawned. It had also given asset markets a role as an important source of economic growth. The asset-dependent economy quickly assumed a position of commensurate prominence in framing the monetary-policy debate.

The Fed had, in effect, become beholden to the monster it had created. The corollary was that it had also become steadfast in protecting the financial-market-based underpinnings of the US economy.

Largely for that reason, and fearful of "Japan Syndrome" in the aftermath of the collapse of the US equity bubble, the Fed remained overly accommodative during the 2003-2006 period. The federal funds rate was held at a 46-year low of 1% through June 2004, before being raised 17 times in small increments of 25 basis points per move over the two-year period from mid-2004 to mid-2006. Yet it was precisely during this period of gradual normalization and prolonged accommodation that unbridled risk-taking sowed the seeds of the Great Crisis that was soon to come.

Over time, the Fed's dilemma has become increasingly intractable. The crisis and recession of 2008-2009 was far worse than its predecessors, and the aftershocks were far more wrenching. Yet, because the US central bank had repeatedly upped the ante in providing support to the Asset Economy, taking its policy rate to zero, it had run out of traditional ammunition.

And so the Fed, under Ben Bernanke's leadership, turned to the liquidity injections of quantitative easing, making it even more of a creature of financial markets. With the interest-rate transmission mechanism of monetary policy no longer operative at the zero bound, asset markets became more essential than ever in supporting the economy.

Exceptionally low inflation was the icing on the cake—providing the inflation-targeting Fed with plenty of leeway to experiment with unconventional policies while avoiding adverse interest-rate consequences in the inflation-sensitive bond market.

Today’s Fed inherits the deeply entrenched moral hazard of the Asset Economy. In carefully crafted, highly conditional language, it is signaling much greater gradualism relative to its normalization strategy of a decade ago. The debate in the markets is whether there will be two or three rate hikes of 25 basis points per year—suggesting that it could take as long as four years to return the federal funds rate to a 3% norm.

But, as the experience of 2004-2007 revealed, the excess liquidity spawned by gradual normalization leaves financial markets predisposed to excesses and accidents. With prospects for a much longer normalization, those risks are all the more worrisome. Early warning signs of troubles in high-yield markets, emerging-market debt, and eurozone interest-rate derivatives markets are particularly worrisome in this regard.

The longer the Fed remains trapped in this mindset, the tougher its dilemma becomes—and the greater the systemic risks in financial markets and the asset-dependent US economy. It will take a fiercely independent central bank to wean the real economy from the markets. A Fed caught up in the political economy of the growth debate is incapable of performing that function.

Only by shortening the normalization timeline can the Fed hope to reduce the build-up of systemic risks. The sooner the Fed takes on the markets, the less likely the markets will be to take on the economy. Yes, a steeper normalization path would produce an outcry. But that would be far preferable to another devastating crisis.

Stephen S. Roach, a former chairman of Morgan Stanley Asia and the firm’s chief economist, is the author of Unbalanced: The Codependency of America and China *(Yale University Press, 2014).*