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Rethinking the Fed's policy framework

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The dovish turn in March 2019 is unprecedented and inconsistent with the Fed's remit. The Fed, mandated by US Congress, has three objectives: achieve maximum employment, maintain price stability and ensure moderate long-term interest rates. Currently, the unemployment rate is about half a percent below its long-run normal level, implying the economy is operating above potential. Consumer price inflation (1.4%y on PCE deflator) is below the 2% goal due to energy prices. If anything, service price inflation runs ahead of the desired level of 2%. Long-term rates are moderate with 30-year Treasury yields well within 3%.

Global uncertainties have arguably led to a soft patch in growth, yet with US imports and exports averaging no more than 15% of US GDP, the impact on the economy is limited. The current foreign demand shortfall is unlikely to tip the US into recession considering the strength in private domestic demand.

> **The Fed's U-turn provided immediate relief to borrowers in the leveraged loan markets, calming fears of potential outflows from loan funds**

After a decade-long expansion with household expenditure on durables and housing as a share of GDP reverting to 2005-2006 highs, there is a significant risk that consumer demand may be overextended. To sustain demand for vehicles and other durable goods further, it may imply extending loans to less creditworthy borrowers. Already, despite full employment, default rates on auto loans have been rising over the past five years. This creates a financial imbalance. The last three US recessions (savings and loans crisis, dotcom bubble and subprime crisis) were caused by unsustainable financial imbalances.

The U-turn may help reverse the declining high yield issuance and is also a good relief to the equity market drawdown, providing another example of the Fed's alleged 'market dependence' as opposed to 'data dependence'. As former BoE governor Mervyn King once described it, the Fed is "trying to avoid an equity crash next week". The balance sheet run-off policy should end prematurely in September 2019 and Chair Jerome Powell has suggested that Fed assets will stabilize at about $3.6T or around 17% of GDP.

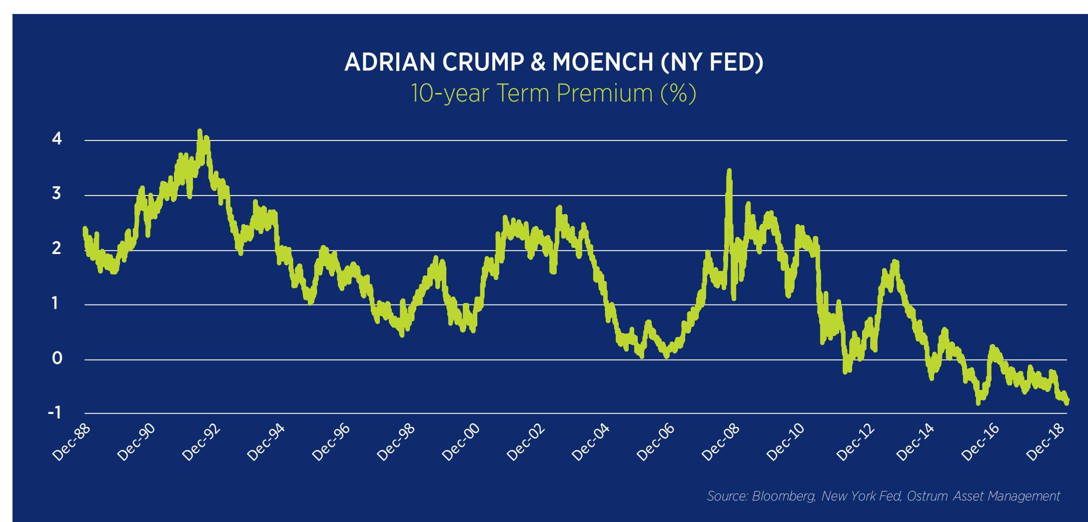
The market is questioning the Fed's operational framework and the independence of monetary authorities. Yes, rebalancing away from MBS may be consistent with monetary normalization but the shift has occurred when foreign official demand for Treasuries is down on the back of pressure from the Trump Administration to ease financial conditions.

The Fed's current operational framework is a result of the 2008 financial collapse. At this time, Fed Chair Bernanke decided to remunerate excess reserves (Fed liabilities) to reduce systemic banking risk. Abundant reserves have become the norm and the centralization of liquidity provisioning creates unwanted consequences. Unsecured interbank lending has shrunk to only a handful of loans each day. Yet, trillions of derivatives depend on judgmental LIBOR quotes.

> **A move to a new market-based reference is coming and may not go smoothly with repurchase agreements forming the bulk of interbank lending**

A lack of available collateral may restrain the money multiplier and hamper policy transmission to the real economy. In sum, Central Bank reserves no longer represent high-powered money but instead provide insurance against the resurgence of a systemic crisis. This explains why excess money issuance has not spurred goods and services inflation. Elevated bank reserves also come with other pitfalls. Interest paid on $1.5T excess reserves by the Fed amount to roughly $35b annually. Interest payments reduce cash returned by the Central Bank to the US Treasury at a time when the federal deficit hovers about 5pp of GDP. US taxpayers are funding this insurance premium.

Normally, the provision of bank reserves is matched by asset purchases and when the Fed provides liquidity through short-term repo, collateral received is Treasury bills. Policy since 2008 has created interest rate exposure that can be estimated by the term premium (difference between long-term rates and compounded expected short rates) at minus 72bp over 10 years as at April 1, 2019 (see graph). Fed liabilities (bank reserves and currency in circulation) have zero duration and policy implications of the current asset-liability mismatch have not been seriously debated. If an inflation outburst were to occur, the Fed would have to sell bonds to rein in aggregate demand to preserve the credibility of its price stability mandate. These asset sales, however, would only compound the economic costs of higher inflation and reduce Treasury remittances. In our view, the Fed will need to engineer a reverse twist and raise T-bill holdings. This would be the next step in monetary normalization. And this is only one of many moves needed ...



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