MONETARY SCENARIOS

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Global Monetary Viewpoint

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Executive Summary
The narrative of Fed balance sheet reduction driving down speculative temperatures in asset markets makes no fundamental sense.

Payment of a market interest rate on reserves at the Fed mean that these are no longer at the pivot of the monetary system.

Even so shrinkage of the Fed balance sheet does emerge periodically as a market story as in late 2018. Such nonsense can justify serious consideration of contrarian trades.

Opportunities for these would come from the combination of "Fed comedy" and a growingly harsh global economic reality. weakened. The end of that comedy would not be pretty.

Market strategy as outlined on 15/1 here remains valid. There is ow a likely brief Indian summer for speculative narratives on Amazon.

Balance Sheet Mess at the Trump Fed: symptoms of a defective monetary policy

The shrinking of the Fed's balance sheet according to present program is not a fundamental source of asset market deflation. It can though become part of the bear narrative during days when speculative temperatures are falling.

President Trump picked up that narrative in his public complaints during the market "swoon" of late last year against his personally chosen Fed Chief, Jerome Powell.

In fact, the real problem with the Fed's balance sheet program is not restrictiveness – this it is not – but a lack of coherence common to all present aspects of US monetary policy.

Fed's self-review of its policy settings

Chief Powell has told us that there is to be a fundamental review of Fed policy-making. Unfortunately. that does not provide grounds for optimism about less incoherence ahead.

Vice-chair Professor Clarida provided some more detail on plans for this institutional self-review in a recent speech. There is to be an experts' conference at the Chicago Fed in early June 2019, followed by a report the following year composed by the Fed Board in Washington.

Meanwhile Chief Powell is revving up "transparency", holding a press conference at the end of every FOMC meeting from now on and granting an extensive TV interview to David Rubenstein.

All of this, however, is a far cry from the meaningful audits of Fed policy against which Chief Powell spoke so fervently (in 2015) when still a simple Fed Governor.

Hand-picked outside input into the Fed's deliberations is akin to the ECB holding its annual "watchers conference" where the discussants are selected by the officials. And as to the media appearances of the chief, this cable TV anchor has the reputation as the softest interviewer of the great.

The less said about the highly tedious press briefings at the end of FOMC meetings the better. They are mainly an opportunity for the Fed Chair to bolster his institution's power to manipulate interest rate expectations.

Perils of data-dependency

Take the issue of "data-dependency" which has become the chosen hallmark of Trump Fed policy. Vice-Chair Clarida has

promoted policy data dependence (as in his speech last month) on two grounds.

First, with the Fed's dual mandate now so closely fulfilled (low unemployment and stable prices – where the latter is interpreted as 2 per cent inflation) the Fed must work all the harder (by studying all the data) to make sure there is no slippage into a non-ideal situation.

Second, towards that end the Fed should try to navigate better by the stars of r (r*), the neutral interest rate, and of u (u*), the natural unemployment rate. By monitoring error reports (the economy slipping from ideal path) and carefully responding to them, the navigator can get better estimates of the exact position of those stars, which are themselves moving in unpredictable fashion through time.

Many decades ago, Milton Friedman in his now famous essay on lags cast doubt on the ability of policy-makers (or anyone else) to judge whether the economy is in real time. Even if that ability were available, a good current reading is no guarantee of accurate vision as to what is unfolding next.

Starry wonder

As regards all this star wonder, there is serious doubt about whether the captain on the Fed ship has the right navigation system and whether indeed such a system exists.

In particular, the concepts of asset inflation (strengthening of irrational forces under influence of monetary inflation) and natural rhythm of prices (under sound money prices fluctuate in both directions for considerable periods of time reflecting factors such as the uneven pace of globalization and technological change) are totally absent from the navigator's handbook as approved by the Fed Chief and vice-Chief.

If we were to conceptualize a neutral interest rate defined not in terms of the dual mandate but more generally sound money, how could we have a clue where this is? (Sound money means no monetary inflation: under this regime there would be no asset inflation and prices in long run would tend to revert to a mean).

Other than neo-Keynesian engineers, there are no economists prepared confidently to provide even rough estimates of where the neutral rate of interest for example was in the mid/late1920s or early.mid 1960s (periods of actual great asset inflation); many would at most make a loose judgement that it was surely significantly higher than actual market rates at the time.

The Fed's view on balance sheet reduction

What do the neo-Keynesian engineers now navigating the stars have to say about the pace of Fed balance sheet reduction?

Turning again to vice-chair Clarida:

If we find that the ongoing program of balance sheet normalization no longer provides the achievement of the dual mandate, we will not hesitate to make changes.

Well, the reader should not try hard to unravel this gobbledegook.

It surely just amounts to – if the markets think Fed balance sheet reduction is important and contributing to asset deflation or economic slowdown, and some relief can be provided by going slower or postponement, well let's do that, though we are quite unsure about the underlying economics here. And that is what to expect.

Back to basics of when and why monetary base matters

Let's get into this matter at a deeper level than Fed communications with the purpose of determining whether indeed the path of balance sheet reduction is relevant to the financial market and broader economic outlook

A key first point is that monetary base (defined as deposits at the Federal Reserve plus currency in circulation) – roughly equal to the size of the balance sheet as measured on its liability side - is very different in nature today from in a classical monetary system.

Specifically deposits at the Federal Reserve now pay interest at a "market rate".

By contrast in classical monetary systems – including far back the gold standard – reserves or the equivalent paid no interest. This difference is crucial to understanding the diminished role monetary base now plays.

Where reserves pay no interest and there is broad demand for these along with currency in circulation which is a stable function of real income and prices, then they are indeed pivotal.

A shortage of reserves relative to demand pushes up interest rates in money markets towards restoring balance between supply and demand (at higher rates banks try harder to economize on reserves and the public shifts from deposits backed by high reserves to those by low reserves so as to gain interest). Nominal incomes and prices adjust into line with continuing equilibrium in the market for reserves at a long-run average level of rates which is consistent with economic balance.

The supply of base money including reserves is set either by some arbitrary quantity rule or on a more discretionary basis or by an automatic mechanism (as under the gold standard).

If indeed the other constituents of monetary base – cash in circulation or gold coin (as under a gold standard) – enjoy a stable and broad demand, then that indeed bolsters the pivot function of this aggregate in a benign way.

By contrast take the present regime where the Fed sets the rate of interest on reserves with the intention of this determining the level of money market rates generally.

Reserve deposits in this latter world become a very close substitute for Treasury bills. If the supply of reserves at some point tends to fall behind demand at prevailing interest rates on 1-month bills and on reserves (potentially slightly different in normal circumstances) then the interest rate on T-bills (and on other

money market assets of top quality) would rise to a higher spread above the reserve deposit rate.

That widened spread would be indicative of scarce reserves. But considerable substitutability between bills and reserves would cap the spread. The scarcity would have little or no market consequence or economic consequence. This is the present situation and indeed in recent month the spread has fluctuated.

Arithmetic of Fed's present balance sheet plans

The total size of the Fed's balance sheet is now around $4.1tn and on the present program of gradual disposals (through redemptions, both in the Treasury bond portfolio and mortgage portfolio), it would fall to $3.5tn by late 2020.

According to estimates from the St. Louis Fed, if the monetary base (and balance sheet) were the same proportion of the money supply (M2) today as in 2008 (on the eve of the Crash), then this would have to shrink by $1.8tn.

In fact, during this time there has been rapid growth in the demand for currency in circulation (most plausibly a reflection of zero and then super-low interest rates); and so estimated excess reserves (over and above legally reserve reserves by the banks) are now at around £1.4tn.

How to revert to classical monetary base pivot?

If we reverted to the classic monetary system where reserves paid no interest what would be banks' demand for excess reserves (in excess of legal requirement)?

We don't know but most likely larger than the very low level prior to 2008.

Banks are more concerned now than then to maintain a buffer of cash and reserves (even without interest) to mitigate pressure in crisis, even though there are important safety channels, including "too big to fail" and deposit insurance. As illustration, the amount of reserves which had to be subtracted towards normalization could well be south of $1tn, say $800bn – or 4% of US GDP.

If the Fed were to choose this path back to pivoting the monetary base in zero-interest bearing form, shrinking by 4% of GDP is hardly a big challenge. The Fed has simply to swap with the Treasury that amount of T-bonds, getting T-bills in exchange (and Treasury Secretary Mnuchin and Fed Chief Powell reportedly get on well!). Then the Fed sells the T-bills into the market over a few days as an open market operation to drain reserves.

The Treasury can progress with normalization of the share of long-maturity debt in its liability structure (the Fed and Treasury combined) gradually, without disrupting in any way the long-term Treasury market.

Monetary normalization – in the sense of normalizing the quantity of monetary base and making it non-interest bearing- is a totally separate operation from Treasury bond maturity normalization (effected by the Treasury shifting down the

proportion of floating rate debt which became elevated under the QE operations).

Is there a chance of the Trump Fed choosing this monetary normalization path?

There is absolutely no indication in that direction. '

Should we just ignore all the chatter about balance sheet shrinkage?

In fact, all we have here is some maturity normalization (integrating the Fed's balance sheet with the Treasury's) and pull-back from the mortgage credit market – at a pretty slow pace and likely to be halted within the next two years if not sooner.

Yes, the hoary topic might come up in market and Fed commentaries – but that is all, all smoke without real substance.

There would be real news if the Fed heads back to a classical monetary system. But such decisions do not come from within – they require a quake at the core of the political system.

Summing up: how should investors navigate Fed incoherence?

Take our central scenario here (as presented in *Global Monetary Viewpoint*, 15/1) continuing economic slowdown globally and in the US this year and heading into recession. How should the Fed incoherence impact market strategy?

The Fed star-watchers will determine that policy-easing is in order and they will present this as a combination of "rate moderation" and "curtailing balance sheet shrinkage". At some point, related to their on-going policy review, they will hint that present short-falls of inflation below target means inflation above target becomes desirable for some time into the subsequent economic expansion.

The drama of the Fed taking actions always with a lag behind changing circumstances in real time and never admitting error will keep day-traders busy and short-sellers in asset markets awake at night, Serious investors will largely "tune out" the noise of Fed drama, some would say comedy (the essence of which is the coming together of rigidity – inability to change ways – and a harsh break in reality). Beware: at the comedy's end much economic and market devastation will be apparent.

For now, the speculative narrative re-writers are busy enjoying the Indian Summer (likely very brief) of the Powell Fed's put (announced rescinding of coming rate rises as previously planned). One such story has been the bulging potential smart ad revenues of Amazon as it capitalizes on its huge knowledge of individual purchases to "introduce them" to other sellers of products and services in given locations. A promising outlook for Amazon ads translates into grown competition for the other smart ad producers – especially Facebook and Google. All very exciting: yet the reality which transcends all this is that smart ad business like any other business is likely to prove highly sensitive to the path of the business cycle.

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