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Opinion

US Federal Reserve's Current Monetary Policy Is A Major Mistake

By Mike Cosgrove 08/28/18

The current Federal Reserve policy, if continued, will end badly for the U.S. economy and equity markets. The Fed, under Chair Yellen, embarked on a nonsense policy path of both normalizing interest rates and quantitative tightening.

Equity prices are probably fine for the remainder of 2018 and the first part of 2019. In the second half of 2019, however, quantitative tightening may place downward pressure on equities and even push the U.S. economy into recession in the latter part of 2020.

The Federal Reserve has a lot of experience in raising interest rates and has a decent idea about the time lags involved with that policy. At the margin, a higher cost of money, adjusted for inflation, eventually slows price pressures. The technical process the Fed uses for increasing short-term interest rates does not depend on reducing the size of the Fed's balance sheet.

In comparison, the Fed has zero experience with the massive quantitative tightening program it has undertaken and no knowledge about the time lags associated with it. But pull enough liquidity out and eventually, quantitative tightening will depress equity prices and end economic growth. The Trump administration shifted tax and regulatory policy to pro-growth so that the U.S. economy can return to strong growth and prosperity. The Fed has embarked on a dual monetary policy that will truncate that strong growth.

This academic experiment that Fed officials dreamed up of — never having had any experience with it — is only going to end one way: a stock market bust and major recession. By the time Federal Reserve officials recognize quantitative tightening is pushing down equity prices, it would be too late, because of the time lags, to stop the economy from also going into recession.

The amount of quantitative tightening started small, $10 billion a month, in October 2017, relative to their $4.5 trillion balance sheet. The amount of tightening, however, increases by $10 billion each quarter and by October 2018, the Fed will be draining liquidity at a pace of $50 billion every month. This $50 billion per month reduction is separated into $30 billion in Treasuries and $20 billion in agency securities, primarily mortgage-backed securities (MBS).

That monthly $50 billion reduction over 12 months amounts to a $600 billion reduction in liquidity, which is equivalent to the size of QE2. QE1, which involved the purchase of $1.25 trillion of MBS in two stages, was rolled out in late November 2008. The central bank started its policy of adding liquidity to a liquidity-starved economy. And to no one's surprise, equities – a highly liquid market – bottomed a few months later in March 2009 and started a secular bull market, which continues today.

Equities are supported by a strong domestic economy and a growing global economy, so the pulling out of liquidity from a large balance sheet is likely to take time before it works to depress equity prices. However, the Fed is also pushing up the cost of money which, at the margin, slows household and business borrowing.

Somehow, Fed officials got it into their heads that they could pull $600 billion of liquidity every 12 months out of the economy and not have adverse effects on equity prices, economic investment and growth. Clearly, adding liquidity had very beneficial effects on equity and housing prices and the balance sheet of American households.

A rational Federal Reserve policy would have been to first normalize interest rates and allow those time lags to take effect. The second leg of quantitative tightening should come next if the economy and equity prices hold up okay. But both should never be done at the same time.

Fortunately, we have a new Federal Reserve Chair who can persuade members to halt quantitative tightening until after interest rates have normalized. However, in Powell's speech at Jackson Hole on Aug. 24, he missed an opportunity to introduce the topic of halting or slowing the liquidity squeeze.

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