Markets and the Fed have to practise a new dance
By Henry Kaufman

The overwhelming focus of market attention on monetary developments is unprecedented. Every report, speech or commentary from the US Federal Reserve is under the analyst’s microscope.

Last year much of the focus was on when the Fed would begin to reduce its quantitative easing asset-purchase programme. The consensus view was that the central bank would begin unwinding, or tapering, in the later part of 2013. This was correct, but the anticipated market consequences generally were not. While some feared that financial markets would be threatened by such actions, developments subsequently have been quite the contrary. Stock and bond prices have actually increased and market volatility has largely diminished.

Many market participants are looking for the Fed to return to policies of a more traditional kind. It is not entirely clear, however, what this would involve. Would it be a return to “bills only”, whereby the Fed eased or tightened by engaging in the purchase and sale of the US Treasury bills? Would it consist of a return to a sort of monetary targeting such as the growth of money or credit? Or would it entail leaving it to the markets to deal with excess behaviour, whereby those who did well would prosper and those who did poorly would fail?

Financial market participants are also trying to anticipate when the Fed will increase short-term rates and reduce its holdings of securities. The Fed is still trying to encourage markets to believe such tightening is a year or two away. Inflation is not an imminent threat, unemployment is still too high and wages are not showing any real cyclical improvement. Moreover, the recovery in both consumer spending and the housing market will be jeopardised by any significant increase.

It is illogical to assume that the Fed can reduce materially, if at all, the size of its $4.3tn balance sheet which totalled only $950bn in mid-2008. So, what developments would be the correct backdrop that should encourage such reductions? A significant acceleration in economic growth, sharp increases in the rate of inflation or large budget surpluses by the US government, or some combination thereof.

None of these developments is likely to materialise soon. The Fed may be considering executing reverse repurchase agreements, the temporary sale of securities and the promise to buy back the securities at a specified time, to start the process of unwinding its balance sheet.

Such actions represent a tightening of policy with negative interest rate implications, but they do not decrease the size of the balance sheet unless the Fed disgorges its holdings outright. The best that we should hope for is sustainable economic growth that will permit nominal output to increase more than the size of the central bank’s balance sheet and, therefore, in relative terms, decrease the significance of the Fed’s holdings.

The quandary for both the central bank and market participants is the challenge of incorporating the impact of structural changes into their projections of economic and financial behaviour. Such changes are difficult to perceive and to quantify. Moreover, our economic and financial competence has been predominantly schooled in searching for past relationships that fit the current scene.

The key question is whether the business cycle pattern that analysts have depended on for so long is still usable because of those fundamental structural changes. For example, the huge strides in technology in recent decades are most likely impossible to quantify. Do we really capture much of these improvements in our economic data? There is a fair probability that our productivity is understated.

Furthermore, the reliance on cyclical developments has been muted by globalisation. In contrast to the past, many businesses and financial institutions think and act internationally. The economic and financial behaviour of countries has consequences beyond their borders more than it did in the past. But how do we capture these consequences to improve our understanding of the past and of the future?
Relying on cyclical patterns to judge economic and financial trends may not be as dependable as it once was because of the structural changes in financial markets. Compared with just a few decades ago, financial markets are huge, trading activity is huge and financial assets are highly concentrated in relatively few institutions that are deemed too big to fail.

In response to the financial crisis of 2008, the US Congress introduced the Dodd-Frank Act, legislating for increased responsibility to official supervisory authorities. Considering the complexity of the financial and economic situation, the Fed may try to contain future market excesses through selective intervention in the markets rather than through just raising interest rates. As a result, cyclical economic and financial anchors will be weakened further.

*The writer is president of Henry Kaufman & Company and author of 'The Road to Financial Reformation: Warnings, Consequences, Reforms'*

**RELATED TOPICS**  Federal Reserve USA, United States of America, Central Banks, US Quantitative Easing