End of the Free QE Lunch[1,2]

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February 18, 2014

Nobel Laureate Milton Friedman noted that "there is no such thing as a free lunch."[3] Well, based on CFS monetary and financial data, it appears that the seemingly free lunch from quantitative easing (QE) is nearing an end.

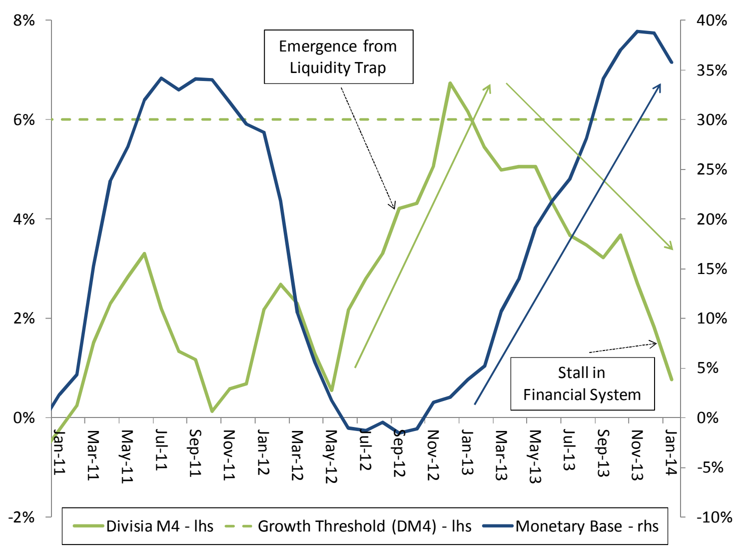
Specifically, our data show:

- Benefits witnessed in the banking system from QE are vanishing fast,
- The economy is softening; weather is playing a much more limited role than many believe, and
- Visibility and confidence among businesses remains limited.

Benefits from QE are Vanishing Fast

Despite low interest rates since the crisis, monetary policy has never been more volatile at least when measured by swings in base money. Surges in base money or the size of the Federal Reserve's balance sheet from QE created a situation where banks were flush with reserves or liquidity. These reserves provided the fuel to create additional liquidity through the financial system or the money multiplier between May and November 2012.

Figure 1. Financial System Slide, Despite QE3 (year-over-year)



Source: Bloomberg LP, Federal Reserve, and Center for Financial Stability.

[1] Based on CFS Monetary and Financial data for January 2014, released at 9:00 A.M. ET, February 18, 2014.
[2] With thanks to William A. Barnett (CFS Director of Advances in Monetary and Financial Measurement), Jeff van den Noort, and Ryan Mattson.
[3] Please note that although we are quoting Milton Friedman. Today, money matters for Keynesians, monetarists and all economists. CFS monetary aggregates and components provide an essential barometer to measure Fed actions, the economy, as well as bank and shadow banking liabilities in real time. Our recent piece "IMF Debt Plan Would Worry Keynes" centered on Keynes.

Here, CFS Divisia M4 (DM4) - the broadest real time measure of US financial liabilities today - responded to the surge in liquidity from the Fed and it began to grow at progressively higher rates (see Figure 1).

The present drop in DM4 growth rates from 6.2% on a year-over-year basis in January 2013 to 0.8% in January 2014 seems particularly troubling.

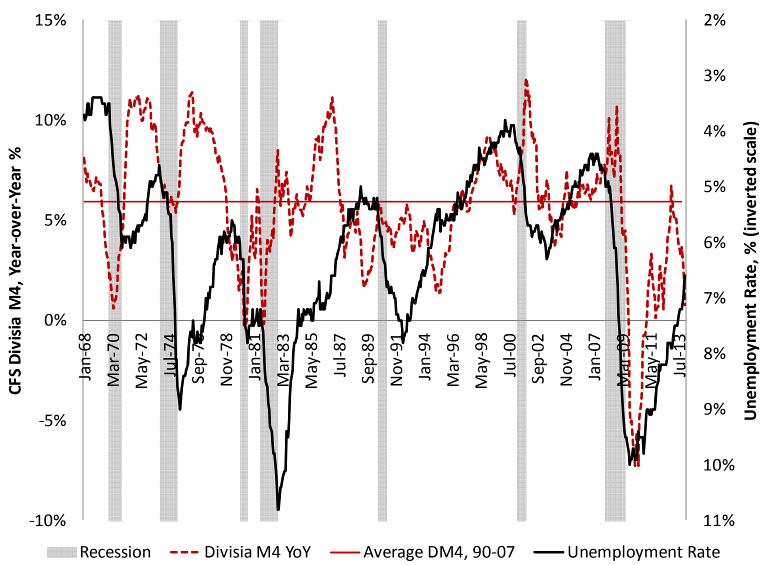
The Economy is Softening

Many are blaming storms and unseasonably cold weather for the recent economic slowdown. DM4 would suggest that other factors may also be operative especially as our data are seasonally adjusted.

Growth in coming quarters will likely remain soft and disappoint. The present slide in DM4 growth presents a meaningful indicator for a tepid economic expansion at the moment and in the months ahead. Likewise, recent data stretching from nonfarm payrolls to retail sales to the latest Federal Reserve senior loan officer survey also corroborate a slowdown even before the recent spell of unusually harsh weather.

DM4 is a leading indicator. Over a year ago, DM4 data highlighted that the Federal Reserve Board's unemployment target might be achieved earlier than anticipated.[4] Sadly, the Fed is now moving away from the 6.5% target, due to an expectation for an even lower unemployment rate. Ironically, with a slowdown in DM4 growth and variable economic targets, there is risk for disappointment.

Figure 2. Monetary Growth and Unemployment



Source: Bureau of Labor Statistics, Federal Reserve, and Center for Financial Stability.

Similarly, DM4 data were instrumental in our constructive view for the U.S. economy and equities as well as concern for a bond market correction at the start of 2013.[5, 6]

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[4] "New Fed Targets and Money" - http://www.centerforfinancialstability.org/test2/amfm/Highlights_Dec12.pdf, January 16, 2014.

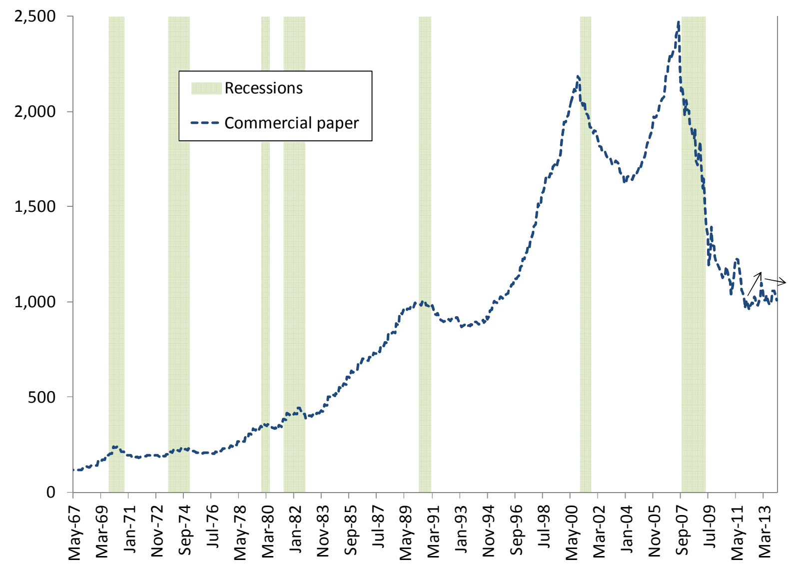
[5] "Goodbye Liquidity Trap," Center for Financial Stability, February 20, 2013.

Business Confidence Remains Weak

Based on the commercial paper components within the CFS monetary aggregates, business confidence remains surprisingly weak. In late 2012 into early 2013, the real issuance of commercial paper increased. A boost in the commercial paper offered signaled a resumption of interest in tapping markets for cash to investment or spend. This represented a meaningful shift from an unprecedented fall of 61% from peak to trough coincident with the financial crisis versus an average 16% drop in prior recessions.

Although real issuance of commercial paper seems to have finally bottomed in October 2012, recovery appears possible later in the year at the earliest. In contrast, the issuance of commercial paper completely recovered lost ground within 33 months of its trough in previous recessions.

Figure 3. Commercial Paper Monetary Component (Real, January 2014 Billions US$)



Source: Bloomberg LP, Federal Reserve, and Center for Financial Stability.

Conclusion

In sum, visible benefits from QE in 2013 are vanishing. There is no free lunch.

Figure 3. Major CFS Monetary Aggregates and Reserve Balances, % year-over-year

	2009	2010	2011	2012	2013	Aug-13	Sep-13	Oct-13	Nov-13	Dec-13	Jan-14
CFS DM4	-5.0%	-0.7%	0.7%	6.7%	1.8%	3.5%	3.2%	3.7%	2.7%	1.8%	0.8%
CFS DM4-	-5.2%	-0.6%	2.5%	6.7%	2.3%	4.0%	4.0%	4.5%	3.5%	2.3%	1.6%
CFS DM3	-2.4%	0.2%	3.3%	6.7%	2.2%	4.4%	4.1%	4.3%	3.3%	2.2%	2.1%
Reserves	35.0%	-5.3%	46.5%	-2.1%	60.7%	41.7%	52.6%	57.8%	61.0%	60.7%	55.1%

Source: Center for Financial Stability and Federal Reserve Board (total reserves of depository institutions).

[6] "Bernanke Still Pouring Shots Of QE To Markets Already Drunk On Liquidity," Forbes, January 30, 2013.

About CFS Money Supply

CFS Divisia monetary measures were developed under the direction of Professor William A. Barnett - one of the world's leading experts on monetary and financial aggregation theory. CFS money supply data are essential, especially since the Federal Reserve ceased production of M3 in 2006. Similarly, Divisia measures are superior, as they accurately weight various classifications of money from cash to leverage in the shadow banking system.

For the full Monetary and Financial Data Release:
http://www.CenterforFinancialStability.org/amfm/Divisia_Jan14.pdf

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Next release – November 20, 2013 at 9:00 A.M. ET

Additional information: www.CenterforFinancialStability.org