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The Fed's Intertemporal Game

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The Fed is making a promise into the future that it may or may not be able to keep.

The offer to keep rates low through the middle of 2015 should be thought of as a risky game that the Federal Reserve is playing with private individuals, corporations, and investors. Sadly, extension of the large scale asset purchase program (LSAP) and "forward guidance" communication strategy represents a doubling down of a bet being waged over time. If the game ends poorly and market interest rates rise sharply, all players lose.

"Forward guidance" is predicated on the idea that comments and communiqués from the Fed can lower short-term interest rate expectations, thereby reducing longer term rates.

This may or may not be the case.

History illustrates that intentional or even unintentional failure by a central bank to meet a pledge can cost the institution its credibility, unleash a forceful slide in markets, and thrust an economy into recession.

Over the years, loss of policy credibility is typically associated with developing nations. However, today, times are different. Many developing nations are impressively adhering to clear and transparent monetary policies, reducing debt, and running manageable budget deficits. This is the key to the "emerging markets" success story stretching across countries ranging from Chile, Mexico, Poland, Korea, and Singapore to many others. Sadly, many advanced economies are moving in the wrong direction with policy choices resembling developing nations in days past.

Despite the developing nation prevalence, the phenomenon of lost credibility is not unique to less developed nations. In 1974, Fed Chairman Arthur Burns promised to restrain inflation via wage and price controls. The Fed even convinced the Bureau of Labor Statistics (BLS) to create a new consumer price index (CPI) excluding food and energy to illustrate preservation of low inflation. Despite the promise of inflation restraint and the new core CPI, prices soared, the economy stalled while fluctuating violently, and the Fed's credibility was tattered.

Going forward, the Fed's current strategy can work. But, Treasury bond yields must remain at historic lows. This cannot be guaranteed:

First, bonds are substantially overvalued relative to stocks. For instance, the price-to-yield ratio (or the inverse of the bond yield) has never been further apart from the S&P price-to-earnings ratio since 1920. Between 1960 and 2007, these ratios tracked remarkably well with the exception of the late 1990s when equity valuations substantially exceeded their bond counterparts.

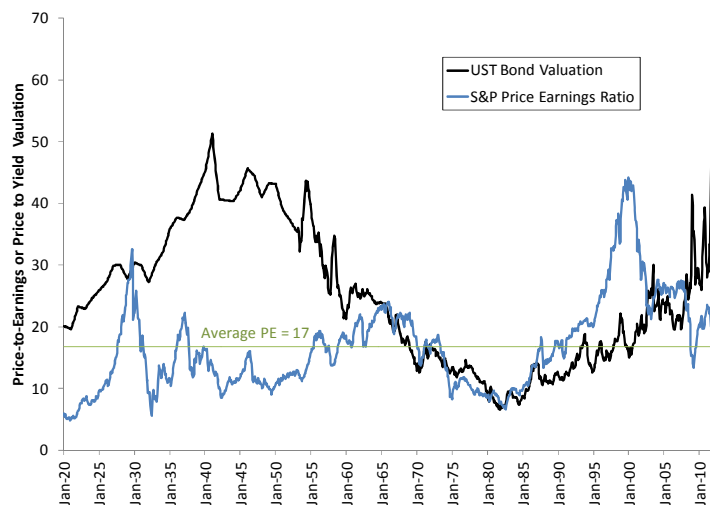
So, return to a more normal bond valuation could trigger a sharp correction and losses for individuals, corporations, and even the Fed itself.



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Figure 1. Visible Policy Distortions in Financial Markets



Source: Robert Shiller (Yale University), Bloomberg LP, and Center for Financial Stability.

Second, the relationship between the US Treasury and the Federal Reserve is now more intertwined than at any time since the Fed-Treasury Accord in 1951. At that time, Chairman William McChesney Martin developed the Accord to break the link between Treasury's desire for subsidized credit and the Fed's delivery of artificially low rates. The Accord unleashed an era of Fed independence lasting over decades. Unfortunately, this may be nearing an end.

The Fed's role in funding supersized US budget deficits is alive and well today. After perpetual purchases of Treasury debt, the Fed is now the single largest creditor to the US government. Last year, the Fed bought 61% of the net issuance of Treasury debt, pushing its claims against the US government above those of China, Japan, the UK, and all of the oil producing nations combined.

So, concern regarding this increasingly symbiotic relationship could similarly disturb bond markets.

Third, a gigantic US public debt raises the sensitivity of future budget deficits to fluctuations in interest rates, even with return to a normal interest rate environment. A 2% increase in Treasury rates will boost the budget deficit by a full 2.1% of GDP or \$340 billion per year over time. In contrast, the same 2% push higher in rates would have boosted the budget deficit by only 0.7% of GDP during the uncertain and volatile 1970s.

At present, the US government has a reduced margin of error for enduring higher interest rates. Budget deficits are now 7%-10% of GDP relative to a more sustainable 0%-5% of GDP during the late 1970s.

Going forward, if bond prices fall and yields rise, holders of bonds will suffer large losses with the Fed at the forefront. Markets may even adjust more swiftly than many anticipate or hope. Such a move can tarnish the Fed's credibility and halt growth in an already weak US economy. Ironically, job creation would cease and the unemployment rate might even head higher. So, extension of the LSAP and offer of low interest rates over time reduces to a dangerous game for the Fed, economy, and markets.



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