Global Monetary Viewpoint

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Fed reinforces its bad money regime as double recession looms

Europe to again join race to bottom, as undeclared currency war erupts

The dark age for money has been long in coming.

The Fed's late-August announced change in its monetary framework is an essential point of despair.

The control of the machinery of money is now vested in a Board whose unambiguous declared main purpose is getting the slack in the labour market back down to the low level apparent on the eve of the pandemic. This Board will fully use its vaunted non-conventional tools towards achieving this aim, albeit stopping short of including in this toolbox either negative rates or explicit yield curve control.

Yes, there is the constraint on the use of these tools, that the average inflation rate should hold at 2 per cent over an arbitrary span of years to be chosen at the Board's discretion. This average is to take account of the undershoot in recent years – meaning that inflation well above that level would not trigger any pull-back from full-throttle pump-priming monetary policy.

All automatic mechanisms such as control the machinery of money under sound money regimes are absent from this "revised" framework as indeed has long been the case.

Average 2 per cent inflation target is nonsense

The aim of 2 per cent average inflation, however, is itself a nonsense. There is no predictable or straightforward relationship between any policy tool or aggregate which the Fed controls in today's monetary system without anchor and the path of prices over the medium term. Rigorous pegging of short-term rates and manipulation of long-term rates are the essential tools now of Fed policy – together with the size and composition of its balance sheet. However, the link between these and price outcomes is unknown and unknowable.

Prices of goods and services may nonetheless remain on a stable path for considerable periods under the influence of inertia of price expectations and due to the impact of non-monetary factors (globalization, productivity growth, resource abundance). When for whatever reason, inflation breaks well above 2 per cent, the Fed has no reliable tools to deploy, which would promise a return of prices to the path.

Executive Summary

The Fed is now to double down on its deeply flawed monetary regime in the pursuit of the unemployment low-point on the eve of the pandemic.

This is all emperor's new clothes stuff.

The unemployment low should not camouflage the lack of overall economic prosperity for two decades and the related failure of the labour market to generate an ample supply of well-paying jobs.

And point of fact: In the Fed's monetary system, now wholly without anchor, there is no systematic relationship between its use of the key tools of interest rate manipulation and QE on the one hand, and inflation outcomes on the other.

In any case, the so-called inflation target is so ambiguous and discretionary in its formulation that it is hardly an effective constraint in any way at all.

A likely doubling down of recession ahead will not bring any change in the Fed's regime; rather this will be reinforced.

All of this does not mean a weak dollar. There is now a race to the bottom amidst fiat monies – and Europe is at the epicentre of a looming financial and credit crisis.

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Yes, through the last two or three decades, the Fed has told us that it had a reliable operating system for determining price outcomes and for stabilizing the economy. Fed officials explained in their regular speeches how this was based on rigorous neo-Keynesian analysis coupled with a system of econometric equations of which the Phillips curve and Taylor rule were vital components. However, now the Fed recognizes that these econometric estimations have been revealed as bogus.

Fed officials stare at employment, not prosperity

So, with what are the Fed managers left? A bland view that to get employment up the Fed should expand its balance sheet and hold down rates at zero all in the conviction that inflation pressures will remain non-existent for many years to come. This conviction stems perhaps from extrapolating further downward pressure on prices from non-monetary factors (including technology and structural adaptation in the labour market). These are dubious assumptions as globalization stalls and huge malinvestment past and present, and the war against COVID 19, weigh on productivity growth.

All of this suits the Fed's political masters wonderfully as it means monetary repression tax without limit. If wrong and inflation suddenly accelerates, there will be a new source of revenue, inflation tax, which would be incidentally popular amongst many indebted private sector actors.

Long day's journey into fiat money darkness

How did we get to this point?

It has been a long time coming. First the fall of the international gold standard in 1914; second the fall of the US gold coin standard in 1933; third the collapse of the dollar-gold regime (in which dollars were freely convertible into gold for non-US residents at a fixed rate) in 1968-71; fourth the cutting loose and failure of fiat money anchors laid when what was left of the dollar's gold anchor was demolished in 1971.

These fiat anchors took the form of monetary base or money supply control (US monetarist experiment ends in 1983/4, money supply targeting abandoned by the early 1990s). In Germany, monetarism died finally with the end of the hard DM also by the early/mid-1990s). Since the early 1990s our now anchorless monetary systems have been steered under the so-called 2 per cent inflation target, where central banks apply interest rate manipulation, with the input of "econometric expertise", towards achieving the inflation outcome.

The Fed's big lie

The big lie of the 2 per cent inflation standard has been that the central banks have simultaneously been applying policy to bolster employment and financial stability, equating along the way jobs and prosperity. Chief Powell's Jackson Hole "reformulation" doubled down on that lie in proclaiming that employment is now the prime objective of US monetary policy.

The 2 per cent inflation standard, both historically, and ongoing, has in fact been employment and prosperity destroying. The idea, which underpins the Jackson Hole reformulation, that holding rates down at near-zero or below on a prolonged basis and radical expansion of the central bank balance sheet improves these outcomes, has no basis. The opposite is the case.

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Troubled history of 2 per cent inflation standard

This standard has been in force over decades since the mid-1990s, a period in which there have been powerful non-monetary disinflationary forces. The Fed (and other central banks) in trying to drive up prices in this context have suppressed rates at abnormally low levels, feeding bouts of asset inflation and subsequent busts.

Integral to this whole process has been colossal malinvestment which weighs on productivity growth and ultimately prosperity in general (albeit not for monopoly capital). Indeed, the primary emphasis in financial markets, driven by low rates, has been on 'momentum' investment and financial engineering. In a climate of enormous uncertainty about when asset inflation will crush into asset deflation across much of the economy, long gestate capital spending is eschewed. Firms do better for their shareholders by leveraging up and playing in the financial speculation game.

Yes, on the eve of the pandemic employment was at a high and unemployment at a low. But years of malinvestment and monopolization in the US economy meant that the growth of average living standards had fallen far behind the standards of previous long cyclical expansions. Much of the vaunted success in the labour market reflected a rapid growth of low-paid low productivity jobs rather than of the higher productivity higher-paid jobs which distinguish eras of prosperity.

So now post Jackson Hole there is the prospect of more of the same, but even more so. Potentially massive further malinvestment could now be a possibility over coming years in those big tech and related areas which have been the darlings of this latest episode of asset inflation during the pandemic. In some ways, that is if we are lucky.

A deadly prospect

We should consider a deadlier prospect. Before we even get into that further cycle of induced malinvestment, the past cycle could yet encounter a big bust.

We are still in a US and global recession, despite the bounce-back of many economic aggregates through the summer. The essence of recession is the appearance of enormous malinvestment long formed during many years of prior asset inflation. Correspondingly there is an impairment to the banking and credit system, whilst new capital spending by business falls to a much lower level than during the cyclical expansion.

All this has been apparent in the course of the US and global economy since February this year (if not earlier); but alongside there has been a massive supply shock (the pandemic reinforced by government lock-downs), which has been going partially into reverse since late Spring.

Receding supply shock camouflages continuing recession

The partial reversal of the supply shock does not eradicate the essence of the present recession. Nevertheless, the central banks which have been implementing their "mother of all stimuli" certainly hope this is the case.

Even so, there is widespread optimism that vaccine announcements might so lift animal spirits as to spare us from a continuing recession. Yes, expanses of malinvestment will still be there. However, if the narrative persists in a potent

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form that the Fed has extinguished solvency risk. Meanwhile, there is a wave of pent-up demand across swathes of the US and global economy. Then maybe bad debts can build up without recessionary consequence.

Our central scenario does not share that optimism.

Central scenario:

Fed's mother of all monetary stimuli flops: Europe is epicentre of storm

The recession continues even if the Trump Administration gives an accelerated authorization to a weak vaccine just before Election Day, which is highly improbable now given setbacks in leading programs.

Clouds are likely to darken above critical areas of global banking, perhaps causing a slump in an array of bank shares. The epicentre of the storm is likely to be Europe, including critically the UK, which has a bearing on how European Central Banks will modify their policy stances through the remaining months of this year and beyond.

The ECB may not reformulate its inflation target in the same way as the Fed. Adopting a 2 per cent average inflation target in such a vague formulation may not be possible given opposition from the Bundesbank and its allies. Even so, without such a change, the ECB will be increasing the radicalism of its policies. Furthermore, when inflation eventually picks up in Europe, possibly many years down the road, the ECB must contend with much greater handicaps. In particular, it could not slim its balance sheet so full now of illiquid junk. We should expect new QE and Italy-saving policies through the Autumn.

UK launches currency offensive as ECB acts

The UK will be in the lead of beggar your neighbour monetary policies. The reluctance of the UK government to push ahead with support policies which would now drive debt to GDP ratios into alarming territory means that it will search for alternative "stimulus" policies. Number one here will be Sterling devaluation accomplished by the Bank of England signalling even greater radicalism.

Will an extension and deepening of the US and global recession, coupled with broader asset market crash, bring the Fed to rethink the Jackson Hole framework? Not from within this Fed, or from a Trump or Biden Administration. Monetary failure could, however, galvanize forces in the broader political arena both in the US and Germany, which could poignantly call into question the long-run continuation of the present monetary status quo.

Bottom Line

Our central scenario here is that a doubling down of the recession ahead coupled with banking and credit market stress means that the Fed (and more broadly central bank) mother of all stimuli will be exposed as deeply flawed and failed. Nevertheless, this result will not stop more of the same. The ultimate constraint here is political – but the forces here are as yet feeble.

The bottom line here for investors is to be wary that stock markets, as of now, are behaving as if the recession is already over. Though bank shares are widely unpopular and well down in many cases on pre-pandemic highs they do not

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reflect a doubling down of recession and crippling losses to emerge from huge revealed malinvestments. The narrative that the Fed has removed solvency risk from the system may not have been bought in its entirety by investors in financial equities. Still, there is much underlying optimism in that direction. In recent days there has been the cool-down of Big Tech, but this has hardly percolated out to financials and credit; when rose-coloured spectacles come off there, we should expect the euro to fall, reflecting Europe's situation at the epicentre of banking and credit crisis.

The pound could be especially vulnerable, given the importance of the financial sector in the UK economy, and the likelihood that the Johnson government will turn to the instrument of beggar your neighbour devaluation to stimulate the economy. Also, the ECB will be seeking to accomplish a stealth devaluation of the euro, though it may have its job done for it by the outbreak of a financial sector crisis.

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