What the Fed Is Actually Doing: Some Perspective on Current Rate/Inflation Fears

The fear of rising interest rates seems ubiquitous these days. One driver of this fear is the belief that US inflation is set to take off, thanks to the US Federal Reserve's (Fed) quantitative easing (QE) programs. Popular wisdom is that the creation of $2 trillion of new Federal Reserve assets is inflationary.

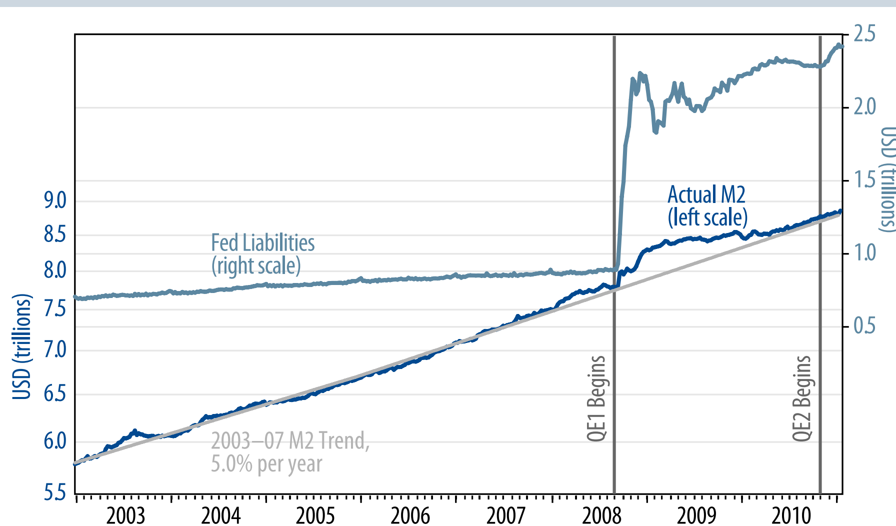
However, there is quite a gulf between perception and reality concerning the Fed's QE policy. When we look at the Fed's actual actions and results, we conclude that nothing that the Fed has done so far has been inflationary, and Fed actions are unlikely to prove inflationary in the future. Nearly all of the new liquidity injected into the financial system has found its way back to the Fed. Virtually none of the new liquidity is circulating through the economy, and it is unlikely to do so as long as the banking system remains in its current state of impairment. We'll detail these facts below alongside a parsing of Fed Chairman Ben Bernanke's pertinent statements on these issues.

"We're not printing money. The amount of currency in circulation is not changing. The money supply is not changing in any significant way."

—Ben Bernanke, on 60 Minutes
05 Dec 10

Strictly interpreted, Mr. Bernanke's first remark here is dissembling. "Printing money" can be said to occur whenever the Fed expands its balance sheet. The Fed creates liabilities that did not previously exist, and it uses that "credit" to acquire assets. It doesn't matter whether the new liabilities are Federal Reserve notes (currency) or banks' deposits at the Fed. So, the Fed has been printing money, but what matters for the economy and for inflation is how the private banking system is utilizing that "Fed credit."

Exhibit 1
M2 Money versus Prior Trend versus Fed Liquidity

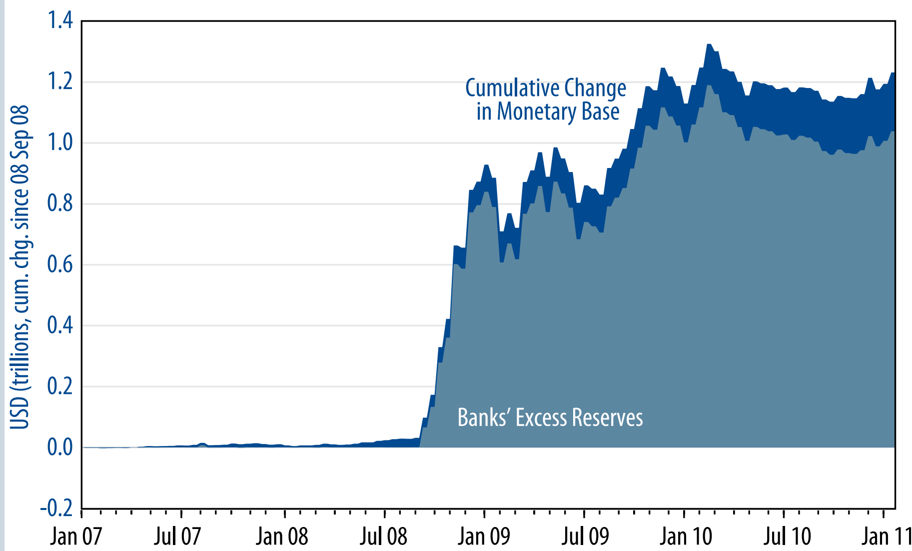


Source: Federal Reserve Board

From this perspective, Mr. Bernanke's statements ring true. While the Fed injected over $1 trillion of new liquidity into the banking system during the first round of quantitative easing (QE1) between September 2008 and January 2009, virtually none of that liquidity has circulated through the economy. As he says, neither currency in circulation nor the broad money stock has picked up (Exhibit 1). Instead, virtually all of the new liquidity is sitting idle as excess reserves held by banks (Exhibit 2).[1] The same can be said of the liquidity injected in the past three months as part of quantitative easing (QE2).

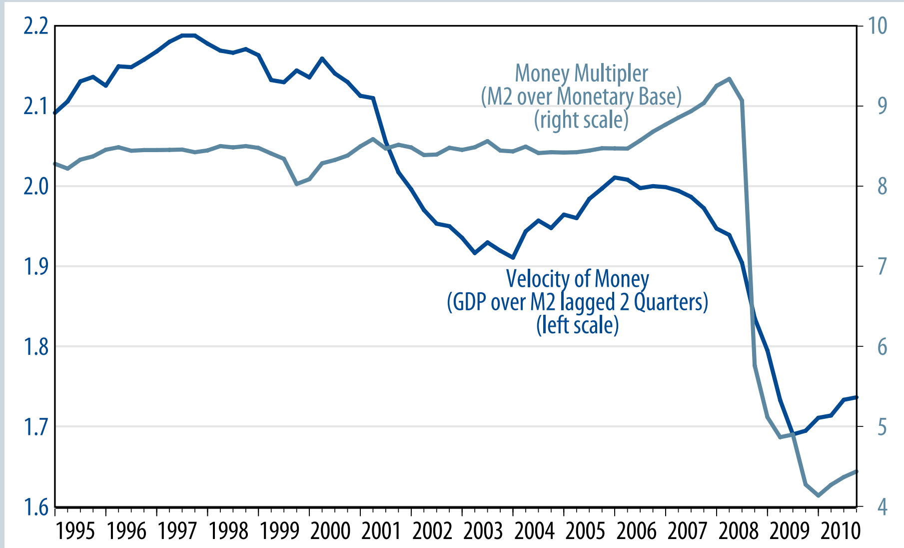
© Western Asset Management Company 2011. This publication is the property of Western Asset Management Company and is intended for the sole use of its clients, consultants, and other intended recipients. It should not be forwarded to any other person. Contents herein should be treated as confidential and proprietary information. This material may not be reproduced or used in any form or medium without express written permission.

Exhibit 2
Fed Balance Sheet versus Banks' Excess Reserves



As of 26 Jan 11
Source: Federal Reserve Board

Exhibit 3
Velocity of Money and Money Multiplier



Source: Bureau of Economic Analysis

For any measure of liquidity or money, what matters is both how much is in existence and how rapidly that stock is turning over. The effects of the money stock on the economy depend partly on the size of that stock and partly on how many times each dollar in the money stock is spent—the velocity of money. For the stock of liquidity—the Fed's liabilities—what matters is its size, as well as the number of dollars of liquidity that are needed for the financial system to support each dollar of money stock: the money multiplier.

Over the last three years, the trend growth in money has essentially remained unchanged (Exhibit 1), but the velocity of M2 money has declined substantially (Exhibit 3) so that nominal GDP growth has slowed substantially. While the stock of liquidity has more than doubled relative to previous trends, again, the money stock has not changed at all. Twice as much liquidity now supports each dollar of money stock, as was the case prior to the credit crisis. The money multiplier has fallen by half. As Exhibit 3 shows, there has been no substantive reversal of the late-2008 plunges in the velocity of money and the money multiplier.

These measures of turnover have declined partly because of increased caution and fear among businesses and consumers and partly because the Fed began paying interest on reserves in late 2008, giving banks an incentive to hold more reserves against any given stock of deposits. However, the main driver of the dramatically smaller money multiplier is most likely the more conservative operations undertaken by banks in the face of heightened financial uncertainty and increased bank regulation. Banks are holding 16 times as much cash reserves for every dollar of deposit liabilities as they did previously. In effect, increased Fed leverage has merely offset dramatic deleveraging by banks, consumers and businesses, with no net impact on the economy and so no reason to expect any inflationary pressure.

What would in normal conditions be inflationary is not inflationary under current, abnormal conditions in the US financial system, and there is no indication that those abnormalities are about to

change. This was the lesson learned from the Great Depression. Then, both the velocity of money and the money multiplier plunged much as they have recently, and those declines were sustained until 1940, 11 years after the initial banking panic.[2] Parallel developments are now taking place, and history provides no reason to think that current abnormalities will be quickly reversed.

As the banking system and the US economy recover, there may come a point when some of this liquidity needs to be withdrawn to sustain a non-inflationary environment. However, for now, there is no good reason to believe that Fed policy has entered inflationary territory.

"What we're doing is [lowering] interest rates by buying Treasury securities."

—Ben Bernanke, ibid.

Judging by Mr. Bernanke's statement here, it would appear that QE2 has been quite unsuccessful so far. During QE1, Treasury and corporate bond rates declined dramatically from October/ November 2008 through January 2009. Nearly three months into QE2, Treasury and corporate yields at all maturities beyond three years were at their highest points since June 2010, well before the markets began to anticipate QE2.

Why did yields behave differently in QE2 compared with QE1? Much of the difference reflects changing expectations about the economy. Also, when QE1 began, liquidity was in extremely short supply, while at present, liquidity is plentiful. The failure to drive interest rates lower certainly casts even more doubt on the belief that QE2 will prove to be stimulative to economic growth or inflation.

"We've been very, very clear that we will not allow inflation to rise above two percent or less."

—Ben Bernanke, ibid.

Well, not quite. In the weeks leading up to the beginning of QE2, various Fed officials made comments suggesting they desired higher inflation. William Dudley, president of the US Federal Reserve Bank of New York, was reported as favoring "temporary" inflation of as much as 4% in order to offset recent inflation rates that were below the Fed's desired level. President Charles Evans of the US Federal Reserve Bank of Chicago made similar comments.

Real-world experience from the 1960s and 1970s is clear: once inflation takes hold, it is exceedingly difficult to contain. Those difficulties are largely political. As Mr. Bernanke went on to say, "We could raise interest rates in 15 minutes if we had to." Certainly, the Fed could. The question is whether Fed members would indeed find the political will to do so. This was much of the reason that we were initially troubled by the onset of QE2 late last year.

Exhibit 4
Five- and 20-Year TIPS' Breakeven Inflation Rates

Source: Federal Reserve Board

In a white paper then, we fretted that an open-ended commitment to stimulus ran the risk of eventually fomenting a massive flight out of dollar assets should investors en masse lose confidence in the Fed's resolve to contain inflation.[3] Despite those concerns, we gave the Fed the benefit of the doubt then, and it is reassuring to see Mr. Bernanke commit so unequivocally recently to keeping inflation in check.

However, again, previous remarks from Fed officials were not as clear as Mr. Bernanke contends, and so it is understandable that investors' inflation expectations have been awakened in recent months, as suggested by TIPS breakeven inflation rates in Exhibit 4. The recent rise in inflation expectations can also be partly attributed to improvement in economic growth expectations among financial market participants.

To repeat, there is nothing in the Fed's actual operations so far that could be expected to prove inflationary. Mr. Bernanke's categorical, if belated, commitment to restraining inflation makes us more confident that quantitative easing efforts will cease before the Fed enters inflationary territory. While inflation expectations have increased recently, they remain at or below the levels seen in early 2010. We believe that those inflation expectations will be pulled down as hopes for a sharp, quick upturn in economic growth prove unfounded, and as Mr. Bernanke and other Fed officials continue re-emphasizing their commitment to restraining inflation.

Footnotes

[1] Total system liquidity, as shown in Exhibit 1, is merely the total liabilities (balance sheet) of the Fed. The monetary base, as shown in Exhibit 2, is the amount of those liabilities that are assets of the private sector. The difference between total Fed liabilities and the monetary base is deposits at the Fed by the US Treasury and by foreign central banks. Prior to the fall of 2008, such deposits were essentially zero, so Fed liabilities, Fed credit and the monetary base were essentially equal. Since September 2008, the US Treasury has held deposits at the Fed of as much as $400 billion, causing disparate movement in Fed liabilities and the monetary base (actual financial system liquidity). In fact, in the first two months of QE2, US Treasury deposits at the Fed increased by $100 billion so that little of the QE2-induced increase in the Fed's balance sheet made its way through to the monetary base (private sector). Since the start of the year, US Treasury deposits at the Fed have worked down some, and the monetary base has increased accordingly.

[2] The behavior of the velocity of money and the money multiplier was analyzed in some detail in a previous white paper with a similar name, *"What Is The Fed Doing?"* December 2008, available on our website.

[3] See *"The Fed's Adventures With QE2: Muddying the Waters,"* November 2010, available on our website.

Past results are not indicative of future investment results. This publication is for informational purposes only and reflects the current opinions of Western Asset Management. Information contained herein is believed to be accurate, but cannot be guaranteed. Opinions represented are not intended as an offer or solicitation with respect to the purchase or sale of any security and are subject to change without notice. Statements in this material should not be considered investment advice. Employees and/or clients of Western Asset Management may have a position in the securities mentioned. This publication has been prepared without taking into account your objectives, financial situation or needs. Before acting on this information, you should consider its appropriateness having regard to your objectives, financial situation or needs. It is your responsibility to be aware of and observe the applicable laws and regulations of your country of residence.

Western Asset Management Company Distribuidora de Títulos e Valores Limitada is authorized and regulated by Comissão de Valores Mobiliários and Banco Central do Brasil. Western Asset Management Company Pty Ltd ABN 41 117 767 923 is the holder of the Australian Financial Services Licence 303160. Western Asset Management Company Pte. Ltd. Co. Reg. No. 200007692R is a holder of a Capital Markets Services Licence for fund management and regulated by the Monetary Authority of Singapore. Western Asset Management Company Ltd is a registered financial instruments dealer whose business is investment advisory or agency business, investment management, and Type II Financial Instruments Dealing business with the registration number KLFB (FID) No. 427, and a member of JSIAA (membership number 011-01319). Western Asset Management Company Limited ("WAMCL") is authorized and regulated by the Financial Services Authority ("FSA"). In the UK this communication is a financial promotion solely intended for professional clients as defined in the FSA Handbook and has been approved by WAMCL.