The Consequences of Easy Monetary Policy

John Mauldin | September 1, 2012

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By John Mauldin

"No very deep knowledge of economics is usually needed for grasping the immediate effects of a measure; but the task of economics is to foretell the remoter effects, and so to allow us to avoid such acts as attempt to remedy a present ill by sowing the seeds of a much greater ill for the future."

- Ludwig von Mises

We heard from Bernanke today with his Jackson Hole speech. Not quite the fireworks of his speech ten years ago, but it does offer us a chance to contrast his thinking with that of another Federal Reserve official who just published a paper on the Dallas Federal Reserve website. Bernanke laid out the rationalization for his policy of ever more quantitative easing. But how effective is it? And are there unintended consequences we should be aware of? Why is it that the markets seem to positively salivate over the prospect of additional QE?

Quickly, I will be doing an inaugural "Fireside Chat" with Barry Ritholtz on Tuesday, September 11 at 1 PM Eastern. This webinar will be hosted by my friends at Altegris Investments and will be available to accredited investors and financial professionals. If you have already registered with the Mauldin Circle (and are in the US), you will shortly be receiving an invitation to attend. If you have not, I invite you to go to www.mauldincircle.com and register today, so you can hear Barry and me discuss the latest news and, of course, touch on the election and what it means for investors. Now, let's delve into quantitative easing.

Got LSAP?

No one really expected any fireworks in Bernanke's speech, and he fully met expectations. We got the obligatory rationalization for what passes as current Fed policy. The part the markets wanted to hear is highlighted below for you.

"… As we assess the benefits and costs of alternative policy approaches, though, we must not lose sight of the daunting economic challenges that confront our nation. The stagnation of the labor market in particular is a grave concern not only because of the enormous suffering and waste

of human talent it entails, but also because persistently high levels of unemployment will wreak structural damage on our economy that could last for many years.

"Over the past five years, the Federal Reserve has acted to support economic growth and foster job creation, and it is important to achieve further progress, particularly in the labor market. Taking due account of the uncertainties and limits of its policy tools, **the Federal Reserve will provide additional policy accommodation as needed to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability**."

Did that last sentence ring any bells? Let's look at his Jackson Hole speech in August of 2010 (hat tip Joan McCullough).

"We will continue to monitor economic developments closely and to evaluate whether additional monetary easing would be beneficial. **In particular, the Committee is prepared to provide additional monetary accommodation through unconventional measures if it proves necessary, especially if the outlook were to deteriorate significantly.** The issue at this stage is not whether we have the tools to help support economic activity and guard against disinflation. We do. As I will discuss next, the issue is instead whether, at any given juncture, the benefits of each tool, in terms of additional stimulus, outweigh the associated costs or risks of using the tool."

Standard-issue Fed speech. This has been his theme for the last four years, if memory serves. In every speech he gives a nod to the proposition that he and his colleagues are seriously analyzing the effects of Fed quantitative easing policies to make sure the benefits outweigh the costs. I have not heard a serious critique or exposition from Bernanke of those risks, as of yet. But we did get a victory lap from him this year, as he took credit for the economy and the stock market. Let's go back to the speech (again, my bold):

"Importantly, the effects of LSAPs [large-sized asset purchases] do not appear to be confined to longer-term Treasury yields.

"Notably, LSAPs have been found to be associated with significant declines in the yields on both corporate bonds and MBS. The first purchase program, in particular, has been linked to substantial reductions in MBS yields and retail mortgage rates.

"LSAPs also **appear to have boosted stock prices**, presumably both by lowering discount rates and by improving the economic outlook; it is probably not a coincidence that the sustained recovery in US equity prices began in March 2009, shortly after the FOMC's decision to greatly expand securities purchases. **This effect is potentially important, because stock values affect both consumption and investment decisions.**"

I missed the part where Congress gave the Fed a third mandate, to target the stock market. But Bernanke not only takes credit for the stock market, he points out that the rebound in the housing market is also due to Fed policy, because it fostered lower mortgage rates. Which it did. But let's also remember that it was Fed policy that helped create the housing bubble to begin with. Which I don't remember Bernanke taking credit for, even though he was on the Fed then and up to

his eyeballs in supporting that policy.

Joan McCullough, in her own irreverent style, gave us a few must-read paragraphs this afternoon:

"And then [Bernanke] has the *sand* to make a public comment that stocks go up when he prints money because discount rates have gone down and the economic outlook has improved on account of it? This is what makes the hot dogs run stocks up the flagpole when The Bernank saddles up? Better economic outlook? Amazing.

"Lemme go back now and give you the reality version of the Bernanke portfolio balance channel.

"He relieves investors of the lowest risk-bearing vehicles, forcing them to seek yield elsewhere and at the same time, take on increasing risk. Until, increasingly yield-starved as this 'balancing' is relentless, they arrive at the door of the stock market. And mindlessly take the plunge. Because they have no choice. They are now balls-to-the-walls exposed. Waiting for the next round of QE.

"Because Lord knows, the first two did jack. Of course, in the earliest part of his diatribe today, he does make a case as to how the lower rates worked some magic on the economy, although exactly how much is difficult to pinpoint. As usual, too, he also blames the fiscal intransigence as well as tight credit conditions at the banks for holding back the beauty of his genius from working its total magic."

Quantitative Easing as Trickle-Down Economics

Let me get this straight. If I design a tax policy that somehow might benefit "the rich," I am immediately labeled a Luddite supply-side theorist, as well as heartless, etc.

It is pretty standard for Keynesian economics professors to deride supply-side economics and what they call trickle-down economics. Cutting taxes on the rich will translate into a better economy and jobs? They scoff at such notions, as do almost all the liberal elements in politics.

Which brings us to this delicious irony. While they abhor trickle-down economic policy, they love what is in effect trickle-down monetary policy.

Bernanke explicitly targets a policy of helping the rich (those who own stocks) and then suggests that the result of making the rich richer will be increased consumption and final demand. Which will somehow trickle down to the guys and gals in the unemployment line.

The paper posted at the Dallas Fed, which we will take up in the next section, specifically notes that QE has a special benefit for "the senior management of banks in particular." That amounts to a thunderous indictment of the crony capitalism of current policy. It's hard to argue that there is much trickle down with that particular unintended consequence!

The paper also notes that "… it is also worth asking whether, to some degree, this [rising income inequality] might be another unintended consequence of ultra easy monetary policy. Not only has the share of wages (in total factor income) been declining in many countries, but the rising profit share has been increasingly driven by the financial sector [which explicitly benefits from QE]. It seems to defy common sense that at one point 40 percent of all US corporate profits (value added?) came from this single source."

Understand, I am NOT arguing that an easy monetary policy doesn't have an effect on stocks and that it will have an effect on the overall economy. There is clearly a wealth effect. It is just that almost all (not quite but almost) of the arguments that one can make for trying to boost the stock market are the same that one uses for arguing that tax cuts also increase consumption and the wealth effect.

As a short preview to next week's letter, Christina Romer and her husband and fellow UC Berkeley professor, David H. Romer, published a paper in the normally staid *American Economic Review* which noted that tax cuts and increases have a multiplier of about 3. (Christina Romer was Obama's chair of the Council of Economic Advisors, from the beginning of his term until *[very]* shortly after this paper was published.)

Most mainstream economists and liberals (or those who are both, as in the case of Krugman) make fun of the wealth and economic effects from tax cuts and ignore Romer's work, or try to show why it does not apply to eliminating the Bush tax cuts, which they oppose (and which, interestingly, the Romers' study specifically included). But then they turn around and ask for more of what is effectively the same thing in monetary policy. It will be great fun to watch the contorted positions they have to assume in trying to suggest this is not the case. Kind of like the contorted position that Clint Eastwood was referring to last night. They will use anecdotal "evidence" and allegories without actually referring to academic analysis or peer-reviewed studies. It is much easier to make an assertion than to actually demonstrate its validity in the real world. Their antics will serve to drive me nuts, however.

Note that I am not saying that either tax policy or monetary policy should be evaluated in the harsh glare of immediate economic results. Taxes have to be evaluated on more than just their effect on the economy, and monetary policy has to be judged on more than the immediate reaction of the markets.

That Which Is Seen and That Which Is Not Seen

Which brings us to the more serious part of this letter. Let's start with a review of a quote from Bastiat:

"In the economic sphere an act, a habit, an institution, a law produces not only one effect, but a series of effects. Of these effects, the first alone is immediate; it appears simultaneously with its cause; ***it is seen***. The other effects emerge only subsequently; ***they are not seen;*** we are fortunate if we ***foresee*** them.

"There is only one difference between a bad economist and a good one: the bad economist confines himself to the *visible* effect; the good economist takes into account both the effect that can be seen and those effects that must be *foreseen.*

"Yet this difference is tremendous; for it almost always happens that when the immediate consequence is favorable, the later consequences are disastrous, and vice versa. Whence it follows that the bad economist pursues a small present good that will be followed by a great evil to come, while the good economist pursues a great good to come, at the risk of a small present evil."

- From an essay by Frédéric Bastiat in 1850, "That Which Is Seen and That Which Is Unseen"

"Ultra Easy Monetary Policy and the Law of Unintended Consequences"

William R. White is currently the chairman of the Economic Development and Review Committee at the OECD in Paris. He was previously Economic Advisor and Head of the Monetary and Economic Department at the Bank for International Settlements in Basel, Switzerland. He is clearly no economic lightweight, nor is he an ideologue. When he writes, attention must be paid. (http://williamwhite.ca/content/biography)

And he has written a rather pointed indictment of Federal Reserve monetary policy, which has been published on the Dallas Federal Reserve website: http://dallasfed.org/assets/documents/institute/wpapers/2012/0126.pdf

Bascially, he looks at the unintended consequences of quantitative easing and concludes that there are limits to what central banks can do, and negative consequences if policies are too easy for too long. He notes later in the essay that:

"Stimulative monetary policies are commonly referred to as 'Keynesian'. However, it is important to note that Keynes himself was not convinced of the effectiveness of easy money in restoring real growth in the face of a Deep Slump. This is one of the principal insights of the General Theory."

I am going to quote him at length in the next few pages. I hope that it intrigues you enough that you will want to go and read the paper yourself. This is not just dry theory. If QE is maintained for too long, then those of us in the "cheap seats" will have to deal with the consequences. Let me note that there are some 126 footnotes. I would recommend at least keeping up with them, as I found the "extra" commentary to often be very enlightening. This is a well-written paper that avoids the all-too-typical verbal garbage that passes for economics writing these days.

Let's start with his introduction:

"The central banks of the advanced market economies (AME's) [3] have embarked upon one of the greatest economic experiments of all time – ultra easy monetary policy. In the aftermath of the economic and financial crisis which began in the summer of 2007, they lowered policy rates

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effectively to the zero lower bound (ZLB). In addition, they took various actions which not only caused their balance sheets to swell enormously, but also increased the riskiness of the assets they chose to purchase. Their actions also had the effect of putting downward pressure on their exchange rates against the currencies of Emerging Market Economies (EME's). Since virtually all EME's tended to resist this pressure[4], their foreign exchange reserves rose to record levels, helping to lower long term rates in AME's as well. Moreover, domestic monetary conditions in the EMEs were eased as well. The size and global scope of these discretionary policies makes them historically unprecedented. Even during the Great Depression of the 1930's, policy rates and longer term rates in the most affected countries (like the US) were never reduced to such low levels[5].

"In the immediate aftermath of the bankruptcy of Lehman Brothers in September 2008, the exceptional measures introduced by the central banks of major AME's were rightly and successfully directed to restoring financial stability. Interbank markets in particular had dried up, and there were serious concerns about a financial implosion that could have had important implications for the real economy. Subsequently, however, as the financial system seemed to stabilize, the justification for central bank easing became more firmly rooted in the belief that such policies were required to restore aggregate demand[6] after the sharp economic downturn of 2009. In part, this was a response to the prevailing orthodoxy that monetary policy in the 1930's had not been easy enough and that this error had contributed materially to the severity of the Great Depression in the United States.[7]

"However, it was also due to the growing reluctance to use more fiscal stimulus to support demand, given growing market concerns about the extent to which sovereign debt had built up during the economic downturn. The fact that monetary policy was increasingly seen as the 'only game in town' implied that central banks in some AME's intensified their easing even as the economic recovery seemed to strengthen through 2010 and early 2011. Subsequent fears about a further economic downturn, reopening the issue of potential financial instability[8], gave further impetus to 'ultra easy monetary policy'.

"From a Keynesian perspective, based essentially on a one period model of the determinants of aggregate demand, it seemed clearly appropriate to try to support the level of spending. After the recession of 2009, the economies of the AME's seemed to be operating well below potential, and inflationary pressures remained subdued. Indeed, various authors used plausible versions of the Taylor rule to assert that the real policy rate required to reestablish a full employment equilibrium (and prevent deflation) was significantly negative. Such findings were used to justify the use of non standard monetary measures when nominal policy rates hit the ZLB.

"There is, however, an alternative perspective that focuses on how such policies can also lead to unintended consequences over longer time periods. This strand of thought also goes back to the pre War period, when many business cycle theorists[9] focused on the cumulative effects of bank-created-credit on the supply side of the economy. In particular, the Austrian school of thought, spearheaded by von Mises and Hayek, warned that credit driven expansions would eventually lead to a costly misallocation of real resources ('malinvestments') that would end in crisis. Based on his experience during the Japanese crisis of the 1990's, Koo (2003) pointed out that an overhang of corporate investment and corporate debt could also lead to the same result (a

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'balance sheet recession').

"Researchers at the Bank for International Settlements have suggested that a much broader spectrum of credit driven 'imbalances[10]', financial as well as real, could potentially lead to boom-bust processes that might threaten both price stability and financial stability[11]. This BIS way of thinking about economic and financial crises, treating them as systemic breakdowns that could be triggered anywhere in an overstretched system, also has much in common with insights provided by interdisciplinary work on complex adaptive systems. This work indicates that such systems, built up as a result of cumulative processes, can have highly unpredictable dynamics and can demonstrate significant non linearities[12]. The insights of George Soros, reflecting decades of active market participation, are of a similar nature. [13]"

And then White anticipates his conclusion:

"One reason for believing this is that monetary stimulus, operating through traditional ('flow') channels, might now be less effective in stimulating aggregate demand than previously. Further, cumulative ('stock') effects provide negative feedback mechanisms that over time also weaken both supply and demand. It is also the case that ultra easy monetary policies can eventually threaten the health of financial institutions and the functioning of financial markets, threaten the 'independence' of central banks, and can encourage imprudent behavior on the part of governments. None of these unintended consequences is desirable. Since monetary policy is not 'a free lunch', governments must therefore use much more vigorously the policy levers they still control to support strong, sustainable and balanced growth at the global level."

White anticipates the objection that ultra-easy monetary policies clearly had a positive effect early on.

"The force of these arguments might seem to lead to the conclusion that continuing with ultra easy monetary policy is a thoroughly bad idea. However, an effective counter argument is that such policies avert near term economic disaster and, in effect, 'buy time' to pursue other policies that could have more desirable outcomes. Among these policies might be suggested[18] more international policy coordination and higher fixed investment (both public and private) in AME's. These policies would contribute to stronger aggregate demand at the global level. This would please Keynes. As well, explicit debt reduction, accompanied by structural reforms to redress other 'imbalances' and increase potential growth, would make remaining debts more easily serviceable. This would please Hayek. Indeed, it could be suggested that a combination of all these policies must be vigorously pursued if we are to have any hope of achieving the 'strong, sustained and balanced growth' desired by the G 20. We do not live in an 'either-or' world.

"The danger remains, of course, that ultra easy monetary policy will be wrongly judged as being sufficient to achieve these ends. In that case, the 'bought time' would in fact have been wasted[19]. In this case, the arguments presented in this paper then logically imply that monetary policy should be tightened, regardless of the current state of the economy, because the near term expected benefits of ultra easy monetary policies are outweighed by the longer term expected costs. Undoubtedly this would be very painful, but (by definition) less painful than the alternative of not doing so. John Kenneth Galbraith touched upon a similar practical conundrum some years ago

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when he said

"'Politics is not the art of the possible. It is choosing between the unpalatable and the disastrous'.

"This might well be where the central banks of the AME's [advanced-market economies] are now headed, absent the vigorous pursuit by governments of the alternative policies suggested above."

White then launches into a long litany of unintended and undesirable consequences of maintaining an easy monetary policy too long, some of which we can clearly see developing now. He particularly notes problems with the shadow banking system and the effects of low interest rates on insurance companies (and, I would add, pensions!).

"What are the implications of ultra easy monetary policy for governments? One technical response is that it could influence the maturity structure of government debt. With a positively sloped yield curve, governments might be tempted to rely on ever shorter financing. This would leave them open to significant refinancing risks when interest rates eventually began to rise. Indeed, if the maturity structure became short enough, higher rates to fight inflationary pressure might cause a widening of the government deficit sufficient to raise fears of fiscal dominance. In the limit, monetary tightening might then raise inflationary expectations rather than lower them."

"A more fundamental effect on governments, however, is that it fosters false confidence in the sustainability of their fiscal position… Koo, Martin Wolf of the Financial Times, and others are undoubtedly right in suggesting that a debt driven private sector collapse should normally be offset by public sector stimulus. What cannot be forgotten, however, is the suddenness with which market confidence can be lost, and the fact that the Japanese situation is highly unusual in a number of ways."

If interest rates were to rise in the US to more normal levels, the deficit would explode under current spending and tax policies, destroying whatever policy solutions are reached next year.

There is no easy way to exit from current policies, and the longer one waits the more difficult it will get. This is true in the US, Europe, and Japan. It is part and parcel of the Endgame. And this is the defining challenge of our time, and especially in the US as we approach the coming election. I will attempt to outline the key economic issues next week.

California, Chicago, New York, and a Little "Elderly Confusion"

I did an interview with *King World News* last week that seemingly went viral. You can listen to it at www.kingworldnews.com/Mauldin

I will be speaking at the Casey Investment Summit in Carlsbad, California, on September 7-9 and then in Palo Alto Sept. 12-13, at an investment conference again sponsored by Altegris Investments.

I will be in Chicago on September 19, presenting at the RDA Financial Network Investor

Forum, from 6:00 to 7:30 PM. The Forum will be held at the Chicago Marriott Oak Brook. This event is sponsored by Steve Blumenthal and my friends at CMG. (And congratulations, Steve, on your marriage last month!) If you would like to attend please email Linda Cianci at Linda@cmgwealth.com.

And I'm speaking October 1 in New York at the 8th Annual Value Investing Congress. I'll be joined by many really smart speakers, including Bill Ackman and David Einhorn. I've been able to secure a "friends and family" discount, if you'd like to join me there: $1,500 off the regular price to attend. To take advantage of these savings, ***register by September 7th*** at www.ValueInvestingCongress.com/Mauldin with discount code **N12JM**.

I have been writing this letter later and later over the past year. That correlates with my decision to quit drinking. I have some theories about why that is so, but that is a story for another day. Whatever my writing schedule, I have always gotten up to walk (fairly briskly) every 2-3 hours to stretch my legs and think. Given my later state now, that means I am walking around very late at night or early in the morning, and typically in gym gear and an old tee shirt with the sleeves cut off. Not the height of fashion, but it is comfortable on writing days.

Tonight I got up and walked farther than usual, thinking about Fed policy and meditating on what to write. It's about 3 or so, and I notice a car has pulled up beside me and red lights have started to flash. I guess I should note that I currently live (until my lease is up) in Highland Park, a city unto itself inside Dallas, otherwise known as The Bubble. Not much happens here, and it is quite safe, but the police can be a little overzealous, or at least that has been my experience. I guess that comes with not having much to do.

So this nice officer gets out and shines a flashlight on me and asks if I am OK. Not sure how to take that, I say yes. "Can I help you?" is the next question, with a clear undertone of "What in hades are you doing out here at 3 AM?"

"Just walking around thinking about Fed policy. I am writing on that tonight."

Oh. I don't guess that was what he was expecting.

"Are you sure you are OK?" he asked in a more-concerned voice. I again assured him I was just fine.

"You're not doing anything wrong, but sometimes we get elderly people who get a little confused. I have seen you on the streets tonight and was just wondering."

I can possibly be described as confused as times. Maybe. Trying to figure out these speeches and the consequences for policy are matters that try men's souls.

But elderly? Seriously? I am not even 63! What part of me was walking elderly? I was motoring on. With clear direction as to where I was going. And only a few extra blocks from my

house.

And with that perhaps I should hit the end button. Elderly confusion indeed. I'm on top of my game.

Your still on top of his A game and bringing that A game to you every week analyst,

John Mauldin

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