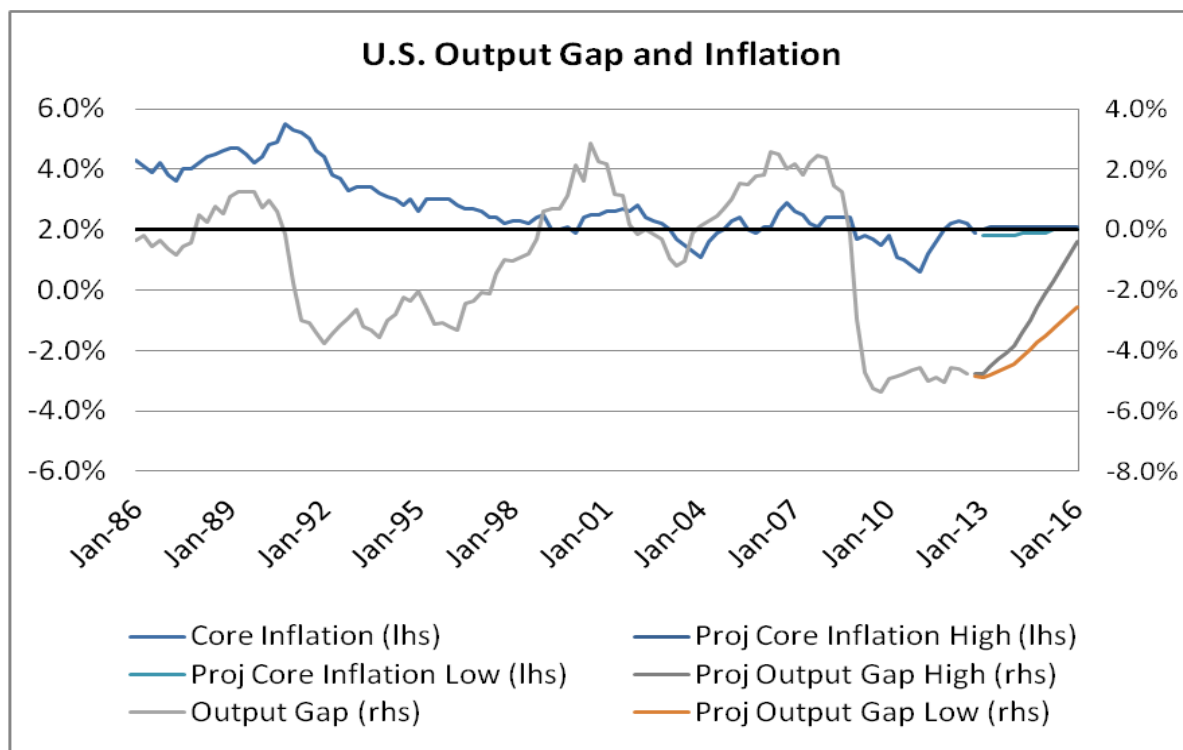


### **The Catch-22 of Exiting QE**

Central bankers are discovering that their newfound policy tool of announcing forward guidance on the course of monetary policy can be a tricky business. The media often miss the subtleties of the message or create confusion with catchy headlines, which is understandable given the nature of their news-oriented business. One would think, however, that sophisticated financial market participants can grasp the obvious and expressed conditionality underlying these forward-looking statements and respond accordingly. That naïve rationality might work when asset prices are based on fundamentals but not when financial flows are driven by excessive liquidity, as they inevitably are when monetary policy rates are near zero and central banks are among the biggest buyers of securities. In short, quantitative easing creates its own Catch-22 when it comes time to exit: these extraordinary policies provide the requisite conditions for banks to recapitalize and for households to refinance debt at manageable rates, but they also encourage excessive risk-taking in carry trades that have a finite horizon tied to the end of quantitative easing itself. For carry traders, timing is everything; the devil takes the hindmost when the herd heads for the exit. To compound the difficulties of unwinding over-positioned markets, no one wants to step in front of the panicked herd, which is whatever assets were the objects of the carry trades ultimately bear the brunt of the market correction. Over the past year, the stretch for yield extended to ever-riskier credits, heavy issuers of debt and currencies of countries whose central banks had 'normal' policy rates and no intention of joining the QE Club.

My guess is that Ben Bernanke has not lost much sleep about pricking the bubble in credit spreads with his comments on the timetable for the Fed's exit from QE. It had to be done and better that the subject was on the table sooner rather than later. However his latest comments along with those of Bill Dudley indicate that the Fed is concerned about the market's over-shooting in steepening yield curves and probably in selling emerging market currencies. Much of Bernanke's press conference after the release of the June 18-19 FOMC meeting was devoted to 1) clarification of the timetable for tapering asset purchases; 2) the presumed economic conditions underlying that hypothetical timetable; and 3) the unchanged and distant timetable for normalizing the fed funds rate. The minutes made it clear that "a few" of the voting members (who are 12 of the 19 FOMC 'participants') favored an early tapering of asset purchases as early as the June meeting. In Fed lingo "a few" means more than one but less than four, so this outlier always was a minority view that unfortunately garnered a disproportionate amount of press coverage over the past two months. Chairman Bernanke emphasized that the majority of FOMC voting members participants did not think current employment and inflation conditions warrant tapering of purchases; about half of them felt purchases likely would be necessary well into 2014. A surprising number apparently were quite concerned about the low readings on inflation that have dropped significantly below the Fed's targets.

The figure below depicts situation as likely presented to the FOMC by the staff. Despite the marked improvement in hiring as measured by the payroll survey and lower unemployment, the US economy still is operating well below its full potential. Using a conservative estimate of only 2% growth in potential output since the apparent break in the productivity trend in 2003, US real GDP is almost 5% short of what it could produce without generating more inflation. Indeed, such a large output gap tends to be associated with disinflation, so it is not surprising that many of the FOMC members are concerned that both actual inflation and expectations of future inflation are not only below targets but also are declining. The targets set by the Fed, which range from 1-1/2% to 2% for various measures of core inflation excluding the volatile food and energy components, are not arbitrary. Rather they represent the Fed's best estimates of price stability in practice given the statistical vagaries of these price measures. So, for example, the fact that core CPI inflation has slipped below its 2% target to 1.7% after four years of recovery is a legitimate cause for concern, especially if the disparity widens. Granted, the theoretical concept is a difficult one to convey in simply terms and is not known with any great degree of certainty during an economic expansion. There is no getting around the fact that policy debates will take place amidst a high degree of uncertainty that now is amplified by a stressful transition from a leveraged and globalizing world economy to one that is deleveraging, de-globalizing and de-industrializing.



Nonetheless, few if any FOMC participants would dispute the essence of the evidence on the output gap and inflation show above. By any metric, unemployment still is high and the world economy is weak. The internal debate about when to taper purchases in essence reflects the hard truth that central banks cannot buy an increasing share of outstanding debt securities forever with impunity. At some point the recovery must be deemed sustainable. The minority of FOMC participants who favor an early exit tend to weigh the risks of fomenting asset price bubbles as more worrisome than the risks about prematurely withdrawing stimulus from in incomplete recovery. The majority of members probably are feeling more comfortable now that the credit bubble has burst without financial markets coming unglued.

The cat and mouse game between central banks and financial markets is far from over though. The FOMC's internal debate belies the difficulties inherent in conveying an exit strategy when financial flows heavily driven by central bank liquidity. It is hard to have it both ways - a graceful exit requires market prices to be based on fundamentals rather than flows, yet until unconventional policies are wound down flows will be unduly influenced by exceptional liquidity offered by those same policies. Mr. Bernanke understands this Catch-22 and is resolved to stay the course of Machiavellian transparency. He will continue to stress the conditionality of any timetable for tapering purchases: the economy must deliver the optimistic outcomes that the FOMC is forecasting in order to proceed. That game plan should buy time and help to keep the 'feral hogs' that feed on liquidity at bay. By yearend, though, the FOMC is likely to have played out that strategy and will have to face the fact that unconventional policies probably are approaching their limits, especially with respect to buying Treasuries. We then will go through a replay of how to communicate forward guidance with the debate refocused on the normalization of the fed funds rate. By that time, the FOMC's transparency campaign should shift the discussion to include what the neutral fed funds rate should be for a global economy that is undergoing an extraordinary transition.

Dr Robert S Gay  
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