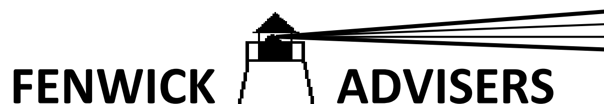

Advice from Australia's Shadow Open Market Committee

To: Graham Rich, Publisher
PortfolioConstruction Forum

Thank you for organizing the mock meeting of Australia's Shadow Open Market Committee as part of your Asset Allocation Seminar. Not surprisingly, Australians have a keen interest in the Federal Reserve's monetary policy. Needless to say, we are likely to witness some momentous changes in the year ahead, notably the winding down of quantitative easing (QE) at least in the United States. I was relieved that the stalwart participants were undaunted by the charge they were given, namely to decide whether or not the FOMC should begin to unwind its program of large-scale asset purchases at their next meeting on December 17-18.

Your video clip of Chairs Volcker, Greenspan and Bernanke and nominee Yellen was a nice touch to start the meeting – a perfect reminder of the Fed's rich heritage and the often difficult decisions these leaders have faced over the past three decades. Paul Volcker, who was Chair during most of my years at the Fed, brought back the most vivid memories. Those were the most trying times with both inflation and unemployment at 10% and seemingly no end in sight. Mr. Volcker stood alone as an advocate of tight money and bore the brunt of congressional and public backlash. No one appreciated how difficult it would be to rectify an entire decade of misguided and wrong-footed US monetary and fiscal policy during the 1970s. And no one wanted to take the bitter medicine of disinflation that was prescribed by the Volcker Fed. Nonetheless, in his most memorable and enduring words, he "stayed the course" toward what would be several decades of disinflation and prosperity.

By comparison, Mr. Greenspan's tenure was a walk in the park, although I am sure it did not seem that way to him of the Fed staff at the time. There were bumps in the road – the savings and loan crisis of the early 1990s, the Asian/Russian crisis of 1997-8 and the post-9/11 deflation scare of the early 2000s. Your video clip of Greenspan's 'irrational exuberance" speech is a classic, of course, that captures his intellectual bent quite well. To him, financial markets were prone to fits of fear and greed that amplified fluctuations in asset prices and complicated the conduct of monetary policy. Although his observations on human nature may have been close to the mark, his policy decisions during times of financial market stress in themselves were overreactions. Mistakes were made, giving rise to the impression of the so-called "Greenspan put" on financial asset prices. Bankers and investors engaged in unwarranted amounts of financial risk on the false premise that the Fed would bail them out. When the Fed was forced to correct course after these temporary miscues, financial markets had to pay the price.

Mr. Greenspan weathered 18 years at the helm of the world's central bank. His successor, Ben Bernanke, along with Mr. Volcker managed only eight years – not

surprisingly since I doubt that few people of normal fortitude could endure the immense responsibility and stress of either the Great Recession of the early 1980s or th3 Great Financial Crisis (GFC) of the 2000s for much longer than they did. Like Volcker, Bernanke was presented with an immediate and serious mess that had germinated and spread during previous years of beguiling tranquility. Bernanke's nightmare was insidiously hidden within the financial system, whereas Volcker's was deeply imbedded in the structure of the real economy. In Fed lingo, Bernanke faced 'systemic risk' that could, and would, reverberate around the world of global finance and eventually sabotage the real economy. Undaunted, Bernanke played the trump card available to all Fed Chairs – in times of systemic crises the FOMC can lower the Fed funds rate to zero if need be to ensure the safety and soundness of the financial system. As intended, banks' profit margins widened and balance sheets were repaired. However, when the real economy still languished, Mr. Bernanke played another trump card of his creative design, so-called quantitative easing (QE) in which the Fed bought mortgages and Treasury bonds in order to lower the long-term interest costs that households and companies paid on their debts.

Extraordinary policies such as QE have their limits. As Greenspan can attest, one can stay too long with a strategy that, however seemingly sensible in the face of crises, becomes unsustainable as conditions change. The Fed cannot buy assets forever. Mr. Bernanke has done the best he could do under difficult circumstances, and most of the participants in the Shadow Open Market Committee meeting sensed the time is nigh to withdraw that second trump card. Unlike other times when the Fed had to make course adjustments, QE has not yet created the excesses and "irrational exuberances" that proved so difficult to unwind in the past. The emphasis is on "not yet". Procrastination will transform a sensible but expedient policy into a potentially dangerous one for future generations. While Volcker was prescient to "'stay the course", Chair Yellen must chart a new course. She hinted at what that might be, Graham, in your video clip of her Congressional testimony in which she made explicit reference to the Fed's unspoken priority of maintaining financial stability. I believe her version is different from Pat practice and will encompass 'containing bubbles' as well as cleaning up messes. Her colleague and confidant, Ben Bernanke, would help in this ambitious endeavor if he begins the process of unwinding QE before he departs in February. Australia's Shadow Open Market Committee concurs; two-thirds of participants voted to begin tapering at the December FOMC meeting. Perhaps Mr. Bernanke should take heart in that bold advice because his tenure at the Fed and its aftermath will be no less a milestone in financial history than the post-Volcker era of disinflation.

Best regards,

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