Monetary Policy and Economic and Financial Market Performance

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Recent Related Publications

- with Charles Plosser, "The Murky Future of Monetary Policy", Hoover Institution Monetary Policy Conference, October 1, 2020.
- "Labor Market Conditions and the Fed's New Strategic Framework", Shadow Open Market Committee, January 7, 2021.
- with Michael Bordo, "Do Enlarged Budget Deficits Cause Inflation: The Historic Record", National Bureau of Economic Research, Working Paper 28195, December 2020.
- "Money Supply Spikes and Implications", Berenberg Capital Markets, June 1, 2020

Deep Economic Contraction and Strong but Partial Recovery

- Negative supply and demand shocks to US and global economies
- Robust rebound in global industrial production and trade
- US: strong recovery of goods consumption and production; services lag; housing robust
- Unprecedented monetary and fiscal policy responses
  - Deficit spending: increase > 17% of GDP
  - Monetary policy: 0% rates, massive asset purchases, money supply surge
- Low inflation (for now) and bond yields (for now), weaker US dollar
- Fed's new framework: lofty objectives, fuzzy strategy

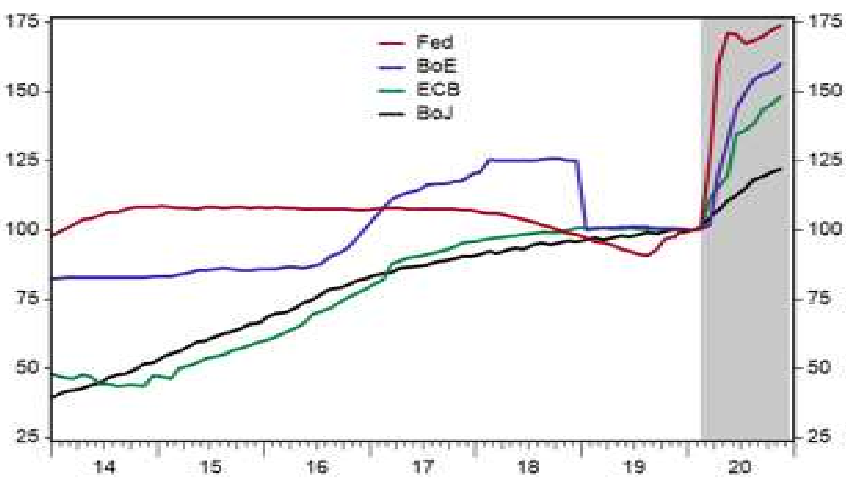
Fiscal Policies: Flood of Deficit Spending

- Total deficit spending responses to pandemic exceed 17% of GDP
  - CARES Act = 13% of GDP
  - 2/3rds of latest $900 legislation direct payments to individuals, business
- More than twice responses to financial crisis in 2008-2009
- Unprecedented fiscal stimulus in pipeline
- Sizable portion of budget authorizations of CARES Act still unspent by states
- Adds significantly to government debt and debt service costs
- Income support to individuals and small businesses were proper role of government, but portion of spending poorly targeted

Surge in Fed Balance Sheet

- Chart of Fed's balance sheet

Central Bank Balance Sheets, Jan.-2020 = 100



Sources: FRB, BoE, ECB, BoJ/Haver

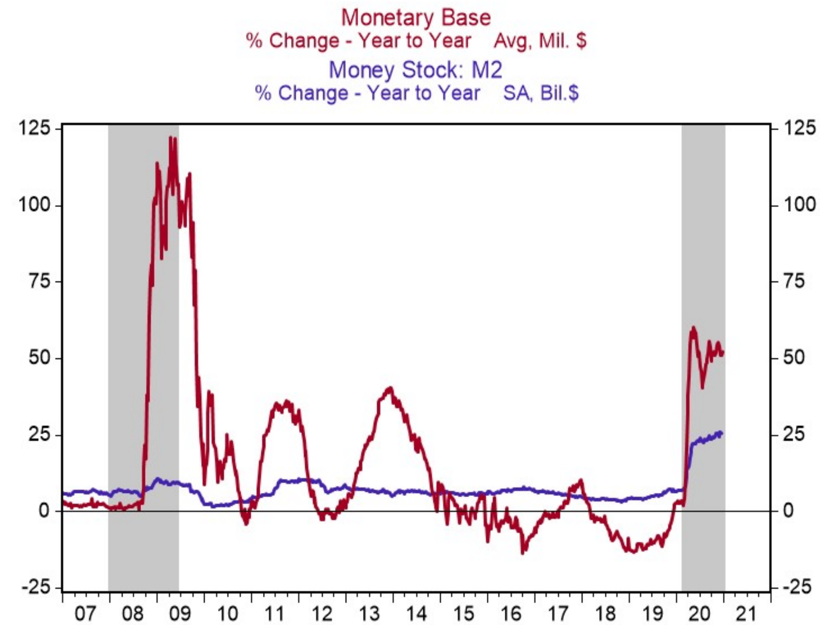
- Table of changes by component

(billions)	11-Mar-20	30-Dec-20	Change in billions	% of increase
Total	**4,272**	**7,322**	**3,050**	
Treasuries	2,523	4,689	2,166	71.0
MBS	1,372	2,039	668	21.9
Loans	0	57	57	1.9
Paycheck Protection Program Liquidity Facility	0	51	51	1.7
Money Market Mutual Fund Liquidity Facility	0	4	4	0.1
Primary credit to depository institutions	0	2	2	0.1
Primary Dealer Credit Facility	0	0	0	0.0
Net Portfolio Holdings of Commercial Paper Funding Facility II LLC	0	9	9	0.3
Outstanding amount of facility asset purchases	***0***	***0***	***0***	***0.0***
Net Portfolio Holdings of Corporate Credit Facility LLC	0	47	47	1.5
Outstanding amount of facility asset purchases	***0***	***14***	***14***	***0.5***
Net Portfolio Holdings of Main Street Facilities LLC	0	54	54	1.8
Outstanding amount of facility asset purchases	***0***	***16***	***16***	***1***
Net Portfolio Holdings of Municipal Liquidity Facility LLC	0	21	21	0.7
Outstanding amount of facility asset purchases	***0***	***6***	***6***	***0.2***
Net Portfolio Holdings of TALF II LLC	0	13	13	0.4
Outstanding amount of facility asset purchases	***0***	***4***	***4***	***0.1***
Central bank liquidity swaps	0	18	18	0.6

Sources: Federal Reserve Board and Berenberg Capital Markets

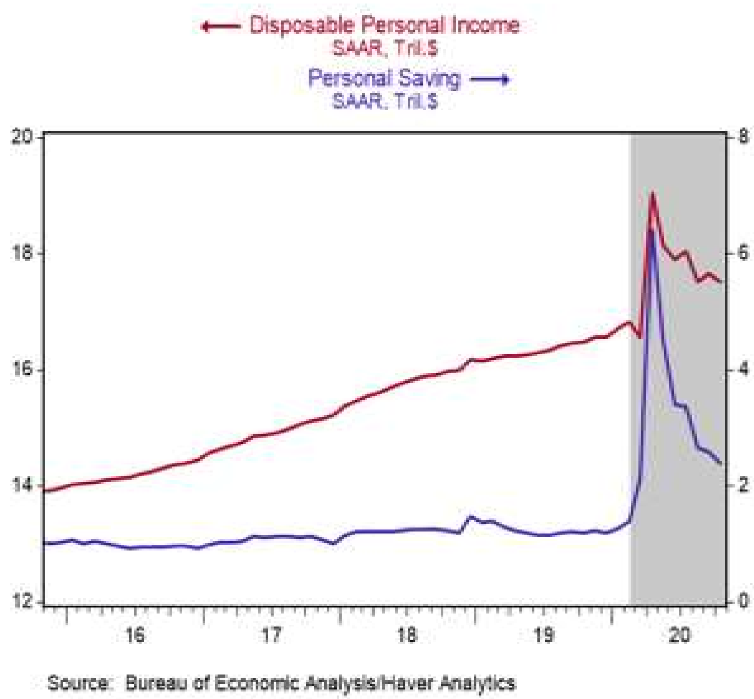
Money Supply Surges

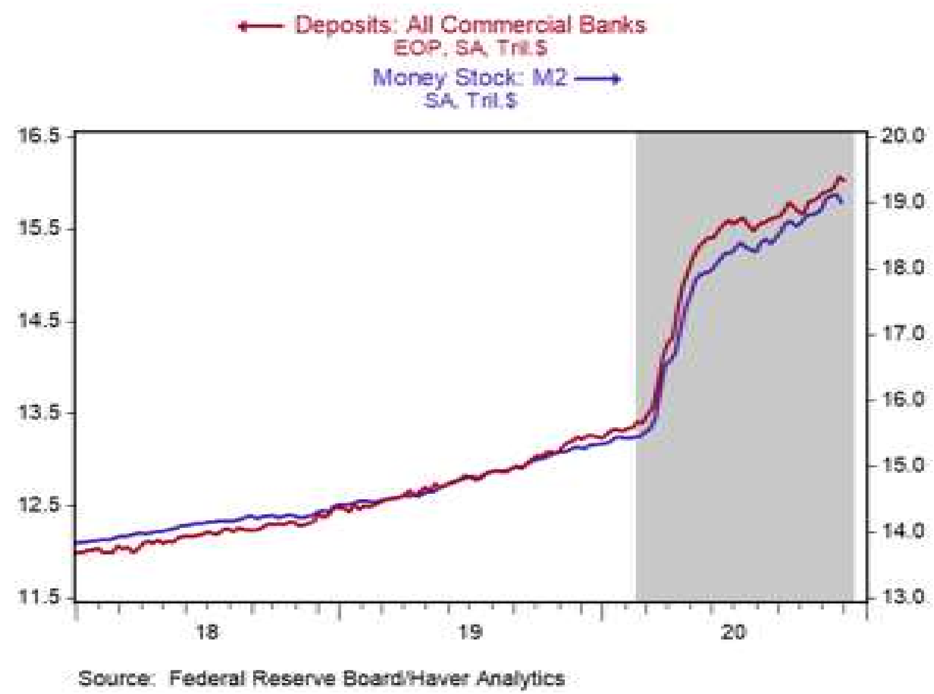
- Monetary base: +53.6% yr/yr
- M2: +25.1% yr/yr
- Sharp contrast to post-financial crisis when QEs didn't generate sustained rise in money
- Reflects combination of expansive monetary and fiscal policies
- Likely outcome: acceleration in economy, inflation risks in 2022



Sources: Haver Analytics, Federal Reserve Board

Fiscal + Monetary Policies + Forced Savings





Fed's New Strategic Framework: Lofty Goals but No Strategy for Achieving Them

- Fed upgrades priority of employment mandate and introduces an asymmetric flexible inflation averaging target
  - Maximum inclusive employment
  - "Make up strategy" to overshoot 2% inflation
- Lofty objectives are fuzzy and Fed does not establish any strategy for achieving them
- Fed acknowledges Phillips Curve is flat and unreliable, but not failures of past policies and does not replace PC or NAIRU with new strategy
- Likely: this is less a longer-run strategic plan and more a short-run tactic until economy gets back to normal

Historic Context and Market Observations

- There is a history of deficits being associated with inflation, usually during wars and sometimes during peacetime
- Important role of fiscal dominance over monetary policy, when fiscal authorities dominate or exert pressure on central bank
- Such pressures are apparent now and may build in future
- Expansive fiscal + monetary policies raise risk of inflation in 2022
  - Money will be put to work in economy as pandemic ebbs
- *Ex ante* real bond yields too low and inflationary expectations to rise
- Ultra easy Fed and its forward guidance pushing down US dollar