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Price or market stability: the Federal Reserve’s evolving mandate

The Fed’s ability to deliver on the dual mandate of price stability and full employment is incompatible with its new goal of keeping U.S. Treasury bond markets stable amid persistent inflation and higher-for-longer interest rates.

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By David Teeters

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Last year, the consensus view on Wall Street was that the Fed's fastest interest-rate hiking cycle in decades would tame transitory above-target inflation. Strong labor market conditions indicated a U.S. economy operating at near full employment, despite higher interest rates. Markets expected that, with inflation defeated, 2024 would see a series of interest-rate cuts. A Fed pivot to eased policy rates would guide the economy to a *soft landing* and prevent a recession. This matters to us, as investors and business owners, since the Fed's primary policy tool of setting interest rates feeds across global financial markets in our highly leveraged and financialized world. Ignoring these changing financial realities is not a luxury that we can afford.

Yet inflation has remained persistently above target, and expectations for interest-rate cuts have not been realized. Inflation forecasts were wrong for myriad reasons. Western policy makers remained fixated on the risks of deflation, due to the long-term effects of demographics and technology. Economists thought higher inflation readings were temporary supply-side effects. Inflation was expected to stabilize as the economy accommodated disruptions from COVID-related shutdowns, the effects of the war in Ukraine on commodity markets, and other geopolitical risks. Clearly, other unanticipated factors have been at work in creating higher inflation expectations.

The creation of independent central banks, such as the Fed, with legal mandates for inflation targeting, has been one of the great financial innovations of the last four decades. However, Goodhart's Law tells us that when a metric becomes a policy target, it is no longer a reliable measure. Are policy makers focused on the correct indicator? Stated differently, do current *official inflation* measures contain the same information value as before?

A recent study by authors including former U.S. Secretary of the Treasury Larry Summers questions the discrepancy between booming economic conditions and persistent pessimism in U.S. consumer sentiment. If you calculate inflation using the original methodology from the 1970s, the current rate would be closer to 18%, much higher than reported measures. Many of us can relate to this *realized inflation* as closer to what we feel in our own purchases of food, clothing and other things that make up our consumption baskets. Summers and his colleagues find that this reconstructed measure explains 70% of public dissatisfaction with their share of the gains from the economy.

How did we get to this point?

Decades of increasing U.S. funding commitments for baby-boomer retirement, Medicare benefits and the U.S. military have been exacerbated by the twin factors of COVID-era stimulus checks and tax cuts. Additionally, the solution for every recent market crisis has been to find a bigger balance sheet to provide funding for the problem. Defaults were resolved through debt restructuring, via the process of amend and extend (and often pretend). Deregulation removed the safeguards against financial excesses put into place following the Great Depression.

One of the simplest ways to understand the role of credit in our complex financial markets is to remember Hyman Minsky's three categories of credit:

- *Hedge finance* is when both principal and interest can be repaid from existing cash flows.
- *Speculative finance* describes when existing cash flows cover interest payments, but the principal is dependent on refinancing on maturity.
- *Ponzi finance* is when cash flows do not cover either the principal or interest payments.

The legacy of almost 15 years of zero interest rates across much of the world was an increase in leverage, or debt financing, across sovereign, banking, corporate and household balance sheets. This tremendous amount of speculative (and often Ponzi) debt needs to be refinanced on maturity. Financial market participants, meanwhile, have become accustomed to relying on the Federal Reserve to lower interest rates and provide liquid enough financial market conditions for this debt to be refinanced.

This is the *financialized* world in which we live: assets are increasingly recognized on balance sheets for the benefit of the financing on the liability side. This is the financial engineering of companies by private equity firms, the transformation of houses into mortgage-backed securities, and the securitization of nature with ESG and climate finance.

What does this mean for the Fed's policy path going forward?

The Fed is still dealing with the hangover from its balance sheet expansion via the process of *quantitative easing* in response to the Global Financial Crisis. The resulting increased

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leverage across balance sheets may not be visible to average investors. But it does fundamentally change the structure of the economy and the need to continue to source financing.

The challenge facing the Fed now, in terms of how to approach interest rates, is the very different realities of economic indicators on the health of *Main Street* (average retail investors and small businesses) and the booming financial markets of *Wall Street*. Perry Mehrling captures the importance of our monetary system as the structural link between the two. A direct result of the Fed's effort to balance these challenges via balance-sheet expansion has been to increase the potential monetary base. Precisely because monetarism is so unfashionable is why we should go back to challenge our understanding of inflation with Milton Friedman's words: "Inflation is always and everywhere a monetary phenomenon."

Despite the Fed's rapid interest-rate hiking cycle, financial market conditions are arguably easier today than when they started. This is evident in equity markets that continue to defy traditional norms of valuations in their relentless move higher. Even the fastest pace of corporate defaults and bankruptcies since the Global Financial Crisis hasn't dented market confidence. Wall Street is trying to force the Fed's pivot to lower rates to provide the cheaper refinancing required to prevent a recession. Main Street and consumers, however, don't have the same access to cheap credit and bear the brunt of persistently higher inflation. This feeds through to consumer sentiment, as highlighted above by Summers and his co-authors.

The problem with the Fed's balancing act is that the balance sheets that need to be refinanced include those of the U.S. government. Outstanding U.S. Treasury bond issuance is increasing by $1 trillion every 100 days. This is the type of deficit financing that is required in wartime or a severe recession. In the case of a recession, this issuance would increase even faster as Treasury receipts (from taxation) fall and expenses (for example, from unemployment benefits) increase.

Government bonds have unsurprisingly lost 20-40% of their value (due to the inverse relationship between yield and price) since the interest-rate hiking cycle started. At current prices, who will buy these new U.S. Treasuries, as well as the debt that needs to be rolled over to finance the U.S. sovereign balance sheet? Foreign buyers (mostly central bank reserve managers) stopped increasing their holdings of U.S. Treasuries in 2014. This search for alternative reserve assets only accelerated with the seizure of Russia's foreign exchange reserves following the invasion of Ukraine. Next, it was the banking sector that increased its holdings in response to new regulations, or *financial repression*. This ended with last year's U.S. banking crisis, which forced the Fed to *guarantee the value of the U.S. Treasury bond as*

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the world's risk-free asset with the Bank Term Funding Program.

When the rules of the game change…

The Fed's official dual mandate is full employment and price stability. The reality is that this legal mandate is now superseded by an unofficial but widely recognized third goal: the need to keep U.S. Treasury markets functioning.

Last year, Charles Calomiris described scenarios under what is known as *fiscal dominance*. The concern is that, with the U.S.'s current debt-to-GDP ratio above 100%, interest-rate hikes are inflationary, as increased interest payments on outstanding debt are returned to the economy. At the same time, interest-rate cuts, leading to looser monetary conditions, are also inflationary.

This is the unpleasant monetarist arithmetic of bond markets and the Fed's increasingly more difficult choices. The Fed will have to sacrifice price stability if it wishes to keep bond markets stable. This is new and difficult to navigate terrain for the Fed, and it will reduce its ability to effectively manage crises.

There's no such thing as a free lunch. The U.S.'s funding commitments and the excesses of previous crises must eventually be paid for. Shifting bad debt onto a larger balance sheet dilutes the problem and buys time to keep economy-wide balance sheets sustainable. The only bigger balance sheet to accommodate U.S. financing needs is that of the collective household sector. This makes for uncomfortable political choices in distributing these costs (particularly in a high-stakes election year). If time cannot be bought, debt dynamics can quickly spiral out of control, as interest payments on the outstanding debt approach the tax revenue of the government. If buyers can't be found for the debt, then that leaves the Fed with the unthinkable outcome of outright monetization of the debt.

…but there is no alternative to the game…

What is described here are widely known, slow-moving phenomena. What's different now is the urgency with which the Fed's reduced options impact each of us as investors and business owners. What is to be done?

First, to paraphrase Warren Buffett, *don't bet against America*. The rest of the world is bound to U.S. capital markets through the widespread offshore use of U.S. dollars in eurodollar

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markets and because of the petrodollar system. As non-U.S. companies need dollars to repay their USD-denominated debt and to purchase commodities, this demand for dollars can counterintuitively push the price of the USD higher. The exorbitant privilege of the U.S. is that it has a printing press and can and will print the dollars needed to keep U.S. Treasury markets liquid.

However, the rest of the world knows this. Zoltan Pozsar's Bretton Woods III framework builds on the perspective of state competitors to the U.S. who recognize the flaws in the current global monetary system and are working on alternatives from the margins. For now, there is no alternative: as Europe remains focused on internal challenges, the euro is not a contender for global reserve currency, and the Chinese are explicitly uninterested.

Even so, we shouldn't be lulled into complacency that things will remain this way. China will continue to provide shocks to the global economy, as its financial system suffers tremendous strain following decades of malinvestment and unbalanced growth. Even Japan, long a capital provider to the world via its zero-interest-rate policy, is changing as the Bank of Japan hikes interest rates. These are topics for future posts.

…we must change the way we play the game

In the face of such uncertainty, how should we, as ordinary investors and business leaders, react? This isn't financial advice, but a few points of common sense — grounded in financial experience:

- Challenge the implicit assumptions of your current financing requirements, particularly if exposed to rollover risk.
- Stress-test with scenarios including higher rates or constrained credit.
- Manage conversations with banks to diversify funding sources: the right time to obtain a credit facility is when you can; when you need it is typically too late.

Investment success is always and everywhere dependent on active risk management. For our own investments, "business as usual" no longer applies. The pendulum of the decades-long shift from active to passive management has altered market structures. Your capital has been earned at a high price; be sure to challenge those you entrust with it and understand what informs their underlying asset allocation strategy.

In his 2023 article, "The Fed's balancing act," my IESE colleague Eduard Talamas raised the question of the Fed's most precious asset: its credibility. Gold, long derided as a financial

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asset, has recently seen a steady move higher in price. We must be alert if this is the market passing judgment on the credibility of the Fed, given the challenges it faces in this shift to a new reality.

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