A Terribly *Risky* Time

By Bernard Connolly

Capitalism itself could be at stake.

The transcript of the Federal Open Market Committee meeting in March 2006, Ben Bernanke's first as chairman, provides many examples of the Committee's arrogance, complacency, and hubris just twenty-four months before the collapse of Bear Stearns. That complacency did not extend to Dino Kos, then manager of the System Open Market Account. Kos warned that developments in the carry trade, notably in the Icelandic currency in circumstances of mounting concern about the stability of Iceland's banking system, were an indication that the search for yield "went to some pretty distant and unlikely places—as we are now discovering. It does raise questions about other sectors that leveraged money went into and about which we don't yet know." But, as the transcript records, the FOMC quite literally laughed off Kos's concerns. The Committee was laughing on the other side of its face not long after.

The report by Kos to the March 2006 FOMC meeting, on financial market developments, included something else that turned out to be particularly pregnant. The context was that of the banks' demand for central bank reserves (specifically, the Bank of New York's management of its required reserves), which had been pushing the fed funds rate above the top of the range set by the FOMC, requiring the provision of large additional amounts of reserves by the Fed. Kos commented prophetically that, "This episode illustrates the potential effect that just one bank with a large level of requirements can have on the entire funds market when it dramatically adjusts its reserve holdings in a very inelastic fashion." That remark was to have enormous resonance less than eighteen months later when fears about each other's solvency, initially occasioned by non-U.S. banks but rooted in U.S. developments, led to a dramatic freezing-up of the interbank market.

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The remark also has resonance for the repo market turbulence of this autumn. The reasons for that turbulence are much disputed. But it is clear that banks' management of their reserves has been very inelastic, for whatever reason (Chairman and CEO Jamie Dimon has argued that post-crisis regulation has prevented JPMorgan, for one, from deploying its balance sheet elastically in the repo market in response to higher repo rates). But there is also a debate about whether the Fed's massive ongoing reverse-repo operations in response to those disturbances constitute a renewal of quantitative easing. In the 2006 episode, Bernanke had no doubt. His first substantive utterance as chairman of the FOMC was to refer to the operations recounted by Kos as "quantitative easing," asking how long such operations were likely to continue. Of course, the Fed refuses to qualify the current operations by the System Open Market Account, which include very substantial permanent purchases of Treasury bills as well as overnight and term repo operations, as quantitative easing. Yet if the March 2006 operations, which did not include outright purchases of anything, were, as Bernanke said, quantitative easing, the current operations, which do include outright purchases, are definitely quantitative easing.

But is that just an unimportant question of semantics? In mid-October, New York Fed President John Williams insisted in a speech that, "[A]ll these actions are aimed at the implementation of monetary policy and do not in any way represent a change in the stance of monetary policy." That is true. But it raises a very troubling question. It may or may not have been the case that this autumn's repo market disturbances were initially occasioned in part by settlement of domestic purchases of newly issued Treasury securities and by foreign central banks' massive use, in the face of an inverted foreign exchange-hedged yield curve, of the Fed's foreign reverse repo facility rather than of the primary market for Treasury bonds. But what is quite clear is that the Fed's purchases of Treasury bills increase the monetary base—the only operational definition of "monetization" of budget deficits. One can see, stylistically, the purchases as providing primary dealers with the cash to purchase the Treasury bonds, issued in massive volume, that foreign central banks did not want to buy given the yield curve and the level of the dollar.

Dino Kos *predicted the financial crisis. The FOMC laughed off his concerns.*

Does that matter? It might seem not. The Fed has not been buying bonds. The large-scale asset purchases in the period up to 2014 did involve purchases of bonds and were intended to reduce yields at the long end, while the current purchases of Treasury bills are intended to offset an increase in rates at the very short end. But what is happening now points very clearly to what will have to happen if there is another recession or a plausible forecast of recession. The scope for monetary policy to respond effectively is very limited. Real ten-year rates are already virtually zero (by contrast, they were around 2.75 percent just before the economy began keeling over in the autumn of 2007 and were almost 4.5 percent in similar circumstances in the spring of 2000). In a recession, absent a major fiscal expansion, large-scale asset purchases would have to be resumed. Even nominal bond yields would quickly

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drop to zero or go negative, but from today's starting point that would not be enough. To avoid the downward-sloping negative yield curve that would destroy both the viability of the financial system and any social justification for its existence (a fate already facing the financial system in the euro area and Japan), the Fed would, had it the authority, have to buy equities and private credits—but that too would, if continued indefinitely, as it would have to be, rob the financial system of its purpose. Instead, the nation's capital stock would be held by the government, via its Fed arm, and credit would be allocated by the government, again via its Fed arm. In substance if not in form there would be socialism—and thence general impoverishment.

Of course the Fed, unlike the European Central Bank, does not have the authority to buy equities or private credits. But in the circumstances posited, the government would very probably give itself such authority, financing purchases by issuing bonds which the Fed would have to buy. Alternatively or additionally, the government would increase its spending on goods, services, and transfer payments. Once again, the Fed would have to buy the bonds issued to finance those bigger budget deficits.

Monetization would be taking place on a vast scale. But the result would not be inflation. Unless the public believed that nominal yields would continue falling, even below zero—that is, unless private sector expectations about the economy were permanently depressed, in which case underlying recessionary forces would always be present—the financial system would have no rationale. Then the processes of state acquisition of private assets and of ever-bigger budget deficits would have to go on indefinitely—cash would dominate in private portfolios, and asset purchases by the central bank would simply be giving the public the cash it was demanding to hold in a display of Keynesian liquidity preference.

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Unfortunately, a future recession seems inevitable, given, as I have been arguing for two decades, the cycle of bringing spending forward from the future which has been in operation over those two decades. The only thing that could defer it yet again, absent bigger, monetized budget deficits (or dollar depreciation so huge that it would destroy economies everywhere else) would be a set of even bigger financial bubbles and thus an even bigger risk of a new, more violent financial crisis. Such a crisis would, this time around, equally end in state control of the financial system.

I wrote ten years ago that we were heading towards a zero-long-yield world whose outcome would be not inflation but state control of the commanding heights of the economy, as Lenin put it in defending the 1921 New Economic Policy in the Soviet Union, which allowed some very limited, small-scale private economic activity in sectors not considered significant. That is where the U.S. economy—along with the global economy—is heading unless the fuel of capitalism is replenished. That fuel is optimism: optimism about future productivity and optimism about the returns on future investment that benefits society and not just the political and business *nomenklatura* ("Davos Man"). Sadly, globalization, which should have increased contestability and made market-rigging and rent-seeking less prevalent, has turned out, thanks to the efforts of the global *nomenklatura* in combination with geostrategic economic policies, to have increased concentration and created more opportunities for distorting markets. Vested interests and geostrategy are destroying capitalism.

To loop back to the recent disturbances in the repo market, for a market whose "plumbing" problems have reflected the fundamental impossibility, at a global level, of finding a politically and economically sustainable equilibrium (so that no regulatory or behavioral change can prevent the recurrence of problems), there has been a reminder, should one have been necessary after 2007, that liquidity can suddenly disappear. And if liquidity disappears, the overvaluation of assets which has been sustaining demand in the U.S. and global economies will disappear with it. If that happens, the chain of events leading to socialism—or to complete economic breakdown—will develop terrifyingly fast. ◆