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Fed Needs Goldilocks for Roach Motel Check-Out: Caroline Baum

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Commentary by Caroline Baum

Oct. 5 (Bloomberg) -- If only the moderator had called on me, I might have gotten an answer to my questions and left with more confidence in the Federal Reserve's ability to pull off its exit strategy without a hitch.

Speaking at a **conference** in Washington last week sponsored by the Cato Institute and Shadow Open Market Committee, a group of self-appointed Fed watchers, Fed Vice Chairman **Don Kohn** reiterated the conditions and tools for withdrawing excess liquidity already outlined by Fed chief **Ben Bernanke**.

The tools include raising the interest rate the Fed pays on **reserve balances** to put a floor under short-term rates; draining reserves via outright sales of securities or reverse repurchase agreements; and allowing loans made under the Fed's "unusual and exigent circumstances" authority to wind down, paring the central bank's **balance sheet** through natural attrition.

That's not an option with the long-term **securities** the Fed has purchased, and continues to purchase. If the Fed perceives spreads between Treasuries and mortgages, for example, to be "distorted," or if long-term interest rates don't rise with increases in the Fed's target rate, the Fed "could consider sales of those assets," Kohn said.

That statement presumes the Fed knows the right level for spreads, according to **Ram Bhagavatula**, managing director at Combinatorics Capital LLC, a hedge fund in New York.

"In 2007, Bernanke said spreads were too tight. Last year, spreads were too wide," he said. "How do they know what's right?"

'Just Right'

In fairy-tale land, **Goldilocks** may be able to tell when the porridge is "too hot" or "too cold," but how do a handful of humans know when it's "just right?" That's a tough call in any environment; the difficulty is compounded when the discerner is also the distorter-in-chief.

"Once the Fed got involved in the credit side of the equation," buying **mortgage-backed securities** to keep home-loan rates low, "they destroyed information in the private markets," Bhagavatula said.

Yields on all debt securities, not just MBS, have narrowed relative to Treasuries this year. How much is the result of the Fed's outright purchases and how much is natural healing? Are investors buying junk bonds because they have absolute value or provide a good return on a risk-adjusted basis?

There's another problem with Kohn's comment, one that had me squirming in my seat at the Sept. 30 conference. It was a little less than a year ago, in that same auditorium at Cato, that Kohn gave an elegant **defense** of the Fed's hands-off approach to asset bubbles.

Selective Prescience

With the benefit of hindsight -- after fanning the bubble, watching it burst and cleaning up the mess -- Kohn said he was still skeptical about the Fed's ability to identify an asset bubble in time to lean against it and unconvinced that using monetary policy to check speculation would have benefits that outweigh the costs.

How is it the Fed can be so prescient when it comes to credit spreads and interest rates and so clueless when it comes to asset prices? And why is Kohn willing to intervene in one case and not lean in the other, using monetary policy to take some of the wind out of economy-destabilizing bubbles? Supervision isn't a substitute for monetary policy. No amount of regulation -- more, better, different -- can counteract the powerful incentive of easy money.

Policy Asymmetry

I didn't get a chance to ask my question, and I doubt Kohn would have answered it to my satisfaction. To think that the Fed, or anyone, can discern market distortions in a "structured economic environment," as a Tokyo reader referred to the U.S. economy, is ludicrous.

"It makes the exit strategy difficult to execute," Bhagavatula said.

Exiting is never easy. The history of Fed policy in the modern era is one of asymmetric responses, in more ways than one.

First, the Fed doesn't tolerate deflation, or a decline in the price level, even if it's the good kind. Technological innovation enables businesses to **produce more** with less. The economy grows, prices fall, real incomes rise. What's not to like?

Prices can also decline because demand collapses. That's the Great Depression scenario, with prices, output and wages all falling.

The second asymmetry is evident in interest-rate changes. The Fed is "quick to ease and slow to tighten," Bhagavatula said, pointing to the 1994 tightening episode as an exception. "The record shows rates go down precipitously and up slowly."

Exit Hurdles

He doesn't expect this time to be different. Yes, the Fed wants to do the right thing and raise rates preemptively to maintain price stability. Bernanke and Kohn are dedicated civil servants who made decisions under the worst of circumstances for the good of the nation, not for their personal aggrandizement.

It's always easier to check in to the Roach Motel than check out, politically and, this time, practically. Banks are holding $854 billion of **excess reserves** in their accounts at the Fed compared with an average of $1 billion to $2 billion before the crisis. Eventually the Fed will have to suck them up to avert inflation.

Add to that the age-old problem faced by policy makers, and you can understand why the exit is fraught with risks. The decision to withdraw monetary accommodation is based on "a forecast of economic developments, not on current conditions," Kohn reminded us last week.

We all know how that worked out in the past.

(Caroline Baum, author of "Just What I Said," is a Bloomberg News columnist. The opinions expressed are her own.)

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Last Updated: October 4, 2009 21:00 EDT

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