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Another Black Monday May Be Around the Corner

The Federal Reserve's policies threaten the American economy and financial markets.

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The Federal Reserve's policies are threatening U.S. financial markets and the economy. They are in danger of a steep recession and the risk of a repeat of 1987's Black Monday.

Early in the pandemic, the volume of U.S. dollars in circulation soared. For two years starting in March 2020, the M2 money supply—a measure of the cash and checkable deposits in circulation plus savings deposits and other easily convertible assets—grew at an unprecedented annual rate of 16.5%. That is more than three times the appropriate rate for hitting the Fed's 2% inflation target.

Then, in March 2022, the Fed changed course, first tightening the money supply by increasing the federal-funds rate and then introducing quantitative tightening. Between July 2022 and August 2023, the M2 supply contracted by 3.9%, the most extreme contraction since 1933.

The first factor contributing to the contraction of the money supply is the Fed's quantitative tightening. In June 2022, the Fed started to reduce its balance sheet by \$45 billion a month. In September 2022, it doubled its monthly balance-sheet reduction to \$90 billion. This balance-sheet runoff by the Fed requires the public to buy an equivalent amount of securities, reducing their deposits as they buy the bonds.

Quantitative tightening has already produced a dramatic selloff in the bond market. But just as they did ahead of the September 2019 crunch in the repurchase-agreement market, Fed officials keep repeating their mistaken mantras that quantitative tightening can operate “in the background” and “on autopilot,” implying minimal market effect. But basic balance-sheet accounting shows that unless commercial banks are creating enough “new money” through their lending activity to offset the Fed's balance-sheet shrinkage, quantitative tightening has a contractionary effect on the money supply.

The second factor contributing to shrinking M2 is the decreased availability of commercial bank credit—the sum of loans and bank holdings of securities. With the steep rise in rates, bank lending has slowed, and banks have been selling off securities. In September 2022, U.S. commercial banks held \$17.36 trillion, but by September this year the total had fallen to \$17.28 trillion. Within that total, bank holdings of securities have fallen nearly \$600 billion over the same period.

This brings us to the stock-market crash of 1987. In that year the key 10-year bond yield rose steeply from January onward (from 7% in January to 10% by Black Monday in October) and the money supply slowed sharply.

In 1987 growth of M2 declined by almost half, from 9.7% year-on-year in January to 4.9% in September, while M3—no longer published by the Fed—slowed from 8.7% to 3.6% over the same period. A bond-market crunch and monetary squeeze together led to a sudden, drastic reassessment of equity-market valuations. The same could happen today, particularly since the current jump in bond yields and monetary squeeze are much more pronounced than in 1987.

Because of the sustained decline in the money supply, the economy is in real danger. So far, only the remaining excess money the Fed created between 2020 and 2021—the cumulative excess savings from the Covid handouts—has been keeping businesses hiring and consumers spending. The effects of the excess money are still giving the economy a lift, but that extra fuel is almost exhausted. When it dries up, the economy will run on fumes.

In all of this, an appreciation for time lags is critical. The Fed ignored the huge acceleration in the quantity of money and thus failed to anticipate the ensuing inflation. When inflation struck in early 2021, Fed officials tried to argue it was “transitory,” caused by supply-chain disruptions.

The Fed continues to ignore the money supply, and we now face the opposite problem. The money supply has been contracting for 18 months, and soon, after the overhanging extra money from 2020-21 has been used up, spending will plunge and inflation will fall, not simply to 2%, but below—and perhaps even into deflation in 2025.

Since Fed officials pay no attention to either monetary aggregates or their credit counterparts, they are overlooking these signals, and the risks are intensifying each day. Instead, we hear Fed leaders talk about being “data-dependent”—keeping their eyes firmly on lagging economic indicators such as the labor market and the composition of the consumer-price index, not the monetary causes for their movement.

Monetary analysis tells a very different story than the measures the Fed follows. The first effect of a monetary contraction is higher market interest rates for a brief period. Then comes an economic slump. The economy goes into recession and inflation falls. This results in a second and more permanent effect of subpar money growth, namely lower interest rates and a weaker currency.

When the stock market crashes, “higher for longer” will become a thing of the past as the Fed makes an abrupt pivot. Then the 10-year yields and U.S. dollar will come tumbling down.

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