



Whiplashed

By John Greenwood

Introduction and Overview

- Recent years have seen several episodes when major central banks have been whiplashed by their own policies, forcing them to reverse direction abruptly – at least superficially – in the short-term.
- The reason for the abrupt reversals in their policies, as we are currently seeing with the Fed and as we saw in the case of the Bank of England last September, is that policymakers are increasingly pre-occupied with short-term indicators (ensuring smooth market functioning, stable interest rates, and well-behaved Financial Conditions Indicators) instead of keeping their eye on better long-term measures of monetary policy such as the rate of growth of broad money.
- In effect, “data dependency” – which implies focus on current conditions – is being prioritised over longer-term consistency. One striking result has been the roller-coaster in US M2 growth from 17% in 2020-21 to –2.4% in the year to February 2023.
- Superficially, the Fed has reversed policy in the short-term following the collapse of Silicon Valley Bank (SVB), Signature Bank, and Republic Bank by expanding its balance sheet by \$392 bn in the two weeks ended March 24.
- Below the surface, however, the contraction of commercial bank deposits continues based on the inverted yield curve and record high IOR payments, spelling further declines in broad money (M2).
- Either the US economy will continue towards recession later this year and a steep decline of inflation in 2024, or there will be further bank and non-bank crises in 2023 forcing a more drastic turnaround in Fed policy towards easing.
- Elsewhere, the conflict between central bank rhetoric and the effect of central bank actions is less pronounced but still evident.
- The ECB lifted rates by 50bp on March 16 but underlying M3 growth has already fallen from 11.7% in January 2021 to 3.8% in January 2023, or by -1.6% (annualised) in the four months to January – from too fast to too slow.
- In the UK, the Bank of England raised rates by 0.25% on March 22 to 4.25% but the growth rate of M4x had already declined to 3.8% year-on-year or by -4.2% (annualised) in the four months to January 2023.

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*The IMM Newsletter offers economic research written by John Greenwood, founder and Chief Economist of International Monetary Monitor Ltd. John was also the publisher, editor and lead author of **Asian Monetary Monitor**, a bi-monthly publication that he operated for 20 years from Hong Kong between 1977 and 1996. He was a pioneer of monetary research in Asia. From 1999 to 2021 he was Chief Economist at Invesco, based in London.*

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1. The Current Episode of Fed Whiplash

Figure 1. Despite growth in the Fed's balance sheet in the past 2 weeks,...

**US FEDERAL RESERVE ASSETS: CHANGE OF TOTAL ASSETS
(US\$ BN, WEEKLY DATA)**

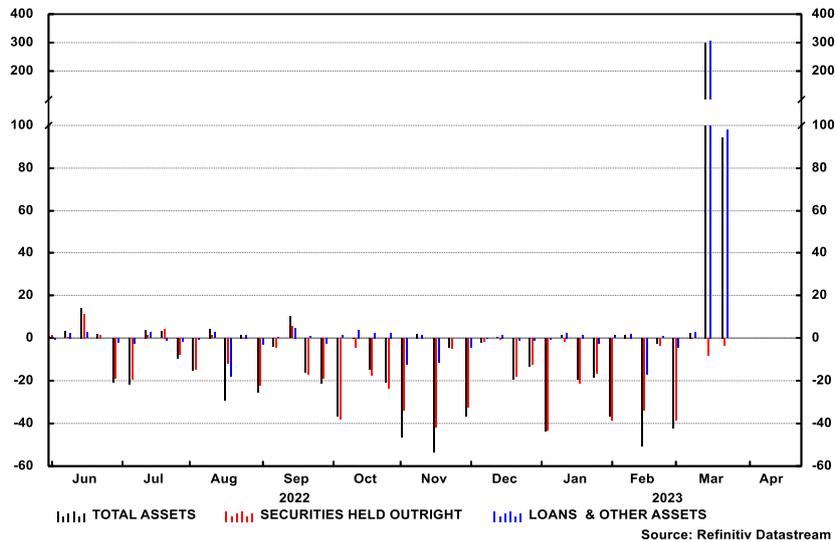


Figure 2. ...M2 money growth continues to decline.

US: M2 GROWTH RATES (WEEKLY DATA)



The run on SVB's deposits together with the illiquidity of the bank's long-term (HTM or Hold-to-Maturity) security portfolio triggered the closure of the bank and led to its temporary administration by the FDIC before acquisition by First Citizens with deposit guarantees extended to all depositors, even to those with deposits in excess of \$250,000. But the backdrop to the bank run was the abrupt shift in Federal Reserve monetary policy that converted a massive expansion of money growth in 2020-21 averaging 17.6% year-on-year to an abrupt contraction from March 2022 onwards. Never in the history of the Fed has such an abrupt switch been experienced.

To FOMC members and most Fed participants in the monetary policy process, no such volte-face was observed or noted. They reported a shift from a Fed funds rate range of 0-0.25% to 4.75-5.00% over the past year as a smooth, though admittedly rapid, process. The FOMC Minutes and policy statements have long ceased to comment on monetary growth, preferring instead to discuss the transmission mechanism of monetary policy in terms of interest rates, changes in FCIs (Financial Conditions Indicators), and labour market conditions (employment or unemployment, and wage growth). Led by the Fed, professional commentators and mass media also tend to focus on these mostly coincident or lagging indicators.

But the dominant effects on asset markets, on the economic growth rate and on inflation over the next 12-24 months will come less from the current level of interest rates and more from what has happened to M2 in the past 12 months. The key point is that interest rates are as much a consequence of prior policies (especially broad money growth) as a driver of future trends.

The reason why interest rates are not the panacea that New Keynesian economics claims is that a substantial and sustained change in money growth, which is the ultimate driver of asset prices, economic activity, and inflation, has its effects on interest rates in two stages. In the **first stage**, an acceleration of money growth lowers interest rates, bond yields, and other yields (e.g., on real estate). This is the Keynesian liquidity effect. However, in the **second stage**, as asset prices rise, the economy strengthens, the demand for credit picks up, and inflation increases, interest rates also rise. This is the Fisher effect. The first effect is typically short-lived; the second effect is much more permanent. (The converse set of responses applies in two analogous stages for a substantial and sustained deceleration of money growth.)

The steep rise in the Fed funds rate from March 2022 onwards was therefore an **inevitable result** of excess M2 growth in 2020 and 2021. The market reaction had come first. The yield on 10-year Treasuries troughed at 0.54% as early as August 2020 (five months from the onset of Covid), rising to 1.00-1.70% in January 2021, and again to 2% by the time the Fed started raising rates in March 2022. By this time the excess money growth had produced huge rises in asset prices (equities, home prices, commodity prices etc.), an overheated economy, and rising inflation from April 2021 (when the US headline CPI surged to 4.2% year-on-year).

However, throughout 2021 Fed and government officials talked of inflation not as a monetary phenomenon which was likely to persist for at least two years (as we did), but as a “transitory” phenomenon produced by shifts in consumer spending and disruptions to supply chains due to the lockdown of economies, shortages of specific goods such as computer chips and second-hand cars and – later – energy price increases. All this predated President Putin’s invasion of Ukraine in February 2022.

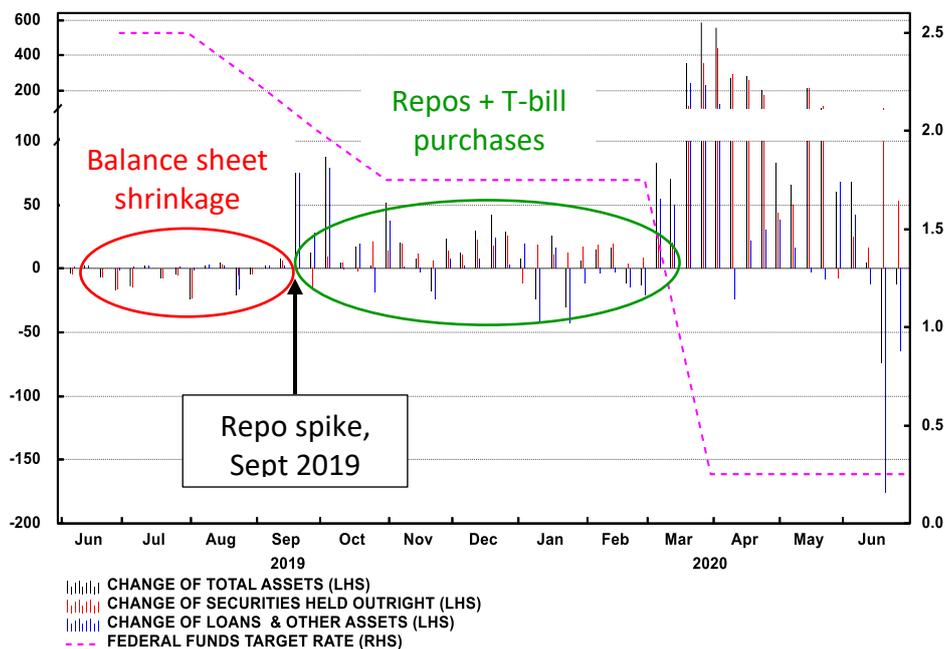
In effect, the Fed has been whiplashed by its own prior policy mistakes.

2. The Repo Whiplash of September/October 2019

But this is by no means the first such episode of Fed whiplash. Immediately before the Covid outbreak in March 2020 there had been the repo market crunch in September 2019. As shown in Figure 3, the Fed had been gradually reducing the size

Figure 3. An earlier episode of whiplash: the repo spike of Sept 2019.

**US FEDERAL RESERVE: RATE OF ASSET PURCHASES/SALES
THE 2019-20 U-TURNS (US\$ BN, WEEKLY DATA)**



Source: Refinitiv Datastream

of its balance sheet following the QE1, QE2, and QE3 asset purchases of 2009-15. The unwind had started in October 2017, draining cash out of the banking system, and continued for almost two years. In addition, the Fed continued raising rates until severe stock and bond-market volatility forced a pause at the end of 2018. The whiplash came in two stages: the Fed was forced to cut rates in three steps in July, September and October 2019, but a steep upward spike up in repo rates in mid-September led the Fed to a more radical reversal of its balance sheet contraction. In the week-ended September 20th the Fed announced the offer of an open-ended repo window to be followed by T-bill purchases (shown by the green oval in Fig. 3).

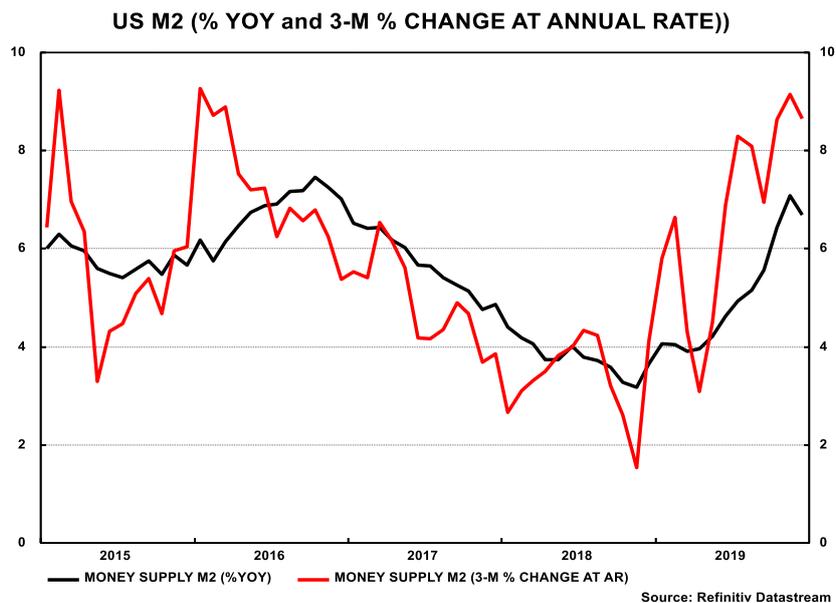
The underlying problem, once again, was that the Fed was ignoring money growth. Pre-occupied with keeping interest rates within what it viewed to be the critical 25 basis point Federal funds range, it had allowed money growth to slump. As shown in Figure 4, M2 slowed from 7.4% year-on-year in October 2016 to 3.2% by November 2018. The 3-month annualised growth rates shown in red slowed even more.

The trap was set, and even though M2 growth accelerated through the early months of 2019, this was not enough to ease money market tightness. The trap snapped shut in September 2019, with steep rises in the repo markets when overnight rates

reached as much as 8%, whiplashing the FOMC and forcing a radical reversal of policy.

By allowing broad money growth to slow so much, the Fed was cutting off the supply of credit to critical funding markets and to the economy more generally. But the economy is a voracious animal; it needs constant feeding with adequate supplies of

Figure 4. US M2 growth slumped ahead of the repo spike in Sept 2019.



money and credit. However, Fed policymakers had starved the beast of money growth and had continued raising rates to 2.25-2.50% until December 2018. As usual it took 6-9 months for the main effects to show up, and then the policy reversal consisted of three Fed fund rate cuts in July, September and October 2019, and a decision to go from balance sheet contraction (QT) to balance sheet expansion with open-ended repos and T-bill purchases.

Bizarrely, Jay Powell insisted the renewed balance sheet expansion was “not QE”, and the FOMC stated, “These actions are purely technical measures to support the effective implementation of the FOMC’s monetary policy, and do not represent a change in the stance of monetary policy.” (FOMC Statement, October 11, 2019)

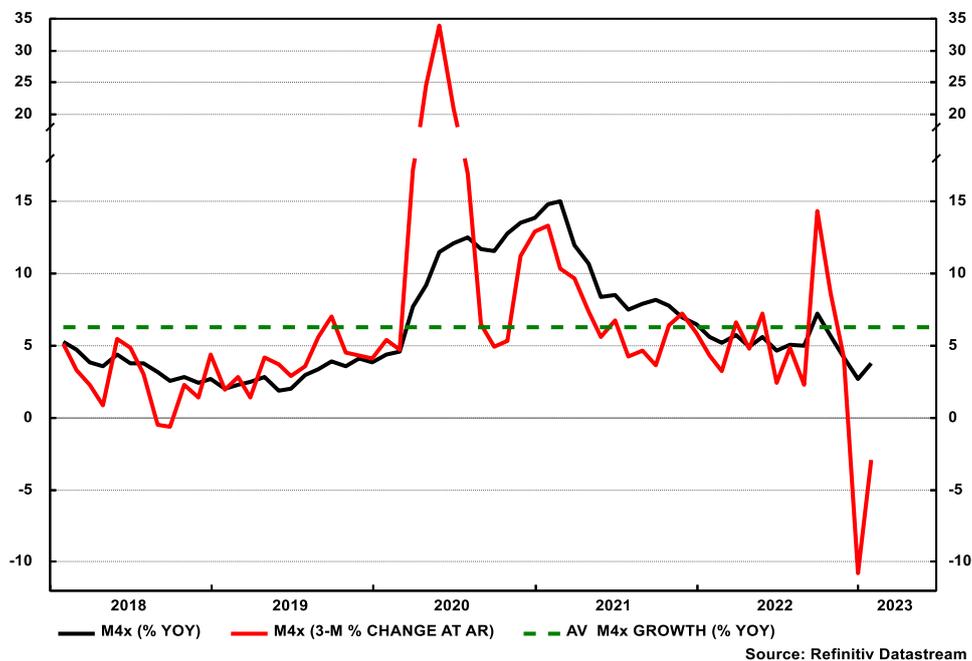
3. The Bank of England Whiplash of September/October 2022

Another policy reversal of a similar, but no less dramatic kind, was the Bank of England’s intervention in the gilt-edged market in September-October 2022. As in the episode of the Fed’s policy reversal in September 2019 or in the most recent steps by the Fed and the FDIC to calm bank runs on specific banks, the Bank of England found itself whiplashed by the monetary squeeze it had imposed following a period of excessive ease.

Like the Federal Reserve System, the Bank of England engaged in large-scale QE or asset purchases right from the start of the Covid pandemic. The rationale, expressed forcefully by Governor Bailey, was that Covid was likely to be a deflationary event with potential for long-term “scarring” of the economy and therefore the Bank needed to ensure that ample liquidity was available for the credit markets and to fund households and firms during the lockdown. In the Governor’s words, it was right to “Go big”.

Accordingly, asset purchases boosted UK broad money, M4x, to a growth rate of 33.9% on a 3-month annualised basis by May 2020 (see red line in Figure 5).

Figure 5. Bank of England whiplashed by excessive easing in 2020-21.
UK: M4x MONEY GROWTH RATE (% YOY and 3-M % CHANGE AT AR)



The Bank of England’s QE purchases remained in place until November 2021, having been supplemented by a variant of “Funding for Lending”, this time in the form of loans to banks that lent to SME borrowers. The result was that M4x grew at double-digit rates (an average of 10.5% p.a.) from March 2020 to December 2021, or between two and three times the rate required to meet the 2% inflation target.

From the end of 2021 the Bank ceased QE purchases and allowed some run-off of the securities and loans on its balance sheet. As shown in Figure 5, M4x growth slowed below 5% p.a. on an annualised basis. The problem was that the effects of its earlier largesse were still coming through in the form of higher inflation and rising wages.

Consequently, when Boris Johnson lost his position as prime minister in August 2022 and was replaced by Liz Truss and a team of radical tax-cutters on September 6th, the consumer price inflation rate had already soared to 10%. On hearing in the budget of September 23rd that the new government planned to implement unfunded tax cuts (i.e., tax cuts that would initially widen the budget deficit) and that their

plans had not been cleared by the Office for Budget Responsibility (the UK's fiscal watchdog), the UK gilt market and the pound both sold off sharply. The gilt sell-off was especially damaging to pension funds; the fall in the pound was a serious threat to inflation.

Since, through a mixture of over-zealous actuarial valuation (that effectively forced pension funds to hold a very high proportion of their portfolios in nominal and index-linked gilts) and risk-taking behaviour by asset managers, pension funds had accumulated leveraged bets on gilt derivatives to boost returns. The whole process was given the safe and risk averse sounding name of Liability Driven Investment (LDI). The sell-off of gilts precipitated by the Truss budget resulted in a dramatic decline in prices (rise in yields) that was hugely damaging to pension funds. Yields on the 30-year nominal gilt increased from 3.45% to over 5% within days – an unprecedented rise in such a short timeframe. Sales of gilts to meet margin calls appeared to be pushing prices ever lower and yields ever higher in a kind of death spiral for pension funds. Spreads widened. “Market functioning” seemed to be breaking down. Bank of England intervention was required.

Within days the Bank announced that it would temporarily postpone its planned start of QT or ***gilt sales*** which were due to commence very soon, and instead embark on limited QE or ***gilt purchases*** up to a specified limit for a limited period (approximately two working weeks). Effectively, the Bank had been whiplashed by a combination of the budget and the market response to it on the one hand and its own tightening regime on the other.

But we also need to ask the question, would the episode have happened at all if the Bank had not previously pumped up the supply of money (M4x) and driven the inflation rate to double digit levels? Given that the inflation rate was already so high, the sense of panic was all the greater, exacerbated by the thought that sterling weakness would directly add to the inflation.

As it is the Bank has been accorded high praise by the successor administration of PM Rishi Sunak and Chancellor Jeremy Hunt for saving the pension funds from a catastrophic meltdown and for restoring calmer markets (or “smooth market functioning” in Fed jargon).

Each of the three episodes documented here – (1) the Fed's apparent reversal of current policy to deal with problems in the banking sector, (2) the Fed's U-turn in September 2019 to deal with the spike in money market (mainly repo) rates, and (3) the Bank of England's postponement of QT in October 2022 in order to rescue UK pension funds by engaging in gilt purchases – all illustrate the tendency of central banks to be thrown off course because they do not fully understand the implications of their prior actions.

In their minds, interest rate changes and – to a lesser degree, changes on their own balance sheet – are at the core of monetary policy. As they see it, their actions in these two spheres percolate outwards through the money markets, the asset markets, and to the economy. Above-target inflation is largely an accident imposed on the

economy by supply chain problems, by energy shocks, and by Putin's war in the Ukraine.

Our central bankers do not see that what really matters is the amount of money that they and the commercial banks generate together. Nor, despite paying lip service to the notion, do they adequately consider the long and variable lags in effect of changes in the stock of money in the hands of the public. In all three cases, either excess or inadequate money growth has had to be abruptly reversed. The result in each case was a mini-crisis that the central banks have then had to manage.

The solution is not to continue to focus on interest rates and QE/QT as mechanisms to deliver economic, price and financial stability. As we are repeatedly seeing, this whole approach is more de-stabilising than stabilising. The solution is to move towards managing "money in the hands of the public" (i.e., broad money), not managing interest rates or "money on the books of central banks." Ensuring stable growth of purchasing power in the hands of the non-bank public will do far more to stabilise the economy in the medium term than any quick fix of short-term interest rates.

Summary and Conclusion

- This report has documented three episodes in which major central banks have been whiplashed by their own policies, forcing them to reverse direction abruptly in the short-term.
- The episodes selected were the current Fed policy reversal following three bank runs, the repo spike in the US in September 2019 and its aftermath, and the Bank of England's intervention in the gilt market in September/October 2022 to stabilise conditions for LDI pension fund investors.
- The reason for all three abrupt policy reversals was ultimately the same. Policymakers are increasingly pre-occupied with short-term indicators (ensuring smooth market functioning, stable interest rates, and well-behaved Financial Conditions Indicators), instead of keeping their eye on – and maintaining the stability of – more reliable long-term measures of monetary policy such as the rate of growth of broad money.
- "Data dependency" – which implies focus on current conditions – is being mistakenly prioritised over longer-term consistency. One striking result has been the roller-coaster ride in US M2 growth, swinging from 17% p.a. in 2020-21 to -2.4% in the year to February 2023. Similar wide fluctuations of money growth are occurring in other major economies.
- Superficially, the Fed has reversed policy in the short-term by expanding its balance sheet by \$392 bn in the two weeks ended March 24, but below the surface, the contraction of commercial bank deposits continues based on the inverted yield curve and record high IOR (interest on reserves) payments. M2 has already declined by 2.4% in the year to February 2023, and further declines are in the pipeline.
- Either the US economy will continue towards recession later this year and a steep decline of inflation in 2024, or there will be further bank and non-bank



crises in 2023 forcing an even more drastic turnaround in Fed policy towards easing.

- Investors should maintain high levels of liquidity and hold only trading positions in equities.
- Be ready for more severe equity declines later this year (or early next year) when a US recession takes hold and be prepared for more substantial declines in commodities and real estate.

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