Irish Talks; US Housing Starts, CPI; Altman

WHAT TO WATCH: EU and IMF experts will start scanning Ireland’s bank books tomorrow ahead of a possible aid package. The EU and Greece denied claims that the next installment of Athens’ emergency loan will be delayed, the AP reported. Cost of living in the U.S. probably rose for a fourth month in October. Economists estimate CPI rose 0.3%. 8:30 a.m. Roger Altman, co-chairman of Evercore Partners and a former deputy treasury secretary, has emerged as a leading candidate to replace Lawrence Summers as director of the National Economic Council.

ECONOMY: U.S. housing starts likely fell 2% in October from previous month after rising 0.3% in September, economists said. Fed’s Rosengren addresses Providence Chamber of Commerce, 8 a.m.

COMPANIES: European cos.’ sales of U.S. dollar bonds fell to the lowest in at least 12 years. Analysts are raising estimates of 2011 revenue at S&P 500 cos. for first time in 6 years; avg. estimate is for sales to climb 5.7% percent to $1,014.08-trillion next year.

GOVERNMENT: Hillary Clinton press conference at 9 a.m., before meeting with leaders on Capitol Hill in a bid to persuade lawmakers to ratify START arms control treaty this year.

MARKETS: The euro traded near a seven-week low against the dollar. The dollar rose against the yen for a seventh straight day, marking a six-week high and the longest run of gains since 1995. Copper fell to a seven-week low in London.

BIG PICTURE  CHARLES W. CALOMIRIS AND ELLIS TALLMAN, GUEST COLUMNISTS

In Monetary Targeting, Two Tails Are Better Than One

[Editor’s note: Calomiris is among those who signed an open letter to the Federal Reserve asking it to discontinue a round of quantitative easing.]

The Federal Reserve’s new bond purchasing plan risks much relative to its expected return of stimulating growth. The plan will destabilize global trade and finance, damage the Fed’s credibility, and cause inflation to jump.

Foreign complaints show that the new round of quantitative easing threatens free trade and capital mobility. Several countries, notably Brazil, have imposed capital controls to prevent capital inflows and currency appreciation from Fed loosening.

The central bank may have damaged its credibility by announcing a major change in response to a small and imprecisely measured gap between actual and targeted inflation rates. The Fed’s stated desire to keep long-term interest rates low creates further reputation and communication risk. If quantitative easing lowers deflation risk, it should increase long-term interest rates,

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and clearly it has already boosted both long-term Treasury yields and survey inflation expectations. Is that a success or a failure?

Quantitative easing is an insurance policy against “left-tail” risk of sudden deflation. Meanwhile, it is creating a right-tail inflation risk that is much bigger than the left-tail deflation risk.

While the Fed argues that an inflationary surge is unlikely, surveyed inflation expectations have already risen to 3 percent. Three percent expected inflation is not reassuring; expectations about averages do not measure the size of the tails of the distribution. The Fed says it would have plenty of time to react to prevent inflation from accelerating too fast. Those reassurances are hollow.

The Fed might be unable or unwilling to respond to a rapid expansion of bank credit supply by contracting its balance sheet sufficiently in time to prevent inflation.

Consider the following scenario. In 2011, the economy grows more than expected, and banks’ profits, borrowers’ loan demands, long-term interest rates and inflation all increase. Judging from the past behavior of U.S. banks, these conditions could lead them to want to quickly disgorge their roughly $1 trillion in excess reserves, about a quarter of which resides in the four largest U.S. banks. Think of the excess reserves as under-utilized lending capacity. Banks might respond quickly to global lending opportunities, and their response could be rapid and highly correlated. The money multiplier, which has fallen to historic lows during the crisis, could snap back like a rubber band, implying hundreds of billions, or even trillions, in credit expansion, unless the Fed responded by dramatically contracting its balance sheet.

This scenario is not without precedent, as the expansion of bank credit supply after the 1937-1938 recession demonstrates. From December 1939 to December 1941, total loans and securities holdings of banks grew 20 percent to $61.1 billion from $50.9 billion. Over that same period, the excess reserve holdings of Fed member banks fell to about 4 percent of assets from 10 percent. Given the severity of the recent credit supply decline and the availability of excess reserves, an increase of 30 percent or 40 percent in credit supply over 2011-2012 is conceivable.

The Fed’s balance sheet has changed dramatically as it has responded to the financial crisis, and the current structure could make it difficult for the central bank to respond effectively. Illiquid mortgage-backed securities make up around $1 trillion, or roughly half, of the Fed’s current balance sheet. The quick sale of these assets would reduce their long-term recovery value and cause the Fed to realize huge capital losses.

Large potential losses could threaten Fed solvency and force the central bank to ask Congress to recapitalize its balance sheet. There is a risk that Congress or the administration might block recapitalization to prevent a Fed contraction.

While the Fed might contract its balance sheet using other means, those might also imply large losses. Under the scenario outlined here, a rise in long-term interest rates could impose large losses if the central bank sold long-term Treasuries ($600 billion of which it is in the process of purchasing).

The Fed could try to stop credit expansion by raising the interest rate on excess reserves. If the profitability of bank lending rises sufficiently, a large increase in interest rates paid on reserves would be needed, which could also threaten Fed solvency.

Money-market mutual funds might engage in reverse repo arrangements with the Fed to allow it to contract without recognizing investment losses. That accounting trick could work, but only if money-market funds have a huge appetite for entering into such contracts with a financially weak central bank. Such arrangements might face Securities and Exchange Commission scrutiny.

The Fed might raise reserve requirements to prevent credit expansion. That would disadvantage U.S. banks’ competitiveness relative to other lenders. And such a visible, contractionary action by the Fed at a time of high unemployment might invite political attacks from Congress.

Central banks should have to defend their strategies using scenarios to measure “tail risk.” The Fed should worry about both tails of the inflation risk distribution, and about its exit strategy to limit exposure to inflation risk. The new round of asset purchases has already created international havoc and compromised the Fed’s reputation. The Fed is risking even more if its bet goes sour.

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