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Fed policy mistake?

Financial markets were extremely volatile due to fears that the Federal Reserve (Fed) will overtighten and cause a deep recession. Fed Chair Jerome Powell's hawkish policy speech has driven the US dollar to historic highs, resulting in turmoil across asset classes. Fed policies have severe and far-reaching implications globally. In this light, the United Nations (UN), along with some prominent economists, have questioned the wisdom and prudence of the Fed's actions and policies.

UN calls for halt in rate hikes

In a statement, the UN Conference on Trade and Development (UNCTAD) said, "Excessive monetary tightening could usher in a period of stagnation and economic instability… Any belief that they (central banks) will be able to bring down prices by relying on higher interest rates without generating a recession is, the report suggests, an imprudent gamble." UNCTAD Secretary-General Rebeca Grynspan stated that "The current course of action is hurting vulnerable people everywhere, especially in developing countries. We must change course." Fed rate hikes severely affect emerging market countries with dwindling forex reserves and falling currencies. In fact, some countries are now suffering from liquidity and solvency issues.

Fed was behind the curve

One of the Fed's foremost critics is Larry Summers, president emeritus of Harvard university, a prominent economist, and former Treasury secretary. Summers predicted that "There is a chance that macroeconomic stimulus on a scale closer to World War 2 levels than normal recession levels will set off inflationary pressures of a kind we have not seen in a generation." As inflation rose sharply, Summers criticized the Fed for being behind the curve. Because the Fed acted late, Summers now expects it to hike its policy rate to 5% to bring down inflation. He lamented that the US economy "is unlikely to achieve inflation stability without a recession of a magnitude that would take unemployment towards the 6% range."

A grade of D for the Fed

Jeremy Siegel, a highly-respected finance professor at Wharton and author of the classic book "Stocks for the Long Run", gave the Fed a grade of D and provided an angry rebuke to Fed policies. Siegel said, "They get a D, barely. They are responsible for the inflation by being way too accommodative and way too late in the beginning of their tightening, and then I believe that they are going overboard in the other direction or at least indicating by their dot plot for 2023 that they are going to become tighter for longer, which I think is going to be a big mistake on the other side."

Asleep at the wheel

When asked how fast inflation will subside, Mohamed El Erian, chief economic adviser at Allianz, replied that "It's going to take some time because the Fed has been asleep at the wheel." El Erian commented that "The Fed is so late that it's looking at two challenges: putting the inflation genie back into the bottle and it's looking at not creating too much damage to economic growth and inequality." El Erian believes that “The Fed is trying to regain its credibility. It risks what is probably one of the biggest policy mistakes it has made, which is slamming on the brakes now as the economy slows down – and that’s what risks tipping us into recession.”

Every man for himself

As the US grapples with the worst inflation in 40 years, the Fed has stubbornly pursued its policy agenda without much regard for unintended consequences. In response, many countries are forced to take unilateral action to protect their own interests.

1. More than 90 central banks raised interest rates this year, with half of them hiking by at least 75bps in one shot.
2. As countries are forced to defend their respective currencies and intervene in forex markets, global central bank forex reserves have fallen $1 trillion or 7.8% this year, the fastest on record.
3. BRICS (Brazil, Russia, India, China, South Africa) are mulling the creation of their own reserve currency. This is intended to diminish the economic influence of the US and challenge the dominance of the US dollar as the world’s primary reserve currency.
4. OPEC+ announced that it will reduce production by 2 million barrels per day to shore up prices, openly defying US pressure to increase output.
5. China cut interest rates and unveiled a 1 trillion yuan economic stimulus to revive its slowing economy.
6. China and India are buying oil directly from Russia. The Philippine government is contemplating this as well.
7. India curtailed rice exports due to lower production brought about by unfavorable weather conditions.
8. The Bank of England (BOE) intervened after a massive selloff of gilts to prevent the net asset values (NAV) of pension funds from going into negative territory.
9. Japan maintained its accommodative monetary policy as domestic inflation remained low. This caused the yen to fall to a 24-year low, prompting the Bank of Japan (BOJ) to support its currency for the first time since 1998.

Boomerang

The Fed’s monetary tightening is driven by its commitment to bring down elevated inflation and prevent it from being entrenched. However, some economists suggest that the Fed is on the verge of committing a double policy error. They warn that the Fed is unwittingly causing a severe global recession by overtightening. Fed policy typically works with long and variable lags as the impact of rate hikes takes time to pass through the economy. Considering this, the Fed may be overly depressing future economic growth. Detractors assert that the Fed has to be more prudent, judicious, and circumspect in order to avoid unintended collateral damage to the global economy that will ultimately boomerang back to the US itself.

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