# Powell Hikes Herald "The Minsky Moment"

Shanmuganathan Nagasundaram
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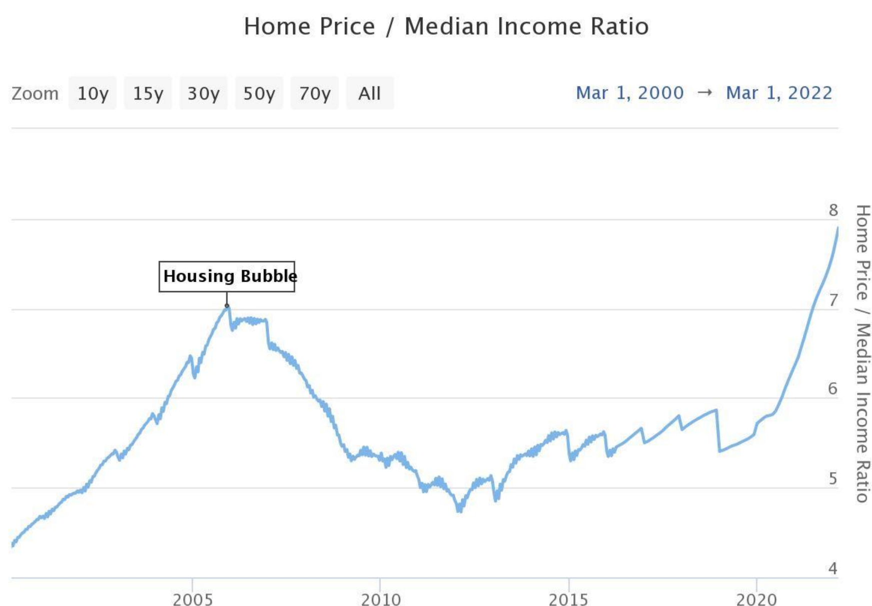
The 75 basis hike by the US Federal Reserve on June 15th was quite extraordinary for a number of reasons

a. The 2022 Q1 US GDP was negative at -1.4% and the Q2 GDP current estimate at 0% (and trending downwards over the last few months starting from a high of nearly 2%) pretty much indicates that the US economy is in a recession right now.
b. The US Stock markets (Nasdaq and S&P) have been in a bear market (defined as a correction > 20%) and the DJIA was on the verge of slipping into one even prior to the 75 basis point hike.
c. The US Bond markets had possibly the worst 6 month period in the last 40 years.
d. The Cryptos which had a total M.Cap of more than $3T have lost more than 2/3rd of its market capitalization in the last 6 months.
e. The current US housing bubble which is much larger than the 2008 bubble (median house prices relative to median income is nearly 33% higher than that of 2008) has started correcting with six consecutive monthly declines for the Housing Market Index.




f. The US Consumer Confidence sank to a low of 50.2 – a level not seen since 1980 when the US Fed Funds rate was at 20%.

Under any one of the above conditions, the Fed would have normally dropped rates. Atleast that is what it has been doing for the last 20+ years. For sure, this hike of 75bps is going to worsen the market conditions in equities, bonds and real estate. If ever there was a lingering hope of the US Economy escaping a recession, this hike effectively vanquishes that.

So what is so different this time that amidst a sea of red in all (good) asset classes, the Fed has not only raised rates, but did so by an unprecedented 75 basis points (a quantum hike not seen since the days of Volcker at the Fed)?. Obviously consumer price inflation. But then that is really not the key question to be asked.

The important question then is – "Is the 75 bps raise the right move by the Fed?" Directionally Yes. In terms of the quantum, this 75bps increase is pretty much the equivalent of applying a band-aid for a bullet wound. Even much higher increases – 200 or for that matter even 500 bps would leave real interest rates deeply in the negative territory. There is virtually zero probability that this 75bps hike would even moderately reduce the inflation numbers though this hike is big enough to guarantee the onset of the Minsky moment i.e. setting off an Inflationary Depression.

Minsky Moment refers to a period of a sudden collapse in asset prices caused by an unsustainable increase in credit & debt. But let us forget Powell and Minsky for a moment. To understand the nature of the crisis ahead, we need to go back in time. Wearing the Misesian hat, I would have to dial back to atleast 1971 (Nixon closing the Gold Window) and perhaps for a more holistic description to 1913 (i.e. formation of the Federal Reserve). The subsequent events are just an inevitable consequence of these watershed moments in history. The inescapable end result of these events has to be a "Crack Up Boom" and this inevitable consequence is now imminent as well.

But in some sense talking about 1913 and 1971 is a case of "spilt milk under the

bridge". To focus on the recent history, let us rewind to Bernanke in 2010. A host of pronouncements by Bernanke surrounding ZIRP, QE, inflation etc were patently absurd such as the one below.

A recap of a 2010 interview by Bernanke

**CBS 60 Minutes** - At some point, the economy will pick up, and banks will suddenly realize they have huge amounts of reserves to invest and lend. And that will be a potentially dangerous time for the economy. With so much money flooding into the system all at once, inflation could skyrocket.

**Mr. BERNANKE**: We could raise interest rates in 15 minutes, if we have to. So there really is no problem with raising rates, tightening monetary policy, slowing the economy, reducing inflation at the appropriate time.

I have often wondered about the pronouncements that Central Bankers across the world get away with. Bernanke's assertions, quite obviously absurd today, was ridiculous even back then if one understood Economics. As Peter Schiff recently remarked, "the worst economists in the world work at the Central Banks".

Bernanke was either lying or just plainly incompetent - & I am not really sure which is worse. Now that the massive expansion of the Fed Balance Sheet is reflecting in the consumer price inflation we are seeing today and it's not just a 15-minute-problem as forecasted by Bernanke, the really important question to ask is "**Was QE the correct response to the 2008 Great Recession?**"

Ofcourse, the media as well as the public at large believe that inflation will moderate over the next few years. How a 10%+ consumer price inflation will decrease with a 1.5% or even a 5% interest rate is beyond any economic logic. If one understood the correct economics i.e. Austrian Economics, then it would be easy to see as to why we are closer to the trough rather than the peak of inflation in the current cycle.

The 10-year treasury which is at 3.2% today (was around 0.6% in June 2020 and 1.4% in June 2021) is still absurdly low and my guess is we will cross 6% in about a year's time.

### Of QE, Monetization of Deficits and Banana Republics

Returning to the all-important question raised earlier – **"Was QE the correct response to the 2008 Great Recession?"**. I would have to point out at this juncture that not only has the results have been pronounced on the above with a near unanimous thumbs-up, but Bernanke & Co have taken the victory lap as well. A bit premature, as the world now is beginning to recognize.

It is but imperative to point out that the **success of QE is contingent upon the successful execution of QT**. The massive expansion of the Balance Sheet from less than $1T before 2008 to nearly $9T today is hardly the sign of a stabilizing economy despite other macro-indicators such as GDP growth, stock market returns etc. **IF AND ONLY IF the balance sheet can be rolled back meaningfully without cratering the economy can QE be defined a success.**

As Mises would point out, this creation of artificial money and credit has the same impact as that of a drug overdose on individuals i.e. a temporary high with an apparent sense of stability. It is only when the drug is stopped, do the withdrawal symptoms surface and that is exactly the scenario with QE as well.

The US Fed has previously twice attempted QT and on both occasions, had to roll-back in short order due to adverse market reactions. Given the set of extremely negative indicators we are starting with today (as specified in the introduction), the chances of QT being done for any meaningful period of time is indeed remote.

The best case for QT would be about a 0.5T reduction in the Fed Balance Sheet to about $8.5T before QT is replaced with QE to infinity. QE, which is vanilla monetization of Government deficits (that Bernanke denied under Oath), is the defining characteristic of a Banana Republic and certainly not the hallmark of the World's Reserve Currency. QE merely postponed the economic pain involved - and that pain will be experienced with interest compounded manifold in the years ahead - while casting in stone the path for dethroning of the US Dollar as the world's reserve currency.

When historians draw parallels to the ongoing collapse of the US Economy with that of the Roman Empire, QE's will be seen as the equivalent of "Seigniorage on Steroids" and the Chinese would be compared to the Barbarians.

Hemingway's famous quote is perhaps best indicative of these historical events

The first panacea for a mismanaged nation is **inflation of the currency**; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists. —Ernest Hemingway

## The Pain Ahead

In all probability, the Q2 GDP will be negative and this in combination with the bursting of the housing bubble will put the US Fed and the US Government in a difficult spot. Do they fight the pervasive inflation with rate hikes and QT OR do they support the faltering economy with rate cuts and QE?

My guess, and this would sound really absurd today, is that they would do a combination of rate hikes and QE. The explanation would be that the rate hikes

would temper the inflation and QE would support the economy. Not unexpectedly, the actual result would be the opposite – QE would accelerate the inflation to double-digits and the rate hikes would deepen the recession into a depression.

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Shanmuganathan Nagasundaram

**About the Author:** Shanmuganathan "Shan" Nagasundaram, is the Chief Investment Officer at "Plus43 Capital". He can be contacted at shan@plus43capital.com