Monetary Policy: Little Economic Impact, High Risks

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US fiscal and monetary policies are both on unsustainable courses. By far, fiscal policy—with its reckless deficit spending and rapidly mounting government debt, inefficient structures of the tax system and spending programs and appallingly dysfunctional budget and policy process—ranks first in terms of harming economic performance and threatening the standards of living of future generations. The Federal Reserve's monetary policy is also misguided, and although its risks are different in nature and less straightforward than those posed by fiscal policy, they are very important, and particularly pressing in the current fiscal environment. The combination of alarmingly high budget deficits and the Fed's massive purchases of government and agency bonds (effective debt monetization) involve unacceptably high potential risks.

A common notion about monetary policy is that with inflation low and unemployment high, there should be little concern or risk in the Fed's efforts to stimulate an acceleration of demand and create jobs. There are many reasons why this view is shortsighted, and it's worth describing, at the risk of sounding like a broken record.

The broadest concern is that the Fed, with QEIII and its signal that it will keep rates and bond yields artificially low until there are significant reductions in unemployment and beyond, has pushed monetary policy beyond its limits, all in an effort to lower the unemployment rate when the economy is already expanding, just not fast enough. The Fed's policies are distorting the normal functioning of financial markets, including artificially suppressing the government's debt service costs and suppressing market discipline on fiscal policymakers; it is risking and even promoting higher inflation; its policies are undisciplined, with muddled and moving targets; and the Fed is setting a bad precedent for future monetary policymaking in an environment in which central bank discipline and credibility will be critical. Monetary policymakers are always tempted to concentrate on the short term, especially when circumstances appear to be a 'special case', but the past is replete with lessons that monetary policy should operate with a longer horizon, and the Fed's policy response under current circumstances is truly short-sighted and precedent-setting.

The Fed has clearly crossed the fiscal policy boundary and, particularly with QEIII, monetary policy is being used as credit policy. Now that those boundaries have been broken, how does the Fed cross back over and credibly redefine its proper role? What are the longer-term international consequences (including implications for foreign holders of US debt and even the future role of the US dollar) of massive deficit spending and the Fed's debt monetization?

The Fed is challenging several of the basic foundations and lessons of 'modern' macroeconomics: it is explicitly attempting to "exploit the Phillips Curve," ignoring the lessons from the past while downplaying distortions, long-run inflation risks and potential costs; and it is assuming that its persistently aggressive monetary stimulus will not affect expectations. The Fed's muddled targets and mixed messages are a setback for central bank transparency and credibility.

The Fed's policy is driven by its nearly exclusive short-run goal of reducing the unemployment rate. The Fed has indicated it would be tolerant of—even advocate—inflation rising above its stated target. It is striking that current conditions have elicited unprecedented monetary stimulus. The economy has been growing for nearly 3½ years since the 2009Q2 recession trough, and the financial crisis is long past. Such massive quantitative easing during an economic expansion also raises serious issues of inconsistencies and undesired costs and risks associated with the Fed's dual mandate from Congress under the Full Employment Act of 1978**.** The inconsistencies involve the limits of monetary policy to achieve output and/or employment targets in the face of noncyclical impediments.

It is not necessarily true that all will end badly. Consider the optimistic outcome: the economy improves and unemployment rate falls as the "economic headwinds" recede (that is, as some of the non-monetary factors that have been inhibiting economic growth and job creation dissipate); inflation remains muted and somehow expectations are unaffected; and the Fed with perfect timing announces the end of its MBS purchase program and signals an eventual rise in policy rates such that market rates and bond yields adjust gradually to normal levels consistent with sustained economic growth and inflation; and the Fed crosses back over broken boundaries and re-establishes monetary guidelines/targets under normal conditions. This path is possible, but a lot can go wrong along the way, and risks abound, not the least of which is political pressures that forestall policy adjustments. Even if things proceed smoothly, the Fed would take full credit for the lower unemployment rate, reinforcing a dangerous precedent for future discretionary monetary policy, and raising concerns about its independence.

Is it really all cyclical? Why has the economy rebounded so slowly and the unemployment rate remained stubbornly high despite unprecedented monetary stimulus (and large fiscal stimulus)? Are things so dire that labor market conditions should be characterized as "grave" (Bernanke, Jackson Hole, August 2012), and the Fed embark on open-ended quantitative easing through MBS purchases? The Fed argues that the high unemployment rate is virtually all cyclical, related to insufficient demand, and can be remedied by more QE. A few observations are appropriate. Although real and nominal GDP have rebounded above their prior expansion peaks (by 2.2 percent and 9.4 percent, respectively), both are below levels that would have occurred had the deep recession and adjustment never occurred. Also, employment gains and the decline in the unemployment rate during the recovery have been roughly in line with the slow pace of recovery (based on Okun's Law), following the *outsized* rise in the unemployment rate during the recession. But these patterns have had little to do with the Fed's monetary policy. The outsized job losses and spike in the unemployment rate during the Great Recession resulted from the jarring impact of the financial crisis and extreme risk aversion. The subsequent slower-than-desired rebound in aggregate demand and decline in the unemployment rate has in no way reflected insufficiently stimulative monetary policy. Even prior to QEIII, the Fed's zero interest rate and quantitative easing of QEI, QEII and Operation Twist generated $1.5 trillion of excess reserves in the banking system and pushed bond yields to near-historic lows. While QEI certainly helped to end the financial crisis, subsequent QE has done little to stimulate demand and job creation, and have primarily added to excess reserves. Arguments that the "economy would have performed much worse/unemployment would have been much high" without the QE are based on mis-specified models that have proved unreliable in predicting key macroeconomic trends in recent years.

There is ample evidence that aggregate demand and jobs have been constrained by an array of non monetary factors. Some of these factors stem from government policies. Others are necessary adjustments to the housing and debt balloon, financial crisis and loss in net wealth.

The Fed is trying to offset these "negative headwinds" through QEII, Operation Twist and now QEIII, and has purposely expanded its scope.

Consider recent conditions that have dampened demand, production and employment. Necessary household deleveraging has slowed consumption and in the aftermath of the financial crisis, new banking regulations have constrained select bank lending activities. The ongoing mess in mortgage markets has constrained the supply of mortgage credit, limiting home purchases and refinancing that would benefit household balance sheets. Tight conditions in the primary mortgage origination market persist, despite the Fed's QEIII, in part generated by the new financial regulatory apparatus, high risk weightings on mortgage securities, and fear of "put backs" by the GSEs. Since QEIII initiated significant MBS purchases, spreads between primary and secondary mortgage rates have widened, and households have not received much benefit. Business appetite for investment spending and hiring has been diminished by uncertainties (stemming from both government policies and macroeconomic circumstances); the unprecedented $1.8 trillion of cash held by nonfinancial businesses reflects a reticence to expand and hire that is unrelated to the Fed's monetary policy or the real cost of capital.

Some evidence suggests labor market conditions are noncyclical in nature: there is anecdotal evidence of labor market inefficiencies and supply constraints, including regional and sector specific skill mismatches; the duration of unemployment is unusually high; and the Beveridge Curve (the relationship between job vacancies and unemployment) seems to have shifted out. Additionally, there has been significant job displacement in key sectors. Construction jobs are nearly 2 million below their prior expansion peak, and many of these are not expected to come back. The downsizing of state and local government employment (393,000 job losses since the recession trough) following several decades of persistently outsized growth (relative to both population and school enrollments) has contributed significantly to the shortfall of employment gains and added to the unemployment rate.

These characteristics call into question whether the Fed's massive quantitative easing is an efficient and appropriate policy tool for lowering unemployment. Clearly, other policy instruments, fiscal and regulatory, would be more effective, and would not involve some of the large risks, or create as many distortions, as the Fed's current policy. Yet the Fed is quick to say it has the tools in its "monetary toolkit" to stimulate further, but is reticent to consider and spell out what should be its limitations.

Aiding and abetting reckless fiscal policy. The Fed's monetary policy has breached the boundary that traditionally has separated it from fiscal policy with undesirable, if unintended, side effects. Monetary policy is now partially captive of fiscal policy, and its independence has been tarnished, in reality and perception.

The Fed is facilitating the government's massive deficit spending by lowering the government's debt service costs and by neutering market discipline on fiscal policy. Also, by extending the duration of its portfolio through Operation Twist, the Fed is making the adjustment that normally is the role of the Treasury's debt management, but with added risks of potentially higher inflation and making more difficult its eventual exit from currently unsustainable monetary policy.

The government's debt service and the costs of new bond issuance are reduced by the lower bond yields that result from the Fed's near-zero Federal funds rate, interest rate signaling and the Fed's purchases of government bonds. Ten-year Treasury bond yields are below inflation and dramatically below nominal GDP growth. The interest income the Fed earns from its bloated portfolio is remitted back to the US Treasury general fund. As a result of QEI and QEII, the Fed is now one of the largest holders of US Treasury debt, if not the largest. Under Operation Twist the Fed will have purchased more than $600 billion of long duration Treasury securities, extending the duration of its portfolio. Under this program, the Fed effectively has been purchasing more than half of net new Treasury bond issuance and effectively "controls" the market for long-dated Treasury bonds. The Fed's MBS purchases under QEIII add to the central bank's income and reduce government debt service costs; presently, its purchases exceed net new mortgage origination.

The Fed touts the benefits of its interest rate signaling in reducing bond yields, but its signals provide mixed messages and adverse incentives. For fiscal policymakers, lower bond yields, lower deficits and lower borrowing costs on new debt ease pressures to reform fiscal policy. Too many elected officials and even some economic analysts believe that as long as bond yields are low, runaway deficit spending is OK. Inadvertently, the Fed aids and abets this misperception.

Equally importantly, the Fed is effectively preventing the fixed income markets from sending out warnings about fiscal policy and disciplining policymakers. The "bond vigilantes" of the past that effectively disciplined Washington have been pushed to the sidelines. The old adage "don't fight the Fed" certainly rings true when the Fed is the biggest holder and purchaser of US Treasury bonds, signals its intentions to keep bond yields low until labor markets improve significantly, and expresses its tolerance—and even advocacy—of a rise in inflation above its stated target. To market participants, the Fed is providing a confusing mixed message: take more duration and credit risk because we will make every effort to keep bond yields low for an extended period, but beware that we advocate higher inflation (even though our long-run inflation objective remains 2 percent).

The Fed's muddled signal on inflation—effectively that lowering unemployment is vastly more important than a (temporary) rise in inflation above its target—should be a caution that the Fed's 'subconscious' intention is to use monetary policy to lower future real debt service costs and reduce the value of current Treasury bond securities.

The Fed's MBS purchases under QEIII increase its involvement in credit policy and allocation, and add to uncertainty about the future conduct of monetary policy. Will future targets become guidelines that are violated when the economy, or a specific sector of the economy, is underperforming? The Fed's decision to purchase MBS rather than Treasury securities reflects its perception that this will have a bigger impact on financial markets and the economy—in part because of the ongoing problems in the mortgage market and weakness in housing--and the fact that it already owns so many Treasury bonds. The announcement effect on MBS yields has been sizable, but its impact on what really matters—primary mortgage rates—has been minor because of bottlenecks in mortgage markets that cannot be remedied by more QE or MBS purchases. But the MBS purchases have reduced the losses and improved the finances of Fannie Mae and Freddie Mac. This may have the added unintentional impact of delaying reforms of these flawed institutions, which were root causes of the unsustainable housing bubble and financial crisis. This is not the Fed's intention, but in the realm of Washington politics, it is a reality.

As with the Fed's aggressive monetary stimulus, is QEIII the most appropriate policy tool to improve the functioning of mortgage markets and contribute to a healthier housing sector? Clearly, the answer is no. The broader question is whether it is the Fed's role to expand the scope of monetary policy if fiscal, regulatory and other non-monetary policy tools are not being used properly (due to politics or whatever), regardless of the costs and risks? Across nations and over time, past lessons involving the over-interpretation of the uses of monetary policy indicate quite clearly that the answer is no; presumably, this is particularly true in an environment of economic expansion.

Eventually, the normalization of yields will push up the government's debt service costs. Although budget projections by the CBO and others assume rates will rise back to normal levels by 2014-2015, the eventual rise in rates may exceed current projections: the Fed may need to tighten more than currently anticipated (either in government projections or by markets), inflation and/or inflationary expectations may rise more, or demand for Treasury debt securities —from domestic or foreign creditors—may diminish, reflecting heightened risk premia related to uncertainty about future interest rates, inflation, monetary policy or the US dollar. Certainly, the Fed has the tools to tighten monetary policy and raise rates as needed. But when the appropriate time comes, the negative impact on budget deficits will add to the significant political pressures on the Fed to keep rates lower for longer.

Best practices on achieving the dual mandate. The Fed needs to reconsider how to best use monetary policy to achieve its dual mandate. Its interpretation has changed significantly since low inflation and low unemployment were established as goals by the Full Employment Act of 1978. Fed chairs Volcker and Greenspan correctly acknowledged that targeting the unemployment rate was fraught with difficulties and inconsistencies, and argued that stable low inflation is the best foundation for sustained economic growth and maximum employment. For several decades, a generally healthy monetary policy balance produced good results. The Fed's focus has shifted dramatically to the short-run objective of lowering unemployment and recently the willingness to (temporarily?) set aside its inflation target. The Fed's well-intentioned efforts to "do everything possible", perhaps reflecting political pressure following the financial crisis and the Fed's monetary and regulatory involvement, defy the lessons of history. Current monetary policy is particularly bothersome in the context of reckless fiscal policy. The normalization and rebalancing of monetary policy, which is essential for sustained healthy economic performance, requires that the Fed acknowledge its limited ability to address short-run concerns.