



**The Fed's Monetary Policy:
Limitations and Concerns**

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The Federal Reserve's unprecedented monetary stimulus and its forecasts of sustained low inflation and a return to earlier low unemployment are seemingly inconsistent. The Fed states with confidence that its bloated balance sheet and zero-anchored Federal funds rate policy are necessary to reduce unemployment and will not be inflationary, that distortions stemming from its policies have been minor relative to the benefits and that it will know when and how to transition toward monetary policy normalcy. And the Fed seems unperturbed that its monetary policy is so closely intertwined with fiscal policy. The Fed adeptly sidesteps concerns by admitting that while things may go wrong, it remains vigilant.

In general, financial markets accept the Fed's assessments. Can the outcomes be as good as the Fed projects? I hope so, but there is room for concern and skepticism. First, the Fed's current monetary policy has no historical precedent upon which to assess future outcomes. Moreover, other leading central banks—the Bank of England, the European Central Bank and the Bank of Japan—are also engaging in quantitative easing by one name or another, contributing to excess global liquidity. Although the Fed is trying to depreciate the US dollar, other central banks are trying to lower their currencies. The confluence of current global monetary policies is clearly unprecedented.

Second, long after the financial crisis and economic recovery, the Fed continues to manage its dual mandate with a primary focus on bringing down the unemployment rate, even though inflation hovers above its long-run target. Third, the Fed views the economic world through NAIRU-tinted glasses and perceives that inflation will recede as long as the unemployment rate is above its estimate of full employment. Historically, the Fed's track record in economic forecasting is so-so and real time NAIRU-based predictions of inflation have proved unreliable, as recently as last year. With US bond yields kept artificially low by the Fed's massive bond purchases and policy signaling, risks are skewed. The Fed is understating long-run risks and may not heed early warning signs.

Even if the Fed's projections prove correct—that inflation stays low—and the Fed is able to exit on a timely basis without unduly jarring financial markets and the economy, its policies set a very bad precedent. The Fed has muddled the boundaries between its lender-of-last-resort function during crisis and its conduct of monetary policy during normal, non crisis periods. The absence of boundaries increases the probability of potentially costly policy mistakes. Future Federal Reserve regimes will feel compelled to adopt aggressively activist monetary policy to address high unemployment or other undesirable economic outcomes. Government officials, financial market participants and the public will alter behavior with the expectation that the Fed will pursue such activist policies. Following the Greenspan-put and the turbo-charged Bernanke-put, what's next, and with what impacts on economic and financial behavior? Moreover, history has taught us the pitfalls that may stem from the blurred lines between monetary and fiscal policies. Those lessons must not be ignored in the pursuit of short-run objectives.

Following the Fed's alternative liquidity facilities and QEI, which successfully restored order to the financial system, subsequent monetary policies—QEII, Operation Twist and the Fed's announcement that it will keep rates at zero through year-end 2014—have all been attempts to stimulate demand in an effort to bring down the unemployment rate. Currently, the economy is in its 12th quarter of slow recovery, and real GDP now exceeds its prior expansion peak, but

employment is nearly 4 percent below its prior expansion peak. Despite the high unemployment rate, core inflation has risen above 2 percent from below 1 percent, during a period when the Fed, based on its internal models, was issuing warnings about deflation. I expect inflation will rise modestly further this year, while the Fed's unprecedented monetary stimulus contributes little to lowering the unemployment rate but accentuates harmful financial market distortions in the US and globally.

The Fed's unprecedented monetary stimulus has not generated a rapid recovery because a host of nonmonetary factors have constrained demand, production and employment. Large imbalances that built up in the prior expansion and the negative shock to net wealth involve lengthy adjustments, and labor market-specific problems are beyond the scope of the Fed's monetary policy. That's why the Fed's excess monetary stimulus is fairly ineffective. Many of the constraints on growth would be much more efficiently addressed with other policy tools, including fiscal and regulatory measures.

Consumer spending has been inhibited by household balance sheet repair following the large wealth loss; household and financial deleveraging; and the dramatic decline in home prices and distressed mortgage mess. Households have increased their rates of saving, spent and borrowed less and altered their consumption patterns. Heightened uncertainties, some relating to uncertainty and distrust of government policies, have contributed to risk-averse behavior, particularly by businesses. Amid financial deleveraging, nonfinancial businesses have limited operating expenses and hiring, and postponed investment spending and expansion plans. Businesses now hold more cash than at any time in history, despite ample credit availability through bank lending and bond issuance.

Labor markets remain impaired even as aggregate demand has risen. Skill mismatches leave job openings vacant even as aggregate unemployment remains high. The unemployment rate is close to 4 percent for those with at least a college education but 12.6 percent for those with a high school education or less. Geographic immobility stemming from lower home prices and negative equity in homes prevents some labor force participants from moving to take jobs. Construction employment remains nearly 2 million below its prior peak when residential investment was excessive, and many of those jobs will not come back. The downsizing of bloated state and local government payrolls has reduced government jobs, and a rebound is not expected. Extended unemployment insurance has extended job search time. Is it the proper role of the Fed's monetary policy to address these factors, and if so, what are the costs of doing so?

The Fed asserts that the rise in the unemployment rate is primarily cyclical. This misinterprets economic conditions. Instead, there is a large gray area in between structural and cyclical—high unemployment that is not normally identified as structural but cannot be lowered on a timely basis by more monetary stimulus. Under current conditions, productive capacity is below that which is implied in estimates of long-run potential, and the natural rate of unemployment is higher than is implied by the NAIRU. In fact, the record of 2.4% annualized economic growth in the expansion to date, accompanied by a decline in unemployment of almost 2 full percentage points and a rise in inflation, indicates that productive capacity is indeed impaired. Until these constraining factors dissipate, standard measures are overestimating economic slack. In this

environment, more stimulus will have only very limited success in compensating for these nagging economic problems.

The excess liquidity provided by QE, reflected in the Fed's bloated balance sheet, will remain in the financial system until it generates stronger demand and/or it is drained. Until demand picks up, the excess liquidity will not generate a significant acceleration of inflation, but is distorting financial markets and asset prices in the US and globally. The Fed is understating the negative impacts of these distortions, particularly the potential costs of excess risk-taking.

The Fed's QE, along with Operation Twist and its zero policy rate signaling, is increasing the demand for longer duration and risky financial assets, depressing the US dollar and boosting prices of global commodities (transacted in dollars) and distorting global capital markets. US Treasury yields are artificially low—real 10-year yields are negative—as are corporate bond yields, and the stock market has appreciated. The low interest rates have reduced interest income for the aged, and squeezed insurance companies and affected some of the insurance policies they offer. Higher commodity prices have pushed up headline inflation and suppressed real disposable income. For select emerging nations, the resulting inflation pressures have been significant, and undesired capital flows have distorted local markets and exchange rates, and forced their central banks into unsound monetary policies. More research on the costs and potential risks of these distortions is required, but these costs should not be brushed aside by the Fed's assertions that they are small relative to the benefits of the Fed's efforts to stimulate aggregate demand.

Inflation should rise only modestly in 2012, but the longer-run risk is significant. Economic conditions are improving. Bank lending is rising—commercial and industrial loans have increased over 12 percent in the last year (over 14 percent for US-domestically chartered banks), and consumer loans outstanding are rising, despite continued bank write offs. Housing activity is picking up and motor vehicle sales are strong. Demand will accelerate in lagged response to the monetary stimulus, and eventually excess demand for all goods and services will generate higher inflation. With constrained productive capacity, this may occur sooner than is currently expected. This will catch the Fed by surprise, because the unemployment rate will still be high.

Why has core inflation drifted above the Fed's 2 percent target while the unemployment rate has remained well above standard estimates of the NAIRU and actual real GDP is well below the Fed's estimate of potential GDP? The answer lies in the inadequacy of slack-based inflation models to appropriately capture wage and price setting behavior, and the difficulty in measuring economic slack.

In reality, businesses raise prices when they can—when conditions provide them the flexibility to do so without losing market share. Typically, inflation occurs when unemployment is low and economic performance strong, but inflation pressures can mount even when there is labor market and economic slack. The key linkages integral to the NAIRU model—the link between unemployment and wages (the traditional Phillips curve), the link between wages and unit labor (or operating) costs and the link between operating costs and product prices—may be bent in unforeseen ways by economic and financial conditions.

Recently, wages have continued to rise, despite the high unemployment rate. This may reflect skill mismatches accentuated by rapid shifts in the composition of output and changes in production processes and adjustments to prior large imbalances. Meanwhile, the ongoing internationalization of goods and labor markets is reducing demand for semi-skilled domestic labor. The 2010-2011 spurt in labor productivity that reduced unit labor costs widened profit margins. These characteristics were not captured by standard measures of slack.

In 2011, product demand provided businesses flexibility to increase prices in a wide array of industries. Recently, slower productivity gains have boosted unit labor costs. This may cut into margins, but in certain sectors, price pressures are emerging. The housing component of the inflation indices is rising, reflecting increased demand for rentals and the end of home price declines. Nominal GDP—the broadest measure of current dollar spending and aggregate demand—has grown an estimated 4.2 percent in the last year and is now 8.9 percent above its prior expansion peak. As nominal spending accelerates across sectors, product prices will increase in a wider array of goods and services, and inflation pressures will mount.

The Fed relied on an after-the-fact explanation of the rise in inflation in 2011—that its QEII eliminated expectations of deflation and influenced wage and price setting behavior. When inflation rises further, will the Fed stick to this explanation and announce that it will drain the excess liquidity provided by QEII in order to dampen inflationary expectations? Not likely: political pressures to reduce the unemployment rate will persist, and the Fed wants higher inflation because it perceives that it would be associated with stronger growth and lower unemployment, and because it would reduce the real debt service facing the government and households. The recent rise in inflation was accepted because it rose from well below the Fed's target to slightly above it. A further increase would put the Fed in an awkward position of explaining why it is continuing to overweight the unemployment rate in its dual mandate, even though inflation is above its target, and why its models of inflation have been incorrect. The financial markets may become impatient with the Fed's explanations.

Here's the problem: if the Fed continues to focus primarily on reducing the unemployment rate, relies on NAIRU and GDP Gap models that may not reliably capture the inflation process and then falls back on after-the-fact explanations when it is surprised by higher inflation, then bad outcomes occur. The Fed's current strategy of trying to "exploit the Phillips Curve" as long as inflationary expectations remain anchored poses the same risks as it did decades ago. Political pressures from the Congress and Administration may be contributing to the Fed's skewed focus on the unemployment rate. Those pressures have always existed, although they may now be more intense. Firmer guidelines are needed to prevent the Fed from complying with those pressures, to establish boundaries and to avoid extending monetary policy beyond its scope into areas that are more appropriately and/or better addressed by fiscal or regulatory policies.