The Fed's "whatever it takes" policy makes sense, warts and all.

In Defense *of* QE

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Since the financial crisis struck in 2007, the Federal Reserve under Chairman Ben S. Bernanke has pursued a policy that can best be described as "whatever it takes." At almost every stage, there were complaints when the Fed took what even central bank officials labeled extraordinary actions.

When straightforward interest rate cuts, even large ones, in the central bank's target for overnight rates weren't powerful enough to unlock frozen financial markets, the Fed fashioned numerous new ways to feed money and credit into the economy, including creation of special lending facilities focused on specific problem areas, such as commercial paper. And once the overnight rate target was firmly stuck at the dreaded zero lower bound, officials began providing investors with ever more specific forms of guidance about the likely future path of interest rates. Words became a central policy tool.

In March, for instance, the latest iteration of that guidance told the public that only one of the nineteen Federal Open Market Committee participants expected the 0–0.25 percent target to be increased this year, while three said that should happen sometime in 2014, thirteen said in 2015, and one said not until 2016. Even at the end of 2015, fifteen of the nineteen expected the target would be 1.25 percent or less. In other words, unless

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the still-sluggish recovery unexpectedly gains legs, interest rates aren't going up much anytime soon. That information about the path of short-term rates also helped lower market expectations for longer-term rates.

Even more explicitly, in January the FOMC majority had linked a future increase in their overnight target to achieving both a jobless rate of 6.5 percent or less and an inflation rate no higher than 2.5 percent. In December, the latest number the committee had, the rate was 7.8 percent. It was the first time the Fed had ever set any sort of employment target related to its statutory responsibility of fostering "maximum employment." More recently, Bernanke and several other officials have made it clear that a drop in the jobless rate is not a trigger for an automatic rate increase but rather a threshold for considering one.

But what has really upset many of the Fed's critics is its decision last September to seek to drive longer-term interest rates down even further through large-scale purchases of Treasury and mortgage-backed securities. Since then, the Fed each month has been buying $45 billion worth of Treasuries and $40 billion worth of mortgage-backed securities, which over the course of a year would increase the Fed's balance sheet by more than $1 trillion. With that program underway, total Fed assets passed the $3.3 trillion mark.

As the Fed moved repeatedly to ease monetary policy even after the recession had ended, the main criticism was that the action would lead to high, even runaway inflation. Economist and Fed historian Allan Meltzer warned that it was not *whether* the policy would lead to high inflation but *when*.

Former Fed Vice Chairman Donald L. Kohn of the Brookings Institution said in an interview that reality has blunted the warnings about Fed policy generating high inflation. When Kohn retired from the Fed in mid-2010, in conversations he had with business and financial sector people the talk was "all about inflation and buy gold and the world going to hell in a hand basket." Now, four years into the recovery, those predictions have faded. "Inflation has been going down and inflation expectations have been stable or going down a little. So that line of attack has been defused by the facts," he said.

Inflation has been replaced by worries about financial stability, and in particular by fears of new asset price bubbles in stocks, bonds, housing in some markets, and even farmland.

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According to Bernanke and other Fed officials, one of the key channels through which the asset purchases affect the economy is by encouraging the investors who are selling the Treasuries and the mortgage-backed securities to the Fed to use the money they get to buy riskier assets including equities. And yes, stock price indices have been setting new highs, though not in inflation-adjusted terms. The concern is that once the Fed stops expanding its balance sheet, stock prices could plummet, interest rates could shoot up causing bond prices to collapse, rising home values could cause investors snapping up foreclosed homes to lose their shirts, and banks lending to farmers could face losses on defaulted loans. And some combination of those developments could bring on a new crisis.

Maybe, but maybe not. It wasn't simply losses that caused the crisis, rather losses by a range of financial firms that typically financed longer-term investments

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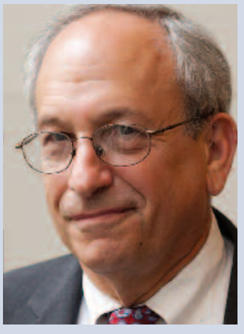
Unexpected Twist



Donald L. Kohn

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with short-term, even overnight loans. When uncertainty about such firms' solvency arose, the financing dried up and the crisis was on.

In contrast, when the bubble in high-tech stocks burst in 2000, a lot of people lost money. So did some of the lenders who financed a massive expansion in some high-tech capacities such as fiber optic networks. However, there was no financial crisis because no one could buy stocks with no money down—as many purchasers did during the housing bubble seven or eight years ago—and the same thing is true today. Furthermore, stock prices are being supported by high and rising corporate profits. In fact, last year profits of U.S. non-financial corporations were higher as a share of real value added than they were in 2006 before the crisis. Perhaps even more surprising, by that measure they were about 40 percent higher than they were in the booming economy of 1999.

Certainly Fed officials are having second thoughts about selling the mortgage-backed securities.

Joseph Gagnon of the Peterson Institute for International Economics, a former senior Fed economist, explained the linkages in the Fed's quantitative easing this way: "We want people to invest in risky assets but we don't want them to do it in a leveraged way that is risky. You would want people to buy more equities and push up the stock market. If people feel wealthier and spend more, corporations have an easier time issuing new equity and financing investments, new startups, or whatever."

Neither Gagnon nor Kohn can estimate how much the Fed purchases are helping boost economic growth, but both believe they are.

"I think it is really helping the housing market," Gagnon said. "And I think it has helped the stock market. It's hard to be sure about the stock market, but a lot of people think it is. What I found convincing is people saying, 'Look, by lowering the cost of business loans and by allowing businesses to refinance into longer-term bonds at lower rates, you have directly increased profits of corporations because interest rates are a cost.' What is even more clear is that the mortgage-backed securities they are buying are supporting the housing market."

Similarly, Kohn said, "I think it is having a positive effect on the economy. It is helping reduce mortgage rates. It's probably helping to reduce intermediate-term rates which affect cars and other consumer durables which are purchased with three-year or four-year credit. The harder question is how much those changes in financial conditions feed through to the economy."

The true hard question at this point is whether the benefits to the economy for quantitative easing will be worth the damage that might be done if a damaging bubble does develop or if interest rates shoot up whenever the Fed begins to reverse course which may be tricky indeed. Fed officials are spending a lot of time thinking about that, and as of late May there was no consensus about when or exactly how to begin. The first step undoubtedly will be to reduce the $45 billion worth of monthly purchases of Treasury bonds. But should there also be a cut in the $40 billion worth of mortgage-backed securities being bought? That's a harder question.

Eric Rosengren, president of the Boston Federal Reserve Bank, who has been a strong supporter of quantitative easing, indicated in a May 16 speech that he is not ready to trim the monthly purchases.

"Some observers and indeed policymakers have criticized the degree of monetary accommodation in the United States as excessive," Rosengren said. "However, when we look at the data on outcomes in the economy to date, I see it differently. The outcomes could lead one to argue that policy has not been sufficiently accommodative. Inflation is below target and unemployment is above target," and based on economic projections of FOMC members this is "likely to persist for several more years."

At the other end of the policy spectrum, Rosengren's counterpart in Richmond, Jeffrey M.

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Lacker, the same day said that U.S. economic growth has resumed, but it's limited "in large part, by structural factors that monetary policy is not capable of offsetting. In this situation, the benefit-cost tradeoff associated with further monetary stimulus does not look promising. The Fed seems to be unable to improve real growth, despite striving mightily over the last few years, and further increases in the size of our balance sheet raise the risks associated with the 'exit process' when it's time to withdraw stimulus. This is why I do not support the current asset purchase program."

It's always difficult for the FOMC to decide to change the direction of policy—much harder than just to modify the pace at which policy is moving. In the current situation, that probably means the first step will come later than many financial market observers now expect. Of course, a lot will depend on the month-to-month flow of economic data. Still, many on the committee believe that once the Fed begins to take its foot off the accelerator, that new direction could last for several years—if all goes well.

One wild card is the resumption by some firms—not banks but broker-dealers and other non-banking firms—of the practice of making longer-term loans and investments financed by short-term money. For the most part, the Fed does not have direct supervisory responsibility for these firms. So far the volume of activities is limited, but Fed officials are acutely aware of the danger should this activity grow and some event, such as the failure of a major bank in Europe, triggers a wave of uncertainty in the global system.

"I think it is worth worrying about the financial stability effects of an exit from quantitative easing," Kohn said, but added that one mitigating factor is that "the exit will occur when the economy is stronger, so earnings will be higher and people will be able to pay their debts and sales will be higher. Yes, floating rate debt will go up, but people will have more income from which to pay it back. So it's a little hard to know what the effect of rising rates will be on the ability of people to service their debts, whether the purchasers really are taking a lot more risk than is justified by the difference in yields.

Kohn also noted that the Fed has paid a lot of attention in its stress testing exercises with major banks to what might happen if there were a major increase in rates. So far virtually all the institutions have come out well. The experience in 1994 when the Fed raised rates for the first time in five years turned out pretty well, he recalled. "In a growing economy, a lot of interest rate risks can be absorbed."

Nevertheless, Kohn cautioned, "When they announce they are beginning a tapering of their purchases, it's going to be seen as the first step in an exit even if they are still buying. They are going to have to be very careful how they do that."

Gagnon is less concerned about a recovery-killing spike in longer-term interest rates because, he said, "Monetary policy from now on cannot pretend it does not control bond yields."

"It used to be," he explained, "that we said monetary policy was only about the overnight interest rate. That was all we could do, and the bond market was something else. It really never was true, but we now have the central bank talking about the future path of the overnight interest rate, which affects interest rates over at least two or three years. And now the central bank buys bonds, five-, ten-, and even thirty-year bonds, which affects their yields too. And it has an unlimited ability to do that, and therefore operate on the

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entire term structure of interest rates. And, I would argue, it should operate that way to achieve its objectives of stable prices and maximum employment.

"Now that may mean that at some point in the future all yields will have to rise, including bond yields. But it means there can be no bond market panic that would jeopardize the Fed's objectives unless the Fed foolishly allowed it. That doesn't mean that there won't be a rise in long-term interest rates, and if you want to call that a bond market panic, fine. But it doesn't need to happen to the extent that it might actually threaten the recovery, that it might actually threaten deflation, that it might actually threaten a second or third dip in the economy. We have never thought this way before."

Finally, there's the issue of the Fed's balance sheet. Months ago, the Fed announced it eventually would sell many of the accumulated assets, including all the mortgage-backed assets, so that only Treasury securities would remain. Both those propositions are now up in the air, however.

Certainly Fed officials are having second thoughts about selling the mortgage-backed securities. That's a less liquid market than the one for Treasuries and selling the securities could have a noticeable impact on private holdings of such securities and affect mortgage interest. Furthermore, mortgage-backed securities are in a sense self-liquidating in that the mortgages backing each security get paid off over time, in many cases simply because the house is sold or the mortgage gets refinanced. And the Fed has other channels through which it can tighten policy without selling mortgage-backed securities. The same could be said of Treasury securities, which mature over a long period of time.

For one thing, the Fed could increase the quarter-percentage point interest rate it pays on the roughly $1.9 trillion worth of reserves financial institutions have on deposit at Federal Reserve banks as a way to raise short-term rates.

Lurking in the background is another politically difficult issue for the Fed associated with exiting from quantitative easing. The purchase of the assets has sharply increased Fed income since it costs virtually nothing for the central bank to create the money to pay for them while the assets yield a higher return. Last year, for example, the Fed remitted $88.4 billion to the Treasury. Eventually, though, the Fed will need to begin to raise rates as economic activity improves to prevent an unwanted acceleration of inflation. At that point, the arithmetic changes.

As rates rise, the cost of money created by the Fed goes up and the value of the assets on its balance sheet goes down. The Fed is not a profit-making institution, so in a sense it doesn't matter in the same way it would for a commercial bank. But its cash flow could change significantly, particularly as even overnight rates kept rising. In those same projections, where the overnight rate target is headed in the next several years the figure for longer run is shown as around 4 percent. Most of the assets on the Fed's balance sheet yield less than that, and there would be mark-to-market paper losses on many of the assets now owned. In short, the Fed could have several years with losses.

Inflation has been replaced by worries about financial stability.

Gagnon, who testified about this issue recently, said the losses could be as high as $100 billion or perhaps more for a couple of years. "But you must view that in light of the previous massive unusual annual gains. You must also view it in light of the fact that Treasury, as a result of the asset purchases, has locked in lower borrowing costs for up to thirty years than it otherwise would have had.

"It could be a political issue, Gagnon said, "but if it is, it's unfair." Part of the problem is that the cost of the interest the Fed would be paying banks would be one part of the losses, and that would not look good. "It's optics," he said.

Kohn is concerned that this could be one more issue potentially affecting congressional views about central bank independence.

"The exit from these policies will be a very tricky moment for the Federal Reserve," he said. Interest rates will be rising. That's always unpopular and the political unpopularity will be compounded by the fact that, if as seems likely, Congress hasn't done anything about the long-term trajectory of its own debt, this will bring home just what a fiscal mess the country is in. And then the Fed won't be sending so much money to the Treasury. So there are economic consequences that have always gotten politicians excited when the Fed raised rates."

Still, if the economy is vibrant enough to cause the Fed to raise rates high enough to create these "losses," maybe the budget will be in good enough shape that Congress's collective nose won't be out of joint. The Fed can always hope. ◆