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More Fed Easing: High Risk, Low Reward

Monetary Policy Cannot Solve the Problems Facing Our Economy

September 14, 2012

Recent disappointing economic indicators have led the Federal Reserve to take additional extraordinary monetary actions to support the anemic recovery. On Thursday, September 13, 2012, the Federal Open Market Committee (FOMC) announced a third round of large-scale asset purchases, known as **quantitative easing**, amounting to $40 billion per month. The FOMC also extended its pledge to keep short-term interest rates near zero through at least mid-2015, and reconfirmed its asset maturity extension program, known as Operation Twist, will continue through the end of 2012.

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The employment portion of the Federal Reserve's dual mandate for full employment and price stability has motivated the FOMC to take a series of extraordinary monetary actions over the four years since the height of the financial crisis.

But despite Federal Reserve's best attempts, it has fallen short in its quest for more jobs. A dismal Employment Report released on Friday, September 7, 2012, found just 96,000 payroll jobs were created in August and the unemployment rate has remained above eight percent for 43 consecutive months. While the unemployment rate has declined from its October 2009 peak of 10.0%, the decline has been driven by declining labor force participation, not job creation. Job creation remains anemic, and labor force participation has slumped to its lowest level since September 1981.

Although the Fed has taken several extraordinary actions since the crisis, the Fed has fallen short in its quest for more jobs.

The Federal Reserve's actions will likely prove ineffective because monetary policy cannot solve the problems facing the anemic economy recovery. Liquidity is high, and interest rates are low. America's businesses are not sidelined because monetary policy hasn't done enough; rather, they are sidelined because uncertainty over budget, regulatory, and tax policies is as high as it has ever been in Washington.

The Fed's actions will likely prove ineffective because monetary policy cannot solve the problems facing our economy—it is the uncertainty over budget, regulatory, and tax policies that inhibits economy growth.

Naturally, the question arises as to whether the new round of monetary accommodation will provide much benefit to the economy. The consensus among economists and market watchers is that it will do little good, while increasing the risk of harmful price inflation in the future.

The Fed's Unconventional Post-Crisis Monetary Policy

The Federal Reserve took several extraordinary actions during the height of the financial crisis in the fall of 2008. The Federal Reserve stepped in as the lender of last resort to support the ailing financial system through a series of emergency lending programs.

Since the financial crisis, the Federal Reserve has pursued unconventional monetary policy in an attempt to fulfill the employment half of its dual mandate.

The Federal Reserve also slashed short-term interest rates by nearly four percentage points during 2008—to the present near-zero level—in an effort to support the economy more broadly. The Federal Reserve's efforts succeeded in quelling the financial crisis and staving off a depression, but they also limited the Federal Reserve's ability to support the economic recovery through conventional monetary actions. In cutting interest rates to near zero, the Federal Reserve reached the "zero bound" that serves as the limit of conventional monetary policy—the Federal Reserve cannot lower interest rates any further.

Therefore, the Federal Reserve began pursuing unconventional monetary policy to fulfill the employment half of its dual mandate. The Federal Reserve instituted two large-scale asset purchase programs known as quantitative easing (QE). The first QE began in January 2009 and consisted of the purchase of over $1.1 trillion in federal agency mortgage-backed securities and nearly $170 billion in federal agency debt securities.[1] The second QE occurred shortly after economic activity slowed during the summer of 2010; it consisted of the purchase of $600 billion in U.S. Treasury debt securities.

Both quantitative easing programs sought to boost economic activity through the **portfolio balance channel**. In essence, the Federal Reserve made purchases to change the quantity and allocation of financial assets held by the public in order to push down long-term interest rates on mortgages, car loans, and corporate loans, among others. By lowering borrowing costs, the Federal Reserve hoped that consumers and businesses would borrow more to fund purchases and investments that would spur the economy.

In addition, the Federal Reserve has used the communications channel to spur the economy. In August 2011, the Federal Reserve began providing explicit forward guidance on the expected path of the target rate for federal funds. The federal funds rate is the primary lever by which the Federal Reserve can affect short-term interest rates. The current guidance calls for a near-zero target rate at last through the middle of 2015.

The Federal Reserve also attempted to spur the economy by changing the mix of assets it holds on its balance sheet. In a program first announced in September 2011—dubbed "operation twist"—the Federal Reserve began selling off a total a total of $400 billion in shorter-term securities to fund the purchase of another $400 billion in longer-term security purchases. By selling shorter-term securities and buying longer-term securities, the Federal Reserve is trying to lower longer-term interest rates and flatten the yield curve.[2]

Unlike the quantitative easing programs, operation twist did not markedly increase the size of the Federal Reserve's balance sheet; it simply changed the asset mix. In June 2012, the Federal Reserve expanded operation twist by another $267 billion.

Major Monetary Easing Measures Taken by the Federal Reserve since 2008

Extraordinary Action	Amount	Purpose	Announced / Begun
Quantitative Easing 1	$1.3 trillion	Spur economic activity by pushing down longer-term interest rates.	November 2008 / January 2009
Quantitative Easing 2	$600 billion	Spur economic activity by pushing down longer-term interest rates.	August 2010 / November 2010
Forward Guidance	N/A	Spur economic activity by pushing down shorter-to-medium interest rates.	August 2011 / August 2011
Operation Twist	$400 billion	Spur economic activity by pushing down longer-term interest rates.	September 2011 / September 2011
Operation Twist 2	$267 billion	Spur economic activity by pushing down longer-term interest rates.	June 2012 / June 2012
Quantitaive Easing 3	$40 billion per month	Spur economic activity by pushing down longer-term interest rates.	September 2012 / September 2012

On Thursday, September 13, 2012, the Federal Reserve announced a third round of quantitative easing in the amount of $40 billion per month for an unknown amount of time. Like previous QE programs, the current program seeks to lower longer-term interest rates through the purchase of assets. QE3 will mirror the first QE program in that it will consist of the purchase of agency mortgage-backed securities, not U.S. Treasury debt securities. Unlike the previous two QE programs, which announced a fixed amount of purchases at the initiation of the program, the new program will be open-ended and subject to improvements in labor market conditions. Second, the Fed extended its commitment to holding short-term interest rates at near-zero levels through at least mid-2015 rather than the previously announced end of 2014. Finally, the Fed reiterated its commitment to continue Operation Twist through the end of this year.

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The Benefits and Costs of Additional Monetary Easing

Most economists and market commentators believe that additional monetary easing will have little positive effect on the economy. One estimate provided by forecasting firm Macroeconomic Advisers finds that a $600-$750 billion asset purchase program implemented over two years would add a meager 0.25% to economic output and lower the unemployment rate by approximately 0.2%. The most recent *Blue Chip Economic Indicators* featured special survey questions about the prospects of another round of quantitative easing. Regarding whether the Federal Reserve should announce a new large-scale asset purchase program, 76 percent of the surveyed economists answered no. And even if a new round of quantitative easing occurred, 66.1 percent of the economists that were surveyed said the program would have little to no effect on their forecast for real GDP growth in the second half of 2012.

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The likelihood of either of the Federal Reserve's new actions having a substantial positive effect on economic growth and job creation is low. Monetary policy can boost economic growth and help to create jobs only in the short term. It does so by improving the economic climate by increasing

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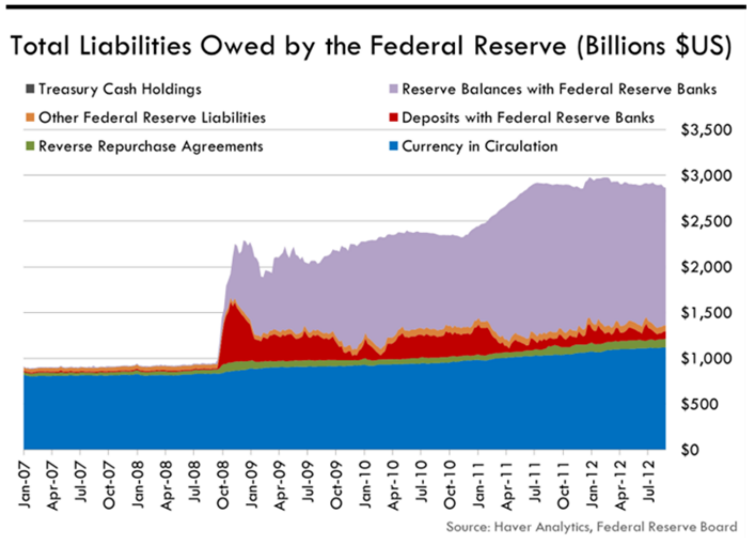
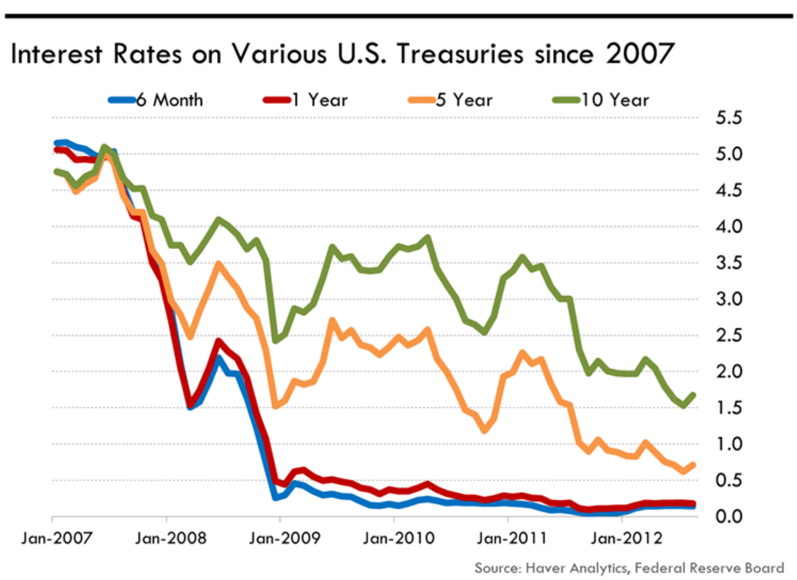
liquidity and decreasing interest rates. However, the problems facing the economic recovery do not involve a lack of liquidity or high interest rates. At present, both banks and non-financial corporations have more than enough liquidity. The purple area in the below chart depicts the dramatic increase in commercial bank reserves held at the Fed since the fall of 2008.



Commercial banks now have nearly $1.5 trillion in *excess* reserves that they have chosen to park at the Federal Reserve rather than lend out to businesses. Similarly, U.S. non-financial corporations have chosen to hold their retained earnings in cash and cash-like equivalents rather than make the long-term investments in buildings, equipment, and software that drive job creation. These short-term cash holdings were more than $1.5 trillion at the end of the 2nd quarter of 2012. Banks have money to lend, and non-financial corporations have money to invest—illiquidity is not the problem holding back the U.S. economy.

Lowering interest rates would make it cheaper for businesses to borrow to make investments and hire workers. However, interest rates are already at nearly 50-year lows. The chart below depicts the sharp decline of U.S. treasury rates over the past five years.



Liquidity is high, and interest rates are already low. The Fed's new round of quantitative easing and its promise to hold short term rates near zero for even longer will not remove real roadblocks to a strong and sustained recovery.

American consumers and businesses are not avoiding the large purchases and long-term fixed investments that stimulate jobs because the Federal Reserve hasn't yet provided enough monetary accommodation; rather, it is uncertainty over budget, regulatory, and tax policy is so high that it is discouraging consumers and businesses. The likelihood of hitting the so-called "fiscal cliff" at the end of 2012—and with it the possibility of tax increases—and new regulations related to energy production, healthcare, and financial reform are causing businesses to take a "wait-and-see" approach to new hiring. Moreover, the lack of a credible plan to address the ever increasing level of federal debt has stifled job creating investments not just in 2012, but for many years to come.

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The problems that are preventing consumers from making large, stimulating purchases and businesses from making the long-term fixed investments that drive job creation are not monetary problems that the Federal Reserve can fix. The problems facing the current anemic economic recovery related to fiscal, tax, and regulatory issues that only the President and Congress can solve.

<u>Additional Extraordinary Actions Could Actually Hurt the Economy</u>

Besides adding more short-term uncertainty, additional monetary easing may actually harm the economy over the long term. More quantitative easing will increase the size of the Federal Reserve's balance sheet (see the chart below).

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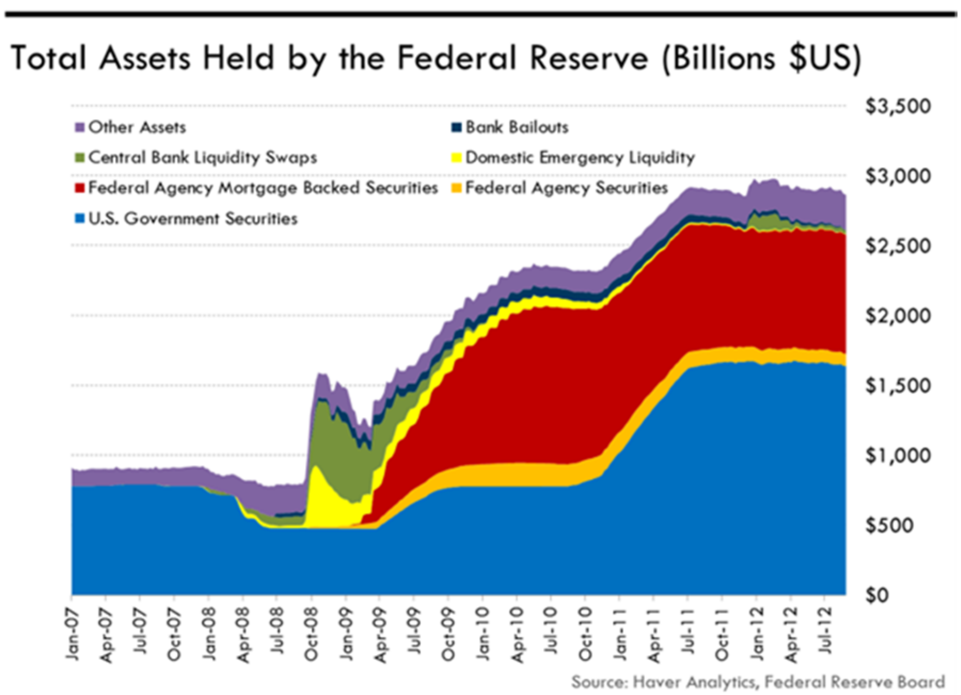

The Federal Reserve's growing balance sheet increases the risk of future price inflation by making the Federal Reserve's eventual exit strategy from its extraordinary monetary actions more difficult to execute. Although the Federal Reserve has the techincal capability to prevent price inflation, it is not entirely clear whether the Federal Reserve will be able to excute its exit from the current monetary accomodation in a proper and timely fashion.

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The Federal Reserve will have to reduce the size of its balance sheet through asset sales and reverse repurcahse agremeents (repos). Given the lag time between a monetary action and its full effect on prices, the Federal Reserve will need to begin well before the public perceives a vigorous recovery. For central banks, including the Federal Reserve, timing a shift to a restrictive monetary policy to prevent an inflationary outbreak has proven challenging in the past. Moreover, the scale of the necessary asset sales and reverse repos is unprecented and may produce unanticipated problems.

The Federal Reserve's exit is also complicated by other factors. The Federal Reserve was the single largest purchaser of U.S. Treasuries during its second quantitative easing proram—in fiscal year 2011, the Federal Reserve purcahsed 77% of all the additional debt issued by the Treasury.[3] Through these large-scale purchases, the federal government was allowed to borrow nearly a trillion dollars without actually increasing its debt to private and foreign investors. Unintentionally, the Federal Reserve may have contributed to a delay in resolving the looming fiscal crisis by masking the true cost of four consecutive fiscal years of federal budget deficits in excess of $1 trillion.

Once the Federal Reserves begins to sell Treasuries, the Treasury will be forced to seek more private and foreign investors. Without the demand from the Federal Reserve, interest rates on Treasuries are likely to increase.

Moreover, the Federal Reserve returns its profits (the excess of interest paid to the Federal Reserve less its operating costs) to the Treasury. In calendar year 2011, the Federal Reserve remitted $75.4 billion to the Treasury, or apprioximatly 97% of its comprehensive income.[4] To neutralize some of the liquidity that the Federal Reserve created through quantitative easing, the Federal Reserve may increase the rate of interest it pays to commercial banks on their excess reserves to encourage banks to hold excess reserves at the Federal Reserve rather than lend them out into the economy. However, this policy option would likely reduce the Federal Reserve's profits and thus its payments to the Treasury. Both selling Treasuries and increasing the interest paid on reserve may worsen federal budget deficits.

The Federal Reserve's current policy of credit allocation may also make its exit more difficult. The Federal Reserve has inserted itself into the credit market by buying agency debt and agency mortgaged-backed securities and is providing an ongoing subsidy to one portion of the market—housing—in an effort to spur economic activity more broadly. By picking winners and losers in the credit market, the Federal Reserve necessarily politicizes its actions. This politicization will only increase when the Federal Reserve eventually decides to withdraw its support of the housing market in order to tamp down on inflation. As a result, this policy of credit allocation—taken together with the Federal Reserve's effects on the fiscal prospects of the federal government—is undermining the independence of the Federal

Reserve going forward, and with it, the implementation of proper non-inflationary monetary policy over time.

Conclusion

Despite having taken several extraordinary monetary actions over the past four years, with questionable beneficial effects, the Federal Reserve decided on Thursday, September 13, 2012 to initiate a third round of quantitative easing and to extend its commitment to near-zero interset rates through mid-2015. However, these new actions will do little to benefit the sluggish economic recovery—both in terms of increased output growth or more jobs—because the problems facing the economy are not monetary. For a robust recovery to ensue, policymakers must remove the budget, tax, and regulatory roadblocks that are creating market uncertainty and preventing businesses from making the long-term fixed investments that spur economic growth and job creation.

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[1] The Federal Reserve purchased federal agency debt securities issued by Fannie Mae and Freddie Mac and federal agency mortgage-backed securities issued by Fannie Mae, Freddie Mac, and Ginnie Mae.
[2] Officially known as the maturity extension program, the Federal Reserve executes operation twist by selling U.S. treasury securities with remaining maturities of 3 years or less and purchasing an equal amount of U.S. treasury securities with remaining maturities of 6 years to 30 years.
[3] Gramm, Phil and Taylor, John B., "The Hidden Costs of Monetary Easing," *The Wall Street Journal* (September 11, 2012), *available at:* http://online.wsj.com/article/SB10000872396390443686004577639590237612020.html.
[4] Federal Reserve Banks Combined Statements of Income and Comprehensive Income for the years ended December 31, 2011 and December 31, 2010, 98th Annual Report of the Board of Governors of the Federal Reserve System (May 2012).