

America Needs More Expansionary Monetary Policy

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Why Is this Recovery So Slow?

There are four major forces preventing a rapid return of the US economy to its full potential: 1) households have increased their rate of saving to make up for losses in the value of their houses and to prepare for retirement; 2) banks continue to apply tighter-than-normal standards and terms on loans to households and businesses; 3) foreign governments continue to send record levels of capital into US markets in order to prevent their currencies from appreciating and thus perpetuating a large US trade deficit; and 4) state and local governments, constrained by balanced budget rules, cut spending and raised taxes during and immediately after the recession. Although the last of these forces appears to have run its course, tax increases and spending cuts at the federal level are now taking over as a major factor retarding growth this year.

All of these forces reflect either greater saving or reduced borrowing, both of which hold down spending in the US economy.

What Can Monetary Policy Do?

Monetary policy influences the level of spending in the economy by changing the returns to saving and the costs of borrowing. Interest rates, both short-term and long-term, are convenient measures of both the return to saving and the cost of borrowing. Higher interest rates encourage saving, discourage borrowing, and thus reduce total spending. Right now, total spending in the US economy is too low. The appropriate monetary response is to lower interest rates to discourage saving and to encourage borrowing and thus spending.

Appropriate monetary policy helps to speed the economy's return to equilibrium. Inappropriate monetary policy, on the other hand, can push the economy away from equilibrium. Thus, excessively tight policy can cause a prolonged recession, whereas excessively loose policy can cause runaway inflation. Right now, there is no reasonable doubt that the US economy is below its equilibrium level of output. The case for easy monetary policy is strong.

One caveat to this prescription is that monetary policy affects spending with a lag, typically estimated to be around one to three years. Thus, policymakers need to look forward and to set interest rates to guide the economy to equilibrium roughly two years in the future. According to the Blue Chip survey of private-sector forecasters, in the fourth quarter of next year the unemployment rate is expected to be 7 percent and the inflation rate is expected to be 2 percent. The same forecasters report an expected long-run rate of unemployment of less than 6 percent. Apparently, private-sector forecasters do not expect the economy to return to equilibrium within

two years. I would also note that these forecasters have been repeatedly surprised by how low inflation has turned out to be over the past three years. I expect inflation to be less than 2 percent next year. The bottom line is that a consideration of how the economy will evolve over the next two years leads to the conclusion that the current stance of monetary policy is too tight.

What Is Different about Unconventional Monetary Policy?

Normally, monetary policy operates directly on the short-term rate of interest on high-quality assets. Longer-term rates of interest and rates of return on other assets move more or less in sync with the short-term interest rate, reflecting expectations about monetary policy in the future and financial arbitrage. When the short-term interest rate hits zero, the monetary authority can no longer ease policy through this tool. However, the underlying source of monetary power is the ability to print money to buy assets, and this power is not limited to purchasing only short-term assets. One element of unconventional monetary policy is to use newly printed money to purchase unconventional assets. Another element of unconventional policy is to communicate to market participants that the future path of the short-term interest rate will be lower than they might otherwise expect. In these ways, the monetary authority can influence longer-term rates of interest, as well as the rates of return (and thus the prices) of any financial asset it chooses to buy or sell.

My research shows that purchases of long-term bonds by the Federal Reserve have lowered long-term interest rates not only on the bonds being purchased but also on a broad range of long-term assets. Other researchers have confirmed this result, including in the United Kingdom, which is the only other country to have tried large-scale purchases of longer-term assets. I estimate that the 10-year Treasury yield and the 30-year mortgage rate are at least 1 percentage point lower than they would have been in the absence of the Federal Reserve's unconventional policies.

Most market participants believe that these policies have boosted stock prices and helped to keep the dollar from appreciating. There is no doubt that all of these financial developments encourage spending—consumption, investment, and exports—and thus support economic growth. I note in particular that refinancing long-term debts at lower interest rates goes a long way toward repairing household and corporate balance sheets that are holding back spending.

What Are the Costs of Unconventional Policy?

Chairman Bernanke has identified four costs or risks that are of greater concern with unconventional monetary policy than with conventional policy. Three of these costs arise because unconventional monetary policy requires much larger fluctuations in the balance sheet of the monetary authority than conventional monetary policy. In my view, none of these costs is close to being significant now or at any time in the foreseeable future.

1. The first cost of unconventional monetary policy is that the Federal Reserve could become the dominant buyer and holder of long-term Treasury and agency securities, thereby reducing the liquidity and efficiency of the markets for these assets. So far, this concern is purely hypothetical and it would almost surely require far greater purchases than most people expect to occur over the next couple of years. But if it should ever occur, the Federal Reserve could

address this problem by announcing adjustable daily target ranges for the yields of the securities it is buying. To hit these targets it would accelerate or decelerate its rate of purchase within the day. That would give market participants some assurance about the price for which they could buy and sell Treasury securities at any time, which is the operational definition of a liquid market. More broadly, one of the main purposes of quantitative easing is to force investors out of the market being targeted and into other markets, which would become more liquid. The Treasury yield curve can still provide a market benchmark even if private investors hold most of their portfolios in other markets.

2. The second cost is that the public might believe that it will be difficult for the Federal Reserve to tighten policy at the right time to prevent excessive inflation in the future. This fear might increase uncertainty and instability in markets. The key to preventing this cost from materializing is constant communication by the Federal Reserve about its capabilities and intentions. The Federal Reserve has developed several tools to adjust policy that provide ample scope for future tightening. However, the real concern may be more with the Federal Reserve's willingness than with its ability. Experience shows that inflation fears are highly sensitive to strong policy actions (or the lack thereof) in response to observed inflation. Thus the Federal Reserve needs to calibrate its policy stance visibly in response to deviations of both unemployment and inflation from their previously projected levels.

3. The third cost is that low long-term yields may encourage risky behavior that threatens financial stability. Some observers have argued that we are already seeing a risky bubble in the bond market. But low long-term yields are not a bubble when they reflect expectations of the path of the short-term interest rate that are guided by the monetary authority and are supported by its holdings of long-term securities. It is unlikely that systemically important institutions are holding excessive long positions in bonds, and it is the job of risk managers at those firms, prudential supervisors of those firms, and the new Financial Stability Oversight Council to prevent such behavior. Moreover, by boosting the economic recovery, increasing corporate profits, and decreasing the rate of bankruptcies, unconventional monetary policy reduces risks to financial stability considerably.

As Chairman Bernanke said last month, the current low level of interest rates reflects the weakness of the economy. The sooner we can return to full employment, the sooner we will return to normal levels of interest rates. Premature tightening will only delay the return to normalcy. Indeed, in my view, if the Federal Reserve had been more aggressive in easing earlier, we might already have returned to normal levels of interest rates by now.

4. The fourth cost is the possibility that the Federal Reserve could incur financial losses on its enlarged balance sheet. This so-called cost is a complete red herring. Indeed, the most unremarked benefit of unconventional monetary policy is the way it reduces the burden of our national debt for future generations. Since 2009, the Federal Reserve has passed to the Treasury record profits from unconventional monetary policy, and it is likely to continue to do so for the next few years. Any losses in the more distant future must be examined in tandem with the previous windfall profits. In addition, the Treasury also has benefitted from higher tax revenues and from issuing debt at lower interest rates. There is no plausible scenario in which unconventional monetary policy could raise the long-term burden of our national debt.

Should the Federal Reserve Have a Dual Mandate?

Monetary policymakers around the world act as if they have a dual mandate, even in countries where the only formal mandate is for price stability. It is not in the interest of accountability and transparency to pretend that monetary policy does not affect employment and output or to pretend that society does not care about employment and output. The dual mandate has served us well and we should keep it.