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The Fed's Exit Strategy: A Delicate Balancing Act

The U.S. central bank has a tough road ahead because it has been setting the wrong policies, and Congress should make it stop

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The 2008 financial crisis and the ensuing Great Recession led to extraordinary monetary policies in which the U.S. Federal Reserve Bank lowered its target fed funds rate to near zero, engaged in massive quantitative easing (QE) and created special vehicles to bail out nonbank financial institutions. It is now more than five years since the crisis ended, but short-run interest rates remain near zero and the Fed's balance sheet continues to expand, although at a slower rate since tapering began earlier this year.

The Fed's bloated balance sheet, with assets of more than US$ 4 trillion acquired through several rounds of QE, and the corresponding newly created base money (currency plus reserves held at the Fed) pose substantial challenges to policymakers. Much of the new base money has been sterilized and not lent out. Banks are holding about US$ 2.6 trillion in excess reserves at the Fed. Banks are willing to hold such large cash balances because of the lackluster recovery, the need to rebuild their balance sheets and conform to expected higher capital requirements, and because the Fed began paying interest on excess reserves in October 2008.

However, once the economy becomes stronger, banks will want to meet the demand for credit and begin to lend out their excess reserves. The resulting multiple expansion of bank money (demand deposits) will show up in faster growth of M2, and as the velocity of money increases nominal GDP and the price level will rise at a faster pace.

The Fed faces a delicate balancing act: if it moves too slowly to shrink its balance sheet and raise interest rates, inflation could flare up and move above its 2 percent target. However, if it moves too quickly, the economy could be thrown back into recession.

The Fed's macro models did not predict the financial crisis and cannot be relied on to guide its exit strategy. The economy is complex and its path uncertain; the more so as the Fed is operating by pure discretion in a fiat money regime without any rule to anchor the future value of the dollar.

At present, with the fed funds rate near zero and year-over-year Consumer Price Index inflation running at about 2 percent, real (after-tax) short-run interest rates are negative. Meanwhile,

longer-run rates have been kept artificially low by the Fed's large-scale purchases of Treasuries, mortgage-backed securities and agency debt.

The intended purpose of QE was to stimulate consumption via asset price inflation. With ultra-low interest rates, the Fed also expected to see net investment rebound, but businesses have been slow to take on new projects and expand their workforce. Instead, Fed policy has incentivized investors to take on more risk, pushing up prices of stocks and junk bonds. Meanwhile, those who have relied on lifetime savings for retirement have lost nearly US$ 400 billion dollars each year since the Fed's zero interest rate policy was enacted. They will never recover that lost wealth.

In effect, the Fed has been engaged in financial repression and credit allocation. It has suppressed the natural rate of interest that would match voluntary saving and investment; it has politicized and misallocated credit by favoring housing and government debt. Monetary policy has become subservient to fiscal policy.

The Fed has monetized much of the federal government's net new debt and in doing so has allowed the government to live beyond its means and thus avoid hard choices. In this sense the Fed is not independent, regardless of what monetary policymakers say. Only the Fed can create money out of thin air. The fact that most of the new base money has not entered into the money supply and has not caused runaway inflation does not mean that the Fed will be able to keep the genie in the bottle forever.

The ride up was politically feasible as the Fed engaged in its stimulus; the ride down will be much more difficult. Yet, the longer the Fed waits to normalize its balance sheet and interest rates, the more damage will be done to the real economy.

It is an illusion to think that monetary policy alone can promote economic growth and full employment. There are limits to what central banks can do: they can control the growth of base money and maintain long-run price stability, but they cannot permanently impact real variables. The stagflation of the 1970s and 80s should be proof enough, yet some Fed policymakers still act as if there is an exploitable tradeoff between inflation and unemployment.

Fed officials, of course, are bound by law to focus on both maximum employment and price stability. But as former Fed chairman Paul Volcker has noted, the dual mandate is "operationally confusing and ultimately illusory." That is why Charles Plosser, president and CEO of the Federal Reserve Bank of Philadelphia, favors "a more limited central bank" designed to maintain price stability. In his opinion, "the public has come to expect too much from its central bank."

How can the Fed best exit its bloated balance sheet and prevent serious inflation? That is the fundamental question. The simple answer is to end discretionary monetary policy, adopt a monetary rule (such as the Taylor Rule), end debt monetization and abolish the dual mandate. We should not ask the Fed to do what it cannot do – namely, fine-tune the economy and influence real variables.

The Fed has not explicitly stated its exit strategy. Its "forward guidance" is murky at best. Various options have been discussed: increasing interest on excess reserves to prevent them from entering the credit market and expanding the money supply; increasing reserve requirements; using reverse repos to drain reserves; and gradually selling off Fed assets. Each alternative has costs as well as benefits.

When the Fed ends QE later this year, it plans to continue its ultralow interest rate policy for at least another year. If the fed funds rate stays near zero, the Fed could increase the rate it pays on excess reserves. But that could quickly become very costly and also politically difficult, especially since foreign central banks hold substantial funds at the Fed. The Fed could also increase reserve requirements, but that could nip any recovery in the bud – a risky policy given the mid-term elections and the 2016 presidential race. Reverse repos would only temporarily drain base money (the Fed would "sell" securities to banks and nonbanks in return for cash and then repurchase them, paying an implicit interest rate after a short duration).

Finally, if the Fed actually reduced its portfolio, interest rates would increase – depressing asset prices. The Fed and other holders of longer-term assets would suffer capital losses, which could throw the economy into another deep recession.

Also, as the cost of servicing the federal debt increased with rising interest rates, the political class would have a strong incentive to pressure the Fed to inflate in order to reduce the real burden of the debt. Higher rates also would harm emerging markets and prick asset bubbles. Employment and production would be sure to suffer in the process.

For all these reasons, the Fed is likely to delay making any hard choices regarding the size and speed of interest rate hikes. Consequently, the ultimate costs of adjustment will be high. Asset prices could tumble even before rates rise, once investors expect them to rise – as they must.

The lesson is simple: to avoid difficult and costly exit decisions, the Fed should avoid making policy mistakes in the first place. Replacing a purely discretionary Fed that has gained substantial power as a result of the crisis by a simple monetary rule would increase certainty over the future value of the dollar, breed financial stability, and help depoliticize monetary policy – thus avoiding the mischief of QE, bailouts and credit allocation.

The next step should be for Congress to recognize the limits of monetary policy and establish a bipartisan Centennial Monetary Commission by enacting a bill introduced by Representative Kevin Brady, a republican from Texas who is chairman of the Joint Economic Committee. It is the duty of Congress to safeguard the value of the dollar. To do so, members need to consider alternatives to pure discretionary government fiat money.

Policymakers and the public need to face the reality that when they ask too much of monetary policy, they are apt to get instability and stagflation, not growth and prosperity.

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