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Robert Feinberg: Philly Fed President Warns of QE Unwinding

By: Robert Feinberg – December 4th, 2012

Charles Plosser, president of the Federal Reserve Bank of Philadelphia, gave the closing address at the recent 30th Annual Monetary Conference at the Cato Institute.

Plosser studied at the University of Chicago and taught at the University of Rochester before assuming his current post in 2006. In this capacity, Plosser serves as one of the rotating members of the Federal Open Market Committee (FOMC), which sets the Federal Funds Rate (FFR) and other elements of monetary policy, and he formerly served as a member of the Shadow Open Market Committee of conservative monetary economists.

Disclaiming that his views represent the Fed, Plosser reviewed the extensive extraordinary actions the Fed has taken in order to support economic recovery after the 2008 episode of the financial crisis. These include support for individual financial institutions, such as Bear Stearns and AIG; reduction of the FFR to essentially zero; and large-scale purchases of government bonds and mortgage-backed securities in three bouts of so-called quantitative easing (QE) that have swelled the Fed's balance sheet from $900 billion to approximately $3 trillion. In addition, the Fed undertook a program called Operation Twist, which had not been employed since the 1960s, to flatten the rates across the range of debt maturities, or the yield curve.

By the end of this year, according to Plosser, the Fed will hold almost no short-term government securities, and he questioned why the Fed would take such a step when the Treasury itself could flatten the curve by adjusting its issuance of securities accordingly.

Despite these actions, Plosser said the effect on the economy was "lackluster" and diminished with each dose of QE. He recalled that "the experience of the 1970s clearly demonstrated that attempts to use monetary policy to pursue an employment or unemployment target over a sustained period can lead to extremely poor economic outcomes, jeopardizing both employment and inflation."

At the same time, these measures designed to achieve short-term objectives entail, in Plosser's view, long-term risks of moral hazard, future inflation and the loss of institutional credibility, and he discussed each of these in detail.

Finally, Plosser set forth four principles to which he believes the Fed should adhere to going forward to improve monetary policy and safeguard the credibility and independence of the Fed:

1. Be clear and explicit about the goals and objectives of policy, and acknowledge what the policy can and cannot achieve.

2. Make a credible commitment to monetary policy goals by how policy will be conducted in a way that is consistent with the goals, such as by articulating a reaction function or rule that will guide policy decisions.

3. Be clear and transparent in communications with the public about the actions that are in fact taken.

4. Strive to ensure and maintain the independence of the central bank.

Plosser was especially critical of guidance that the FOMC will maintain a policy such as a zero FFR until a given date or a given threshold, such as when a level of unemployment has been reached. However, he did allow that perhaps the Fed might abandon its rules for a time, as long as it explained the reasons for such a deviation and articulated a plan to return to the rules.

With specific reference to the unwinding of QE, Plosser questioned whether the Fed would be able to manage successfully the expectations of the public as to when and how the Fed will eventually tighten policy and on what basis the decision will be made, given that "the Fed has never bothered to articulate a reaction function, a systematic approach to policy, before."

In closing, Plosser referred to a statement by Milton Friedman in a 1969 speech he delivered as president of the American Economic Association. Friedman lamented that monetary policy tools have been used in ways they were not intended to be used to achieve objectives monetary policy was not meant to achieve, and the result is to weaken the use of monetary policy for the purposes for which is, in fact, intended.