The Fed's Limited Instruments

For FOMC policymakers, there is no obvious money play.

BY JOHN M. BERRY

Federal Reserve Chairman Ben S. Bernanke doesn't want to admit it, but his central bank is running out of ways to boost U.S. economic growth to any marked degree.

The chairman and his colleagues on the Federal Open Market Committee long ago dropped their target for overnight interest rates to almost zero. To extend the potency of that move, the FOMC later signaled that absent an unexpectedly rapid economic recovery, it doesn't intend to raise that target until late 2014.

Along the way, the committee also directed the purchase of $2.3 trillion worth of longer-term Treasury and asset-backed securities in a successful effort to push down long rates. And long rates were reduced further through Operation Twist—a swap of Treasury securities maturing in the next three years for longer-dated ones—a process that will end late this year with virtually all of the Fed's holdings of the shorter-term paper gone.

What is left for the Fed? Not much. The central bank could buy more assets, but that probably would have only a limited effect on markets because long-term rates are already at record

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THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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lows. For instance, in July's quarterly Treasury funding, bidders bought ten-year notes at a yield of a scant 1.46 percent, the lowest ever for an auction. A day later, thirty-year bonds were sold yielding just 2.58 percent. Such spectacularly low yields have helped in a variety of ways to ease strains in financial markets. However, that hasn't had nearly enough "oomph" to put the economy on a more solid growth path. And while having the Fed buy more Treasuries could lead investors to acquire other assets such as corporate bonds instead, yields on those securities are also already quite low.

Similarly, the conditional commitment to keep rates low for two more years could be extended to 2015 or 2016, but again, at the margin, how much would that help? Three-year Treasury notes were auctioned in July at a yield of just 37 basis points while five-year notes were at 60 basis points. In other words, zero is not far away even well out the yield curve.

All those efforts leave just one additional untried policy shift that a number of prominent economists have urged on the Fed: make it known one way or another that the central bank would seek, or at least tolerate, an inflation rate higher, and perhaps much higher, than its current 2 percent target.

Among those advocating such a shift are Paul Krugman of Princeton University, who is also a *New York Times* columnist; Christina D. Romer of the University of California at Berkeley, former chairman of President Obama's Council of Economic Advisers; her Berkeley colleague J. Bradford DeLong; Simon Wren-Lewis of Oxford University; and Joseph E. Gagnon, a former senior Fed economist now at the Peterson Institute for International Economics.

Bernanke said, "Does it make sense to actively seek a higher inflation rate to achieve a slightly increased pace of reduction in the unemployment rate? The view of the committee is that that would be very reckless."

Despite the standing of such advocates, Bernanke and most other FOMC participants have flatly rejected the economists' approach. Asked about it at his press conference following the April FOMC meeting, Bernanke said, "I guess the question is, does it make sense to actively seek a higher inflation rate in order to achieve a slightly increased pace of reduction in the unemployment rate? The view of the committee is that that would be very reckless."

The Federal Reserve, Bernanke said, has "spent thirty years building up credibility for low and stable inflation, which has proved extremely valuable in that

Inflation Shift Proponents

Paul Krugman

Christina Romer

Brad DeLong

Simon Wren-Lewis

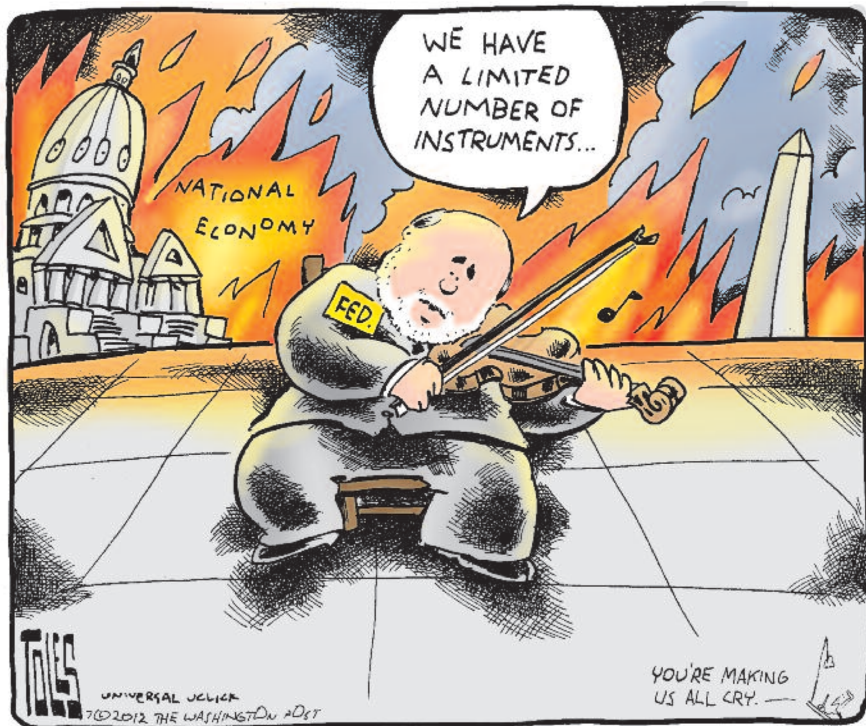
Joseph Gagnon

we've been able to take strong accommodative actions in the last four or five years to support the economy without leading to an unanchoring of inflation expectations or a destabilization of inflation. To risk that asset for what I think would be tentative and perhaps doubtful gains on the real side would be, I think, an unwise thing to do."

Asked about the idea at the July Humphrey-Hawkins hearing before the House Financial Services Committee, he again rejected it, saying he didn't think "we could do that without losing control of the inflation process."

Fed officials and their staff have taken hard looks at a variety of ways the commitment to the 2 percent inflation target might be altered. They came away unconvinced that doing so would spur growth significantly enough to risk the Fed's hard-earned credibility on control of inflation.

Nevertheless, unemployment is still above 8 percent and even Fed officials project at best a very slow decline. Thus those arguing the Fed should, in one way or another, allow more inflation say that if there are costly side effects, well, there are very large costs to having joblessness remain so high for so long. Bernanke himself has warned that workers' skills likely will erode during long spells of unemployment. In June, 42 percent of the unemployed had been without a job for half a year or more.



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Oxford's Simon Wren-Lewis, author of the blog Mainly Macro, wrote earlier this year, "The idea is that the central bank/government could moderate the impact of the zero lower bound constraint on interest rates by announcing that it would allow inflation to go above 2 percent for a significant period after the recession was over. This would help stimulate the economy today through various channels. One is that expected lower future short interest rates should reduce long-term interest rates today, which would in turn stimulate borrowing by firms and consumers."

Berkeley's Romer has suggested that instead of targeting a measure of inflation, the central bank could set a target for the path for nominal GDP.

According to some econometric models, Wren-Lewis said, expected inflation today depends on expected inflation tomorrow. If so, a central bank promise to allow higher inflation in the future would raise actual and expected inflation today, lowering current real short-term interest rates.

However, he added an important caveat: Would the public believe the central bank would indeed let inflation remain above 2 percent after the recession was over? "The temptation would be to renege on this commitment and return to the 2 percent inflation target. A smart private sector would realize this, so the promise to raise future inflation would not be believed, and so it would not be effective," he cautioned.

That sort of concern is a key reason Fed officials are so wary of these ideas. Even Paul Krugman is cautious.

Washington Post blogger Ezra Klein asked Krugman in a May interview what kind of improvement in unemployment a

QE Skeptic

The Cleveland Fed's
Sandra Pianalto

Sandra Pianalto, president of the Cleveland Federal Reserve Bank, said in a July speech that she is wary of another round of so-called quantitative easing. For one thing, no one can be sure that having the Fed hold an ever-growing share of total Treasury securities might not have an adverse impact on some securities markets, she said, adding that any future quantitative easing likely would have a smaller effect on interest rates and the economy than the previous ones.

—J. Berry

change in Fed policy could produce. Replied Krugman, "That's wildly uncertain. Partly because you do see that getting credibility on that commitment to future inflation is an iffy thing. Worth trying, but an iffy thing."

However it was worded, having a central bank say it wanted to create more inflation at a time when deflation—the actual decline in the price level—is not a threat would be unprecedented. "I have never heard of any central banker anywhere who strongly supported something like that," Gagnon said in an interview. And the Fed having set its 2 percent inflation goal only recently, he said, there is no likelihood the FOMC would raise it.

What the Fed could and should do, Gagnon argued, is to announce that with unemployment so far above the 5 percent to 6 percent level Fed officials want to see in the long run, that more inflation—temporarily—could help.

"They could say, we have these two goals and when there are two goals there are tradeoffs between them," Gagnon explained. "It's not that we're changing our 2 percent inflation goal. We're just saying that a little more inflation now, in the short term, in the medium term, a year, two or three years, might not be a bad thing if it got unemployment down.

"I would not recommend doing that—just making an announcement like that—unless you also accompanied it with some actions that the market might see as helping to achieve that goal. Some economists believe that if you just say something like that, the markets will believe you and you don't have to do anything else. They will raise their expectations of future inflation and that will lower the real interest rate and then they will see that they should be doing the investment projects now that they weren't doing before. Economists can do some math that shows that that's possible."

Other economists have proposed adoption of a price level target rather than an inflation rate target.

Gagnon doesn't much like that math. He wants both an announcement and concrete action, such as further large-scale asset purchases. "You would need something concrete and I can't think of what else they could do. But it would be synergistic," he said.

"Markets would say, this is what they are aiming at. Maybe they do want inflation to be a little higher in the near term. Maybe we should mark that into our analysis. That would lower real interest rates, and change people's decisions to save or to borrow or to invest because it changes the return on investments and the cost of investments," Gagnon said.

There are two other proposals for dealing with the inflation issue less directly. Berkeley's Romer has suggested that instead of targeting a measure of inflation, the central bank could set a target for the path for nominal GDP, which has both a real and an inflation component.

In a *New York Times* article last fall, Romer wrote, "It would work like this: The Fed would start from some normal year—like 2007—and say that nominal GDP should have grown at 4.5 percent annually since then, and should keep growing at that pace. Because of the recession and the unusually low inflation in 2009 and 2010, nominal GDP today is about 10

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percent below that path. Adopting nominal GDP targeting commits the Fed to eliminating this gap."

In effect, if growth is very slow, that would commit the Fed to seeking higher inflation. Bernanke hasn't bought that view either. At a press conference, he said nominal GDP was useful as an "information variable" but that the Fed would stick with its separate analyses of employment and inflation.

That doesn't address why the Fed is so unwilling to try to do more with its remaining tool, large-scale asset purchases.

Finally, still other economists have proposed adoption of a price level target rather than an inflation rate target. When the Fed's current inflation target is missed, either up or down, it has no obligation to offset the miss later. With a price level target, which could also be 2 percent a year, if the actual result for a year was a 1 percent increase, then the Fed would try to achieve a 3 percent rise in some following period.

However, the public is familiar neither with nominal GDP nor the difference between an inflation target and a price level target, which would make it really hard to explain adopting either.

In fact, the communications difficulty is probably a fatal flaw in all of the alternatives approaches on inflation. At least many Fed officials see it that way. It is not just a question of how financial markets and investors might react to a policy shift. What about businesses and households? In a most basic way, the Fed would have to persuade them that more inflation would benefit them. It could be a hard sell.

In a world of persistent high unemployment, workers probably would be skeptical that they could get employers to hike their pay to offset the added inflation. Actually many economists, including Gagnon, have been surprised that pay gains didn't disappear altogether in the face of the severe recession. But with the economy operating so far below its potential and employment rising so slowly, why should workers be confident their real incomes wouldn't fall? That fear might offset any impulse for consumers to step up their spending in anticipation that what they want to buy will cost more in the future.

Similarly, indebted households conceivably could increase their spending as they found themselves repaying debt with cheaper dollars—but perhaps not if nominal incomes didn't rise as well. And how would lenders respond in such circumstances? It's plain that by far the biggest drag on housing sales today is the far tighter standards banks have imposed on homebuyers seeking mortgages. Like yields on Treasury securities, mortgage rates are at all-time lows, but many buyers can't meet the much higher down payments and better credit scores demanded by the lenders.

Furthermore, whatever the Fed might do to convince the world it really wanted higher inflation, even temporarily, real interest rates might not be the only thing affected. Under normal conditions, higher expected inflation would tend to increase nominal rates. Might that not diminish the incentive value to having lower real rates, or indeed might it not offset it to a significant degree?

Another question is this. If the Fed promised inflation and that raised expectations for future inflation, how soon could the central bank deliver on the promise? As part of the analysis of a possible shift along the lines Krugman and the others have urged, runs of the Fed's huge model of the U.S. economy, FRB/US, have indicated that with all the slack in the economy it probably would take about three years for inflation to pick up significantly. Of course, with a different econometric model, one in which inflation is almost entirely a function of expectations without regard to past inflation, you could get a much faster response.

The issue is whether a risk of unknown dimension is worth incurring for what seems likely to be a limited payoff.

With all these issues on the table, it's little wonder that Bernanke categorically rejected the inflation-related proposals. "I'm very skeptical that it would increase confidence among businesses and households and increase economic activity," Bernanke said at the July hearing. "I think it would create a lot of problems in financial markets as well."

However, that doesn't address why the Fed is so unwilling to try to do more with its remaining tool, large-scale asset purchases. It may be a matter of keeping their small amount of powder dry to have some ability to respond to any serious development, such as an unmanageable banking crisis in Europe. Of course, several FOMC participants are adamantly opposed to any additional purchases. Others aren't sure the benefits would outweigh the costs. Still others, including John C. Williams, president of the San Francisco Federal Reserve Bank, support it.

Economist Brad DeLong argues the Fed should go all out: "The Fed should announce that it will do $100 billion a month of quantitative easing until market expectations are for a rapid return of nominal GDP to its pre-2008 growth path. And it should say, that if that doesn't work, it will do $200 billion a month. It might not work. But what is the downside?"

The downside is that no one can be sure what it might be. A further big expansion of the Fed's balance sheet surely would make it more difficult when the time comes to unwind these extraordinary measures. The issue is whether a risk of unknown dimension is worth incurring for what seems likely to be a limited payoff.

Sandra Pianalto, president of the Cleveland Federal Reserve Bank, said in a July speech that she is wary of another round of quantitative easing. For one thing, no one can be sure that having the Fed hold an ever-growing share of total Treasury securities might not have an adverse impact on some securities markets, she said, adding that any future quantitative easing likely would have a smaller effect on interest rates and the economy than the previous ones.

And announcement of more quantitative easing would again trigger complaints from Fed critics that it is debasing the dollar. Countries such as Brazil would undoubtedly renew their previous complaint that the Fed wants a cheaper dollar to improve U.S. trade competitiveness.

The broader reality is that many of the problems facing the economy can't be addressed with lower interest rates. Housing, which in past recessions has turned around on a dime when rates came down, is only now, three years after the declared end of the recession, showing solid signs of life. Banks, many of which barely escaped the financial crisis with their lives, are having to raise more capital and have adopted much tougher underwriting standards for lending. Governments at all levels have reduced their spending, cutting public and private employment by 2 million jobs or more which added at least a percentage point to the nation's jobless rate. Meanwhile, households have curbed their spending in order to rebuild their own balance sheets after their wealth took a huge hit in the recession.

The communications difficulty is probably a fatal flaw in all of the alternatives approaches on inflation.

On top of everything else, business and household confidence has taken a wholly unnecessary drubbing by the political deadlock in the U.S. Congress. Inspired primarily by Republican actions focused on denying Obama reelection, the deadlock has created one debt and spending crisis after another. The latest is the so-called fiscal cliff looming at the end of the year when a payroll tax cut and all the Bush income tax cuts expire and large automatic spending cuts are triggered. The latter were part of last year's agreement that temporarily ended the fight over increasing the nation's debt limit.

And then there's the economic crisis in Europe and slowing growth in China, Brazil, India, and many emerging market nations.

The Fed really can do little about this long list of factors holding back U.S. economic growth and job creation. On the other hand, it does still have its important role of lender of last resort through which it could support the financial system should another crisis loom.

On July 19, the editorial page of the *Washington Post* carried a cartoon by Tom Toles showing Bernanke fiddling while the national economy is burning in the background, obviously suggesting the Fed could put out the fire if it only would. Bernanke is saying, "We have a limited number of instruments…" Unfortunately, that really is true. ◆