



The Fed Takes a Gamble

By John H. Makin

The latest Federal Open Market Committee (FOMC) statement, released on September 13, amounts to an extraordinary upgrade in the intensity of the Fed's efforts to ignite more growth and reduce unemployment. The new approach to monetary policy, QE3+, aims at enabling the Federal Reserve to affect real variables like the level of unemployment by committing it to taking further action if goals are not met and maintaining a highly accommodative policy stance—zero interest rates and quantitative easing (QE)—even after the economy starts to improve. QE3+ is a risky, experimental approach to monetary policy that carries with it the chance of higher inflation.

QE3+ has been hinted at for years in academic papers presented at the Fed's Jackson Hole conference and elsewhere. It was forcefully articulated at this year's conference in a paper presented by Michael Woodford, a former Princeton University colleague of Fed chairman Ben Bernanke.¹ The September 13 FOMC statement clearly reflects the influence of Woodford's analysis.

The ideas contained in QE3+ were developed by analysts, including Bernanke, of Japan's unsuccessful efforts to escape the sluggish growth that followed its "lost decade," the 1990s. In the early 2000s, the Bank of Japan moved to a zero interest rate policy and undertook quantitative easing. After some initial success, the Bank of Japan withdrew from its very aggressive stance for fear of igniting inflation, and the Japanese economy slumped again.

QE3+ is a bet that successfully rekindling growth requires a central bank to commit to being somewhat irresponsible by promising to tolerate the threat of higher inflation for a longer period than previously thought prudent. Needless to say, this approach is risky and controversial. Success

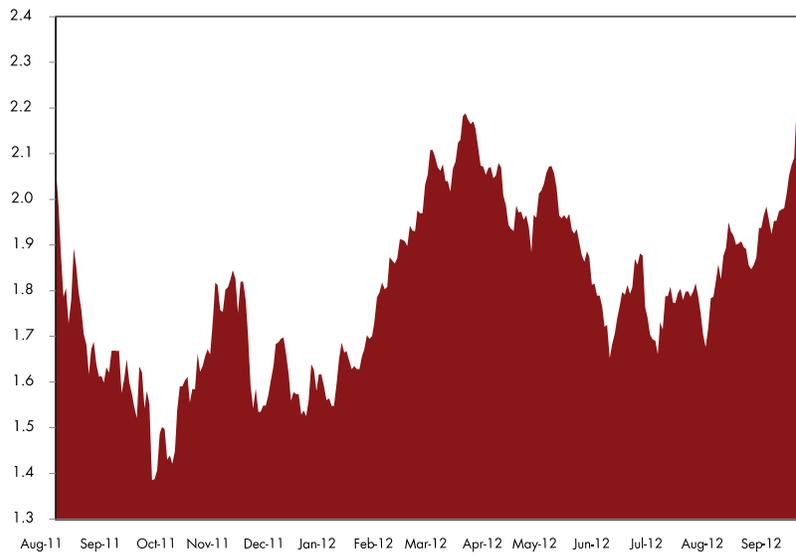
requires getting inflation back under control before inflation expectations become unanchored, but not before some real growth momentum has been achieved from higher asset prices and more hiring. Much depends on tracking inflation expectations, a variable that can be inferred but not directly observed. Figure 1 shows

Key points in this Outlook:

- The Federal Reserve's recently announced QE3+ measures to encourage economic growth and reduce unemployment demonstrate a highly accommodative, risky approach that could bring higher inflation.
- With QE3+, the Fed is committing to low interest rates and additional purchases of mortgage-backed securities indefinitely, until the labor market improves.
- To be successful in this approach, the Fed will have to track inflation expectations but not permanently boost them.

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FIGURE 1
INFLATION EXPECTATIONS, FIVE-YEAR BREAKEVEN RATE (IN PERCENT)



Source: Bloomberg

the post-QE3+ rise in expected inflation. The quick jump of twenty-five basis points in expected annual inflation over the next five years is substantial.

What Is Special about QE3+?

At first blush, the FOMC statement looks like just another round of QE in that it calls for additional purchases of mortgage-backed securities at a pace of \$40 billion per month while continuing with existing Operation Twist measures aimed at pushing down long-term interest rates. But under QE3+, the commitment to continue QE in some form is open-ended. The FOMC commits to closely monitoring economic and financial conditions and goes on to make an extraordinary promise: “If the outlook for the labor market does not improve substantially, the committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability.”

Three things about this statement are extraordinary. First, the Fed is saying that its asset-purchasing commitment and the use of “other policy tools” is open-ended until the outlook for the labor market improves substantially. Second, it makes no allowance for the possibility of failure—no reduction in the unemployment rate—despite the fact that extensive asset purchases have so far not produced a substantial improvement in the

outlook for labor markets. There is an assumption that some level of asset buying or use of other tools will produce substantial improvement in the labor market. Third, there is ambiguity about the Fed’s response to a possible rise in inflation. Is the labor market to improve substantially without a sharp increase in inflation? Or is the suggestion that if inflation picks up, asset buying and other measures will stop? The answer to these questions is not clear from the opaque reference in the Fed statement to “a context of price stability.”

There is more. The Fed also expects that the highly accommodative monetary policy

stance will be warranted for another three years or more—at least through mid-2015—because such a stance should be maintained for a considerable time after the economic recovery strengthens. This is a bold commitment because, once again, the risk of allowing inflation momentum to rise in a recovering economy is essentially ignored. If the economy does pick up, it will be good news for banks; the yield curve should steepen rapidly as real interest rates and expected inflation rise and push up longer-term rates while the Fed continues to hold down short-term rates. The steeper yield curve should boost bank profits, but if expected inflation rises and pushes up long-term rates while the economy is recovering, history shows that the Fed may be unable to contain a sharp increase in longer-term interest rates.

The Fed has taken bold steps by hinting strongly that it will be slow to tighten once the economy recovers and by betting that tolerating signs of higher inflation for a bit longer will not require a sharp reversal of accommodation to avoid embedding higher inflation expectations into nominal contracts including interest rates and wages. We are looking at a “whatever it takes” monetary policy that may result in a much weaker dollar and higher gold and stock prices as the United States exports deflation (stronger foreign currencies) into a world of weak demand growth. The underlying picture of weak demand growth is underscored by what appears to be a slowing Chinese economy. Whatever the outcome, the

range of possibilities is much greater now than before the Fed's bold September 13 statement.

How Will Extra Asset Purchases Lower the Unemployment Rate?

Given the high stakes attached to the Fed's effort to lower the unemployment rate with an open-ended commitment to asset purchases, it is important to understand how these measures might actually work. There are two channels: what we will call a "portfolio balance channel" and a "wage hiring channel." Both depend largely on the ability of a policy to affect prices in unexpected ways, specifically to boost inflation faster than workers or lenders expect. Initial results are likely to be more positive than longer-term results. Sustaining a positive outcome requires inflation to keep rising faster than markets expect. The risk of much higher inflation is part of QE3+, and the Fed's willingness to take that risk is supposed to provide the extra boost for the economy over traditional policy.

First, consider briefly the Fed's version of the portfolio balance channel. The Fed's aggressive purchases of mortgage securities are designed to push down interest rates while raising the prices of mortgage securities and inducing investors to buy riskier assets like stocks and houses. The value of these assets increases, and households and firms feel better off, causing them to spend more money on goods and services. The increase in demand for goods and services signals to producers the need for an increase in output to satisfy the demand. Firms hire more labor to increase output, and employment rises.

This version of the portfolio balance channel probably characterizes the initial stages of QE3+. However, considerable uncertainty is attached to the implications of an inflation rise that occurs before the desired impact on interest rates or employment is achieved.

The second channel, the wage hiring channel, is tied directly to the Fed's stated goal of producing a substantial improvement in the outlook for labor markets. QE3+ can increase employment by affecting real wages. If the increased demand for goods and services resulting from QE3+ boosts prices faster than wages can rise, a feasible outcome at first since wages are often set by contracts that require time to renegotiate, then the inflation rise

lowers real wages and causes firms to demand more labor. However, the process begins to atrophy when labor catches on and bargains more aggressively on wages. Unless persistent asset buying by the Fed keeps boosting inflation by a faster pace than wages increase, higher inflation has no impact on real wages and a sustained positive impact on employment is not likely to occur. By requiring a substantial improvement in labor markets before ceasing asset purchases, the Fed is running the risk that additional doses of QE3+ will end up just boosting inflation without helping the labor market.

If inflation continues to rise while labor market conditions do not improve, eventually the Fed will need to withdraw extra stimulus or risk further bouts of still-higher inflation. Belief in the Fed's commitment to low and stable inflation will atrophy, forcing the Fed to withdraw QE3+. This would return the Fed to stopgap measures that the commitments implicit in QE3+ seek to avoid.

Both interest rates and real wages will respond to QE3+ in a way that will undercut its effect as inflation rises. Interest rates consist of a "real" component and an expected inflation component. Roughly speaking, an interest rate of 3 percent may imply a real rate of 1.5 percent and an expected inflation component of 1.5 percent. Because the Fed's focus on labor market conditions means that the wage hiring channel will ultimately require inflation to rise faster than wages to induce more hiring, lenders will come to expect faster inflation and require higher interest rates to compensate them for an expected loss of purchasing power in future interest receipts. Borrowers will likewise be willing to pay the higher rates because of an inflation-induced reduction in the real inflation-adjusted cost of borrowing.

The important thing to realize is that if the Fed pursues QE3+ consistently even after inflation starts to rise, interest rates will rise and the value of existing fixed income assets will be reduced. The cumulative effect of the so-called portfolio balance effect would be reduced and could be eliminated.

Higher interest rates also cut the value of existing holdings of debt, including government debt. Investors who purchased ten-year Treasury bonds yielding just 1.5 percent interest returns this summer will see a sharp reduction in the value of those bonds as interest rates rise and so demand higher interest rates against future

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higher expected inflation. The substantial benefit that the government has reaped on low-interest debt will begin to erode, and higher interest costs on government debt will increase the deficit. A rise in expected inflation that exceeds actual inflation—if the Fed continues QE3+ even after inflation rises, for example—

will boost the debt-to-GDP ratios, other things equal (for a given primary deficit). Somewhat ominously, during the days immediately following the September 13 announcement of QE3+, interest rates on longer-term government bonds rose, along with most measures of expected inflation. The increase was about thirty basis points, from about 2.75 percent on thirty-year government bonds to 3.05 percent. Part of the increase was probably a result of asset reallocation away from government bonds and into stocks, as relative performance was expected to improve given higher inflation.

However, as holders of government bonds get more nervous about still-higher inflation, selling pressure will increase and bonds will be sold more aggressively, raising borrowing costs. Eventually, even stocks fail to benefit from higher inflation as costs begin to rise more rapidly relative to prices.

Along with rising expected inflation, QE3+ was followed by a general weakening of the dollar against foreign currencies. A weaker dollar leads foreigners to sell dollar bonds, including the large portion of Treasury securities they own, further pushing up borrowing costs in the United States. The weaker dollar may, of course, help boost growth by boosting net exports, but it also risks creating higher interest rates as foreign holders of US bonds sell them off.

QE3+ Is a Risky Experiment

The initial impact of QE3+ is likely to be positive: employment may rise at first, and interest rates may fall because suppliers of labor and lenders will be slow to raise their expectations regarding the pace of inflation. But since “success” in the form of better labor market conditions (higher employment) or a lower burden of debt (lower debt-to-GDP ratio) requires inflation to exceed expectations so that real wages earned by

workers or real interest rates earned by lenders fall as inflation rises, workers and lenders will raise inflation expectations more quickly over time.

Eventually, expected inflation rises as fast as or faster than actual inflation, and easy money has only a transient favorable effect. Another round of positive results requires inflation to rise even more quickly to “fool” workers and lenders. The result would be a deanchoring of stable inflation expectations and an eventual period of rapidly rising inflation and interest rates like what characterized the late 1970s and early 1980s.

Given that unattractive outcome, the Fed would be forced to avoid sharply higher inflation by engaging in a long and costly process of tightening monetary policy to reanchor inflation expectations at a low level. That process could involve returning the Fed to a single mandate—price stability—that explicitly precludes it from employing monetary policy to affect real variables like growth and employment. Ironically, the application of QE3+, with its aim to use monetary policy to improve labor market conditions, may ultimately result in a prohibition, via a single mandate for price stability, of a link between monetary policy and labor market conditions.

Finally, it is important to remember that the chances of success with QE3+ are not zero. If the Fed can raise wealth-enhancing asset purchases and hiring by displaying a willingness to risk higher inflation but not permanently boosting inflation expectations, the economy will be better off a year from now than it is today. QE3+ is an operation analogous to walking a tightrope over Niagara Falls. Success will be exhilarating, but failure will be ugly.

Note

1. Michael Woodford, *Methods of Policy Accommodation at the Interest-Rate Lower Bound* (Paper presented at Jackson Hole Symposium, August 31–September 1, 2012), www.kc.frb.org/publicat/sympos/2012/mw.pdf (accessed September 18, 2012).

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