# Fed Policy Is a Drag on the Economy

By John B. Taylor

As they meet this week, Federal Reserve Chairman Ben Bernanke and his colleagues will be looking at an economic recovery that has been far weaker than expected. Early in 2010 they predicted that growth in 2012 would be a robust 4%. It turned out to be a disappointing 2%. And as the recovery fell short of their expectations, they continued and then doubled down on the emergency interventions used in the panic in 2008.

The Fed ratcheted up purchases of mortgage-backed and U.S. Treasury securities, and now they say more large-scale purchases are coming. They kept extending the near-zero federal funds rate and now say that rate will remain in place for at least several more years. And yet—unlike its actions taken during the panic—the Fed's policies have been accompanied by disappointing outcomes. While the Fed points to external causes, it ignores the possibility that its own policy has been a factor.

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At the very least, the policy creates a great deal of uncertainty. People recognize that the Fed will eventually have to reverse course. When the economy begins to heat up, the Fed will have to sell the assets it has been purchasing to prevent inflation.

If its asset sales are too slow, the bank reserves used to finance the original asset purchases pour out of the banks and into the economy. But if the asset sales are too fast or abrupt, they will drive bond prices down and interest rates up too much, causing a recession. Those who say that there is no problem with the Fed's interest rate and asset purchases because inflation has not increased so far ignore such downsides.

The Fed's current zero interest-rate policy also creates incentives for otherwise risk-averse investors—retirees, pension funds—to take on questionable investments as they search for higher yields in an attempt to bolster their minuscule interest income. The low rates also make it possible for banks to roll over rather than write off bad loans, locking up unproductive assets. And extraordinarily low rates support and feed the spending appetites of Congress and the president, increasing deficits and debt.

More broadly, the Fed's excursion into fiscal policy and credit allocation raises questions about its institutional independence and accountability. This reduces public confidence in the central bank.

The large on-again off-again asset purchases have already created highly variable money growth—from 10% in January 2009 to 2% in June 2010 and back to 10% in early 2012 and then down again. Wide swings in money supply reduce macroeconomic stability—a danger that Milton Friedman warned about long ago.

There is yet another downside. Foreign central banks—whether they like it or not—tend to follow other central banks' easy-money policies to prevent their currency from appreciating sharply, which would put their exporters at a disadvantage. The recent effort of the new Japanese government to force quantitative easing on the Bank of Japan and thus resist dollar depreciation against the yen vividly makes this point. This global increase in money risks commodity booms and busts as we saw in 2011 and 2012.

When dissenters in and outside the Fed point out these costs, a majority of the Federal Open Market Committee—the main policy-making branch of the central bank—respond that the costs are outweighed by a huge benefit. They argue that the ultralow interest rates and asset purchases reduce unemployment by increasing aggregate demand, and they back up the argument with macroeconomic models.

But these models, which are useful for evaluating conventional monetary policy such as rules for the interest rate, were not designed and are not useful for evaluating the Fed's unconventional policies of the past few years. Instead, a basic microeconomic analysis shows that the policies perversely decrease aggregate demand and increase unemployment while they repress the classic signaling and incentive effects of the price system.

Consider the "forward guidance" policy of saying that the short-term rate will be near zero for several years into the future. The purpose of this guidance is to keep longer-term interest rates down and thus encourage more borrowing. A lower future short-term interest rate reduces long-term rates today because portfolio managers can, in a form of arbitrage, easily adjust their portfolio mix between long-term bonds and a sequence of short-term bonds.

So if investors are told by the Fed that the short-term rate is going to be close to zero in the future, then they will bid down the yield on the long-term bond. The forward guidance keeps the long-term rate low and tends to prevent it from rising. Effectively the Fed is imposing an interest-rate ceiling on the longer-term market by saying it will keep the short rate unusually low.

The perverse effect comes when this ceiling is below what would be the equilibrium between borrowers and lenders who normally participate in that market. While borrowers might like a near-zero rate, there is little incentive for lenders to extend credit at that rate.

This is much like the effect of a price ceiling in a rental market where landlords reduce the supply of rental housing. Here lenders supply less credit at the lower rate. The decline in credit availability reduces aggregate demand, which tends to increase unemployment, a classic unintended consequence of the policy.

Research presented at the annual meeting of the American Economic Association this month by Eric Swanson and John Williams of the San Francisco Fed is consistent with this view of credit markets. It shows that during periods of forward guidance, the long-term interest rate does not adjust to events that shift supply or demand as it does in normal periods. In addition, while credit to corporate businesses is up 12% over the past two years, credit has declined to noncorporate businesses where the low rate is more likely to be a disincentive for lenders. Peter Fisher, head of fixed income at the global investment-management firm BlackRock and a former Fed and Treasury official, wrote in September: "[A]s they approach zero, lower rates . . . run the significant risk of perversely discouraging the lending and investment we need."

Ironically, the harmful effects of these interventions lead policy makers to expand them, which further increases their harmful effects. No one should want a continuation of this vicious circle.

If the economy surprises a bit on the upside this year, we can hope that it results in fewer interventions by the Fed—perhaps a halt to asset purchases. This will bolster growth and help put the economy on a sustained recovery path.

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