OPINION

Once Again, the Fed Shies Away From the Exit Door

By John B. Taylor

The Federal Reserve's liquidity operations during the 2008 financial panic represented good central banking: providing loans when markets freeze up. But instead of simply letting those programs expire as the panic subsided, the Fed embarked on its first quantitative easing program (QE1)—large-scale purchases of mortgage-backed securities and Treasurys—trying to stimulate the housing market and the economy.

After that, I warned on these pages in September 2010 about the dangers of "another large dose of quantitative easing" that would raise "more uncertainty about how it will ever be unwound."

Since then the Fed has injected two more massive doses of quantitative easing: QE2 starting in November 2010 and QE3 starting late last year. Then, last month, Fed Chairman Ben Bernanke let it be known in a news conference that the old QE3 (purchasing $85 billion of Treasury bonds and mortgage-backed securities a month until labor market conditions improve substantially) would taper into a new QE3—in which purchases would likely slow by the end of 2013 and stop in the middle of 2014. The turbulent reaction in the markets showed that the predicted dangers from unwinding would be real.

The Fed has justified its policies as a means of helping the economy recover. Yet economic growth has come in at less than half what the Fed predicted with all its unprecedented interventions during the past four years, and growth remains under 2% so far this year. Some at the Fed blame other factors for this terribly weak recovery—the latest excuse being cuts in state and local government purchases. But those cuts are the *result* not the cause of the weak economy as tax revenues have slowed.

> Its policies aren't working, but many believe that unwinding now is too costly. Just like in the 1970s.

A growing number of economists, former central bankers and senior government officials—including Martin Feldstein, Paul Volcker, Allan Meltzer, Raghu Rajan, David Malpass and Peter Fisher—have now concluded that the Fed's policies are not working. Critics want the Fed to return to a more rules-based monetary policy.

Meanwhile, the global monetary system is starting to fracture. Central bankers around the world, especially in emerging markets such as Brazil, India and South Africa, have experienced adverse spillovers of Fed policy on their currencies and economies. To prevent sharp fluctuations in the value of their currencies and volatile inflows and outflows of capital, they have had to deviate from good policy.

The Bank of Japan's recent move toward a policy of massive quantitative easing is a good example. Following the 2008 financial crisis and the weak recovery, the yen significantly appreciated against the dollar as the Fed repeatedly extended its quantitative easing. A new government was elected in Japan in December in part because of the currency issue. Immediately after the election the government asked the Bank of Japan to match the Fed with its own quantitative easing; this is exactly what it did.

Other governments and central banks have imposed capital controls to limit the inflow of capital and the appreciation of their currencies. But capital controls interfere with firms' investment decisions and cause instability as people try to circumvent them—which leads policy makers to seek even more controls to prevent the circumventions. Alarmed by these developments, the Bank for International Settlements, the central bank of central bankers, called last month for an investigation of these spillovers and international monetary policy coordination.

With so many voices rising in objection, some might assume that it will be just a short time until the Fed changes course. Unfortunately, this assumption is unwarranted based on the experience of the late 1960s and 1970s.

In 1968, Milton Friedman explained the folly of the view that permanently lower unemployment could be achieved through easier monetary policy. At first, his view was adopted by a small minority. By the mid-1970s, there was consensus that easy money was not achieving its economic growth or employment goals.

Then the argument shifted to "yes, we agree that the policy is not working, but it is too costly to end." The economy was performing adequately; shutting the money spigot would just make things worse. Yet unemployment and inflation only increased.

It was not until Paul Volcker became chairman of the Federal Reserve in August 1979 that the Fed's excessively easy monetary policy came to an end. Mr. Volcker's resolve was buttressed by new economic models based on rational expectations and price rigidities which showed that the costs of ending easy money were far less than what the pessimists said. These models also predicted that a change in Fed policy would eventually help bring about lower unemployment—which is what the change in Fed policy did help to bring about in the 1980s and '90s.

There's a parallel with today. More policy makers and economists are coming to realize that the Fed's unconventional monetary policy is not working. Yet there is also a sense that unwinding is too costly right now and can't be reversed.

We witnessed this recently with hints about the end of quantitative easing. When Mr. Bernanke mentioned that quantitative easing—today's version of the easy money of the 1970s—will taper off, the market reacted negatively. Many commentators and pundits claimed that tapering will adversely affect the economy and needs to be delayed. Members of the Federal Open Market Committee also came out publicly to say that serious tapering can be put off until later.

The minutes of the June FOMC meeting were released this week. Those minutes, accompanied by Mr. Bernanke's remarks on Wednesday, made it clear that unless a modern-day Paul Volcker soon appears, the return to conventional monetary policy is still a long way off.

Mr. Taylor is a professor of economics at Stanford University, a senior fellow at the Hoover Institution, and a former Treasury undersecretary for international affairs.