

# THE FED NEEDS TO CHANGE COURSE

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This article describes the Federal Reserve's monetary policy, examines its economic impact, and discusses possible exits. Federal Reserve policy is on the wrong course: it is harming economic growth, hurting savers, damaging markets, setting dangerous precedents and misallocating capital away from job-creating parts of the economy. The Fed's September 2012 policy change, in which it announced a third round of quantitative easing (QE3), was a major increase in the aggressiveness of monetary policy and, in my view, another drag on economic growth.

The best exit strategy would be for the government to adopt growth-oriented tax, spending, and regulatory policies in parallel with a growth-oriented Fed resolve to provide sound money and downsize its role in the economy. The combination would encourage investment and hiring in the U.S. private sector. The damage from the Fed's balance sheet holdings and its imposition of zero percent interest rates would diminish, allowing the development of sound money, market-based allocation of capital, and forward-looking private sector confidence—an expectation that the Fed would interfere less with interest rates and debt markets.

## The Fed's QE3 Monetary Policy

In its September 2012 meeting, the Federal Reserve said it anticipated keeping the fed funds rate near zero through mid-2015. It approved a new program of quantitative easing, dubbed QE3, to

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purchase agency mortgage-backed securities (MBS) created by Fannie Mae and Freddie Mac and guaranteed by them and the U.S. government—at a pace of \$40 billion per month.

The Fed also said it would continue Operation Twist through year-end in which the Fed sells shorter-term Treasury notes to buy longer-term notes and bonds. When Operation Twist ends, the market anticipates that the Fed will expand its asset buying to maintain roughly the same rate of long-term Treasury purchases.

By itself, the size of the QE3 monthly purchases is relatively small—below the monthly rates during the \$600 billion in MBS purchases launched in December 2008, the \$1.75 trillion in follow-on QE1 purchases starting March 2009, and the \$600 billion in Treasury bond purchases in QE2. However, the Fed's QE3 purchases are large in the context of the agency MBS market. On the Fed's announcement of QE3, the market heavily bought agency MBS, generating substantial profits for market participants and driving the MBS price up and the yield down in anticipation of the Fed becoming a major new buyer. Mortgage rates were already very low, but the Fed's hope was to lower them a bit more to encourage the housing market and to raise the price (lower the yields) on similar securities.

In addition to shifting its large-scale asset purchases from Treasuries to agency MBS, the Fed made other policy changes in September 2012. It left its QE3 purchases open-ended in terms of timeframe and amount and made ambitious statements that it would continue to expand its QE policies until the labor market improves. The Federal Open Market Committee (2012) noted: "If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency-backed mortgage securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability."

The FOMC's statement also said it anticipated very low interest rates through mid-2015 and planned to delay rate hikes even after the economic recovery takes hold: "The Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens."

This pushed further into the future the rate-hike timing that Chairman Ben Bernanke had laid out previously. Speaking of the timing of rate hikes in his July 2012 congressional Q&A, he

said: “It will be a similar pattern to what we’ve seen in previous episodes where the Fed cut rates, provided support for the recovery, and when the recovery reached a point of takeoff where it could support itself on its own, then the Fed pulled back, took away the punch bowl” (Bernanke 2012a: 28). The most recent interest rate cycle saw a 4.75 percent cut in the fed funds rate from December 2000 to December 2001 followed by “measured” or limited 0.25 percent rate hikes every six weeks in 2004–06 (about 2 percent per year). My view is that the Fed didn’t take the punch bowl away fast enough in that episode, contributing materially to the financial crisis.

The Fed policy stated in Bernanke’s July Q&A was already a slower pace of rate hikes than some of the previous Fed thinking. In September 2009, Fed Governor Kevin Warsh stated that the Fed would take the rate cuts back “symmetrically,” meaning move them up at the same pace as the Fed had moved them down. According to Warsh (2009), “The speed and force of the action ahead may bear some corresponding symmetry to the path that preceded it.” Since rates were cut fast in 2008, the implication would be that at least some of the initial hikes would occur quickly once the crisis stabilized.

In combination, the Fed’s September 2012 policy change was a major increase in the aggressiveness of monetary policy. The Fed approved QE3 purchases, decided to buy MBS, made QE3 open-ended based on the unemployment rate, committed the Fed to new types of asset purchase in the event the labor environment doesn’t improve substantially, extended the formal zero-rate expectation to mid-2015, and expressed the Fed’s expectation that interest rates would be artificially low for a considerable time after the recovery strengthens—a further postponement of rate hikes from Bernanke’s July 2012 expectation of repeating earlier rate patterns and from earlier Fed references to symmetry in rate hikes.

In his September 13, 2012, press conference, Bernanke emphasized the importance of the Fed’s communication techniques in the effectiveness of the Fed’s tools. He said that assuring the public that the Fed will take action if the economy falters should increase confidence and boost the willingness to spend. This Fed assurance that it can protect the economy from slowdowns is often described as the “Bernanke put,” a reference to a financial derivative that provides protection against losses. It is named after the “Greenspan put,” on which equity and housing markets relied in the 2000s to justify high leverage ratios on the view that then-chairman Alan Greenspan

would hike interest rates slowly enough that asset prices were sure to increase. This confidence in the low-rate environment of 2004–07 gave rise to the view that banks and investors should “dance until the music stops,” which many did.

In his September 13 press conference comments on the fiscal cliff, Bernanke seemed to broaden further the sweeping nature of the financial system’s reliance on the Fed. He said he doesn’t think the Fed has the tools to offset the resulting downturn if the fiscal cliff occurs, and “we’d have to think about what to do.”

## Unprecedented Expansion

By November 2012, the fed funds rate has been near zero for almost four years, unique in history. At the same time, the Fed has expanded its balance sheet by \$2 trillion (from \$900 billion to \$2.9 trillion) through large-scale asset purchases during QE1 and QE2, and lengthened the duration of its assets during Operation Twist as it worked to push interest rates down toward zero for longer maturities.

The Federal Reserve’s balance sheet shows that sales of short-duration assets under Operation Twist caused it to run completely out of Treasury bills on August 1, 2012 (per the Fed’s H.4.1 statistical release). It marks the end of an era for the Fed’s once ultraliquid balance sheet. In just four years, the Fed’s balance sheet has been transformed from the world’s most liquid to the most mismatched in terms of maturities. Leveraged 50:1, the Fed uses an incredible \$1.6 trillion of bank reserves as primary funding for \$2.6 trillion in very-long-maturity assets while maintaining only \$55 billion of equity capital.

The Fed projects current policies will cause the average maturity of its bond portfolio to lengthen to 10 years. According to the New York Fed: “Once the maturity extension program [Operation Twist] is completed [at the end of 2012], the Federal Reserve will hold almost no securities maturing through January 2016” (Federal Reserve Bank of New York 2012). Thus, U.S. monetary policy has been reduced to the absurdity of the Fed first buying already very expensive long-term bonds under QE using overnight funding, then buying even pricier and longer-term bonds under Operation Twist and paying for them by selling all of its under-three-year assets.

The net result is that the Fed has accumulated trillions in high-grade duration from the private sector, neutralizing the issuance of long-duration instruments by the U.S. Treasury and government-sponsored enterprises. Under the Fed’s most optimistic transmission

theory, its hope is that the resulting reduction in duration in the private sector will somehow be stimulative by forcing the private sector into riskier and longer-duration credit despite the regulatory push toward safety and deleveraging.

The Treasury has extended the average maturity of the outstanding public debt to 64 months, but the Fed has been buying so much of the long-duration debt that the effective maturity of the public debt has fallen to 47 months—way too short for the world’s biggest debtor. This includes the combined effect of the Fed buying long-term assets and financing them with short-term liabilities.

On August 1, 2012, the Treasury announced that it is developing a floating-rate note program. If the Treasury increases its reliance on floating-rate funding, it would further reduce the effective maturity of the public debt. This will add to the fiscal deficit when the economy recovers and interest rates move back toward normal.

### Contractionary Economic Impact

By the Federal Reserve setting interest rates at close to zero and buying certain assets, the Fed is actually weakening the economy’s output by misallocating capital. The Fed’s policies have been raising the price of agency MBS, other government bonds, corporate bonds, and gold. None of these is a job creator. Capital flows to these higher-priced assets rather than allowing a market-based allocation of capital to job-creating businesses. My several articles in the *Wall Street Journal* and *Forbes* have connected this misallocation of capital to disappointing U.S. growth rates (see, for example, Malpass 2009, 2012, 2013). A *New York Times* story by Catherine Rampell (2012) captured the problem in this headline: “As Low Rates Depress Savers, Governments Reap Benefits.”

By underpricing credit for certain borrowers while applying regulatory limits on traditional lenders, credit ends up being rationed. The regulators overseeing the banking industry are, in effect, imposing a quota weighted against small and new businesses in their choice of capitalization and leverage requirements for different types of lending. It’s also been called “financial repression.” As low rates are pushed out along the yield curve, capital is increasingly misallocated toward government and big corporations. This shows up in declining growth rates and less economic dynamism.

Five-year TIPS yields generally reflect the economy’s real growth prospects, yet they are offering negative real returns, a sign of either

a massive monetary distortion or a very bad economic outlook. Even the 20-year TIP is showing a negative yield, meaning investors are locking in 20-year total pretax returns that are below CPI inflation, further evidence of a massive market distortion favoring the government at the expense of the private sector.

The national income data show the massive shift in income under way in the economy toward government payments and corporate profits and away from small businesses, sole proprietors, dividends, and interest earnings. Since 2006, transfers are up 46 percent and corporate income up an estimated 22 percent, whereas the other three components combined are up only 8.2 percent.

In the September 2012 FOMC statement, the Fed strengthened its forward guidance in the hope that it will encourage consumer spending and GDP, but the more pronounced effect is to discourage business investment. Under the new Fed policy, the weaker the labor market, the more government bonds the Fed will purchase. This threatens the private sector with an even more distorted capital allocation process, creating a feedback loop that discourages productive investment.

By buying bonds, the Fed has dramatically increased the monetary base, M0, which includes currency and bank reserves (the Fed's liabilities to commercial banks). It used to function as "high-powered money," as banks used their reserves at the Fed to back an increase in their leverage. In the current Fed expansion, however, there has not been a commensurate increase in the monetary aggregates or in private sector credit, and measured inflation remains low. Instead, the Fed's newly created liabilities have remained idle in the Fed's excess reserves. They earn interest for the banks and demonstrate a bank's safety and liquidity to the watchful regulators but are not used by banks to back an expansion of their balance sheets.

The effect on the money supply of current monetary policy differs from historical experience. Traditionally, newly created base money would lead to a multiple expansion of the M2 money supply. Bank reserves are counted in M0 but are not considered money in calculating the M2 money supply, which comes from bank leverage, not the Fed. Since the 2008 financial crisis and the change in bank regulatory policy, M0 has grown in line with Fed assets (as is normal), but M2 has grown much slower than M0 rather than faster. This outcome points to a de facto regulatory sterilization of the Fed's expansion of bank reserves that keeps them from being multiplied through the banking system.

Thus, QE hasn't caused much if any increase in M2, bank lending, or total private sector credit, so the Fed's impact has been a zero-sum shift in the mix of credit—any increase in corporate borrowing due to lower yields came at the expense of less credit for other parts of private sector credit (the regulatory rationing problem). The result is a channeling of credit away from job-creating sectors toward the government and corporate borrowers, making the Fed a contractionary force. Artificially low interest rates and bond yields hurt savers and capital allocation more than they help borrowers.

## Market Breakdown

The current policy is causing a weak and artificial environment and a progressive breakdown in the functioning of important financial markets. Through November 2012, the value of loans outstanding in the interbank market has fallen to \$10 billion from an \$80 billion level prior to the 2008 crisis. Similarly, the value of loans outstanding in the fed funds market (in which banks lend to each other with the Fed as counterparty) has fallen to \$100 billion from a \$400 billion level prior to the 2008 crisis. Once viewed as critical to efficient capital allocation, these markets will take time to rebuild when interest rates normalize.

With the Fed a heavy buyer of longer-maturity Treasuries, the yield on a five-year Treasury fell to 0.5 percent in July 2012. Except in the highly distortive monetary policy of the 1970s and the bubble policy of 2002–05, the five-year yield has generally tracked or exceeded nominal GDP growth, which has been running at 4.0 percent. The large gap gives a measure of the credit market distortion.

In sum, current Fed policy is contractionary by damaging markets, hurting savers, and rechanneling capital from job-creating parts of the economy to the government, big banks, big corporations, foreign investment, and gold—none of which are robust job creators. The result is that U.S. growth slowed through the end of 2012 even though the Fed has dramatically expanded its purchases and future purchase commitments.

Of course, not all of the economic weakness since 2009 is due to the Fed's policy. Some of the slowdown in U.S. growth owes to Europe's debt crisis, the year-end mega-tax increase risks at the end of 2010 and again in 2012, slowing growth in corporate earnings, and the slowdown in China. However, the longer the harmful monetary

policy persists, the more the weight on the economy, making the distortions more difficult to unwind.

## Costs of Fed Policy

Fed Chairman Ben Bernanke's August 31, 2012, Jackson Hole speech addressed some of the costs of the Fed's large-scale asset purchases and argued that the purchases had lowered bond yields enough to be economically meaningful. My view is that the net result of the current monetary policy has been a massive and growing distortion of credit markets that slows growth.

The chairman minimized four potential costs: that QE might impair the functioning of the Treasury market, create exit problems, cause an imprudent reach for yield leading to bubbles, and risk the Fed losing money. However, the speech didn't address other costs: that zero rates and QE distort market pricing, freeze the interbank market, create credit rationing by underpricing credit, and reallocate the flow of credit to the government, GSEs, gold, and large companies rather than job creators.

In quantifying the benefits of QE, Bernanke combined the impact of the Fed's 2008 crisis response and its subsequent actions. He summarized the conclusion of a 2012 Fed study: "The first two rounds of large-scale asset purchases may have raised the level of output by almost 3 percent and increased private payroll employment by more than 2 million jobs" (Bernanke 2012b).

In analyzing the impact of the Fed's crisis response, I think it is important to separate differently the two distinct phases in the Fed's expansion rather than using the QE1 and QE2 categories. The steps taken in the heart of the post-Lehman bankruptcy crisis were probably beneficial, including the reduction in the Fed funds rate from 2 percent to 1 percent in October 2008 and the November 2008 Fed program to unfreeze the conventional MBS market by buying \$600 billion in agency MBS and agency debt.

However, the policy continuation was probably contractionary, including the expansion of MBS purchases by \$1.75 trillion starting in March 2009 to form QE1, the \$600 billion QE2 started in November 2010, Operation Twist in late 2011, and QE3 launched in September 2012. The near-zero fed funds rate and the huge expansion of nontraditional measures in 2009–12 extended well after the end of the crisis, harming market-based capital allocation. Some are

framing this issue as “diminishing returns,” but I think the Fed has been achieving negative returns (Malpass 2010).

Chairman Bernanke’s 2012 Jackson Hole speech attributes the slow U.S. recovery to housing weakness, Europe, and a contractionary fiscal policy. Housing and Europe were negatives, but not large enough to explain the degree of U.S. weakness in GDP and job growth. Regarding fiscal policy, Bernanke cites as contractionary the decline in real purchases at the federal, state, and local levels. I think the contractionary aspects of fiscal policy were different: first, the imminent risk of tax increases at year-end 2010 and again in 2012; and second, the risk of future tax increases to pay for high growth rates in federal spending and national debt.

Regarding the “fiscal cliff”—that is, scheduled 2012 year-end spending cuts and tax increases—the Jackson Hole speech advised: “Policymakers should take care to avoid a sharp near-term fiscal contraction that could endanger the recovery.” I think it is imperative that policymakers separate the fiscal impact of government tax policies from spending policies rather than combining them into the concept of fiscal contraction in which spending cuts are treated the same as tax increases. Looking at 2012 year-end, tax increases would be contractionary, but spending cuts, especially given the current high levels of spending and debt, would encourage business investment and improve the growth outlook.

Bernanke concluded his 2012 Jackson Hole speech on an expansionist note: “The costs of nontraditional policies, when considered carefully, appear manageable, implying that we should not rule out the further use of such policies if economic conditions warrant. . . . The Federal Reserve will provide additional policy accommodation as needed to promote a stronger economic recovery and sustained improvement in labor market conditions in a context of price stability.”

## From Fractional Reserves to Credit Rationing

In the past, the Fed “injected liquidity” into the private sector by buying Treasury bills from the market when it wanted to loosen monetary policy. It paid by crediting the seller’s reserve account at the Fed, which was expected to be used. This added to the monetary base (M0). The private sector then multiplied the new reserves, using them to back multiple bank deposits which were used to fund new loans. Banks with extra lending opportunities could borrow reserves

from banks with extra deposits, maximizing the lending from a given Fed injection. The original injection caused a much bigger increase in the M2 money supply (which includes bank deposits) and usually in private sector credit. The banking system's leverage (the ratio of liabilities to capital) increased as the Fed injected more reserves and the regulators permitted more leverage in the banking system.

Inflation arose when the Fed injected too much liquidity relative to the output of the economy and regulators allowed too much bank leverage. With the advent of floating exchange rates, this weakened the dollar, raised the dollar price of gold, and increased nominal prices over time.

The current system works differently. Over the years, the fractional reserve system changed to a system of direct regulatory control over bank leverage and capital, with sporadic efforts to take risk into account. Rather than the availability of reserves, the binding constraint on a bank's lending activity shifted to price competition (based on lending rates) and the assessment of the bank's leverage ratios and capital adequacy by bank management and government regulators.

With near-zero interest rates, there's no price-based constraint, so credit ends up being rationed to various sectors of the economy by government regulators based on their assessment of the riskiness of various loans. This inevitably channels credit to the government and big corporations rather than through a market-based capital allocation process (see Malpass 2009).

Bernanke raised this capital allocation problem directly in his August 27, 2010, Jackson Hole speech: "Generally speaking, large firms in good financial condition can obtain credit easily and on favorable terms. . . . Bank-dependent smaller firms, by contrast, have faced significantly greater problems obtaining credit. . . . Through the provision of specific guidance and extensive examiner training, we are working to help banks strike a good balance between appropriate prudence and reasonable willingness to make loans to creditworthy borrowers" (Bernanke 2010). This points to a very government-intensive process of credit rationing that has been one of the root causes of slow growth and poor capital allocation in the 2010–12 period.

Regarding inflation under the new system, the regulatory mix is not allowing a rapid increase in bank leverage, a contrast with previous monetary stimuli. The concept of the Fed "printing money" as measured by the monetary base or the Fed's balance sheet footings

doesn't have the same meaning as in the past because powerful regulators encourage banks to maintain a level of bank reserves at the Fed higher than required reserves and the Fed is paying a higher interest rate on bank reserves than is available in interbank markets. As a result, the banking system is not operating through the old money multiplier function in which bank deposits were a multiple of bank reserves. With the banking system limited, the generation of private sector credits through other parts of the financial system will take time, leaving real growth and inflation muted.

### Exiting Bad Monetary Policy

Under quantitative easing, the Fed has bought trillions of dollars in long-duration bonds, paying for them with new Fed liabilities in the form of short-term interest-bearing reserves held at the Fed. The Fed's balance sheet expanded, but, unlike the old form of liquidity injection, the private sector balance sheet did not increase. Rather than QE providing stimulus, it is compounding the capital misallocation problem by trying to push more credit into high-grade corporate bonds. These are the very assets that were already the most favored by zero-rate credit rationing. It creates a triple-whammy: zero rates favored government and corporate borrowers, QE did the same, and Operation Twist further increased the deviation from market-based credit allocation. The ultra-low Fed rates also encouraged leveraged or speculative purchases of selected assets, including high-yield bonds.

In effect, the Fed is operating as a speculator, borrowing short and lending long while ignoring the conflict of interest this creates when it sets interest rates. The trade is profitable for the Fed as long as interest rates stay low, but is harmful to private sector growth.

The best exit would be for the government to adopt growth-oriented tax, spending, and regulatory policies in parallel with a new growth-oriented Fed resolve to downsize its role in capital allocation and commit to providing a strong and stable dollar. The combination would encourage investment and hiring in the U.S. private sector and would meet the Fed's mandate of maximizing employment by assuring price stability.

With clear communication from the Fed about its commitment to growth, sound money, and maximum employment, the Fed's balance sheet holdings and zero percent interest rate would not be as dangerous or as central to policy as they are now.

It may be useful to consider various ways to cordon off the Fed's monetary policy duties from its enlarged balance sheet. Part of the Fed's balance sheet can be thought of as a giant, heavily leveraged sovereign wealth fund or structured investment vehicle (SIV). It holds a massive maturity mismatch. It is unstable in part because the Fed is dependent on overnight funding (excess reserves) that is intertwined with commercial banks and regulators. There may be ways to separate the SIV from monetary policy. However, it will be important to avoid the big-government approaches chosen elsewhere. China used central bank resources to fund its sovereign wealth fund, creating a new center of government power. Japan uses its central bank to intervene in foreign exchange markets, but then holds the near-permanent assets (largely dollars) at the Ministry of Finance, funded by an increase in the national debt. This approach creates its own set of market distortions.

## Conclusion

The goal should be to allow the development of a growth-oriented policy based on sound money, market-based allocation of capital, and private sector confidence that the Fed will interfere less with interest rates and debt markets than it has been doing. In returning to a less distortive monetary policy, we should create a credit policy that reduces financial system risk, allows a more market-based allocation of credit, and preserves the Fed's monetary policy independence in the context of sound money.

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