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The Fed is wrong to put off the return to normality

(PDF Version)

The US Federal Reserve's decision last week to delay the start of its so-called "tapering" has confused investors about the reliability of its forward guidance. It has also created a trap that will make it difficult to start the tapering programme in the future unless the Fed changes its basic approach.

More specifically, Ben Bernanke, the Fed chair, explained that the Federal Open Market Committee (FOMC) had decided not to reduce its pace of bond-buying because current economic conditions were not as favourable as the FOMC members had expected in June. Looking ahead, he said the Fed could begin tapering later this year "if the data confirm our basic outlook".

That may be a difficult test to pass; the FOMC's projections in recent years have been repeatedly too optimistic. It looks as though they are repeating the mistake again. At the end of its recent FOMC meeting the Fed released a summary of the economic projections of the FOMC members – the governors of the Fed and presidents of the 12 regional Federal Reserve banks. The central tendency of these projections foresees real gross domestic product growth of 2.0-2.3 per cent for the 12 months starting with the fourth quarter of 2012.

That would be higher than the US economy has achieved in any of the past three years. For the first half of 2013 the official annualised GDP growth number is now only 1.8 per cent, and more than one-third of that growth was just inventory accumulation. Private estimates for GDP growth in the current third quarter are at about the same level. To reach the midpoint of the FOMC's central tendency range for this year as a whole would require the growth rate to jump to an annualised rate of 3.2 per cent in the fourth quarter.

Looking further ahead, the FOMC projections call for a growth rate of between 2.9 per cent and 3.1 per cent in 2014. That forecast is already a substantial reduction from the range of 2.9 per cent to 3.5 per cent that the FOMC was predicting less than two months ago. As we get closer to 2014, the prospects for that year are likely to look weaker again.

As Mr Bernanke noted, the rise in long-term interest rates since May is likely to depress the pace of residential construction, the strongest sector in the past year. Consumer spending is likely to remain weak because real after-tax income per capita is lower now than it was a year ago. A fall in the household saving rate has helped to sustain consumer spending but leaves little scope for a further decline in saving to boost future spending. Making the start of tapering depend on the economy achieving the Fed's optimistic outlook is therefore likely to lead to another decision to continue the current pace of bond-buying.

It is hard to argue with the Fed's approach that its economic policy should depend on the data. But it is equally hard to reconcile a strategy of multiyear forward guidance with policies that are sensitive to changes in month-to-month economic news.

There is a better strategy that would allow the Fed to start tapering in October and end bond-buying by the middle of 2014. The Fed has stated that the pace of bond-buying should reflect a balancing of the benefits that the policy achieves in strengthening employment and growth against the costs that they impose on the economy. Putting that into practice would justify – indeed require – the Fed to begin tapering.

Although the initial burst of bond-buying may have helped to stimulate demand in 2010 and 2011, the current strategy is now doing very little to stimulate economic growth and employment. At the same time, continuing to buy long-term bonds and promising to keep the real short-term rate below zero even after the economy has returned to full employment have serious costs. They distort the investment behaviour of individuals and institutions, driving them to reach for higher yields by taking inappropriate risks. They lead banks to make riskier loans in order to get higher returns. The longer this process of abnormally low rates continues, the more disruptive will be the return to normal conditions.

It would be wise, therefore, for the Fed to shift away from its focus on short-term data, to recognise that it has achieved as much as monetary policy can do, and to start at its next meeting on a path to stabilise the size of its bond portfolio.

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