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Fed joins ECB in a high-risk move

The Federal Reserve has now embarked on a very dangerous strategy, buying $40bn of mortgage-backed securities each month for an indefinite number of years. That could lead to high inflation, to destabilising asset bubbles and to legislative changes that limit the Fed's future powers.

The Federal Open Market Committee has announced that it will continue those purchases for as long as "the labour market does not improve substantially" and will maintain "a highly accommodative stance of monetary policy ... for a considerable time after the economic recovery strengthens". It specifically noted that its highly accommodative stance would continue at least until mid-2015, implying nearly $1.5tn of increased bank liquidity.

Although economic weakness now prevents inflationary price increases, these conditions will not last forever. At some point, demand will increase and companies will recover the ability to raise prices. Such price inflation has historically been associated with tight labour markets and rising wages. But this time the unprecedented high level of long-term unemployment could cause the unemployment rate to remain high even when product markets tighten.

The Fed has locked itself into a policy of monetary ease for as long as the unemployment rate remains high. Although the FOMC said that its policy would be conducted "in the context of price stability", it is clear that its real focus will be on unemployment.

And even when the Fed wants to start raising interest rates to reduce inflationary pressures, Congress is likely to object if the unemployment rate is still high. Although the Fed is technically independent of the White House, it is legally accountable to the Congress. The recent Dodd-Frank legislation showed how Congress can limit the Fed's powers. Faced with the alternative of antagonising the Congress, the Fed might delay in raising interest rates to control incipient inflation. The result could be significant increases in inflation and in inflation expectations.

The FOMC justifies its unprecedented easing by pointing to the persistently high rate of unemployment. Indeed, the current rate would still be at the 9.1 per cent level of a year ago if the number of people looking for work had not declined sharply during the year. But the weakness of the labour market is not a reason for taking the risks of an excessively accommodative monetary policy if the resulting lower interest rates will not stimulate demand and employment.

Under current conditions, the Fed's new policy is not likely to strengthen the economic recovery. Mortgage rates are at record lows and home sales are already up sharply. Other potential

homebuyers are blocked by tough credit standards (that is, by the need for a high credit score) rather than the level of mortgage rates. Lower mortgage rates may spill over to reduce rates on corporate debt but large businesses with enormous cash balances are reluctant to invest and to hire because they fear future tax increases. Many small businesses, which depend on local banks, are unable to secure credit because their banks lack the capital needed to increase lending.

The clear impact of the Fed's easing has been to raise share prices, a key part of the Fed's quantitative easing strategy. Ben Bernanke has pointed to this as the "portfolio balance channel" by which monetary easing increases household wealth and therefore stimulates consumer spending. Although that worked in the fourth quarter of 2010 after the last round of quantitative easing, its favourable effect on gross domestic product only lasted for one quarter, followed by an annual growth rate of less than 0.5 per cent in the first quarter of 2011. The danger now is that an economic downturn or a rise in interest rates to normal levels could cause share prices to decline sharply.

European observers of the Fed's recent decision may see similarities with the new open-ended strategy of the European Central Bank. The ECB will buy short-term Italian and Spanish bonds without any limit on the amount for as long as those countries have economic adjustment plans approved by the European Commission and the European Stability Mechanism. In doing so, the ECB can substantially reduce the interest rates on the sovereign debt of those countries, helping them to grow but removing the discipline that the bond market has had on their fiscal actions.

Once the process of buying large amounts of sovereign debt has begun, the ECB will face a difficult choice. Italy and Spain may improve their policies but they are also likely to stray, at least to an extent, from whatever plan they have agreed with the commission and the ESM. When that happens, will the ECB stop buying their bonds, allowing their interest rates to rise sharply? Or will it accept the deviations from plans and thus weaken their incentive for fiscal reform?

In short, the ECB, like the Fed, is now locked into a high-risk strategy.

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