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The Fed's Dangerous Direction

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The Federal Reserve is heading in the wrong direction. What the central bank describes as "unconventional monetary policy" is creating dangerous bubbles in asset markets that will lead to higher future inflation and is supporting the explosive growth of the national debt. Its new "communications strategy" will, moreover, only further confuse markets.

The Fed's recently announced plan to buy $85 billion a month of government bonds and mortgage-backed securities will keep long-term interest rates at historic lows, with a 1.6% yield on 10-year Treasurys and a negative yield on 10-year TIPS (Treasury Inflation-Protected Securities). The Fed sees its strategy as a way of boosting the prices of equities, real estate and other assets. It has indeed boosted asset prices, although the increase in individual balance sheets has had very little positive impact on real economic activity.

Once the Fed stops buying securities, however, interest rates will rise and asset prices, including stock prices, will fall. This will have serious adverse effects on investors, particularly highly leveraged institutions and pension funds.

Long-term interest rates are also likely to rise in the future because of the higher inflation induced by the Fed's current policy. Because of the Fed's purchases of bonds and mortgage-backed securities, commercial banks have $1.4 trillion more in reserves than is legally required by the size of their balance sheets. The banks can use these excess reserves to create loans and deposits, which will increase the money supply and fuel inflation.

For now, the banks are content to leave their excess reserves at the Fed in exchange for a low rate of interest. But the day will come when aggregate demand is increasing, companies want to borrow, and the banks are willing to lend aggressively. When the increase in money starts to cause a rapid increase in prices, the Fed will need to limit the banks' credit creation by raising the interest rate it pays for banks to keep their reserves at the central bank.

That is the "exit strategy" that Fed Chairman Ben Bernanke and others are counting on to prevent future inflation. Unfortunately, no one knows how high rates will have to go to restrain the commercial banks.

Moreover, because of the large number of very long-term unemployed, unemployment may remain high even as prices climb. And so, just when the Fed should act to tighten the money supply, there will be strong voices in the Federal Open Market Committee emphasizing the Fed's dual mandate to achieve "maximum employment" as well as price stability. Congressional leaders are also likely to warn that raising interest rates while unemployment is still high could cause Congress to punish the Fed with new restrictions. These pressures may cause the FOMC to delay in raising rates, allowing inflation to get out of hand.

Although Mr. Bernanke and others at the central bank declare their commitment to price stability, the Fed's new "communications strategy" runs the risk of undermining public confidence in the Fed's

approach to policy. After its December meeting, the FOMC announced that it would keep the federal-funds rate at its current near-zero level until the unemployment rate is less than 6.5%—as long as the predicted inflation rate between one and two years ahead is no more than 2.5%.

The rationale for this radical announcement was discussed last month in a brilliant lecture by Janet Yellen, vice chair of the Fed, at the University of California, Berkeley. She explained that it approximates the optimal path for a dual-mandate monetary policy that is implied by simulations with the Fed's macroeconometric model of the U.S. economy.

This communications strategy may be persuasive to a small group of academic specialists and others versed in modern monetary theory. But the Fed's statement and the actions it implies will confuse the general public and undermine confidence in the bank's commitment to price stability.

In the first place, the Fed's new approach appears to raise the inflation threshold above 2%. Moreover, at his news conference after the December FOMC meeting, Mr. Bernanke made it clear that there is both flexibility and ambiguity in how the central bank will apply this new approach. It won't judge labor-market conditions by the unemployment rate alone, and its expectation of inflation will reflect a variety of indicators.

It will be difficult for the public to understand what the Fed is trying to do, and even technical monetary experts will be unable to anticipate when and by how much the Fed will change the federal-funds rate. The outlook for monetary policy is further confused by the Fed's comment that the new unemployment and inflation guideposts apply only to the fed-funds rate and not to the Fed's purchases of Treasury bonds and mortgage-backed securities.

The final problem with the Fed's unconventional policy is perhaps the most obvious. By keeping long-term interest rates low, it removes pressure on Congress and the Obama administration to deal with budget deficits.

The deficit has increased to 7% of gross domestic product this year from 1.5% in 2007. The ratio of debt to GDP has doubled in that time to 73%. Even if the president's original proposed budget was enacted and accomplished all the deficit reduction that the administration claims, the debt-to-GDP ratio would still be above 70% in 2022 and would be expected to rise after that. The Fed, in short, has killed the bond vigilantes before they could have forced Congress to act.

The Fed would do well to gradually end its program of buying long-term securities and shift its communications to a simple statement that it will do whatever it takes to achieve long-term price stability.

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