The Fed’s monetary policies since 2008 have undermined the creation of a growth-producing economic environment.

In June, much to the consternation of financial markets, the Chairman of the Federal Reserve, Ben Bernanke, warned that the current program of Quantitative Easing (QE) would likely come to an end in 2014. But has this measure been effective in stimulating recovery? Looking at QE’s record, Steven Horwitz argues that by paying a small amount of interest on reserve balances, the Fed has discouraged banks from lending, leading to a de facto bailout program. Now, the Fed faces the very real problem of how to avoid inflation as QE ends and recovery begins.

With the US economy experiencing an extremely slow recovery from the recession of 2007-09, debates over the role of monetary policy have come to the forefront, especially given the variety of new powers and unorthodox strategies that the Federal Reserve has adopted in the last few years. Despite its continued attempt to stimulate aggregate demand with additions to bank reserves designed to keep interest rates low, the ongoing attempts at expansion have yet to produce much of a recovery.

One reason for the ineffectiveness of the injection of reserves is that almost immediately after the onset of the crisis, the Fed decided to begin to pay a small amount of interest on the reserve balances that banks keep there. The most obvious explanation for the Fed’s decision to do so is that as long as that rate is above the yield on safe assets, it will have a contractionary effect on the money supply by encouraging banks to hold rather than lend their reserves.

Restricting bank lending this way was almost certainly the rationale for this policy change because it occurred simultaneously with the Fed injecting capital into failing banks. Those capital injections were not only in violation of the long-standing central bank principle of “lend to good banks at penalty rates” during a crisis, they also ran the risk of igniting inflation. Interest on reserves helped offset that threat by encouraging banks to sit on the new reserves. The conjunction of these two policies also suggests that the clear purpose of those capital injections was about bank solvency not bank liquidity. That is, the point was to rescue failing banks, not to expand the money supply per se. If the goal were the latter, why offset the capital injections with interest payments on the reserves they created?

A little bit later, in the fall of 2008, came the start of “quantitative easing,” or the large-scale purchase of financial assets, often at longer terms than standard expansionary policy. Quantitative easing has been adopted in countries where short term interest rates have fallen to near zero and where clearing junky assets off bank balance sheets was seen as a worthy goal. The hope is that by increasing the quantity of reserves, the policy will lead to lending and spark growth, often by bringing down longer term interest rates. However, this depends on banks having viable lending options in a low interest rate and low growth economy, and it requires that those options are superior to the rate the Fed is paying on those reserves. Four years into quantitative easing, most of the reserves that were created are still sitting in banks’ accounts at the Fed, costing it more in interest each round. Unorthodox monetary policy will not work where the rest of the economic environment is not conducive to expectations of good returns on loans.

Quantitative easing has also raised a number of other concerns. As with all expansions of bank reserves, the most serious danger is inflation. The combination of interest payments on reserves and a dearth of safe investment opportunities in the market has led banks to accumulate massive quantities of excess reserves, preventing much of the expansion of the monetary base from entering the spending stream in the
form of an excess supply of money. The Fed keeps pouring in liquidity but the size of the vessel expands, preventing reserves from spilling over into the spending stream. This cannot go on forever. Should the yields on alternative assets rise, perhaps due to a widening real recovery, and unless the Fed is willing to raise the interest rate on reserves and the Treasury is willing to bear the cost, the drag coming from that rate will be insufficient to keep reserves in the banks.

To some degree, the Fed wants those excess reserves to enter the spending stream, and to make up what it is beginning to understand as a shortfall in nominal GDP, but the challenge will be keeping matters to that much and no more. Much has been made about the viability of any “exit strategy” the Fed might have: how will it get the excess reserves out before they lead to inflation? If it cannot, inflation may be a significant problem down the road.

Wrapping up quantitative easing in 2014 is long overdue. There are now more than enough reserves in the banking system to support recovery, if only banks were willing to lend them. In fact, the big challenge upon ending QE will be the problem noted above: how to avoid inflation as the economy restarts. Simply selling back to the banks the assets the Fed has purchased won’t do the trick because many of them remain junky and are likely to be bought only at a major discount from the prices the Fed paid. That difference means those re-sales can’t get out all the reserves the Fed has put in. So while wrapping up QE is a necessary start to avoiding the problem of inflation, figuring out how to reduce the Fed’s balance sheet, which has more than tripled since 2008, is the bigger challenge.

In addition, more attention will have to be paid to the real economy and the various factors that are creating the uncertainty that is making banks hesitant to lend and firms unwilling to borrow and invest. The reserves are there, but economic climate is not conducive to the lending necessary to spark real recovery.

For now, QE continues to be mostly a way to bail out financial institutions with underperforming mortgage backed securities. Fed purchases of such assets have enabled banks and others to get these assets off their books in exchange for reserves offering a very small but still positive rate of return. To that degree, QE3 is a de facto bailout program, and does indeed need to be brought to a close. In addition, the Fed’s determination to keep interest rates near zero reduces the incentive for households to save, which is the opposite of what is needed after the destruction of so much capital in the housing boom and bust. Sustainable economic recovery requires real savings by households and a regulatory environment with known, stable rules that facilitate new investment. The Fed’s policies of the last few years have undermined the creation of just such a growth-producing environment.

For more on these issues, see Steven Horwitz’s Mercatus Center publication An Introduction to U.S. Monetary Policy.

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