The Fed’s tapering gives us the chance to focus on the economy’s real problems

Last week, in his final press conference as Chairman of the Federal Reserve, Ben Bernanke announced that the Fed would be ‘tapering’ its program of buying Treasury and mortgage-backed securities (also known as quantitative easing or QE) by $10 billion a month starting January. **Steven Horwitz** *argues that this move has been long overdue as the Fed’s policy of QE has had limited effect on the economy and has created a significant inflationary risk if the economy does begin to grow again. He writes that the Fed’s next challenge will be to determine how it can offload the trillions worth of reserves it now holds.*

The Federal Reserve’s recent decision to begin to taper off its quantitative easing (QE) program is long overdue. QE was a mistake from the beginning and the risks it created will outlast the continuation of the program as its effects cannot be as easily unwound. Ending QE will also allow us to focus on the real problems causing the slow recovery, which have little to do with the need for more expansionary monetary policy.

Quantitative easing has not been particularly effective over the last five years in the US. The Fed has tripled its balance sheet, mostly by purchasing assets of dubious quality, but unemployment has remained at or above 7 percent and there have been few signs of a sustainable private sector driven recovery. Meanwhile, the asset purchases associated with QE have pumped trillions of dollars into bank reserves, creating a significant risk of inflation if the economy does begin to grow again and banks start to lend them out rather than hold them, as has been the case. If banks have been holding back because of perceived problems in the economy, and those perceptions change, they would have plenty of reserves to lend, potentially leading to high rates of inflation.

The combination of ineffectiveness and risks associated with long-term inflation are two good reasons to not just taper off the purchases associated with QE but to try to start unwinding them. More generally, the belief that monetary stimulus was important to recovery was misguided from the start. The argument that the slow recovery was due to a lack of aggregate demand that could be remedied by monetary expansion had at least some plausibility for the first year or two, but after that, the advocates of that position need to explain why enough time has not passed for nominal variables to adjust to the lower aggregate demand. If labor and capital continue to be idle after two or three years, much less five, of aggregate demand stimulus, then at some point we should entertain the hypothesis that the problems are with the real economy. It should not have taken five full years to have seen this point, and more attention should have been paid to fiscal and regulatory barriers to recovery in the first place.

The reaction of the US stock market to the tapering announcement suggests that US investors are also welcoming the end of QE, if only because of the reduced uncertainty about the future path of monetary policy. The next challenge for the Fed will be to figure out how to unwind the trillions it has added to reserves through QE. It is tempting to say it can just sell back what it bought, but no one is going to buy most of those mortgage-related assets at anything close to the price that the Fed paid for them. The difference between those prices is the net increase in reserves that the Fed would leave in the banks. Selling those assets might help, but the question of who will buy them at any decent price makes it unlikely to help all that much. The Fed could also use conventiona open market operations to reduce reserve holdings, but that would require selling off a large quantity of US government bonds, again at lower prices which would, in turn, imply significantly higher interest rates. It is not clear the Fed wants to go this way either.

The Fed could also choose to increase the interest rate it is paying on bank reserves as a way to at least prevent the existing reserves from being channeled into spending and inflation. It won’t remove those reserves, but might dampen their effect. Of course the problem here is that this affects fiscal policy: those interest payments come from the federal government’s budget eventually and it’s not clear there’s a willingness to take on that burden.

Perhaps the best outcome of the tapering of QE is that it will take our attention away from monetary policy and aggregate demand and get it re-focused on the real economy and the ways in which excessive regulation (such as Dodd-Frank and the Affordable Care Act) and other forms of uncertainty about the future course of policy and the underlying rules of the economic game are undermining capital formation and job creation. I would argue these are the real problems with the US economy and, while tapering off QE is a good way to weaken a bad policy, the only path to recovery is one in which markets are freed up to reallocate the misallocated resources of the prior boom and put the economy back on a path of sustainable growth.

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