Quantitative Easing and Proposals for Reform of Monetary Policy Operations

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Abstract

Beyond its original mission to "furnish an elastic currency" as lender of last resort and manager of the payments system, the Federal Reserve has always been responsible (along with the Treasury) for regulating and supervising member banks. After World War II, Congress directed the Fed to pursue a dual mandate, long interpreted to mean full employment with reasonable price stability. The Fed has been left to decide how to achieve these objectives, and it has over time come to view price stability as the more important of the two. In our view, the Fed's focus on inflation fighting diverted its attention from its responsibility to regulate and supervise the financial sector, and its mandate to keep unemployment low. Its shift of priorities contributed to creation of the conditions that led to this crisis. Now in its third phase of responding to the crisis and the accompanying deep recession - so-called "quantitative easing 2," or "QE2" - the Fed is currently in the process of purchasing $600 billion in Treasuries. Like its predecessor, QE1, QE2 is unlikely to seriously impact either of the Fed's dual objectives, however, for the following reasons: (1) additional bank reserves do not enable greater bank lending; (2) the interest rate effects are likely to be small at best given the Fed's tactical approach to QE2, while the private sector is attempting to deleverage at any rate, not borrow more; (3) purchases of Treasuries are simply an asset swap that reduce the maturity and liquidity of private sector assets but do not raise incomes of the private sector; and (4) given the reduced maturity of private sector Treasury portfolios, reduced net interest income could actually be mildly deflationary.

The most fundamental shortcoming of QE - or, in fact, of using monetary policy in general to combat the recession - is that it only "works" if it somehow induces the private sector to spend more out of current income. A much more direct approach, particularly given much-needed deleveraging by the private sector, is to target growth in after tax incomes and job creation through appropriate and sufficiently large fiscal actions. Unfortunately, stimulus efforts to date have not met these criteria, and so have mostly kept the recession from being far worse rather than enabling a significant economic recovery. Finally, while there is identical risk to the federal government whether a bailout, a loan, or an asset purchase is undertaken by the Fed or the Treasury, there have been enormous, fundamental differences in democratic accountability for the two institutions when such actions have been taken since the crisis began. Public debates surrounding the wisdom of bailouts for the auto industry, or even continuing to provide benefits to the unemployed, never took place when it came to the Fed committing trillions of dollars to the financial system - even though, again, the federal government is "on the hook" in every instance.

Keywords: Quantitative Easing, Monetary Policy, Fiscal Policy, Macroeconomic Stabilization, Interest Rates, Central Bank Operations

JEL Classification: E42, E43, E62, E63

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