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Easy, queasy money

In the view of **Andrew Smithers**, the Fed seems to be biased towards growth and less concerned than it should be with the risks incurred by pushing up asset prices

The central banks of Japan, the UK and the US have been giving priority to stimulating demand because they believe their economies are operating below optimum level. The usual way would be to lower short-term interest rates but, as these rates are already near zero, central banks have to choose between doing nothing, which appears ineffective, and employing new forms of monetary policy.

The new policies involve buying vast quantities of assets in the programmes called quantitative easing (QE), and publishing more information about their plans and expectations ("forward guidance"). Approaches, however, differ from country to country. The Bank of Japan is using massive QE but no forward guidance. The Bank of England has halted, but not reversed, its QE programme and is now relying on forward guidance, while the Federal Reserve is still expanding QE but threatening to start reducing the size of its monthly purchases ("tapering"), while using a lot of forward guidance.

Both QE and forward guidance are controversial. Among the influential economists who have expressed doubts about QE are Charles Goodhart (see, for example, C.A.E. Goodhart and J.P. Ashworth, *QE: A Successful Start May Be Running Into Diminishing Returns*, Oxford Review of Economic Policy, 2012). Another who has written on the subject is Bill White (see W.R. White, *Ultra Easy Monetary Policy and the Law of Unintended Consequences*, Federal Reserve Bank of Dallas, 2012).

There are worries about both QE's effectiveness and its dangers. I am particularly concerned about the dangers that come from pushing up asset prices. The financial crises of the past – 1929 in the US, 1990 in Japan and the recent one – were all caused by excessive levels of debt and triggered by sharp falls in asset prices. Given that debt levels today have barely fallen from their pre-crisis highs, driving up bond and share prices to dangerous levels, as has occurred in the US, risks creating the conditions for another crisis (as I argued in a recent book, *The Road to Recovery – How and Why Economic Policy Must Change*).

In my view, the key concern of monetary policy, particularly in the US, should be to bring down asset prices slowly so that we can avoid the sharp falls that precipitated crises in the past. Unfortunately, the chief aim of central bankers is to stimulate demand. Together with the IMF, the OECD and other official forecasters, central banks believe that output could rise above trend for some time before absorbing the unused capacity of labour and capital.

> The more forecasts made, the more likely they are to be wrong

The Fed and the BoE have set this out in terms of the level to which they think unemployment can fall without creating inflation. This is known as the non-accelerating inflation level of unemployment (NAIRU). In their forward guidance, they have stated that they propose to keep interest rates at their current near-zero levels until unemployment has fallen to NAIRU levels.

Central banks are not the only entities that can tighten monetary policy: markets can, too. If bond yields rise, even though short-term rates are unchanged, this will probably weaken demand, as it raises the cost of borrowing, which deters investment – particularly in the US where rising bond yields increase the cost of mortgages for buying houses. Both QE and forward guidance are aimed at keeping bond yields down to prevent markets tightening policy.

QE does this by buying bonds, and forward guidance by seeking to persuade the market that a rise in short-term rates will be long postponed. Markets know that central banks aim to keep inflation under control but may have a very different view from central bankers as to when this will require interest rates to rise. Forward guidance aims to prevent markets from having premature expectations about the timing of such increases.

As we have seen in the UK, however, markets often disagree with the views of central bankers. When Mark Carney, BoE governor, produced his first forward guidance announcement, the market showed instant disbelief. Instead of bonds and the exchange rate weakening, they strengthened.

Central banks are no better than markets at forecasting the economy and, the more forecasts they make, the more likely they are to be wrong. Policy must depend on the data available. Unexpected events must lead to unanticipated policies and the best prediction we can make about events is that some of them will be unexpected. There is a widespread view that central banks need to communicate their intentions clearly, but forward guidance involves adding complexity. In its absence, central banks need to make difficult judgments about future inflation, but not strong predictions about the real economy. With forward guidance, both the BoE and the Fed have made forecasts of future unemployment. This complicates things and complication is the enemy of clarity.

Central banks have a difficult job in forecasting inflation. Forward guidance involves two additional and unnecessary risks. The first is to the already damaged

reputations of central banks as forward guidance increases the number of ways in which their forecasts can go wrong. As we have seen on both sides of the Atlantic, the more words are used to clarify intentions, the more blurred the message becomes.

The second risk is that the market assumes that all this talk represents a diminution of central bankers' determination to contain inflation. This makes a rise in inflationary expectations, in the event of a pick-up in prices, more likely and means that when interest rates need to rise they will have to go up more sharply than would otherwise have been necessary.

The BoE and the Fed have both expressed views about the level of the NAIRU and said they do not expect to raise interest rates until this level is reached. At the same time, they have been seeking to stimulate growth. Unemployment has been falling quite rapidly in both countries, which implies that growth is already above trend and, if recent progress is extrapolated into the future, unemployment in both countries would fall to the estimated NAIRUs towards the middle of next year. This is far earlier than the central banks expect.

The Fed has said it will delay raising interest rates until unemployment falls to 6.5 per cent and that this was unlikely for 18 months or more – despite the buoyant forecasts it was then making that GDP would rise by 2.3-2.6 per cent in 2014 and by 3.0-3.5 per cent in 2015. In practice, of course, the Fed's forecasts may be wrong and it may not stick to its declared policy.

I think that both of these scenarios are likely. The predictions are likely to be wrong not only because this is the usual fate of forecasts but because they assume a sharp rise in productivity, of which, at the moment, there is no sign.

Since Q1 2013, labour productivity, measured by dividing the rise in GDP at constant prices by the increase in hours worked, has risen by only 0.3 per cent per annum. If productivity does not pick up, unemployment will fall to the Fed's target despite a growth rate that the Fed sees as inadequate. I doubt that the Fed will, in these circumstances, persist with its declared policy.

The general expectation is that the Fed does not wish to be buying bonds when interest rates start to rise. It will thus wish to end QE first and aim to be tapering well before then. There is much speculation about when this will start. The US budget crisis may have hit confidence and there are many who think that the economy was already slowing. It will probably take at least two quarters of data for the impact of the crisis to be assessed. It may not, therefore, be until around April in 2014 that we will be able to see whether the economy has slowed, whether productivity has improved and whether the labour force is

growing. Policy must always depend on the flow of information available.

The economy's progress determines monetary policy, but the data are seldom clear and their interpretation is biased by the hopes and expectation of central bankers. Today, the Fed seems to be heavily biased towards hoping for growth and less concerned than it should be with the risks of asset price rises and inflation.

There should be a good opportunity to test these concerns over the next six months. The forecasts of unemployment and growth made in June show that the Fed is confident that productivity will pick up sharply and that those currently uninterested in employment will become eager to work. While this may prove to be correct, it seems to me that this confidence reflects a strong leaning towards hope. The Fed's response to productivity data over the next six months will allay or reinforce these anxieties. If productivity remains poor despite steady growth, then the Fed should bring forward the point at which it expects unemployment to fall to its estimate of the NAIRU. If the Fed's policy guidance is on these lines, it will presumably indicate that QE will be tapered more quickly than appears planned. This would be likely to hit both bond and equity markets.

Last time the tapering of QE was aired by the Fed, both markets fell initially, though the composure of the equity market was quickly restored. This time, however, without a marked rise in productivity the optimistic forecasts for the economy would be absent and the impact on equities is likely to be more negative. This is probably also the Fed's own assessment and, as the response in June was a prompt tapering of the threat to taper, there will, I think, be a strong wish to ignore any continued weakness in productivity. The appointment of Janet Yellen as Fed chairman is likely to reinforce any tendency to ignore bad news. She is seen – rightly, to judge from her comments in the past – as a "turtle dove" who is willing to see inflation rise above 2 per cent.

Bad news on productivity, combined with continued moderate growth, will thus provide us with an important guide to Fed policy. If it results in interest rates rising earlier than foreseen, we can also expect tapering to be accelerated. This is likely to be negative in the short term for bond markets but less so in the longer term, as such signs of realism reduce the risks that the Fed will delay monetary tightening and allow inflation and inflationary expectations to become a mounting problem. The earlier the Fed acts, the less sharply will it need to apply the brakes later.

The concern is that, if demand remains weaker than desired, the Fed will postpone plans for tightening policy through tapering and raising interest rates, even if unemployment continues to fall. It is, of course, even more likely to delay if the economy slows.

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