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Tapering Without Tears

By Ronald I. McKinnon

With Hamlet-like indecision, Fed Chairman Bernanke is agonizing over whether to taper or not to taper. On May 22, 2013, Bernanke first broached the possibility that the Fed might taper off its program of quantitative easing—of currently buying about $85 billion per month of long-term financial instruments, mainly U.S. Treasury bonds. Although carefully hedged by suggesting that tapering would wait until the unemployment rate fell to 6.5 percent, his comments unsettled world financial markets. Over the next four days, long-term interest rates rose sharply, and foreign and domestic stock markets fell.

Subsequently, a chastened Fed chairman and several presidents of Federal Reserve district banks—including William Dudley of the Federal Reserve Bank of New York in September—suggested that tapering off would be deferred. On September 18, the Federal Open Market Committee chose not to taper. After these disclaimers, the bond market partially recovered. However, long-term interest rates (now near 2.6 percent on 10-year Treasuries) remain higher than before the tapering speech—with volatility also substantially higher.

Yet there is no doubt that the United States needs to spring its near-zero interest rate trap in order to avoid perpetual stagnation, where real returns on new investments are also driven toward zero. But is there an efficient way out of the trap that

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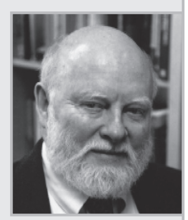
About The Author



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the Fed has set for itself?

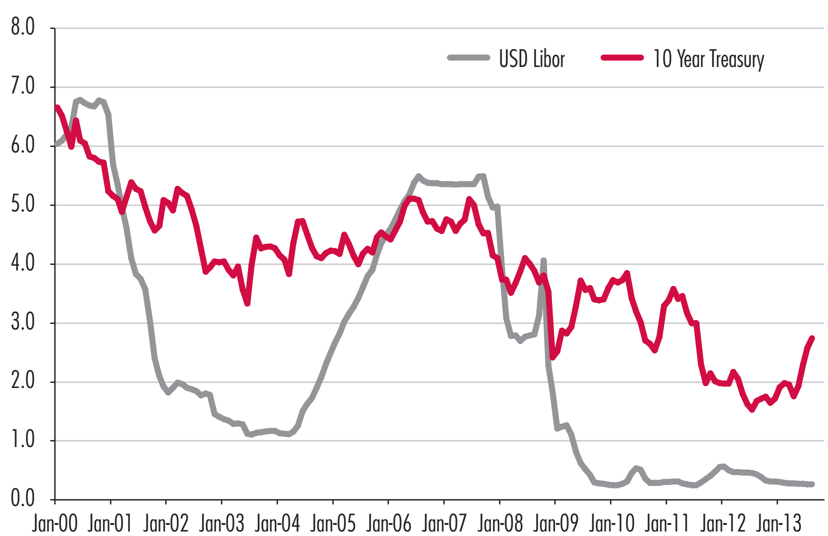
The trap has two related facets at opposite ends of the maturity spectrum. First is the short-term liquidity trap. Since December 2008, the U.S. Federal Reserve Bank has set its overnight interbank policy rate close to zero. This then bid down all short rates on Treasury and high-grade private financial instruments—including the infamous LIBOR, the uncollateralized London Interbank Offer Rate now nearing zero (Figure 1).

The second facet is associated with quantitative easing (QE) and the long end of the bond maturity structure. From the start of QE in 2009, the interest rate on 10-year Treasury bonds fell to well below 2 percent up to 2012 (see Figure 1), and stock markets remained buoyant. But after Bernanke's May 22 discussion of tapering off, the bond and stock markets slumped. Even with tapering off now on uncertain hold, long-term bond markets remain demoralized.

A better way of springing the trap is to start by raising short-term interest rates while leaving QE on hold at long term. Because the overnight policy rate is unambiguously under the Fed's control, the Fed should announce a schedule of slowly phasing in higher policy rates that would end after two years, when they reach some modest upper bound of, say, 2 percent. The current constraint on the supply of loan finance, which arises when nominal rates are near zero, would then be relaxed. Commercial banks with huge excess reserves would now lend them out for a modest return. With short rates even moderately greater than zero, the near moribund interbank market would spring back into life as a needed backstop for commercial banks extending their credit lines to nonfinancial enterprises large and small. And money-market mutual funds need no longer fear "breaking the buck" when they accept short-term deposits.

After a year or so, when the new program achieves credibility, but before reaching the 2 percent end point, the Fed could return to the problem of tapering off QE. We now know that just stopping QE, as initially

Figure 1
U.S. Interest Rates



Source: FRED

suggested in Bernanke's tapering speech, with future short-term interest rates being uncertain, leaves bond holders with no idea of what the equilibrium long-term bond rate will be. (I assume that simply leaving short rates at zero is not credible if only because it does so much damage to the financial system.) Ideally, however, if the new program of phasing in higher short rates capped at 2 percent becomes credible, this will anchor long-term interest rate expectations. When QE is phased out altogether so that the government no longer tries to influence long rates directly, an efficient free market would then set long rates at the average of expected future short rates—plus a liquidity premium. The liquidity premium could vary a bit with the ebb and flow of nonmonetary forces, but the mean long-term interest rate would be effectively pinned down once the market knew what the central bank plans to do: the importance of transparency.

What is the major objection to this new monetary program for freeing up the long-term bond market? Fed officials worry that the "recovery" from the subprime mortgage crisis and economic slump of 2008 is so weak that the economy can't withstand any increase in interest rates. After all, this general concern with economic weakness is what pushed the Federal Reserve into its near-zero interest rate trap to begin with—followed by the Bank of England, the European Central Bank, and the Bank of Japan. All four central banks in the mature industrial countries have fallen into similar traps and their economies remain sluggish.

What is at fault here is received macroeconomic theory. First, although reducing high interest rates to more moderate levels is stimulating for aggregate demand, going from moderate rates to zero imposes a supply constraint for financing investment that dominates any stimulating effect on aggregate demand. Second, fine-tuning monetary policy to target a nonmonetary variable, such as the level of unemployment, has become an ill-advised fetish. After all, Milton Friedman taught us in his famous 1967 AEA presidential address, "The Role of Monetary Policy," the central bank cannot (should not) persistently target a nonmonetary objective—such as the level of unemployment, which is determined by too many other factors.

The most straightforward approach now is for the leading central banks—the Federal Reserve, the Bank of England, the Bank of Japan, and the European Central Bank—to admit they were wrong in driving interest rates too low in the pursuit of a nonmonetary objective such as the level of unemployment. The four central banks could begin slowly increasing short-term interest rates in a coordinated way to some common modest target level, such as the 2 percent suggested above. Coordination is crucial to minimize disruptions in exchange rates. Then our gang of four should phase out quantitative easing so that long-term interest rates once again become determined by markets. The whole process should be transparent so that "markets" know the endpoints of this new policy.

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