FED'S QUANTITATIVE EASING THE RIGHT CALL

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The Federal Reserve's decision to initiate a third round of large-scale asset purchases, colloquially referred to as "Quantitative Easing" (or QE3), was absolutely an appropriate policy prescription.

The goal of the central bank's mortgage-backed security purchase programs is to keep mortgage rates low to entice consumers to purchase homes and refinance existing mortgages. The goal of treasury-backed security purchase programs is to drive bond yields lower to force investors into riskier assets like stocks. With the price of mortgages low and with their stock portfolios doing well, consumers feel wealthier and are more likely to increase their spending, thereby spurring an economic recovery and lowering the stubborn unemployment rate. This is what economists call "the wealth effect," albeit crudely simplified here. Another effect of an expansionary monetary policy is a weaker dollar, which makes U.S. exports more competitive in the global market. What distinguishes this new round of easing from the previous two rounds is that it is open-ended – the nation's central bank could decide to expand the program at any time and buy additional assets if the job market does not improve to its liking.

Congress and the executive branch have assigned the Fed a dual mandate – maximum employment and price stability. The Fed has a statutory obligation to take policy actions that aim to bring unemployment as close as possible to what economists call its "natural rate," which, post-Great Recession, stands at 5.2-6.0%. As of writing, the current rate is 7.9%, nowhere near where it ought to be. The academic literature and historical case studies are clear – loose monetary policy in the form of large-scale asset purchases and low interest rate targets are effective tools for creating the conditions under which output and employment rise.

What about that other half of the dual mandate? "Stable prices" means low inflation. Fed critics fear that such a loose monetary policy risks inflationary pressures, but with core inflation below the Fed's 2% upper bound target since 2008, and with banks holding excess reserves rather than lending them out – bringing money velocity to a 50-year low and still decreasing – inflation does not appear to pose an immediate threat to our economic recovery. There is also a de minimis threat of long-term inflation – for example, the "break-even inflation rate" is signaling that the market is anchoring its long-term inflation expectations close to two percent.

The commitment to maintaining loose monetary policy not only calmed stocks, but it also made them rally. Why? Because QE is raising expectations of economic growth. Improved economic growth means improved corporate profits. A rallying stock market should make union members, pensioners, and anyone else with a 401(k) cheer. In the 1970s, the Fed also took an expansionary monetary policy position, but that easing did not boost stocks because the market did not expect Fed actions to marginally improve the economy. The fact that 2012's market reacted positively indicates not only that further loosening was warranted, but also that QE3 will probably be effective in its mission of boosting output and employment in an environment of stable prices.

Another criticism against QE3 is that the Fed's low interest rates punish retirees and savers. But it is ultimately the weak economic recovery, not exclusively an expansionary monetary policy, that has been keeping interest rates low. If Fed action increases economic growth, then savers' positions will improve because interest rates will eventually rise, thereby increasing the return on savers' accounts. Indeed, by the market's own devices, long-term interest rates rose after the September announcement.

A final criticism of Fed actions charges that the central bank, by keeping interest rates "artificially low," is purposely allowing the federal government more breathing room to cheaply borrow money and run up higher and higher annual budget deficits. This assertion is utterly ill-informed. The Federal Reserve is an independent monetary policymaking organ insulated from political pressures. The legislative and executive branches handle fiscal policy. The actions the Fed takes to fulfill its dual mandate are based on solid economic models, not on short-term electoral calculations. Taxes, expenditures, international trade, deficits, and debt fall within the fiscal policy sphere – the onus is on Congress and the President to address the U.S.'s unhealthy balance sheet, not on the Fed. In making policy, politicians answer to voters and interest groups; the Fed answers to the laws of economics and historical case studies.

You go to war with the Army that you have, not the Army that you wish you had. Critics who take issue with recent Federal Reserve actions have the right to lobby Congress and the President for changes to the Fed's statute that include limiting its mandate to price stability only. But the Fed we have now is doing exactly what it must do in order to fulfill its existing dual mandate independent of political pressures.