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Martin Feldstein: The Fed Should Start to 'Taper' Now

There's little chance that more bond-buying will help the economy. Meanwhile, the financial risks are growing.

By MARTIN FELDSTEIN

The Federal Reserve should begin now to end its program of long-term asset purchases. It should not wait for the improved labor market that it predicts will come later this year, an improvement that is unlikely to occur. Instead, the Fed should emphasize that the pace of quantitative easing must adjust to the likely effectiveness of the program itself, and to the costs and risks of continuing to buy large quantities of bonds.

Although the economy is weak, experience shows that further bond-buying will have little effect on economic growth and employment. Meanwhile, low interest rates are generating excessive risk-taking by banks and other financial investors. These risks could have serious adverse effects on bank capital and the value of pension funds. In Fed Chairman Ben Bernanke's terms, the efficacy of quantitative easing is low and the costs and risks are substantial.

At his June 19 press conference, Mr. Bernanke described the Fed's plan to start reducing the pace of bond-buying later this year and to end purchases by the middle of 2014. He stressed that those actions are conditional on a substantial improvement in the labor market, leading to an unemployment rate of about 7% by mid-2014 with solid economic growth supporting further job gains. He emphasized that the "substantial improvement" would be judged by more than the unemployment rate.

Over the past year, unemployment has declined to 7.6% from 8.2%. However, there has been no increase in the ratio of employment to population, no decline in the teenage unemployment rate, and virtually no increase in the real average weekly earnings of those who are employed. The decline in the number of people in the labor force in the past 12 months actually exceeded the decline in the number of unemployed.

These poor labor-market conditions are unlikely to improve in the coming months. The Fed's forecast of substantial employment gains rests on the assumption that real GDP will grow by about 2.5% during the four quarters of 2013 and by more than 3% in 2014. That would represent a substantial rise from the growth rates of less than 2% in 2012, 1.8% in the first quarter of 2013, and a likely 1.7% in the second quarter. Reaching the Fed's GDP forecast for this year requires the growth rate to jump to more than 3% in the third and fourth quarters.

It is difficult to see how this can happen. U.S. exports are declining in response to weaker growth in other countries and a stronger dollar. The sequester and the higher tax rates that took effect on Jan. 1 will continue to reduce aggregate demand. These forces will more than offset the favorable but small effect on GDP from increased residential investment.

Corporate profits and nonfarm inventory investment declined in the first quarter, and nonresidential fixed investment was essentially unchanged. Spending by state, local and federal governments fell. Personal income declined and after-tax personal income declined even faster. The growth of GDP was sustained primarily by a faster pace of consumer spending that will be hard to maintain with stagnant earnings and a household saving rate that has dropped to only 3.2%.

The higher interest rates that followed the Fed's announced plans for tapering its bond-buying will further weaken GDP and employment. This will make it even more difficult for the Fed to achieve the robust labor market it says is necessary to scale back the bond purchases.

The Fed is also understating the impact of its tapering plan on interest rates. Mr. Bernanke has made it clear that he believes the level of long-term interest rates depends on the total stock of bonds held by the Federal Reserve, and not on the monthly rate of purchases.

But the planned shift from the current monthly bond purchases of $85 billion to zero over the next 12 months clearly had a large impact on long-term rates, pushing them to levels not seen since July 2011. This impact is hard to explain by any effect the tapering might have on the ultimate size of the Fed's bond portfolio. Mr. Bernanke admitted in his June 19 press conference that the very large jump in rates that has occurred was therefore a "puzzle."

The sudden jump in rates suggests that the Fed's statements acted as a "trigger" indicating that the low-rate equilibrium was coming to an end. Market participants have recognized that the interest rate on long-term Treasury bonds is unsustainably low. The real level of 10-year rates was negative until a few months ago and is now only slightly positive.

That real rate would normally be at least 2%. Given the size of the fiscal deficit, the relative size of the national debt, and the low rate of household saving, the real rate should now be significantly higher. Investors nevertheless continued to hold long-term bonds to gain a bit more yield, hoping they would be able to exit quickly before higher interest rates caused asset prices to fall.

Mr. Bernanke's congressional testimony at the end of May and again in June may have been the trigger that caused portfolio investors to start selling bonds, just as the observed problems with subprime mortgage securities triggered a much wider selloff in 2007. If so, long-term interest rates are likely to go higher.

Although interest rates have increased, they are still abnormally low. Investors and financial institutions are still accepting significant risks in order to enhance the yield on their portfolios by buying low-quality corporate bonds, holding longer-term bonds, making covenant-light loans that increase the risk to lenders by imposing fewer restrictions on borrowers. They are also bidding up prices of agricultural land and other assets.

The danger of mispricing risk is that there is no way out without investors taking losses. And the longer the process continues, the bigger those losses could be. That's why the Fed should start tapering this summer before financial market distortions become even more damaging.

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