The Fed and the Taper
Guest: Robert Murphy
July 15, 2014

Robert P. Murphy holds a Ph.D. in economics from New York University and is the author of numerous books. Read his blog at consultingbyrpm.com/blog.

WOODS: We've got to talk about the Fed here, because as you posted on your blog, the Fed has announced a tentative end to bond purchases in October, assuming that the economy doesn't collapse along the way. So I think a good way to start here is to explain what it is they are tapering from. They must have been doing something if they are going to diminish the doing of that thing. So here's what I want you to do, if you can keep all of this straight in your head. Explain what it is that they did in the first place and why they did it, and secondly, what it is that they are doing in the coming months as they continue the so-called taper that represents a departure from what they had originally said they were going to do to when they were tapering.

MURPHY: The main thing they've been doing is what's called quantitative easing. I think most of your listeners are vaguely familiar with that phrase, but just to make sure nobody gets left behind, it's originally the standard thing you would have learned if you took a macro class or you watched them explain on Slate.com or something about how does the Fed do monetary policy. They set interest rates, and lately it's been the federal funds rate, and so if the economy is doing poorly, what they do is they cut interest rates, and that's the thing you would expect. So when George W. Bush was in office, and there was the dot-com recession and things like that, when the Fed would meet, it would cut interest rates to try to stimulate the economy. But the problem was, after the financial crash and panic in the fall of 2008, that's what the Fed started doing, they started slashing interest rates, but they actually got interest rates down to basically 0%, short-term interest rates, the ones that they target, in nominal terms, and so you can't push nominal interest rates much lower than that, or it's unusual to do so. That's why they switched to what they called quantitative easing. So that term, what that means is that now they are going to start announcing what they are doing in terms of how much money they are spending [as opposed to what their interest-rate targets are].

So before this crisis hit, and you would read the newspaper about what the Fed was doing, they wouldn't tell you what the Fed was doing with the balance sheet. They wouldn't tell you how many Treasuries the Fed is going go and buy that month. People would have no idea. And I think partly that's because they didn't want people even thinking like that. They didn't want people realizing that the way the Fed manipulates interest rates was by buying and selling government bonds by creating money electronically out of thin air, as it were, and so I think that's partly why they did—it was good for them that people didn't know. But since the crisis hit, they have been doing quantitative easing, in which they announced to the public and investors: the Fed is going to go buy such and such hundreds of billions of dollars worth of securities or assets, and that's how you know we're on the job, and we're out there fighting for you. So what they've been buying typically since early 2009, and they had various rounds of it, and that's what people mean when they say QE1, QE2, and then now they say QE infinity. What they mean by those few phrases is that the Fed has different programs, and at first they were just announcing a set dollar amount thing. Our plan is to buy such and such amount of Treasuries and mortgage-backed securities over the next several months, and then they would do that. And lo and behold, that didn't fix the economy. Until finally, with what they had called QE infinity, that they meant that the Fed gave an open-ended announcement, they said we're going to buy at this rate per month, like $85 billion a month, let's say, until conditions improve. Finally, now with the so-called taper, that's because they're saying, you know what? The economy is starting to look a little better, and we realize we've got to stop, and we can't just indefinitely be buying $85 billion worth of stuff every month, that's crazy. And so we're going to start tapering down, and so this latest announcement, finally, they're saying as long as the economy doesn't fall off the rails, we expect the last major purchases will be this coming October. We'll do one last $15 billion purchase, and then we're done, and we'll just then hold the Fed's balance sheet stable, and we'll just monitor the situation.

WOODS: All right, so they're saying that these extraordinary measures that they have been taking were taken because of the severity of the situation that required outside-the-box thinking, required major surgery by the Fed, and they realized that because this is an unorthodox approach and because it's potentially dangerous what they're doing, at the earliest possible opportunity they will discontinue it. So what obstacles could they face here? Does it seem like they are just neatly wrapping things up, and economists like yourself who have been warning that the exit strategy from what they have been doing is not going to be quite so neat and clean, maybe you're being disproven there? It looks like they're going to unwind it and everything will be fine. Why will everything not necessarily be fine?

MURPHY: Okay, well, one minor clarification. They already have been tapering. As of right now in July, the total asset purchases this month—the target was $35 billion.

WOODS: Right, which is much lower, right.

MURPHY: Yeah, it might actually be a little bit less because I think they bought a billion more than they were supposed to last month.

WOODS: So it's even less this month, right.

MURPHY: But, so that's down $50 billion from where it had been at $85 billion, so they, especially since Yellen has come in, I don't know the exact time table off the top of my head, but they have been gradually tapering already, and so what they are just doing with this last clarification is saying they've been tapering it at $10 billion a month, and so since it's July, they are saying, well, if we kept doing that, it would be—

WOODS: All done in October.

MURPHY: It would be $25, then be $15, and so the question was are they going to do another $10 in October, meaning there would be $5 billion remaining in November, and so in the latest clarification they are saying, no, no, what we're going to do is just get rid of all $15 billion after the October purchases. In other words, we're going to taper to zero in November instead of just doing that last five.

WOODS: Right.

MURPHY: So that was what the news was. And what they had done, though, if you remember they did postpone a taper originally. In other words, they had been saying previously, back when Bernanke was still at the helmm it was over the summer, and they had been telling everyone they were going to start tapering in, is it like either late September or early October, and then but the market started, not tanking, but sliding in response to that, and so they postponed it, and then all of a sudden the market, you know, went through the roof, and everyone was like, yay! The Fed doesn't have cold feet, and thank goodness there's doves there now instead of these crazy hawks, and so people were cheering. But that's what really alarmed me because that told me the Fed is—if the stock market starts going down in response to the tightening, they are clearly going to go with what makes the stock market go up, so that's one thing. Now, the other main problem here is what was the alleged rationale of that, and I do agree in narrow terms—look at the assets they were buying. They were buying U.S. Treasuries and mortgage-backed securities. They weren't going out and buying underwater homes. They weren't going and giving loans to small business or something. They were propping up government and the big banks that were sitting on these mortgage-backed securities. And so to the extent that helped those institutions and that kept government interest rates down and propped up the housing market and the big banks' balance sheets, when they get out of that, there's an issue there. Is that going to make Treasury interest rates go up? Is that going to make the housing market collapse? Is that going to ruin the financial sector again? So there's that problem.

WOODS: Right, so in other words, buying the mortgage-backed securities helps to prop up housing, so then dumping a whole bunch of them on the market would thereby potentially depress housing.

MURPHY: Yeah, so that's the issue, but even there let's be clear. They're not going to start selling. All they're doing—the taper just means they are going to slowly wind down the net additions to their balance sheet. They're not selling anything. They're going to keep rolling that over. They make that clear in their minutes. The Fed is going to fill a hole of more than $4 trillion in assets and keep it there indefinitely until conditions warrant.

WOODS: Okay, so when they use the term exit strategy, when they talk about exit strategy, they are nevertheless talking about presumably at some point in the future not just tapering from what they have been doing with QE, but they are talking about unwinding the balance sheet and getting it down to normal, traditional levels overall, right? That is what their ultimate goal is. Eventually their ultimate goal has to be to sell, even if that's not what they're doing right now. Presumably eventually that is what the whole exit strategy discussion is about, is that they have to—they can't have this bloated balance sheet forever.

MURPHY: Yeah, you're exactly right, and part of the issue of why couldn't they just do this forever is they have trillions in what's called excess bank reserves, and so the commercial banking system—and this, again, if any of your listeners had been tortured and sat through a standard macro class in college. Where does money come from in our system? The Federal Reserve buys assets. That puts reserves into the commercial banking system. Now the commercial banks are legally allowed to issue loans, pyramided on top of those reserves. Depending on what number you use, there might be like a factor of 10, a multiplier of 10, and so since there's trillions of dollars of excess reserves in the commercial banking system, in principle, if the Fed just sat pat, and the economy returned to normal, lending opportunities returned, and commercial banks started getting more aggressive and comfortable with taking on bigger risks and started advancing loans, then it's not just the money that the Fed has already pumped into the system, but then there would be a multiple expansion of that, and so, yeah, most people agree the Fed can't just keep its current size of its balance sheet indefinitely, that that's way to big, and they do need to let it return to a more normal level, in terms of like the percentage of GDP: how big is it compared to the overall economy? In terms of metrics like that, right now, it is enormous.

WOODS: I want to shift gears for a minute because I want to ask you something that I keep forgetting to ask when I have David Stockman on, and Stockman has been talking an awful a lot about the so-called carry trade. He's been saying that artificially low interest rates give an artificial stimulus to the carry trade, and that this is fraught with peril. Now, there's a recent statement by Janet Yellen in which she indirectly acknowledges that this is indeed a side effect of the Fed's policy up to this point, but look, if we didn't have this Fed policy, there would be even worse consequences, so we more or less have to live with it, is what she's very indirectly saying. Are you able to shed light? I know I am off on a bit of a tangent, but if I don't say this now, I'm never going to remember it. Are you able to explain to us what this talk of the carry trade is all about?

MURPHY: Yeah, the general idea is that if there's low interest rates in one country, in one currency with certain bonds, and that there's higher interest rates elsewhere, then you can borrow in the cheap currency and then go invest in the other one and earn the spread. So if interest rates are real low in one currency borrow it. I'm just making up this number. You borrow it at 1% over here, and then you go earn 3% over there. And so that's fine as long as the currencies don't move against each other too much. And people can pile onto that and especially if the spread is not that big the way you would make money is you get real levered and you borrow a lot, and invest a lot, and as long as things don't move too much, you're fine. But the problem is, if interest rates move against you or if the currencies change, if the dollar weakens, then all of a sudden—it just depends which way the currencies move. So that's part of the issue, that people are engaging in these things that in the short-term are profitable. Obviously, that's why they're doing it, but if things move a little bit, it's going to disturb that equilibrium and people can get caught with their pants down. So that's part of it. Another main thing too is when people are talking about the pressures that the Fed and other major economies' low interest rate policies have been having on less developed economies, it's that if you're some country, and you had tied your currency to the dollar, let's say, and you were trying to peg it so that you didn't want to have price inflation in your own country, and then all of a sudden the Federal Reserve is lowering interest rates and is printing a bunch of money, well, then all of a sudden your country's currency would appreciate against the dollar, if you didn't do anything because now the dollar would fall, and so those countries are put in a weird position where they have to sort of debase their own currency to keep it from strengthening too much against the dollar and ruining their exports, at least in the short term.

Just to give you one other example. I do a lot of consulting work with insurance companies, life insurance companies, and when interest rates were really, really low, when Treasuries, you know, 10-year Treasuries and things were very low, that totally screwed up their whole business model. Because they take money from people and invest it so that they can pay them death benefits down the road. So if now all of a sudden, when they signed a bunch of contracts with people, they thought interest rates were going to be in a certain range, and now all of a sudden they are way lower than that indefinitely, that totally screws up their whole model, where just regular companies setting up pensions for people, if all of a sudden long-term interest rates are a lot lower than they thought they were going to be now all of a sudden all these pension plans are unfunded, not because the company was doing something irresponsible or embezzling funds, it's just because they made a bunch of projections about how much do they have to put aside to be able to pay these retirement benefits, and then boom, if they are earning several percentage points less per year than they thought they were going to, well, that's going to screw everything up. So yeah, the carry trade, all these other things I am bringing up are just incidental, sort of collateral damage from the Fed's decisions, and yet a lot of that just never even gets mentioned if all you're talking about is some real simple Keynesian IS-LM diagram, and say, well, people aren't spending enough, so we got to lower interest rates, duh.

WOODS: You're saying that once the, well, the taper supposedly comes to an end toward the end of this year, but then you still have the Fed with this enormous balance sheet that eventually also will have to be unwound, and that when that happens, you are going to see, it seems to be the case, much more extensive, and widespread, and significant consequences that a lot of observers, the Fed included, have been acknowledging up to now?

MURPHY: Yeah, that's exactly right, but with this stuff I should give the caveat that as I'm sure you know and many of your listeners may be familiar with, I was among the group of Austrian libertarians who thought we were going to see more severe price inflation than we have so far. So I just want to acknowledge that, but it's still—interest rates have been very low. In the Austrian theory of the business cycle, the problem with loose money is not simply, oh man, we're going to get prices rising faster than people like, and that's going to cause difficulty. That's not really the issue. The issue is the intertemporal discoordination of the capital structure and that the wrong sectors are going to be invested in, and that things are just going to be unsustainable. So you still have all those problems, but the fact that we've had interest rates pushed low for so many years has definitely made people make the wrong investment decisions. They have been trying to reflate the bubble. The fact that they haven't caused what looks to people like a booming economy, that doesn't mean that mistakes haven't been made. They have still have been making the wrong investment decisions in light of the fact that the interest rates have been wrong, so there's all those festering problems, and where I think you're going to see them really manifest themselves is when they finally let interest rates go back to where they should be, or at least close to where they should be.

I think this is going to actually manifest itself in the way it's going to appear to even the people running the Federal Reserve and the standard analysts on CNBC on how it's going to jump out at them and the way the problem's going to pop up is, what if they get into a situation where they do start letting interest rates rise, and then they start selling off, or just letting them mature, and then naturally unwinding that way, like, they don't roll over the proceeds when the bonds are holding mature until the Fed's assets start shrinking, and so interest rates start rising, mortgage rates start rising, and then maybe the stock market starts tanking and the real estate market starts tanking. But then what if at the same time consumer prices are rising because now banks start making more loans than they were before because interest rates across the board are rising and so they can earn more by lending to people then leaving the money parked at the Fed, and so they could be caught in this catch-22 situation where they want to keep interest rates really low, and they want to keep a stimulative Fed policy because the economy is bad, but yet the standard metrics of price inflation start taking off. So they've sort of been getting a free pass the last several years, where they're doing things that *prima facie* seem like outrageously stimulative monetary policy, and yet we don't have crude oil going to $150 a barrel. So a lot of the standard textbook reasons that economists would oppose further Fed action, they haven't had a leg to stand on because most economists, the reason the Fed shouldn't be too loose is that all of that might cause prices to rise too quickly.

WOODS: Yeah, and then when they didn't—

MURPHY: Consumer prices, yeah.

WOODS: Exactly, and then when they didn't, economists were all lectured to by the Krugmans of the world for being so backward and not seeing this.

MURPHY: Mhm. So it's ironic because what actually happened—one way that I'm interpreting it is Krugman, and I understand where he is coming from, he is saying give me a break. These economists have been against the Fed from the beginning, and they keep changing their story. In the beginning they were warning us about interest rates spiking and consumer prices taking off, and then that didn't happen, and now, the BIS and these other head-in-the-sand economists and these fuddy-duddy right-wing hawks keep changing their story, and now they are worried about assets all being overvalued, and the leverage problems, and the risks, and so forth. And I do see what Krugman's saying. He's right. They have sort of changed. But to me it's that they have common sense. They realize this is unsustainable. This can't be a good idea for central banks to be having these huge balance sheets for several years in a row with interest rates being held down. Now the ECB has literally negative interest rates. These economists have common sense, and they're realizing this is crazy, and their standard models that were very inadequate going into the crisis that Austrians would say, no, the problem's not price inflation, it's the sectorial imbalances and so forth, they realized, okay, yeah, that reason that we gave up front isn't quite right, and so they start thinking through more realistically about why the bad interest rates are kept artificially low for years on end, and since they are decent economists, they come up with something closer to what the Hayekian story was. So that's the way I would interpret it, is that these guys are good enough to realize that their crude models going into this thing were wrong, and so they're trying to come up with something that's closer to what the Austrian story was back in the 1940s. And Krugman is just saying, no, my crude model, I'm sticking to it, and I don't care. Yeah, that's funny. He relishes the fact that it produces such counterintuitive output as saying the Fed should just go ahead and buy stuff, the government can run trillion-dollar deficits, and it doesn't even matter what it spends the money on—that kind of stuff. Krugman relishes those apparently crazy outcomes. Whereas, these other guys that he opposes, they at least have the common sense to say, man, our mainstream models are spittin' out nutty answers. Maybe we should tell some verbal story that we can't really back up with our mainstream model.

WOODS: You know in one of our previous conversations we talked about a couple of people who had made the observation that, oh, yeah, you know, price inflation has stayed stable, and that's really great, so the policy is fine. But, you know, there seemed to be bubbles everywhere, huh, well, I guess that has no explanation. Well, maybe as you say, there's more to expansionary monetary policy than just price inflation. Maybe there are distortions that manifest themselves in other ways.

Now, I want to ask you one other thing before I let you go here. I have become skeptical, as I'm sure you have, every time I hear that some Fed official, whether it's some lowly economist or some top spokesman, predicted the housing bubble or predicted this or that. Because usually when you peel away the claims, they said some extremely minor or wishy-washy thing that could be taken either way. It's nothing like the robust predictions that we might have gotten from a Mark Thornton, let's say, on our side. So I want to read to you this passage from Janet Yellen, and you tell me is she fibbing here, or is she telling us the truth? She says, "Although it was not recognized at the time, risks to financial stability within in the United States escalated to a dangerous level in the mid-2000s. During that period, policymakers, myself included,"—those are the key two words, Bob—"were aware that homes seemed overvalued by a number of sensible metrics and that home prices might decline, although there was disagreement about how likely such a decline was and how large it might be." What do you make of that?

MURPHY: Yeah, it's this idea that Yellen—it wouldn't surprise me if she had said something along those particular lines, but you're right. If you went and looked in the context, she shouldn't be patting herself on the back. If people want to Google, if you do Bob Murphy, "yet more unimpressive evidence of the prescient Janet Yellen," I have a blog post on that where this was back when her name was being bandied about as a replacement for Bernanke, and it wasn't yet assured that she would be in there. So some of her backers on the progressive blogs and so forth were saying what a genius she had been—how she had seen the crisis well ahead of the other people on the Federal Open Market Committee. And so I went back and just clicked the hyperlinks and went and read the minutes, and she didn't even know that the U.S. was in a recession when it was already in a recession. Okay? So far from her being able to predict the problem, she couldn't even post-dict it.

WOODS: (laughs)

MURPHY: And so—

WOODS: Okay, that's the best line of the whole week on this show.

MURPHY: (laughs) The thing is, they're both right. The people saying Janet Yellen was very prescient compared to her peers certainly on the Federal Reserve when Bernanke was at the helm and me saying she wasn't very good at predicting. Those are both true statements, because the other people were worse than she was. She at least was saying, you know, maybe the economy is not so great, and then everybody was like, what are you talking about? And this is right where we were officially in recession, according to the way the NBER states those things. So yeah, I think you're right, Tom, that Yellen I'm sure made some scattered remarks—and the other thing, too, is just the way they phrase things. They always give themselves huge degrees of freedom, if you will—

WOODS: Oh, yeah.

MURPHY: So you can always, after the fact, go back and point to some clause in one of their sentences that makes it look like they allowed for that possibility, but in terms of were they letting people think in the fall of 2007 that within one year there was going to be something such that people were going to claim, oh, my gosh, we have to do all this stuff or else the whole credit system is going to collapse? No, not at all.

WOODS: Right, exactly, and it seems to me that when I read a speech by the Fed chairman—there are so many caveats in it that you could almost make a drinking game out of it. Like, every other sentence. We failed to anticipate this, but on the other hand that, or this could happen, but on the other hand, there's bad weather. It's always something. it's very, very rarely a straightforward statement. It's annoying but predictable at the same time.

Tell us about the great event that's taking place in the middle of next month, in August, in your city of Nashville, Tennessee.

MURPHY: That's right. It's August 15th, the night of clarity. You can go to nightofclarity.com to get all the details. It's right along the lines of what we've been talking about in this episode. Tom Woods is going to come. And I'm going to be there, and we're talking about crony capitalism, and also Larry Reed and Nelson Nash. The headliner is none other than David Stockman. We're going to give everyone an analysis of what's wrong with the U.S. financial system and offer some clues as to what individual households and business owners can do to protect themselves. So it's all at nightofclarity.com.