THIRD WAY

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The End of QE: What's Next for the Fed?

Third Way

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JIM KESSLER: Good morning, everybody. Happy last day of – well, it's not really the last day of the Congress; it's only the last day for a while for Congress.

We are honored to have as our guest Dr. Martin Feldstein. He's been called, quote, maybe the most influential economist of his generation by The Wall Street Journal, the father of supply-side economics by MIT economist Jon Gruber. In 2002 The New York Times wrote of at the time the president's economic advisers that, quote, they were disciples of Marty. And by "president," the Times didn't just mean the current president, George W. Bush, but Clinton advisers, H.W. Bush advisers and Reagan economic advisers as well. The Times added that, quote, he has built an empire of influence unmatched in the field.

From 1982 to 1984 Dr. Feldstein served as chair of the Council of Economic Advisers under President Reagan, where he expressed his views – sometimes to the delight of the administration, sometimes to the consternation of the administration. And before and after that he shepherded the National Bureau of Economic Research to be the most influential economic think tank in the nation, perhaps in the world.

The word "influential" is a constant whenever anyone talks about Martin Feldstein, but another word comes up as well, and that word is "teacher." He remains a classroom teacher of economics at Harvard. He counts among his former pupils and employees and admirers some of the greatest economic names on the right and on the left of the political spectrum – Larry Summers, Jon Gruber, Bob Reich, Austan Goolsbee, Paul Krugman on the left; Larry Lindsey, Glenn Hubbard, Greg Mankiw, many others on the right.

So Dr. Feldstein, we are honored to be in your class this morning, and thank you so much. (Applause.)

MARTIN FELDSTEIN: Well, thank you very much for all those nice words. This is an interesting challenge. I figured out how to stabilize the cup. Will it stay there? Maybe it's a little bit like the economy and monetary policy. (Laughter.)

Anyway, it's a pleasure to be here and to have a chance to talk with you about the Fed, Fed policy, where it is, where it's been and where it's going. We are indeed close to the end of quantitative easing. Bond-buying will end in October – of course, data-dependent, you can bet on it. Rates will start rising next year. So it really is a good time to look at what the Fed has been doing and what it's likely to do going forward.

I realize this is a very sophisticated audience but an audience with very different specific interests, so it makes it challenging to talk about the Fed policy and the mechanics of how the Fed is going to renormalize interest policy. So I think it's useful to begin by looking at how the current policy evolved before we look at where things are looking forward.

A good place to begin is with the peak in the economy that happened in December of 2007, beginning of the downturn that lasted until the summer of 2009, which made it very long, twice the average length of an economic downturn, and a very deep downturn. And even after the economy started back up, it's very, very slow to recover. So it's worth asking, because it was really key to understanding what the Fed did and was going to do, worth asking: Why was this such a different recovery from previous ones? Why did it take so long to get started, and why when it got started did it come back so, so slowly?

Previous recessions were very different from this downturn, the downturn that began in December of 2007. Previous downturns in the past half-century were basically caused by Federal Reserve tightening. Fed raised short-term real interest rates because it was concerned about inflation, either because it saw the inflation rate was already too high or because it was afraid that the inflation rate would increase, so it raised short-term real interest rates to slow the economy, take some of the pressure out. Sometimes that worked without an economic downturn, but sometimes it led to a recession. But in any case, once the Fed succeeded in dealing with the inflation pressures that caused it to raise interest rates, it brought those real short-term rates down, and the economy typically came back, bounced back, often led by increases in housing activity.

So this time the downturn was not caused by the Fed, and so lowering interest rates was not going to undo the downturn. What was it caused by? It was caused basically by a mispricing of assets – financial assets and real assets, including housing. Housing was a critical part of it. House prices were in a – in a growth path that could be seen to be a serious bubble. By 2006, by the summer of 2006, when house prices peaked, the level of house prices had increased by more than 60 percent, 6 -0, 60 percent above the historic trend. So it was clear that this was a bubble, and like all bubbles, it inevitably was going to burst.

And when it did, house prices came down very sharply. Now, that was a serious problem because at that time, so many homes had very high loan-to-value rate mortgages. Individuals had mortgages of 80 percent, 90 percent, a hundred percent, thanks to the so-called piggyback mortgages, where you got a basic mortgage and then a second mortgage on top of that to piggyback. Well, when house prices came down, those ratios of asset value to mortgage went from slightly positive to negative. Individuals found themselves underwater, owing more on the mortgages that they had than the value of their homes.

And then result, didn't too long to happen, was default, people defaulting on their mortgages, turning in the keys, walking away. And anybody who didn't know whether they could do it could go online. And there was a website, youwalkaway.com. Really true. Check it out. So people were doing this in very large numbers because – I can't remember the number now, but at its peak it was something like 40 percent of all homeowners with mortgages were underwater.

And the result was that the value of mortgages, the value of mortgage-backed securities and the portfolios of banks and others fell. And as those mortgage-backed securities fell, market participants recognized that the problem of mispricing of risk, the mispricing of assets, was not just about subprime mortgages, not just about mortgages in general, but about a very wide class of financial and real assets. So we saw asset prices in general falling.

And the result was that banks and other financial institutions saw the value of their own portfolios decline. Indeed, for many assets, in 2007 and 2008, it was very hard to get any kind of a price for those assets because there was so much uncertainty about what was going to happen to default rates. So the result of that was that banks and other financial institutions simply didn't know the value of the assets in their own portfolio; they didn't know the value of the capital that they had.

And of course, they worried about the value of the assets of other financial institutions about the potential counterparties. And as a result of that, they ask themselves, if I, bank A, make loans to bank B, will they be able to pay me back when I ask for the money back? Are they liquid enough to do that? Ultimately, are they solvent? Are the value of their assets greater than their liabilities? Well, nobody could be sure. And so interbank lending dried up, financial markets became dysfunctional, and because the banks didn't even know the value of their own capital, they were nervous about making loans to nonfinancial corporations as well. And so they held back in lending, and that contributed to this sharp downturn of the economy.

The Fed was slow to recognize how serious the problem was. As late as the summer of 2007, at the big annual Federal Reserve conference in Jackson Hole, the Fed view, as stated publicly at the time, is, look, this is a subprime mortgage problem. It's a tiny part in the mortgage market, and the mortgage market is just a small part of the overall capital market, so don't worry about it. Well, it became progressively clear that the problem was much bigger than that. And by the end of 2008, the Fed had reduced the short-term rate, the federal funds rate, down to zero.

But that was not enough to turn the economy around. The recession had not been caused by high real rates, and so it couldn't be cured by bringing those rates down. And the usual route through which an easier monetary policy had traditionally worked, bouncing up investment in housing, wasn't working because house prices were still way over trend and falling. So whether interest rates were here or a little bit lower wasn't enough to cause people to want to buy homes as their prices were coming down.

Well, the Fed had to focus on this problem of dysfunctional financial markets, the fact that the banks really weren't working, weren't lending, couldn't finance themselves in the interbank market. And they did so with a variety of really creative actions. They injected capital into the banks. They provided guarantees. They forced some mergers. And working together with the Treasury, they succeeded in reviving the financial sector. And that was good news, but it wasn't enough to cause the economy to recover.

So with low interest rates ineffective, it became clear to many of us that getting an economic recovery was going to require fiscal stimulus. And I must say, as somebody who had believed and taught for many years that business cycle management was the business of the Fed, that fiscal policy couldn't work because it took too long for a fiscal stimulus to have an impact, it was tough to say, well, maybe this year is an exception; maybe the fact that the downturn is so deep and the recovery so slow means that there really is time, as there hadn't been in previous business cycles, to use fiscal policy.

So I was a supporter, an advocate of the Bush tax cut in 2008. The idea was that it would be a rebate of taxes to individuals. They would take the money and go out and spend it. That would boost consumer spending in the economy. That would give more confidence. And maybe we'd get out of this downturn.

Well, it didn't work. Got the tax bill. But the evidence looking back is that it had very little impact on aggregate spending. Most of those tax checks simply got saved or used to pay off debt.

When the Obama administration came to town in early 2009, they passed a much larger so-called stimulus bill, a combination of some tax changes, some transfer payments, transfers to state governments and so on – in my judgment, very badly designed and not big enough to fill the hole that had been created by the collapse of consumer spending and, equally important, the collapse of homebuilding. So we found ourselves with an economy that despite the fiscal stimulus and despite the zero interest rates was simply not coming back.

So that led the Fed and Ben Bernanke to announce that something new had to be done. We had tried the traditional zero interest rate. We had tried fiscal policy. And he said, we're going to try something that he labeled unconventional monetary policy, which had two components.

The first was quantitative easing – that is, buying long-term assets, Treasury bonds and government-guaranteed mortgage-backed securities. And the second part was promising the keep the very low interest rate, the interest that had already come down to approximately zero, to keep it very low for a considerable period of time. The exact language changed from announcement to announcement, but the spirit was very clear: Those interest rates were going to stay low as long as the economy was in trouble. It was given the name of forward guidance. So we had quantitative easing and forward guidance as the two pieces of unconventional monetary policy.

Well, the result of that is that we had short-term interest rates driven down to zero, and they've stayed at zero since the end of 2008; the fed funds rate still is very close to zero. The 10-year Treasury bond is also exceptionally low. The 10-year Treasury bond has an interest rate of about 2 ½ percent. Under normal conditions, with the kind of inflation that we have today, you'd expect that number to be 4 percent. And that difference is really a big difference. One way of saying it is the real 10-year interest rate is perhaps a half a percent, maybe is 1 percent when you would expect it to be two plus. So relative to where it would normally be, it's only less than half, maybe a quarter of where it would normally be.

So why did Ben do this? Ben and the Federal Reserve, but I think Ben was the intellectual leader in the unconventional monetary policy. Well, the purpose was to bring down long-term interest rates. He described it in a speech at the Jackson Hole meeting as generating an asset substitution effect, meaning that households and other holders of bonds would now shift from bonds into stocks and houses. And the idea of the low interest rate and of this asset substitution effect was to increase the appetite for risky investments, basically pushing up the value of homes and, even more importantly, pushing up the value of the stock market. And why did he want do that? Well, by increasing household wealth, that would lead to more consumer spending, and more consumer spending would lead to increased GDP.

Well, the impact of that policy was slow, but I would say in retrospect we can say that it was successful. It was successful in pushing up aggregate demand. House prices began to increase in 2012. It's not clear whether they would've increased in any case, but I think the very low interest rates, the cheap mortgage funds and the attractiveness of investing in housing for commercial investors, people who were buying blocks of defaulted homes in mortgage auctions, all of that was driven by this unconventional monetary policy. And the stock market, while it didn't responding immediately to the Bernanke policy, in 2012 the stock market rose 30 percent. So the market took Bernanke seriously.

As a result of these increases of house prices and in the stock market, household wealth in 2013 rose by $10 trillion. The fourth quarter of 2012 to the fourth quarter of 2013, according to the Fed's flow of funds report, household wealth rose – net rose by $10 trillion. That's a lot of money, even for an economy of our size. There is a kind of historic rule of thumb that says, when household wealth goes up by a hundred dollars, households raise their level of annual consumer spending – not instantly, but gradually over time – they raise the level of consumer spending by about $4. So a hundred (dollars) gets you four (dollars), a that means that 10 trillion (dollars) gets you 400 billion (dollars). Four hundred billion (dollars) is about 2 ½ percent of U.S. GDP. So if that traditional rule of thumb holds, and it seems to be, we're seeing a gradual increase in consumer spending – despite weak wage income, we're seeing a gradual increase in consumer spending to boost the economy.

But Ben, when he talked about this and talked about how it had been successful, always warned that there were risks involved, and there were two kinds of risks that he correctly emphasized.

The first was that market participants would be driven by these low interest rates to reach for yield. In other words, since they couldn't get any yield at all in short-term assets and they could get only a very low real yield in 10-year Treasuries, 10-year safe assets, they would go further out in the yield curve, they would take on riskier investments, and that that would be true both for lenders and for investors. So banks took on low-quality loans, so-called covenant-lite loans, where there were fewer built-in guarantees and requirements on the part of the borrower, or so-called leverage loans, the kind of low-grade credit loans that require higher interest rates. Investors boosted the stock market to a point where the price-earnings ratio is extremely high or the value of the market relative to GDP is extremely high. We also see it in the spreads on junk bonds. We see it on the demand for the emerging market debt and a variety of things.

So when interest rates normalize, when interest rates rise, the prices of these securities will fall. And the great danger in all of that is that investors may think they have a highly liquid investment in these bonds, but when they go to sell them, they will discover there isn't the liquidity, there isn't the buying there to keep those prices up. Prices will fall sharply. And the banks, unlike their traditional role, won't step in to buy up this – these assets as their prices fall, because under the Volcker rule, under the admonition that they shouldn't be investing in these securities for – on behalf of the bank, they're not going to be there to do it. So the danger is we will see once again very sharp corrections in these asset prices as interest rates normalize.

Back in 2006 and '7, when I would talk to people in financial markets, I would say, don't you think risk is underpriced? Don't you think you're not getting rewarded enough for buying these risky securities? And they'd say yes. And I'd say, why are you doing it? I mean, why don't you bet on the other side? You've got a derivatives market. You could bet on the other side. And they'd say, Marty, you don't understand. This isn't my money. I am managing money on behalf of an institution, and if I give up that extra little bit of yield and go on the other side, I'm going to be 50 basis points down. That money won't last. They'll come and take my money away and give it to somebody who's earning those extra 50 basis points, because they – the investors don't see these complex risks the way you and I do. But don't worry. I've got my finger on the button, and when the market starts to move, I'm going to – you know, I hear the same story again. I talk to the same people, and I hear them – but at this time it's different, because it's no longer subprime mortgages and so on.

Well, anyway, so that's the first of the problems.

The second problem is the increased liquidity of the commercial banks. When the commercial banks sold bonds or asset-backed securities to the Fed, they received and exchanged deposits at the Fed, so-called reserves.

Now historically, banks had small amounts of required reserves, based on a formula relative to the size of their deposits, and that's all they had. They didn't have excess reserves. If you go back to 2008, in the beginning of that year they had about $50 billion, and that's because the Fed did not pay interest on excess reserves. But then as part of the resolution, as part of dealing with the dysfunctional financial markets, the Fed began to pay interest on the excess reserves, and so it now has become more attractive for the financial institution, for the banks to leave these excess reserves at the Federal Reserve.

But as a result, we now see that the commercial banks have more than $2 trillion – it used to be 50 billion (dollars); it's now more than $2 trillion – of excess reserves at the Fed. They didn't use the reserves that they received to create loans. They didn't increase the money supply. That's why the people say to me, well, if the Fed did all this buying of bonds, didn't it increase the money supply and why aren't we seeing inflation? And the answer is, well, it didn't increase the money supply. It increased the volume of reserves that the commercial banks have at the Fed, rather than using those reserves to create loans and deposits at the commercial banks.

So when the banks – looking forward, when the banks begin to see more profitable lending opportunities, they can use these very liquid assets – available on demand, paying a very small interest rate – they can use them to start supporting more commercial lending.

Now within limits, that's going to be a good thing. Within limits, it's going to help to sustain the expansion. But obviously too much of it can lead to inflationary increases in demand.

Right now inflation, to some eyes, seems very low. When Janet Yellen talks about inflation, she says, well, over the last 12 months the price of consumer expenditures, the PCE, is up about 1 ½ percent. So we still haven't gotten to our target, says she, of 2 percent.

If you look at the consumer price index, which is what most of us normally look at, the CPI is up 2.1 percent, relative to a year ago. Even the PCE, the price of consumer expenditures that the Fed focuses on, in the second quarter of the year was up at 2.3 percent, so above the Fed's target. The employment cost index in the second quarter was up at an annual rate of 2.8 percent.

So I think we're beginning to see these inflationary pressures. We can talk more about what the underlying is – that is causing that.

So how's the Fed going to respond to these two problems? How is it going to respond to the systemic risks caused by reaching for yield, and how's it going to respond to the possibilities of increased inflation as banks use their excess reserves to increase lending and therefore the money stock and therefore business demand?

Let me start with the systemic risk. The Fed has required the banks in the last few years to increase their capital significantly, so that if there are losses on their portfolios of investments and loans, the banks are in a better position to absorb those losses. They won't go under.

But it's not clear whether the increased capital that the banks have been required to hold – whether the increased volume of capital is really enough if the economy sees substantial declines in the value of some of these risky loans and risky investments.

But what worries me more – and what Bob Rubin and I wrote about in a piece which I guess has been circulated or at least referred to – is the nonbanks. The Fed has not changed policies for insurance companies, money market mutual funds, hedge funds and others, and so it's not at all clear what will be done there.

When Bob and I wrote this piece, we expressed our worries about mispricing of assets again, we expressed our worries about the excesses, and we said it's just not clear how big these risks are, either for the banks or others, although it would clearly be better if there were less incentive for banks to reach for yield.

But what we emphasized more than that in our piece was that the Fed policy is essentially limited to the banks, and when Janet Yellen spoke about a month ago at the International Monetary Fund, what she said was we at the Fed are going to focus on the two mandates that we have, low inflation and low unemployment, and therefore we're not going to try to deal with these systemic risk problems. Rather, they have to be dealt with by what she referred to as macroprudential policies.

It is not at all clear what those macroprudential policies really are. Yes, more bank capital – that's an example. But it's hard to find other things. The Fed has provided guidance to the banks about the risks that they're taking in low-quality loans, but it's just guidance. They're not forcing them to cut back, and in fact those things, as we said in that article, have been increasing very, very rapidly.

So responsibility for macroprudential policy apparently rests with the Financial Stability Oversight Council, the FSOC. But the FSOC doesn't really have any power. The only thing that it can do by itself is to classify some nonbanks as institutions to be subject to Federal Reserve regulation. Beyond that, all it can do is make recommendations to groups like the SEC and the CFTC. And it has done some of that, but it has no way of enforcing those. So I think this whole issue of risk going forward is a very serious one and one that sort of nobody's in charge of. The Fed says, don't look to us; we've got our hands full dealing with inflation and unemployment. And the FSOC doesn't have any power to enforce these things. So that's where we are.

Let me turn to Fed policy to prevent inflation. So the Fed will try to limit the commercial bank use of these excess reserves that I've described, and in the process they will increase interest rates, the normalizing of interest rates. Earlier this week the Fed met, and the members of the FOMC indicated that they expect the Fed funds rate to start rising sometime next year – endless speculation about whether it's March or June. It doesn't matter that much. What matters is where it's going to be over the course of the year and at the end of the year how high it's going to get. The estimates of the members of the open market committee is that by the end of next year it'll be a little less than 1 ½ percent, and it will take until the end of 2017 to reach 4 percent, which would be a kind of normal number, assuming we have inflation of 2 percent.

So they will stop buying bonds – as I said earlier, they'll stop buying bonds next month. They won't start selling off any of the bonds or asset-backed securities or even stop rolling over, as those come due, until sometime in 2015.

But what worries me is the question, will the increase in the interest rates be enough to limit the amount that the banks will want to use their reserve to lend, limit the amount of inflationary pressure? And is a 1 1/2 percent interest rate at the end of next year high enough? It means a real Fed funds rate that's approximately 0 or less than 0.

Now how is the Fed going to engineer this? How is it going to make interest rates rise? Well, the traditional textbook way that the Fed has moved interest rates up or down in the past is by intervening in the federal funds market, the market in which banks lend federal funds to each other. When it wants to raise interest rates, it sells bonds into that market, sucks funds out, and that causes interest rates to rise. That won't work now. It won't work because the banks have so much extra federal funds –$2 ½ trillion – that that kind of intervention, that kind of open market operation, contrary to the traditional textbook, that's not going to do anything.

So what's the Fed going to do? It's going to basically increase the interest rate on excess reserves. So it pays an interest rate now which is approximately 0, but it knows that in order to keep the excess reserves, the $2 ½ trillion, at the Fed or to allow them to convert or use only a small part of that, they're going to have to provide an incentive by raising the interest rate on excess reserves.

So in principle, that can work. You get the interest rate up high enough, it's a nice way to – for banks to invest their funds. It involves no risk. You've got the Fed as your counterparty. It involved no capital requirements, but how high will they have to go? And what's going to be the political consequence as the Fed starts paying higher interest to the commercial banks than it, the Fed, is earning on its portfolio? Moreover, paying the banks – not everybody's favorite institution in the American political system – paying the banks not to lend – that's a tough act.

So the Fed recognizes this, and the Fed officials I talk to say, yes, we understand it, and that's something we're going to have to live with, because that's the price that we pay for having done the unconventional monetary policy.

But the Fed also has another tool in mind, which some cynics might say is designed to hide or complicate or obfuscate what's really going on, and that is using the overnight reverse repo policy. So the Fed has the ability to engage in what is called reverse repo transactions, not just with member banks, the way the Fed funds market works, but with any large financial institution – mutual funds, commercial banks that are not members and so on.

What is involved is that the Fed would borrow from those institutions, providing Fed assets as collateral, and then 24 hours later would unwind that transaction. But implicit in that borrowing, in that transaction, would be an interest rate, and that interest rate on the overnight reverse repos would set the floor in the short-term interest market.

So you can think about it as if in an annual basis the Fed borrowed $96 and agreed at the end of the year to pay back a hundred dollars. So that would be a 4 percent interest rate. But of course they're not doing it on an annual basis. They're doing it just for overnight. So the amount, the price differential, is a very, very small number, but nevertheless it corresponds to a significant rate.

Now as I say, unlike the interest on excess reserves, these overnight reverse repos can be done with money market mutual funds, with hedge funds and others, and the goal is to set an interest rate that can then be reinforced by the interest on excess reserves.

So the Fed has been practicing this. Looks like they can do it; the mechanics work. But what's not clear is how high interest rates will have to go to limit the excess demands on the part of the Fed and in the economy as a whole.

So let me stop there, with that as a final warning and question, and open the floor. I look forward to your questions.

JAMES KESSLER: Thank you. Thank you very much.

Let's start with right back here. First question.

Q: I'm just curious. What – or could the Fed raise the required interest rates, so perhaps – excuse me – the required reserve rate to gobble up the excess?

MR. FELDSTEIN: It could. It could, and it would not totally surprise me if they did that. So the banks would scream, they would say that's a tax on the banks, but it would not surprise me totally if the – if the Fed was to say, yes, we will pay you some more, but we're also going to increase the – but there's so much excess reserves that it would take a lot of raising to put a serious damper on it.

Q: What is the amount – do you know what the amount of the required reserve – (inaudible) –

MR. FELDSTEIN: So, nothing, because, you know, we used to have required reserves on all kinds of deposits, but the required reserves now are just on transaction deposits, so a very, very small part of the total portfolio. That's why, in 2008, it was $50 billion. So they could change it. They could say you now have to have it on everything, but there will be a little bit of pushback.

Yes, sir.

Q: Thanks for being here. Does the Fed do a lot of thinking about the (upper trajectory interest rate ?) and – (inaudible) – that relationship to the strength of the dollar, and – (inaudible) – that relationship to exports and jobs? Is that something – (inaudible) –

MR. FELDSTEIN: Yes, yes. You know, they've been asked, do you worry about the economies in the rest of the world? And Janet says, I think, with some honesty and candor, we've got to worry about – our mandate is here. But of course, part of the way – and the Fed doesn't talk about it in its statements, but they know that one of the things that happens when they push up interest rates is that it strengthens the dollar against other currencies. When Mario Draghi was out in Jackson Hole last month, he did speak about that, and he said – basically, he said Europe's in terrible shape. He didn't quite use those words.

He said – and one of the things that's going to help us is a lower Euro, and one of the things that's going to cause that to happen is the different paths of U.S. and Euro interest rate, with interest rates here in the U.S. starting to rise and interest rates there, even on 10-year securities, down to 1 percent in Germany. So the Europeans are certainly aware of how this will have an impact on their economy.

Yes, sir.

Q: Two questions. One on – (inaudible) – what are some of the downsides – (inaudible) – other than how high (interest rates ?) to go? It seems to me that if you're a borrower, in the short-term – (inaudible) – find yourself, in some scenarios, (competing ?) with the Fed, and there's no (counter-party that's better ?) – (inaudible) – question number one.

MR. FELDSTEIN: (Chuckles.) Absolutely.

Q: Question number two, kind of a broader sense of this – (inaudible) – you've kind of got no activity in the (independent ?) lending markets, and shouldn't we watch (a return to a scenario ?) where there's more market discipline, banks lending to each other than using the Fed as a counterparty?

MR. FELDSTEIN: So with respect to the overnight repo – and yes, that's going to open up opportunities where the money market mutual funds say, oh, gee, I'm a little nervous about this economy. I think I will go and do business with the Fed. Why do I need to take on risky commercial paper? So spreads – you know, markets could clear, spreads could widen, interest rates could move up more on commercial paper in order to induce the money market funds to take the risk of dealing with them, but that would be one of the adverse consequences of developing this overnight reverse repo facility.

Your second question was about –

Q: About returning to –

MR. FELDSTEIN: Oh, yeah, returning to a more – yeah, so the Fed said, as part of their statement, in the glorious days yet to come, we will get back to normal, and we won't be using the reverse repo and – but it's not clear that they can – that they have a plan for bringing down the size of the balance sheets of the commercial banks – the reserve part of the balance sheet to a point where the interbank fed funds market functions the way it did in the past. They've got two-plus trillion dollars ahead of them to have to shrink back, and basically, that would be by selling off the bonds and the asset-backed securities that they've acquired. And over time, they could do that, but I wouldn't hold my breath as to exactly when it's going to happen.

Yes, sir.

Q: Hi, Professor. Two questions. And also – (the 20 billion ?) excess reserve – among the $4 trillion of Fed holdings, about 1.6, 1.7 trillion are mortgage-backed securities. How do they go about (unwinding ?) those – (inaudible) – banks? And two, you quite calmly mentioned that we might not be – (inaudible) – risk properly with markets. A lot of us are actually quite concerned that – (inaudible) – crash, where the markets don't calmly (replace ?) risk in assets, but instead, about 50 percent, over the course of six weeks – (inaudible) – concerned about, or –

MR. FELDSTEIN: Let me start with the second. Yes, if my calm way of presenting it didn't indicate that I am really worried about that, then I acted too calmly. I think it is a very serious problem. There's a lot of – I used the word "illiquid" – there's a lot of illiquidity there. In one sense, there's a lot of liquidity in the markets, but the assets are not liquid in the sense that if lots of people start getting nervous all at once, it's going to be very hard to stop prices from adjusting very substantially.

How do you get rid of the asset-backed mortgage securities – mortgage-backed securities? They roll off – I mean, people pay off their mortgages, so the average maturity is something like six or seven years. So even without selling, just not repurchasing, that'll happen. So I think that can happen, and it will just be normal – a normal process. It may push up mortgage rates a little bit, but it's nothing like the kind of consequences of markets getting nervous about risk and pulling our sharply out of risky securities.

Yes.

Q: (Inaudible) – again, thank you for your comments. My question is regarding the housing recovery, and perhaps that's somewhat (anemic ?) – I know (my boss ?) is very interested in that. And I'd just like to get your thoughts. One is, we know that first-time home buyers are down, and we know that sales – (home ?) are down. Janet Yellen has testified in May before Congress as well as July of this year, and when asked at those hearings about the housing market, or the housing recovery, her response has been – (inaudible) – (watching ?), but the latest employment numbers last week for August – (inaudible) – new job creations were way down. There were 142,000 versus over 200,000 for the prior consecutive 12 months. To me, that's a little bit of a red flag. So, just thoughts about the – (inaudible) –

MR. FELDSTEIN: I used to worry a lot – a lot about the housing market, because there were so many underwater mortgages. That's really corrected a lot. And I worried about the kind of mortgages that were out there on the books – these very high loan-to-value, and that's also corrected, and the banks are not making that mistake again. If anything, they're dragging their feet, not completing mortgages because they are so frightened by the Dodd-Frank rules about recourse that borrowers have. The home builders' most recent announcement, also this last week, went in the opposite direction of the housing start and permits numbers. The home builders said, wow, this is the best we've seen for years and years. So I have to think that what we saw in the most recent month's numbers were probably a bit of a wobble and not a significant shift.

Q: And just to add to that note, what – I'm just – (inaudible) – my office and my – (inaudible) – is that because of the – (inaudible) – mortgage (rule ?) that came out in January, gosh, a lot of people are not getting new mortgages. I mean, even people with pristine credit. I had some – (inaudible) –

pristine credit, and it's just, there was a blip on one of the papers – the paperwork, and he couldn't get his mortgage. I mean, and I'm hearing more and more of that. So I don't know if that's –

MR. FELDSTEIN: No, I think that's a serious problem, and I think – people tell me that that new procedure or new passport for granting mortgages is this thick, and very ambiguous as to exactly how to interpret it. And so the banks are saying, why bother? You know, I get 3 percent on a 15-year loan, so if anything goes wrong, the amount of scope for profit in this is so small, I don't want to take risks. So I – maybe some cleaning up of that documentation requirement would help.

Yes sir.

Q: (Off mic.)

MR. FELDSTEIN: So I think basically – let me start with the end and go back – I think basically, they have decided that they are going to raise interest rates, that unless the economy seems to turn down between now and next spring or early summer, we'll start to see the fed funds rate rising. But it's from such a low level and moving to such a low level that I don't think they have to worry about that. But how do they deal with all of this balancing between the two? I wrote a piece earlier in the year in The Wall Street Journal in which I said, the Fed doesn't talk about inflation, and that's not a good thing because the public needs to be reminded that they really care about it and care about not letting the inflation rate rise above their target of 2 percent. Indeed, they do talk about it a little bit, or did then, by saying we have an unemployment target as long as we can do it in the context of price stability. What that meant was in the context of bringing the inflation rate up to 2 percent with little comment about it going above that.

Janet spoke to the Economic Club of New York, and the format of those meetings allows for two members of the club to question the speaker, and I was selected as one of them.

And I said to my old colleague, I say – I call her a colleague because she and I taught together at Harvard when she was a newly minted assistant professor, and I wasn't much beyond that. So I asked her about why we weren't hearing more about inflation from her and the Fed. And of course, she knew I was going to be a questioner and she knew what I had just written, so she was ready and she gave a very good answer. She said, we are symmetric about inflation; we don't want it to be under 2 percent and we don't want it to be over 2 percent. And what she has clarified since, directly to your question, is this: She said, we will decide how to move interest rates based on where the inflation rate is relative to our target, where the – she wouldn't say unemployment rate, but where the state of the labor market is relative to our judgment about that and how fast each of them is moving. So as an economist, you could write down a formula of what that said in terms of departures from target levels of the two.

What makes it complicated is the measurement of the unemployment. And so they've moved away from talking about just the unemployment rate, and she talks about underutilized labor resources. Now, I think there's a problem there, and the problem is this: There's a lot of underutilized labor resources. There's a lot of part-time work, people who'd like to work full-time. There's a lot of long-term unemployed. But it's not clear that any of that moves the inflation pressure in the economy. So an interesting study by Alan Krueger, who was the chairman of the Council of Economic Advisers until a year or so ago under President Obama – very interesting study that he published in which he said, you know, if you divide the unemployment into long-term, six months and above, and short-term, under six months, and you ask, what is it that drives price inflation? You find that it's the short-term unemployment, not the long-term. The long-term unemployment seems to have no bite in that process. Bob Gordon, a professor at Northwestern, has done a similar thing and the folks out at the San Francisco Fed have done a similar thing; they've all come to the conclusion that what matters is the short-term unemployment.

Now, the Alan Krueger estimates are that the rate of short-term unemployment at which inflation pressures would begin to materialize is in the 4 to 4 ½ percent range. We usually think about the overall unemployment rate and think about numbers around 5 ½ percent. For the short-term unemployment, 4 to 4 ½. So where is it today? It's at 4.2. So we are right in the area where you would expect to see price inflation increasing. Now, the most recent CPI number was zero – don't get much better than that. But I think there's a real risk that markets are tight and that there's still going to be, even when we get to, quote, full employment, there's going to be a lot of this structural unemployment for a variety of reasons, where we have long-term unemployed, where we have people who are wanting full-time jobs but don't have them. So they're going to be there but, nevertheless, we're going to be at a point where further tightening of the labor market will cause us inflation that we don't want. So that's the dilemma that the Fed has. That's a long answer to a good question. Yes sir.

Q: (Off mic.)

MR. FELDSTEIN: You would think. It's not happening. And a lot of the action that would previously have been carried out in the commercial banks, thanks to the Volcker Rule, has moved out and moved into nonbanks. So, if you want to be an optimist, you say it's very different. The nonbanks are not part of the payment system. They're not part – they don't have the kind of leverage that the commercial banks have, and so you have a bunch of rich people and sovereign wealth funds and others, want to put their money in such a fund. They may lose some, they may not. That's their business, and it's not a – the danger is that those funds are holding assets which, when markets get nervous, investors will say, well, I think I'm going to lighten up. When they want to lighten up, that means they're going to want some of their money back. That's going to force those nonbanks to sell off assets that they have; it's not clear who the willing buyers are going to be, and that's going to have the effect of driving prices down and interest rates up. We're back to what we were talking about before. But it's not clear who's rushing to fill that gap.

Q: (Off mic.)

MR. FELDSTEIN: Good, it's yours. (Chuckles.)

Q: (Off mic.)

MR. FELDSTEIN: You know, it depends on what it (does ?). Some sense, that's above my pay grade. You're asking me for a political forecast of how this would work out. But I think the answer is it depends on what it does to the economy as a whole. If those folks who've invested lose some money, I don't think that's going to do much. If, on the other hand, it has the kind of impact that we had in '07 and '08, where financial institutions freeze, where the economy turns down, there's going to be much stronger concern about whether we're correctly regulating, supervising these institutions.

And I think, while I said nice things about the Fed and how they responded in '07 and '08, I think they did a bad job before that in supervising the banks in terms of the portfolios that they held. That was mainly about the kind of mortgages that they had and the kind of mortgage-backed securities that they had. Now it's about the kind of loans that they're making and whether the Fed should be tougher on requiring them to cut back on these low-quality loans, because I think that's where the real dangers are to the banks.

MR. KESSLER: Thank you so much, Dr. Feldstein. (Applause.)

(END)