NEW HAVEN – As the US Federal Reserve attempts to exit from its unconventional monetary policy, it is grappling with the disparity between the policy’s success in preventing economic disaster and its failure to foster a robust recovery. To the extent that this disconnect has led to mounting financial-market excesses, the exit will be all the more problematic for markets – and for America’s market-fixated monetary authority.

The Fed’s current quandary is rooted in a radical change in the art and practice of central banking. Conventional monetary policies, designed to fulfill the Fed’s dual mandate of price stability and full employment, are ill-equipped to cope with the systemic risks of asset and credit bubbles, to say nothing of the balance-sheet recessions that ensue after such bubbles burst. This became painfully apparent in recent years, as central banks, confronted by the global financial crisis of 2008-2009, turned to unconventional policies – in particular, massive liquidity injections through quantitative easing (QE).

The theory behind this move – as espoused by Ben Bernanke, first as an academic, then as a Fed governor, and eventually as Fed Chairman – is that operating on the quantity dimension of the credit cycle is the functional equivalent of acting on the price side of the equation. That supposition liberated the Fed from fear of the dreaded “zero bound” that it was approaching in 2003-2004, when, in response to the collapse of the equity bubble, it lowered its benchmark policy rate to 1%. If the Fed ran out of basis points, the argument went, it would still have plenty of tools at its disposal for supporting and guiding the real economy.

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