To Ease or Not to Ease? A Dialogue

Joseph E. Gagnon and Michael Mussa discuss the merits of the Federal Reserve and other central banks engaging in quantitative easing to stimulate the economy.

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Steve Weisman: To ease or not to ease? That's the question we're discussing today at the Peterson Institute for International Economics with Joseph Gagnon, senior fellow here, and Michael Mussa, senior fellow, who have different views about whether the Federal Reserve and other central banks in developed countries should engage in what is called quantitative easing. Joe, first tell us what quantitative easing is.

Joseph Gagnon: Quantitative easing is what central banks do when their normal policy rates—typically overnight rates—get to zero or essentially to zero. You can't lower them below zero. And so, what you can do is try to operate on other margins of the economy. So, you tend to try to push other interest rates down or push other asset prices up. What I am proposing is that the Federal Reserve try to push down interest rates farther out the yield curve, so two-year, three-year, maybe up to four-year interest rates, say on Treasury bills.

Steve Weisman: How should they go about this?

Joseph Gagnon: They would announce their intention—their target to the market so the market would understand what they're doing—and then they would make large purchases of these assets as much as needed to drive the rates down to where they would like them to be.

Steve Weisman: How much might this take?

Joseph Gagnon: I think at the current situation, it's not really worth doing it unless you're going to do something noticeable. The four-year Treasury yield is currently one percentage point, so I would suggest targeting that at 0.25, a quarter of a percentage point, which would be a 75 basis point cut, which would be pretty substantial action, but not unprecedented by monetary standards. It would be the first action they've taken in about 18 months, so in some sense, it's been overdue.

Steve Weisman: I think you said this could involve hundreds of billions and maybe even closer to a trillion in purchases before it's done.

Joseph Gagnon: It could, yes.

Steve Weisman: The reason for this is that the economy, in your view, needs more stimulus—monetary stimulus in this case. Michael Mussa, you've just delivered your assessment of the global economy, what do you think of engaging in this level of monetary stimulus?

Michael Mussa: First I think it needs to be recognized that we've already done a substantial amount of quantitative easing. The Federal Reserve's balance sheet has become much larger than it was before the crisis—banks have a trillion and a quarter or so of excess reserve. The question is: Should we go further at this stage? My view is that we took emergency and extreme measures at the height of the crisis when circumstances looked likely to become far worse than what has actually transpired. Fair enough. I thought that was the right thing to do. I don't think we should

back away from it substantially at this stage until a recovery is more firmly established. But to go further in the direction of substantially greater quantitative easing, when our problem is really that the expansion is a little slower than what we would have hoped does not impress me as sound policy. There's a certain point where you need to say, "Look, we pursue extreme measures in extreme circumstances, but we're not in the business of supplying continually more boosts to the economy once we're pretty much beyond the limits of our normal actions."

Steve Weisman: But this has been the worst economic downturn in generations, and the recovery is very disappointingly slow. Why do you think this is overkill? What risks do you see?

Michael Mussa: There are a number of risks. Let me say, the policy is very much easier than anything we have seen since the early 1930s. We've never engaged in quantitative easing before in the postwar era in the United States. Only Japan has done so, beginning in the late 1990s. And Joe talks about pushing the four-year treasury rate down to a quarter. We were not there even in the Depression, at the four-year rate. So this really is an extreme degree of monetary easing, which, if the economy were falling into very deep trouble, I think we would need to contemplate and pursue. But I think there's a limit as to how far you should go in the circumstance we have at present where we have a high unemployment rate—the highest in a generation, not in generations.

Steve Weisman: Joe, you agree this would be unprecedented, I think, but also that the crisis calls for unprecedented measures. Do you see any risks to doing what you advocate?

Joseph Gagnon: First I agree it is unprecedented. In fact I tend to agree with Chairman Bernanke and Christy Romer, former chair of President Obama's Council of Economic Advisers, that the shock that hit the US economy was probably as great [as] or greater than the shock that caused the Great Depression. And I think the aggressive policy action that we had, which was unprecedented—both monetary and fiscal—really deserves a lot of credit. But in my mind the question is, I do think there are limits, but are we at the limit? At the time, 18 months ago, I thought that the combined monetary and fiscal actions we had done [were] not quite enough—more than half the way, maybe three-quarters of the way, of what would have been optimal. I think there was a lot of uncertainty about that. There [were] some risks—some people worried that we had gone too far, and we might see some inflation, that the economy might not have been able to handle that extra demand and would have shown up as inflation. Now 18 months have gone by, and it seems to me it is clear that it was not too much—that in fact inflation is heading down below levels that the Fed wants to see. So I actually feel comfortable with my initial view that we probably did about three-quarters of what we needed to do.

Steve Weisman: Mike, inflation is heading down. Isn't there a risk of deflation?

Michael Mussa: We may see some deflation. I don't regard that as a substantial risk. Also, I think what we were staring at—in terms of the scenario of worry that was controlling policy at the height of the crisis in late 2008 and 2009—was substantially worse than what has actually transpired. We adopted a policy directed at addressing that substantially worse scenario. So to go beyond it now in a situation that is clearly not as threatening as it was then, does not impress me as well justified.

Steve Weisman: Can you be more specific about what the danger is here?

Michael Mussa: The Federal Reserve already has an exceptionally easy policy and has indicated it is going to continue to pursue it for some time. If we ease further, we're talking about not only an even easier policy, but one that is going to be pursued for an additional significant span of

time, so we're talking about pushing the four-year rate down to 25 basis points and probably keeping it there another couple of years, and the short-term rate down near zero for another four or five years. Otherwise, you're going to have a sudden withdrawal of monetary stimulus from an exceptionally easy stance. And getting stuck with a policy that is that easy for that long has, I think, some substantial dangers to it. Also, we really are interfering enormously with the operation of credit markets that are not normally the direct subject of Federal Reserve action. The presumption is, "We can push short-term interest rates down to 25 basis points—something we haven't seen ever—and we don't need to worry about any side effects of that." I say if the circumstances were desperate, well, go for it. But they're not desperate.

Steve Weisman: Joe, Chairman Bernanke has suggested in Jackson Hole that they might consider these actions, but he wasn't very specific about what conditions would have to be. What's the likelihood of the Fed doing something like this?

Joseph Gagnon: I actually think it's likely. I mean, the way they've now phrased it is that unless things get better, they will do it. They've left themselves room to declare things have gotten better, but it seems like the presumption is that they would do it. In response to Mike, there are risks. The biggest risk, I thought a year and a half ago, was that this would be overkill and it would be inflationary. That hasn't happened. Now I do see a risk that I think the committee is worried about, related to what Mike said. In the future, if they do go further now, and then at some point the economy sort of turns around more rapidly than they expect, are they going to be able and willing to reverse course nimbly enough? You know, will they let excesses into the economy that they then regret? I think that is the worry, but I guess I'm of the view that, well, do what you think is best now, and don't not do it because you're worried you might not do what is best later. In other words, don't make a mistake now because you're worried you'll make a mistake later. Try to do the right thing now, and try to do the right thing later. But, it's easy to say that, and I think they're worried that they won't actually be nimble enough in the future to get ahead of the recovery.

Steve Weisman: Mike, can you foresee any circumstances where you would endorse this proposal?

Michael Mussa: Oh, certainly there are circumstances where the economy falls back into a particularly steep recession, and we see evidence of a worrying rate of deflation, where the resort to substantially greater quantitative easing would be what's left in the bag of tools. Then I think you have to go for it. I agree with Joe—I think the Fed is going to do something a little bit more. I do not believe, however, that there is a clear intention to try and cut the four-year rate down to 25 basis points. I think we'll probably see a few hundred billion of additional purchases of intermediate term assets. And I don't think that is going to have a particularly large effect or be exceptionally catastrophic in its consequences either. However, I think it's a mistake to get into the business of creating the notion that every time the economy has a significant recession, monetary policy is prepared to take the interest rate—federal funds rate—to zero and engage in substantial quantitative easing in order to provide impetus to a recovery that's already underway. That, I think, will get us into more problems in the long run than the benefit of providing the economy an additional boost now.

Steve Weisman: The markets are anticipating something, right Joe?

Joseph Gagnon: I believe they are. Mike is right. I'm not predicting that the Fed will do what I recommended. I think they'll do something probably more like what Mike said. And I think the market is expecting it, yes.

Steve Weisman: Thank you both very much.