Backgrounder

Published by The Heritage Foundation

No. 2481
October 25, 2010

The Fed's QE2 and the Economy: Sailing to Safety or a Ship of Fools?

J. D. Foster, Ph.D.

Abstract: *Quantitative easing is a largely experimental tool employed by the Federal Reserve to address a continuing sluggish economy and the renewed potential of deflation. That the Fed faces this prospect is final proof positive that President Barack Obama's Keynesian stimulus policies have failed, leaving monetary policy as the sole remaining major stimulus tool. The risks associated with quantitative easing are substantial, including that it will fail, or will trigger a resurgence of inflation with or without a pickup in output growth. Even if successful, the Fed will need to act decisively down the road, reversing course by pushing up short-term and long-term interest rates to prevent a bout of new asset price bubbles and inflation. These future actions could produce another recession in the face of still-high unemployment. Navigating these waters successfully will require extraordinary skill and luck. The President and Congress could greatly improve the Fed's prospects for success by vowing not to raise taxes and instead reducing federal budget deficits by substantially reducing spending.*

QE2 once referred to the RMS *Queen Elizabeth 2*, a grand luxury liner that plied the Atlantic between England and New York City. Today, the acronym QE2 is better known as a return to the still experimental policy called quantitative easing (QE), which central banks use to prop up economies when all else fails.

The October 8, 2010, jobs report showed the economy shed jobs on net for the fourth consecutive month, underscoring yet again that the U.S. economy is close to stalling. Trouble enough, the sputtering

Talking Points

- The Federal Reserve's return to quantitative easing has been made necessary by the failure of President Obama's stimulus spending and debt-accumulation policies to restore the economy to health.
- Quantitative easing is a novel and experimental policy that has the Fed buying long-term securities in the dual hope of putting downward pressure on long-term interest rates while injecting reserves directly into the credit system.
- Quantitative easing presents a passel of significant risks, including that it will fail to boost the economy and trigger a bout of asset price bubbles or inflation with or without a stronger economy.
- In addition, once the economy does strengthen, the Fed will be forced to reverse course quickly to prevent high inflation, possibly triggering a new downturn.
- The federal government could mitigate these risks somewhat if it would vow not to raise taxes and instead address projected trillion-dollar deficits by substantially reducing spending.

This paper, in its entirety, can be found at:
http://report.heritage.org/bg2481

Produced by the Thomas A. Roe Institute for Economic Policy Studies

Published by The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002–4999
(202) 546-4400 • heritage.org

Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The Heritage Foundation
LEADERSHIP FOR AMERICA

economy also raises anew the risk of deflation, a steady decline in the overall price level. This risk is pushing the Federal Reserve to prepare for the controversial and risky policy of QE2—the resumption of quantitative easing—joining the party already underway at Japan's central bank and the European Central Bank.

Fiscal policy should be available to take some of the pressure off monetary policy, nudging the economy onto a path of strong, sustainable growth. Regrettably, at the start of his term, President Barack Obama and his congressional allies chose the wrong policy. They opted for a Keynesian policy of rapidly increased deficit spending to propel the economy forward, as though the accumulation of government debt by itself can stimulate prosperity. That policy failed, as is now obvious to all, leaving the country with a sputtering economy and $1.3 trillion budget deficits, which practically rule out an effective fiscal policy response based on lower marginal tax rates.

This leaves the Fed—and the nation's economy—in a tight spot with no easy answers. The economy may yet pick up pace as some forecast, but the risk the economy may stall or even contract is real, and the risk of deflation graver still. A flat economy is bad enough, but the risk of deflation compels the Fed to consider extraordinary risks. Quantitative easing could fail to revive the economy, or it could lead to new asset price bubbles and eventually to rapid inflation, forcing the Fed to reverse itself quickly irrespective of the economy's strength. Finally, when the economy does recover and if inflation remains subdued, the Fed will need to continue to hold inflation at bay by reversing itself strongly, pushing interest rates up quickly, and likely while unemployment remains elevated.

Whatever course the Fed plots, market participants and policymakers will need to spend the next few months with their eyes wide open to any of these serious risks becoming a new reality. In every eventuality, the Fed's task and the economy's path would be greatly eased by the President and Congress reducing federal spending significantly to move federal budget deficits toward sustainable levels.

The Reluctant Recovery

At this stage of the recovery, the economy should be accelerating smartly. It is not. Although many problems remain in residential housing markets, commercial property markets, and various financial institutions, these problems are now sufficiently identified and cabined that their drag on the economy is insufficient to prevent a strong recovery. Yet trend growth in the economy has remained stuck at about a 1 percent growth rate since the recession ended.[1]

The economy lacks vitality because businesses lack confidence in the future. They lack confidence because the federal government under Obama has unleashed a regulatory onslaught and is threatening more. They also lack confidence because Obama is intent on preserving a vastly increased government and associated budget deficits until he can raise taxes dramatically. The January 2011 tax hikes, which will hit a weakened economy, only reinforce these fears.

For its part, the Federal Reserve has largely exhausted its traditional tools for reviving the economy. Above all, the Fed has held the Fed funds rate[2] at near zero since December 2008. In the face of a weakening economy, and with no help and possibly further drag from fiscal policy, the Fed is turning to less conventional tools, such as quantitative easing.

Quantitative Easing

With quantitative easing, the central bank expands the money supply by directly increasing the quantity of reserves in the banking system. Normally, the Fed would increase the amount of money in circulation by lowering the Fed funds rate, thereby lowering the return on holding reserves and thus encouraging bank lending. The Fed raises and lowers the funds rate in an attempt to shift all do-

1. Growth was significantly higher in the winter of 2009 due to some exceptional factors, most especially a powerful rebuilding of inventories. There is nothing wrong with inventory building under the right circumstances, but it does not provide the basis for a sustainable recovery as the subsequent slowdown into the third quarter of 2009 demonstrated.
2. The Fed funds rate is the rate that banks charge each other for overnight lending and effectively anchors the interest rate structure.

The Heritage Foundation
LEADERSHIP FOR AMERICA

mestic interest rates in the same direction, primarily by buying and selling U.S. government securities.

With a funds rate effectively at zero already, the Fed must use other tools. In particular, the Fed can purchase longer-maturity U.S. government bonds, mortgage-backed securities, or other financial instruments to increase the quantity of banking reserves directly. This is quantitative easing, and the purpose is to increase the supply of banking reserves to encourage banks to lend while putting downward pressure on longer-term interest rates to improve the incentives to borrow.

As Chairman of the Federal Reserve Ben Bernanke explained, the key to the effectiveness of quantitative easing is the view that different types of securities are imperfect substitutes in investors' portfolios.[3] Thus, by significantly altering the quantity and thus the price of one type of security, such as mortgage-backed securities, the Fed can force shifts in investors' portfolios that in turn reduce interest rates on similar yet different types of securities.

The Fed first embarked on quantitative easing shortly after the funds rate was reduced to near zero toward the end of 2008 as the financial crisis picked up steam. It expanded the program significantly in March 2009 and ended the program on March 31, 2010. At its conclusion, the Fed's balance sheet held more than $2 trillion in various bonds and similar assets.

Japan first used quantitative easing aggressively in the early 2000s to fight deflation after the collapse of a massive asset price bubble.[4] Facing renewed signs of a flagging economy, Japan announced in early October that it was resuming a policy of quantitative easing with an initial $60 billion installment. The European Central Bank (ECB) has thus far resisted a return to quantitative easing per se, but it is aggressively pursuing a policy of purchasing sovereign debt and private debt as part of Europe's efforts to preserve the euro and to manage the sovereign debt crisis that began in Greece in early 2010. The ECB's policy goal may differ somewhat in intent, but it parallels quantitative easing in effect.

Risks Abound from Action as Much as from Inaction

The Fed's quantitative easing policy is fraught with serious risks. An obvious risk is that the policy will fail and that the economy will continue to slide with deflation to follow. As of early October 2010, the 10-year Treasury bond rate was hovering around 2.5 percent while the average 30-year fixed conforming mortgage rate was near 4.25 percent. With rates already so low and seemingly having little effect in stimulating economic activity, there seems little reason to expect even lower rates to move the economic dial.

Alternatively, at some point inflation may start to gain traction from past and current monetary accommodation even as the economy remains moribund. Numerous commentators have lapsed into the poor habit of thinking that a slow economy at least provides insurance against rising inflation. The "stagflation" in the 1970s, when slow growth and rising inflation last combined to kill off belief in Keynesian fiscal stimulus, teaches otherwise. If higher inflation is on the immediate horizon instead of deflation, then resuming quantitative easing would likely compound the problem.

A third risk is that aggressive past and future monetary accommodation would trigger asset price bubbles in the equity markets, for example, as a precursor to resurgent inflation. Asset price bubbles are common consequences of excessively loose monetary policy. These asset price bubbles would give the economy a welcome dose of levitation—until they popped, leaving a weaker economy buffeted by higher price inflation.

3. See Ben S. Bernanke, "The Economic Outlook and Monetary Policy," speech at the Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, Wyoming, August 27, 2010, at *http://www.federalreserve.gov/newsevents/speech/bernanke20100827a.htm* (October 20, 2010).

4. See Derek Scissors and J. D. Foster, "Two Lost Decades? Why Japan's Economy Is Still Stumbling and How the U.S. Can Stay Upright," Heritage Foundation *WebMemo* No. 2307, February 23, 2009, at *http://www.heritage.org/research/reports/2009/02/two-lost-decades-why-japans-economy-is-still-stumbling-and-how-the-us-can-stay-upright*.

Looking on the Bright Side

These risks, while real, should be considered alongside the possibility the Fed will navigate these waters safely. The picture is not all doom and gloom. It is entirely possible that the economy's intrinsic strengths combined with an extra push from the Fed's quantitative easing will pull the economy onto a strong, sustained recovery without unpleasant asset price bubbles while inflation expectations remain anchored in the foundation of the Fed's credibility. What happens next?

William McChesney Martin, the longest serving Fed Chairman, once quipped that the Fed's job was "to take away the punch bowl just as the party gets going." If the Fed successfully sustains the economy and wards off asset price bubbles before inflation ignites, its job will then be to one-up its traditional role—to take away the punch bowl just as the guests arrive.

Another expression from economic lore—that of monetary policy occasionally "pushing on a string"—suggests that in some circumstances monetary policy may not be effective. Even if quantitative easing proves somewhat effective, large sums are likely needed to achieve small consequences, thus giving the policy a definite pushing-on-a-string quality. Once the economy gains real traction, which will occur at some point, that string will become increasingly taut just as the Fed must pull back about as far as it had previously pushed. In other words, the Fed will likely need to reverse course quickly, selling back bonds from its balance sheet and pushing up the Fed funds rate long before the markets expect or are ready, and long before the Fed itself would prefer. Once the economy picks up pace, the potential inflationary energy contained in past Fed policies may well flow into the economy quickly and manifest itself in surprisingly rapidly rising prices.

In that event, the Fed may well respond quickly to the new inflation threat, containing inflation after a brief rise. However, this victory, if it occurs, will come at the cost of an echo of an economic slowdown. Just as economic growth appears strong enough to create jobs rapidly enough to move the nation toward full employment, the Fed's anti-inflation stance will hit like a bucket of cold water.

However, the alternative would be even less pleasant. If the Fed's actions are too late and too timid, unacceptably rapid inflation will take hold, forcing a much more aggressive monetary tightening and possibly triggering a classic, monetary-policy-induced recession some years hence.

The Way Forward

No matter which way it turns, the Federal Reserve faces a daunting task in the months and years ahead. The economy remains mired in stunted growth and high unemployment due in part to federal policies elsewhere. Deflation threatens, but so does inflation, in the near term and further out. At the same time, ancillary problems beckon, such as growing unease about exchange rates triggered in large part by China's refusal to allow its currency to find a more sustainable level. Getting monetary policy right will require a true maestro and no small amount of luck.

The Fed's task is made all the more difficult by the huge increase in federal spending pushed through by President Obama and his congressional allies, which has driven current and projected budget deficits far beyond $1 trillion annually. These deficits further drain confidence from families and businesses because they raise the risk of a government debt crisis and higher interest rates and because the President and Congress may attempt to use these massive deficits as an excuse to raise taxes even higher. They also drain confidence because Americans instinctively know that the federal government is on a fundamentally unsustainable course.

Alternatively, Washington policymakers could significantly improve the likelihood of the Fed safely navigating these treacherous waters if they were to pursue effective pro-growth fiscal policies. These include a firm stand against tax hikes at least until the economy nears full employment, significantly reducing spending in the near term to reduce budget deficits to historical levels, putting entitlement spending on a sustainable path in the long term, and judiciously reducing marginal tax rates to improve economic incentives.

—J. D. Foster, Ph.D., is Norman B. Ture Senior Fellow in the Economics of Fiscal Policy in the Thomas A. Roe Institute for Economic Policy Studies at The Heritage Foundation.

The Heritage Foundation
LEADERSHIP FOR AMERICA