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Bernanke's Quantitative Easing: Wrong Medicine for an Ailing Economy

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The Federal Reserve's Open Market Committee announced today that it would pursue $40 billion in additional monthly stimulus in the form of quantitative easing. Meanwhile, it will maintain its previous program of exchanging about $45 billion monthly in short-for-long-term securities. Quantitative easing, or QE, is purchasing long-dated government bonds and similar debt instruments.

The policy is certainly well motivated: The U.S. economy is barely growing, as the latest jobs report underscored, predominantly because of severe regulatory and fiscal uncertainty. Under the circumstances, while Federal Reserve Chairman Ben Bernanke's urge to "do something" is understandable, even commendable, the economy would be better off today—and in years to come—if he were to remember the expression "when you're stuck in a hole, stop digging."

The Need to "Do Something." One cannot contest Bernanke's concern. Job growth has gone from slow to slower, while the unemployment rate remains just above 8 percent rather than climbing briskly only because half a million Americans have simply quit the work force since June.[1] President Obama's economic prescriptions of massive deficit spending and heavy regulations have plainly—albeit not surprisingly—failed. If that weren't bad enough, President Obama and Congress seem content to slow the economy further, possibly triggering another recession in 2013, by their refusal to defuse Taxmageddon, a slate of economically devastating tax hikes set to hit on January 1.[2]

As President Obama and Congress are unable or unwilling to provide timely economic help, all eyes turn to Chairman Bernanke. For their part, Bernanke and the Wall Street commentariat bear much of the responsibility for this prayerful behavior. The airwaves are filled with mention of the many non-traditional tools remaining at the Fed's disposal—actions it could take if economic conditions warranted. References to non-traditional tools are necessary because the Fed has already exhausted its traditional tools. For example, the Fed funds rate is near zero, while the real funds rate (the rate after adjusting for inflation) is substantially negative.

QE 3 As Wrong As QEs 1 and 2. The Fed pursued two previous rounds of QE in which it purchased various long-term bonds. It is also continuing a second round of a related exercise called Operation Twist, under which it sells short-term assets to buy long-term assets. The net effect on the economy has been imperceptible, but the net effect on the Fed is quite pronounced, as its balance sheet has ballooned to $2.814 trillion today from $924 billion in mid-September 2009.

It is hard to see how another round of QE would help the economy. Long-term interest rates are already at historic lows. For example, the 10-year Treasury bond rate has wandered between 1.4 percent and 1.8 percent over the past three months, and the conventional 30-year mortgage rate remains below 3.5 percent. For comparison, the average rate on the 10-year Treasury bond during the 2000s was 4.3 percent, and the average mortgage rate was 6.1 percent.

This paper, in its entirety, can be found at **http://report.heritage.org/ib3729**

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With rates this low, even if QE put effective downward pressure on rates—a dubious proposition—the economy would be unlikely to benefit. If a 3.5 percent mortgage rate is of little consequence, there is no reason to believe that a 3.4 percent or even 3.3 percent rate would suddenly produce results.

Nor would quantitative easing result in a burst of money creation as per traditional monetary policy because the Fed now pays a quarter-point interest on excess bank reserves. With little growth in the demand for private credit, banks have chosen to leave their additional reserves on deposit with the Fed, earning this paltry but completely safe return.

One might suspect that Bernanke fears that admitting the Fed's stimulus toolkit is empty would send shockwaves through financial markets. The powerful presumption—at the Fed and in the markets—is that competent central banks *always* have some magic potion to heal economic woes. They don't, and misleading the markets by hinting at such a potion is the opposite of the transparency that Bernanke espouses.

What's the Harm in Trying? Another round of quantitative easing will not help the economy appreciably, but what's the harm? The immediate harm is the added noise in market signals and the added uncertainty about future Fed actions and consequences. Also, if the Fed is able to depress long-term interest rates artificially—as the policy implies—one ill consequence would be widespread distortions of various asset prices, most obviously of long-term debt obligations, but also equity values and commodity prices. Immediately after a housing bubble, a policy of intentionally distorting asset prices is a tough sell.

Further, consider what is at the heart of QE: a central bank buying vast quantities of government debt. Historically, governments have forced central banks to buy debt because the government has proven so irresponsible that financial markets will not buy the bonds necessary to fund government spending.

Despite President Obama's fourth consecutive trillion-dollar budget deficit, the U.S. Treasury has no problem finding buyers for its notes and bonds. The intent today is not to monetize debt in the old-fashioned way. Motivations differ, but are the consequences? Not entirely. The Fed still ends up with boatloads of government bonds.

QE Consequences. The real problem with QE—beyond increased near-term uncertainty—is that the Fed must at some point unload all these bonds it has bought. The Fed will buy bonds in soft markets and sell them when interest rates are already rising, pushing interest rates up further, faster. The problem, in short, is that the Fed will have failed to prop up the economy when it was weak only to risk killing the recovery once it really takes off. This is the outcome to which former Senator Phil Gramm and Professor John Taylor of Stanford refer in their column, "The Hidden Costs of Monetary Easing," in the September 12, 2012, *Wall Street Journal*.

The Fed's concerns about job growth are well founded. Uncertainty over rising regulatory costs, the threat of Taxmageddon, and recession in 2013, combined with the increasing uncertainty associated with an irresponsible and unsustainable fiscal policy, have all contributed to ongoing economic weakness. These matters must be addressed by the President and Congress. Today, the Fed's responses attempting to overcome these Washington headwinds are likely to do much more harm than good. Congress and the President must attend to job growth. The Fed should acknowledge that it can do no more and that it is in a hole—having expanded its balance sheet dangerously—and stop digging.

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1. Rea Hederman Jr. and James Sherk, "Heritage Employment Report: Dog Days of August Howl in the Labor Market," Heritage Foundation *Issue Brief* No. 3719, September 7, 2012, http://www.heritage.org/research/reports/2012/09/august-jobs-report-labor-market-continuing-its-non-recovery.
2. Curtis Dubay, "Congress Should Finish Its Summer Job: Stop Taxmageddon," Heritage Foundation *Issue Brief* No. 3725, September 12, 2012, http://www.heritage.org/research/reports/2012/09/why-congress-should-stop-taxmageddon.