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Bernanke's QE3: Ironically, a Policy Predicated on Irrational Behavior

J.D. Foster

Federal Reserve Chairman Ben Bernanke's Federal Open Market Committee announced a third round of quantitative easing (QE) on September 13. The intent is to stimulate the economy, which has been languishing and is now slowing further under President Obama's economic policies. Two key arguments in support of QE3 are that it will put downward pressure on long-term interest rates—especially mortgage rates—and that it will induce an increase in asset prices that, by increasing personal wealth, will induce an increase in personal consumption. A careful examination shows both arguments to be weak and the latter argument to ironically echo an unfortunate past experiment in monetary policy.

On the other hand, if the Fed goes forward with its plan to buy an additional $40 billion in long-dated federal agency-backed debt and do so indefinitely, it will be adding nearly a half-trillion dollars a year to its already worrisome balance sheet. Shrinking the balance sheet to a more normal size by unloading all these long-dated assets will prove difficult, despite Chairman Bernanke's brave assurances to the contrary. Almost by definition, this unwinding will occur as interest rates rise, making the sell-off difficult for the Fed and hard on the economy. Bernanke should find a convenient excuse to stop QE3 before he does any more damage.

QE3 and Interest Rates. One argument for QE3 is that pushing down long-term interest rates (like mortgage rates) will help the housing market recover and thereby strengthen the recovery. An obvious problem with this argument is that mortgage rates are already very low and housing is already recovering, albeit slowly. How much further can the Fed push rates down, and would this really make a difference to the housing market when so many homeowners are underwater and cannot sell and while unemployment is above 8 percent and threatens to rise?

Perhaps a bigger problem with the interest rate story is the markets' response. While mortgage rates fell following the announcement as hoped, the 10-year Treasury rate soared. Unless one can affirm that mortgage rates are substantially more important to the recovery than all of the market rates tied to the 10-year Treasury, then it would appear that QE3 may backfire.

QE3 and Wealth. Another argument offered by Chairman Bernanke is that QE3 will push up asset prices like housing prices and stock prices. As a result of such increases, the argument goes, wealth holders will be wealthier and will likely spend some of this additional wealth, thereby stimulating the economy.

Discussions of this wealth effect typically revolve around questions regarding the responsiveness of consumption to changes in wealth. Yet in this case, these traditional discussions miss a more fundamental point about rationality. The premise is that QE3 will increase wealth *artificially*. It is clearly an artificial increase because productive assets have become no more productive as a result. The discussion does not even hinge on an increase in inflation that might depress real wages (nominal wages adjusted for prices), which would improve business profits and thus justify an increase in asset prices.

This paper, in its entirety, can be found at **http://report.heritage.org/ib3736**

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The Heritage Foundation
214 Massachusetts Avenue, NE
Washington, DC 20002
(202) 546-4400 | heritage.org

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The clincher to the artificiality of the wealth effect is it will reverse when the Fed at some future date reverses its QE3 purchases, disposing of its mountain of assets. Interest rates will then rise further, faster. Is there any doubt about the depressive effect this interest rate response will have on asset values? What this means, assuming that QE3 produces the desired increase in wealth, is that this increase is entirely transitory.

At some future date—again assuming that the wealth effect of QE3 is real—the value of outstanding wealth will return roughly to whatever level it would have been absent QE3. In terms of wealth, the value will be as though QE3 had never happened.

Assuming wealth holders are rational, they will perceive the transitory nature of their current gains. It would then be irrational for them to increase current spending out of current, transitory wealth gains.

The wealth premise of QE3 is that wealth will go up and spending along with it. But the wealth gain is transitory: Wealth will go down again because QE3 must itself be reversed. Increasing spending on the basis of a temporary and ultimately reversed wealth gain would be irrational. Thus, the wealth argument for stimulating the economy works only if wealth holders are irrational.

The Irony of History. Those with longer memories and a dab of monetary theory may recognize this delicious irony. Decades ago, a premise for the ability of the Fed to stimulate the economy was that the Fed could induce an increase in inflation without anyone really noticing. This would then reduce real wages, reduce unit labor costs, increase hiring, and thus stimulate the economy. Workers and others were presumed, essentially, to be so irrational that they ignored what the Fed was up to.

We learned otherwise as inflation and unemployment rose in tandem under President Jimmy Carter, and monetary theorists have spent the past few decades wrapped up in various theories involving market expectations.

Now we have the Fed once again pursuing a policy of economic stimulus predicated on irrational behavior—in this case not of workers but of a generally more sophisticated lot—wealth holders.

Do Less Harm Is Still the Fed's Best Policy. Chairman Bernanke's latest QE tack, however well motivated by a floundering economy, is misguided. It adds confusion to markets and likely has little or no immediate net beneficial effects, especially through the argued wealth effect, which depends on the irrationality of wealth holders. QE3 also creates future risks that no one can fully appreciate at this point. The only rational course is for Chairman Bernanke to find a convenient excuse at the earliest possible moment and declare that he's pulling the plug on quantitative easing.

*—**J. D. Foster, PhD,** 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.*