A Strategic Approach to QE: A Bad Trade

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The move to further Quantitative Easing (QE) appears to be a “bad trade” based on assessment of risks and rewards over the longer term. Although the economy remains weak and inflation low, QE risks economic volatility.

QE may actually threaten achievement of the frequently stated Federal Reserve Board dual mandate of maximum employment and price stability. The Federal Reserve Act repeatedly emphasizes maximum employment and price stability in the "long run" or “long-term.”[1] Risks from QE induced market and economic volatility may jeopardize the “long term”.

Risks from QE include:

Uncertainty: US economic growth is below potential, due to uncertainty rather than a lack of monetary liquidity from the Fed. We estimate that the present level of uncertainty in the US economy is the highest it has been since the Korean War.[2] This uncertainly likely stems from unknowns related to regulatory reforms underway in finance and health care as well as the presence or expiration of public spending initiatives. Our measure of uncertainty is based on cross-sectional standard deviation of the component growth of the national income accounts during recoveries. This one is different.

The experimental nature of QE may add to this uncertainty. Even Chairman Bernanke acknowledges that the Fed is "still learning about the efficacy and appropriate management of these alternative tools."[3]

Unintended Consequences: Excessively low interest rates indirectly and surprisingly raise risks to businesses and consumers. For example, major insurance companies are abandoning unprofitable business lines due to the low rate environment. MetLife recently halted its long-term care insurance for new policies.[4] Likewise, fixed annuities sales are down 35% in the first three quarters of 2010 relative to last year – largely based on interest rate related challenges for issuers.[5]

Low rates are also forcing retirees or others living on a fixed income to dive more deeply into principal or invest in riskier assets.

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[1] The Federal Reserve Act: Monetary Policy Objectives, Section 2a (http://www.federalreserve.gov)

[2] Goodman, Lawrence and Yubo Wang, “Uneven, Uncertain and Unusual Recovery” – Center for Financial Stability, Inc., July 29, 2010.

[3] Bernanke, Ben S. Bernanke, “Monetary Policy Objectives and Tools in a Low-Inflation Environment” – Federal Reserve Bank of Boston, October 15, 2010.

[4] Holm, Erik and Anne Tergesen, “MetLife to End Sales of Long-Term Care Insurance” – Wall Street Journal, November 11, 2010.

[5] “Low Rates Squeeze Fixed Annuity Issuers” – Retirement Income Journal – November 24, 2010.

Weakened Contingency Plan: Under present circumstances, QE meaningfully weakens the Fed's hand in the event of a serious economic or financial crisis. Although the Fed can engage in additional QE or purchase a wider range of securities, the efficacy of such a move is diminished the more QE is the present policy of choice.

Power of a Few: Markets are now more personal since QE. In other words, the action of a small number of officials holds increasing sway over markets relative to the sum of many atomized players. Some even suggest a Fed Chairman's speech now commands substantially more attention than the "King of Economic Indicators" or payroll employment.

Track Record: History suggests that the ability of the Fed to synchronize monetary policy with the economy is dubious. The Fed policy of "fine tuning" in the 1960s – effectively adjusting monetary policy to smooth disturbances in the economy – ultimately surrendered to inflation in the 1970s. Likewise, the infusion of money in the early 2000s – deemed critical to rescue the world from deflation[6],[7] – remained unchecked until the financial crisis.

Even the Japanese experience with QE is mixed. Despite the creation by Bank of Japan of five times the equivalent of its required reserves between March 2001 and March 2006," Richard Koo from the Nomura Research Institute finds that "quantitative easing was the twenty-first century's greatest monetary non-event".[8] During this period, BoJ clearly helped propel the financial crisis via the carry trade – borrowing in yen and investing in higher yielding assets such as Emerging Markets.

Asset Bubbles: Fluctuations in Fed policy unambiguously influence commodity prices as well as risky assets.[9] For example, a simple annotated chart of the Commodity Research Bureau (CRB) index since the beginning of the financial crisis clearly illustrates how sharp price shifts oscillate between a slide in global demand pushing prices lower or a fresh ease by the Fed propelling prices higher. These swings destabilize Emerging economies, food producers, and consumers.

QE can readily backfire, if risky assets such as stocks, commodities, and Emerging Markets that benefited from the Fed's policy suddenly correct. Emerging Market assets remain especially vulnerable over the next 12 months, due in part to recent gains and appreciation fueled by QE. The Brazilian real is already overvalued by 20-25% based on our calculations. Foreign market volatility could readily tarnish US market and economic performance by the middle of 2011.

Inflation: Although inflation is clearly low, the threat of a downward deflationary spiral may be overstated. Many fear a 1930s style deflation based largely on core inflation or inflation excluding food and energy. The reality is the measure may be somewhat flawed in part due to

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[6] Bernanke, Ben S. "Deflation: Making Sure 'It' Doesn't Happen Here" – Washington, DC, November 21, 2002.
[7] Rogoff, Kenneth, et.al. "Deflation: Determinants, Risk, and Policy Objectives" – IMF, April 30, 2003.
[8] Koo, Richard, *Lessons from Japan's Great Recession* – John Wiley & Sons (Asia) Pte. Ltd., 2008.
[9] Goodman, Lawrence. "Managing the Volatility Moving Money and Markets" – New Orleans, LA, September 16, 2010.

its history. Core inflation was created by Fed Chairman Arthur Burns in the mid 70s with the political purpose of highlighting restrained inflation after the implementation of the Nixon wage and price controls.

Alternative measures suggest inflation is actually modestly higher than the latest official release and substantially higher than core. For example, the MIT Billions Prices Project suggests inflation is presently over 2% year-to-year relative to 1.1% as estimate by the BLS at the end of October (or 0.8% for core inflation).[10]

Limits to Easy Money: A Federal Funds rate below inflation or lower than reasonable ranges implied by a Taylor Rule certainly contributed to the recent financial crisis.[11] There is limited evidence to suggest pursuit of a similar policy will bypass aftershocks this time.

In conclusion, QE risks a meaningful boost in the **volatility** of financial markets and the real economy. In fact, the recent infusion of money may actually even push US growth higher into early 2011. However, meaningful risks and unintended consequences from an experimental policy introduce potential costs to society which will likely trump near term benefits…suggesting that additional QE is a "bad trade."

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[10] The Billions Prices Project at MIT - http://bpp.mit.edu/daily-price-indexes/?country=USA.

[11] Taylor, John B. *Getting Off Track*, Hoover Institute Press, Stanford University, 2009.