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Quantitative Easing — Myths and Half-Truths



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Quantitative Easing — Myths and Half-Truths

1. Introduction and Objective

The performance of government in maintaining steady economic growth and low inflation requires the adept use of both fiscal and monetary policy. There have been major changes in the conduct of both policies during the past four years. In the case of fiscal policy, policymakers on both the Left and the Right now acknowledge the existence of new limits on the degree to which governments can borrow. When these limits are breached, global bond market vigilantes will either demand politically painful deficit reduction, or else exact much higher yields on longer-maturity securities. In response to this reality, fiscal policy itself will necessarily undergo a transformation, one which is now beginning.

More specifically, when large fiscal stimulus really is needed (as right now here in the US), governments will have to pacify bond markets by demonstrating that any increased government borrowing will be earmarked to fund *productive* public sector investments that more than pay for themselves in the long run. Emphasis in fiscal policy must shift away from the *size* of the stimulus (deficit) to the *composition and quality* of government spending that is funded by the deficit — if and when a deficit is required to restore growth.¹

Analogously, in the domain of monetary policy, Fed Chairman Bernanke has been forced by the Global Financial Crisis (GFC) to reinvent monetary policy. The role of the Fed (and indeed of other central banks worldwide) far transcended that of lowering short-term interest rates, and included diverse new activities required of the Fed as the nation's true Lender of Last Resort. In particular, it adopted the policy of Quantitative Easing, a “quantity” policy of asset purchases as opposed to a “price” policy of lowering interest rates. The latter prerogative became unavailable to the Fed as short-term interest rates reached their lowest levels in decades.

Yet whereas almost anyone can understand today's new constraints upon *fiscal* policy given the excessive buildup of federal debt during past decades, there is little understanding of QE monetary policy, and much disagreement about it:

¹ We have stressed this point in our writings during the past two years. In doing so, we have been influenced by the path-breaking 1970 book *Public Investment, the Rate of Return, and Optimal Fiscal Policy* by the Stanford University Professors K. J. Arrow and M. Kurz. This book rigorously laid out the argument for this generalized fiscal policy that focused on the *quality* of government investment spending.

- What exactly is QE? Is it in fact “money printing,” as most investors seem to believe? If not, then what exactly *is* money printing?
- Will QE cause hyperinflation “eventually” as most observers seem to believe — for example when the Fed finally “unwinds” its balance sheet — whatever that means? If not, why not?
- Will QE work on Main Street in reviving economic growth, other things being equal? The answer here requires an understanding of the six “transmission channels” through which QE is *supposed* to work, and then asking how effective each channel might be in stimulating recovery in today’s unusual environment.
- Given answers to the above questions, what can be said of the recent criticism of QE by Dallas Federal Reserve Chairman Richard W. Fisher? In a recent and widely circulated speech given at the Harvard Club of New York, Fisher lambasted current policy, and did so in a way reflecting the views of many other commentators and investors.

These are the questions posed and answered in this **PROFILE**. If you feel somewhat perplexed about these issues, you ought to be since they are as inherently confusing as they are novel. This is why there is widespread disagreement and confusion about the new policy of QE. I have not seen any paper that properly disentangles the above issues, much less addresses them in a coherent and non-ideological manner. I attempt to do so below.

Caveat — The “Controllability” Constraint in this Context

– Why the Fed Cannot Go it Alone –

One point must be emphasized at the outset, especially since we will not discuss it below. The celebrated Tinbergen Controllability Theorem we often cite established that, if government has n goals (e.g., $n = 2$ when the objectives are full employment and price stability), then it must possess at least n independent policy instruments if government is to be able to achieve its goals. This is the meaning of “controllability.” If the number of policy instruments is less than the number of goals, then government will not and cannot achieve its objectives, and we end up with non-controllability. Traditionally, the principal two policy instruments have been monetary policy and fiscal policy. And as is required, each of these instruments can be utilized independently of the other.

By extension, when there are additional *new* goals to be achieved, then new policy instruments are required. In this regard, the Fed had new goals to achieve in 2008–2009 when it needed not

only to revive the economy but also to stabilize the entire financial system. QE policy should be thought of as a new policy variable necessary in today's environment.

Given the need for controllability, the following discussion about the nature and effectiveness of QE policy will necessarily be *incomplete* if we do not make clear our assumptions about the use of fiscal policy. For little can be said about the desirability of QE or about monetary policy more broadly unless we specify that fiscal policy will be optimally utilized. Without fiscal policy doing its part in complementing monetary policy, the economy will be non-controllable, and the efficacy of monetary policy with QE cannot be meaningfully assessed at all. A failure to understand this point is why so many discussions of QE are confused and unconvincing.

Along these lines, one of the principal problems besetting US economic policy is that fiscal policy *qua policy* is effectively dead. Here is one result of this policy vacuum: Virtually any activity by the Fed becomes “big news” since the Fed has now emerged as the only real player in the game. And given its prominence, expectations are high that when the Fed “acts” decisively and lowers rates or adopts QE, it can heal the economy on its own despite our gridlocked Congress. But the controllability theorem reminds us that monetary policy *cannot* do so on its own. High-profile central bankers such as Bernanke often protest that the Fed cannot do it on its own, but they are not very convincing to the markets since they never explain *why* this is so. And when the economy does not recover despite ever easier monetary policy, the Fed is unfairly blamed “for not doing enough.” It takes two to tango!

In what follows, we will therefore assess the effectiveness of QE in a context where fiscal policy *is* assumed to be doing its part. In terms of the *size* of today's fiscal stimulus, this is a defensible assumption. Our own concern is that the composition of government spending be redirected towards profitable investment spending. But there is no need to focus on this any further as this is a paper on monetary policy.

To sum up, we shall investigate whether the advent of QE represents an improvement in an environment where both classical fiscal and monetary policies (without QE) are already doing their job, whatever their inadequacies. What exactly does QE bring to the game that is new?

Topic 1: What Exactly is QE?

As of today, there is much less confusion about the nature of QE than there was when it was initially utilized by the Fed in 2008, and when most investors thought that QE was tantamount to “printing money.” The problem here, as we explained in several previous **PROFILES**, is that the word money has very little meaning as it has been and still is utilized. As we review in Topic 3 below, misunderstandings about how money is issued — *and about the Fed's control over such issuance* — have led many to assume that QE logically implies high *future* inflation, when in truth it need not do so at all.

Essentially, QE is the policy whereby the Fed acquires new assets on its balance sheet by purchasing securities such as mortgage-backed bonds, Treasuries, and other assets. These assets are typically longer-term in maturity than the very short-term assets the Fed buys/sells in much smaller amounts when carrying out its day-to-day Open Market operations. [It is these operations that are required to keep the Fed funds rate at its targeted level.] Now the Fed must “pay” for these longer-maturity asset purchases. More formally, its increased holdings of nearly \$2 trillion in *assets* on its balance sheet must be mirrored by a corresponding increase in its *liabilities*. How does it boost its liabilities in paying for its purchases?

To understand this, recall that the Fed’s liabilities consist of two principal kinds. First, currency in circulation, and second, bank reserves. In strictly correct terms, “printing money” will occur when the Fed prints new currency (new dollar bills) with which to reimburse the primary dealers (e.g., UBS and Citicorp) who acquire the new assets for the Fed, usually on the Open Market. Once this is done, there are literally “a lot more dollars in circulation,” and monetary inflation is a foregone conclusion. The German and Zimbabwean central banks did this in their great hyperinflations of the early 1920s and the 2000s respectively. There are, of course, other ways in which the Fed can print money (e.g., helicopter drops of new bills into our backyards), but we shall ignore these here.

Yet in the US, the Fed has not printed money in this manner at all. As an inspection of its balance sheet reveals, it continues to keep approximately the same amount of currency in circulation now as it did before the GFC, approximately \$800 billion. As a result, the US continues to need only \$100 bills (its largest-sized notes for many decades), whereas Germany and Zimbabwe were forced to create \$1 million and indeed \$10 million bills in their own currencies.

Instead of more currency in circulation in this sense, the Fed’s new liabilities due to QE consist of a vast expansion of its bank reserves. Given QE-3, these will soon have increased by some \$2 trillion from a surprisingly steady level of around \$65 billion in the years preceding 2008. More specifically, when the Fed wishes to “pay” Citicorp for purchasing securities for the Fed on the Open Market, Citicorp is paid via an electronic credit to its reserve account, which, as a primary dealer, it must hold with the NY Fed.

In the right environment, these new reserves *can* and normally would be inflationary. For example, if there is strong demand for new bank loans by households and companies, the banks can now loan up to approximately ten times the amount of their new “free” reserves by crediting the accounts of their customers with new loans adding up to $10 \times \$2 \text{ trillion} = \20 trillion . A vast monetary inflation would result as many more dollars would chase essentially the same number of widgets. Note that whereas the Fed can create growth in bank reserves at virtually *any* rate it wishes, the production of goods and services can only grow at some 3% to 4% annually given normal physical constraints on real growth. It is for this reason that hyperinflation will result once vast quantities of newly created bank reserves are actually lent

out. But the story of how QE works is much more complex than indicated here, as we shall see in discussing Topic 3.

Topic 2: Can QE Work, and if So, How?

When Fed Chairman Bernanke made his case for a sustained future policy of QE at the Jackson Hole convocation of central bankers and in speeches thereafter, he was quite firm in asserting that QE will provide a significant assist to Main Street, and hasten the pace of economic recovery. Of course, he had to argue this point since there was skepticism by several of his own colleagues and by many outside observers that sustained QE would do little if anything to help the recovery, while running significant risks at the same time. Dallas Fed Governor Richard W. Fisher has been particularly open about his concerns, and we shall discuss these in the concluding section of this **PROFILE**.

The Six Policy Transmission Channels

How exactly might QE “work” on Main Street? Or as economists put it, what are the transmission channels between QE monetary policy and the real economy? There are clearly very many such channels, but let us discuss the six most important of these.

1. Interest Rate Reductions

In principle, by buying up lots of securities in the markets, the Fed is shifting the demand curve for such assets outward, thus raising asset prices and lowering yields. Recall here that we are talking about yields on all bonds and notes except for overnight Fed funds. What can be wrong in assuming that QE will lower yields in this manner, and thus boost economic activity in the real economy?

The Fed is No Monopolist: The first thing to understand here is that, whereas the Fed is a true monopolist in the Fed funds market and can hence “set” the overnight funds rate at whatever level it wishes, it is not a monopolist at all in the markets for mortgage-backed securities, notes, and bonds. You and I and pension funds and China are players in the game of determining asset prices — along with the Fed. Thus, for starters, this first transmission channel should be understood to mean that QE can *influence* but in no way set yields on longer-term securities at rates that it might like. Depending upon the circumstances, QE will sometimes reduce yields a lot, and sometimes a little, if at all. In other cases, QE may backfire and raise yields. Let’s investigate this important matter further.

An Inflation Premium: For example, suppose that the markets interpret an aggressive policy of QE as highly inflationary in the longer run. Then in this case, non-Fed players in the markets may well demand a higher “inflation premium,” driving yields way up in response to what they see as irresponsible policy. Think back to the great inflation of 1978–1981. The inflation premium on the long Treasury bond increased by nearly 1,000 basis points given the momentous rise in the CPI during this period. Long bond yields peaked at over 14%. Could the Fed have prevented this huge increase in yields by buying up more and more Treasuries? A very few experts would say yes, but most would say no. “The very act of being seen to do so would be self-defeating, causing even worse jitters in the markets.”

A Credit Risk Premium: Consider another example of how ineffectual QE may prove in reducing rates. Suppose that investors interpret QE as increasing the risks of Treasury bond market downgrades by rating agencies. More generally, suppose that the combination of aggressive QE and huge sustained fiscal deficits of the kind we have been running convince investors that the US is no longer very credit-worthy. Then, regardless of any inflationary threat from QE — or perhaps in addition to an inflationary threat — *real* yields may well be driven up! Note that this did not happen at all during the 1978–1981 crisis when it was only the inflation premium and not any credit default risk premium that was in play.

Safe Haven Effects: For a final example of the limits of QE, consider the US as a nation in which investors foresee both higher inflation and higher credit risk due to QE. Could yields on long-bonds nonetheless *decline* for some reason? Yes, and this could happen even if the Fed were not pursuing QE proper. If global investors perceive the US, for all its problems, as the *least* rotten apple in the barrel, prices of longer-term securities could be driven up and yields down for flight-to-safety reasons. As someone who travels extensively and sees investors worldwide, I often hear: “For all its problems, the US possesses its own printing press, a fundamentally sound and productive economy, and two wide oceans on either side of her.” So perhaps flight-to-safety reasons are an additional explanation for today’s very low yields, yields that just might have fallen as low as they have without any QE at all.

Regrettably, it is very difficult to utilize econometric analysis to disentangle all of these influences on longer-term yields, for which reason the impact of QE alone is hard to decipher in today’s environment. To make matters worse, recall that in the early stage of QE-2, yields on long-Treasuries *rose* rather than fell as had been expected. No suitable explanation was ever forthcoming. But the reader can now understand how this could have happened, and may happen again, via the complex interplay between QE, induced inflation and credit premia, and safe haven effects. It is thus best to be quite *agnostic* regarding claims as to the ability of QE to lower yields.

2. Increased Asset Prices and Wealth Effects

Another transmission channel derives from the possibility of lower interest rates due to QE that was just discussed. As Bernanke has emphasized, lower yields will make mortgages more affordable. Additionally, the prices of stocks and bonds in investors' portfolios should rise. This will result in a wealth effect that should boost consumer confidence and spending. If QE really does lower yields, then the assumption of a wealth effect multiplier is persuasive as far as it goes. But once again, other influences might well be at work that vitiate any such wealth effect.

For example, in the US today, we read more and more articles demonstrating how alarmed baby boomers are about the state of their retirement prospects. They have dramatically under-saved, and are finally acknowledging this — especially since the value of their first and second homes has cratered. They also confront yields on their meager assets that are *half* of what boomers had originally projected. As a result, any such wealth effect as results from QE may be more than offset by other headwinds against spending.

3. Value of the Dollar

Various members of the Fed's Board have admitted that one result of QE will be a reduced value of the dollar. This reflects the belief that foreign investors will interpret extreme monetary easing as long-run inflationary, and thus bad for the dollar. This logic is sound, provided it is the US *alone*, and not its trading partners who implement an aggressive QE policy. Always remember that all currency values are relative, and therefore the policies that affect exchange rates must be compared on a relative basis. In this regard, the appeal of QE has already spread to many other nations' central banks, so that the longer-run impact of QE on the dollar may be much less than is expected.

4. Lender of Last Resort in Crisis

A distinction must be made between QE-1 on the one hand, and QE-2 and QE-3 on the other. During QE-1, the Fed was forced to buy in large numbers of mortgage-backed securities as a true Lender of Last Resort, for the market in such securities was dead in the water. In acting as a Lender of Last Resort, thereby forestalling outright insolvencies both on Main Street and on Wall Street, the Fed, via its policy of QE, can be said to have helped Main Street. We can thus view this impact as yet another transmission channel of QE. During the second and third tranches of QE, such was not the case, for the housing crisis had been transformed from a genuine collapse to one of a poor market turning around very slowly.

5. Increased Bank “Liquidity”

An additional transmission channel that is infrequently discussed and little understood is the role of QE in providing large and instantaneous liquidity to the banking system itself in times of crisis. The resulting extra liquidity assists Main Street by preventing an even worse contraction of credit than would otherwise occur. The reason why this QE transmission channel is little discussed is that the underlying logic is not understood by most everyone. In this regard, I owe the following explanation of this Fed-Main Street link to Professor Benjamin Friedman at Harvard University, a monetary policy scholar who has assisted us in our research on many occasions over the years.

Suppose a bank or a group of banks suddenly get in trouble, and confront looming insolvency issues. What can be done to ease matters? *First, consider Case A:* The banks sit on very few idle free reserves, as was the case before QE made possible the twenty-fold explosion of bank reserves now seen on the Fed’s balance sheet. In this case, it can prove quite difficult for the banks to obtain the extra liquidity they need. Worse, word will get out that a liquidity crisis is developing, and as word gets out, panic spreads.

Now consider Case B: This time, the banks are sitting on huge amounts of idle reserves. These can be sold instantly and anonymously on the Fed funds market, thus raising the required funds with little notice and no fuss.

6. Insurance Against Deflation

As Bernanke understands better than any other central banker does, and as we have stressed throughout the past five years, the risks of deflation currently outweigh those of inflation. When we say “risks” here, we mean both the probability of deflation versus inflation *and* the magnitude of the damage done by each. Now deflation is not necessarily worse than inflation when citizens do not hold debt. As we have seen in past deflations elsewhere, if wages drop 25% and so does the price of goods consumed, then living standards are not impacted at all. And living standards are what citizens care about.

However, when citizens owe a huge stock of debt that is fixed in *nominal* terms, a wage deflation (we have a small one at present) can be disastrous. The result will not be a “sovereign” debt crisis, but rather a “civil” crisis in which we are all forced as individuals to default on all our debts to one another. And as every reader knows well, from Australia to the US, the levels of private household debt to income are at record highs. Thus deflation is a true no-no in today’s environment.

In this regard, the policy of QE can be viewed as a means of reducing the probability of deflation — a relatively invisible means of doing so as contrasted with a highly visible “helicopter drop” of cash of the kind Bernanke cited in his celebrated 2002 speech on deflation

prevention. The latter method is, of course, more effective, since the Fed has direct control over how much newly printed money must be dropped in our front yards to forestall deflation.

Topic 3: QE and Inflation

In Topic 1 concerning the nature of QE, we demonstrated how the policy of QE *can* result in much higher than expected inflation, as many observers assume it will in the future. But the link between QE and future inflation is less obvious than might first appear, and we want to clarify this and transcend the conventional wisdom on this matter. To begin with, we have seen that QE does not entail genuine “money printing” at all. Rather, QE can result in many more dollars chasing the same number of widgets by virtue of the *credit creation process* it can trigger. Once again, flush with excess free reserves, the banks will be very keen to earn profits by making trillions of dollars of new loans to customers. They could do so tomorrow given their \$2 trillion of new, free reserves.

Some question whether consumers and businesses will actually *spend* the new money that they have sitting in their bank accounts once the banks have given them new credits. If they don’t, no inflation will result. But this question is misplaced given an observation made by Keynes himself: If people have excess cash balances in their accounts by virtue of having *borrowed it* at a positive interest rate from their banks, then they will indeed spend it. They will have no incentive to pay interest on money merely to tuck it under their mattresses! They borrowed it at positive cost for a good reason, perhaps to build a new house or plant, and they will thus spend their new money on Main Street. As a result, a vast number of new dollars literally *will* end up chasing an essentially fixed supply of goods and services, resulting in a monetary inflation that investors fear.

Lack of Desire to Borrow: However, there is more to the story than this. First, suppose that businesses and households have no desire to borrow from their banks. Businesses might find (as they are) that investment opportunities within the US are very limited, and they will (as they are) utilize their overseas holdings of currencies to invest elsewhere in the world. Thus there will be no increased business demand for loans in the US economy *per se*, and hence no inflationary pressures from this source. Households for their part might wish to deleverage over an entire decade (as they are) given three decades of over-borrowing and overspending. The need to save more to retire also plays a role here in today’s curtailed demand for credit.

Thus, just as has been the case, all those new bank reserves remain “idle,” new credit creation is dormant, there are no new dollars chasing goods and services, and as a result, there is no monetary inflation *per se*. Of course, there are many other kinds of inflation that could push price indices up or down (oil prices, health care shock, etc.), but these are not being discussed herein. The experience within Japan during the past twenty years shows that this kind of monetary stagnation can perfectly coexist with deficit monetization by the central bank, and can do so for much longer than anyone thought possible.

The New Reserve Remuneration Rate Policy: But there is another and much more recent development that can prevent a reserves-based monetary inflation *even when people do indeed want to borrow again*, and when the reserves permitting their banks to make the desired loans are available. The technical innovation that arises here was discussed by us at length in a **PROFILE** two years ago, and again with the assistance of Professor Friedman at Harvard, who coauthored what is arguably the definitive paper on this subject.

In 2008, a law was passed permitting the Fed for the first time to remunerate banks for holding onto their free reserves, and not lending them out. This was the Reserve Remuneration Rate Act. I believe (but am not certain) that this remuneration fee could be negative as well as positive, with a negative remuneration being one way to prod banks to increase their lending to Main Street.

To understand the importance of this development, suppose that the sun comes out again as consumer confidence and spending rebound. Suppose also that there is a concomitant surge in the demand for credit — new credit that leads to more “money” chasing the existing output level of goods, as described above. Suppose finally that the Fed, realizing what is happening, wishes to *control* the rate at which credit is extended to Main Street. Then the Fed can respond by raising its current remuneration rate of 0.25% on reserves to, say, 4%. When it does so, banks will find it quite tempting to continue to sit on their reserves, and earn 4% risk free. In this way, the Fed can now control the growth of reserves-based credit and money expansion, and thus keep inflation in check.

Would the Fed *wish* to check inflation in this manner in a sunnier economic climate — a very different question than whether it *can* do so (which it indeed can)? In principle, it would wish to do so. This is because the reason for raising the remuneration rate in the first place was the prospect of an overheated economy. This is precisely the environment in which the Fed traditionally has and should raise interest rates. Yet circumstances could arise whereby the Fed would confront political difficulties in raising rates, difficulties stemming from groups that seek higher growth *regardless* of its impact on higher inflation.

There is yet another reason why the Fed might confront opposition to raising the reserve remuneration rate. Some might complain that higher yields due to raising the remuneration rate will *lower* the value of the Fed’s own holdings of longer-dated securities. This could cause the Fed to run a loss in reporting its annual profits. But does such a loss really matter? This leads directly into Topic 4.

Topic 4: Threats from the Fed's "Unwinding" of its Balance Sheet

One final point of confusion concerns what will happen when the Fed "unwinds" its balance sheet by selling off its newly acquired assets on the Open market, and as a result, hugely shrinking the reserve base of its member banks.² To the extent that this issue is discussed at all in the financial press, the following two questions usually arise:

(i) Won't shrinking back the Fed's balance sheet cause interest rates to rise, thus curtailing growth on Main Street?

(ii) Won't the Fed run the risk in unwinding that there are no buyers for many of the assets it is selling, assets such as mortgage-backs, thus causing the Fed to incur huge losses in its unwinding activities?

As for the first question, in shrinking its balance sheet by selling off its assets, the Fed should *in principle* raise interest rates since it is shifting the supply curve of assets outward. But remember that the Fed is neither a monopolist nor a monopsonist in the markets for longer-dated securities, and other forces of the kind discussed above could offset this implication of "more supply" for yields. For example, (i) inflation could drop; (ii) the safe haven effect could strengthen; or (iii) foreigners (and Americans, for that matter) could undergo a change in "asset preferences" by shifting out of equities and into bonds, as they have of late.

The answer to the second question is important in its own right, and it also obviates the concerns underlying the first question.

The reality is that the Fed in fact may well not need to unwind its balance sheet at all, ever, now that it possesses its new policy variable of changing the reserve remuneration rate.

Before the advent of the Reserve Remuneration Act, the Fed would typically be compelled to increase or decrease its balance sheet in order to achieve its objectives. The advent of the new policy variable removes its need to do so. As a result, the Fed, in principle, need never sell off its holdings of mortgage-backed securities. It can hold them until the cows come home. In turn, the Fed may not have to worry about big losses due to a fire-sale of mortgage-backs. But even if the Fed were to lose money on a number of securities — and remember that the Fed usually ends up *making* money on most everything — it doesn't really matter. For the Fed's income statement and balance sheet are of no interest to anyone other than the Treasury. Any profits the Fed makes are paid directly to the Treasury, and likewise when it incurs losses. Try to recall a single instance when these figures were featured in the news, or mattered to anyone.

² If the Fed's assets are reduced by being sold off, its liabilities (bank reserves) must shrink by the same amount.

Topic 5: Will QE be Effective Given Today's Unique Circumstances?
– A Critique by Dallas Fed Chairman Richard W. Fisher –

An entire book could be written answering this Topic 5 question. For brevity, we shall simply discuss the interesting speech that Richard W. Fisher delivered at the New York Harvard Club on September 19. By critiquing his assertions that further QE is not needed, and is risky, we can partially answer the question posed above. Partially.

To begin with, Fisher is not nearly as pessimistic as people have interpreted him to be. For example, consider what he says toward the end of his talk:

“Even though I am skeptical about the efficacy of large-scale asset purchases, I understand the logic of concentrating on mortgage-backed securities (MBS). The program could help offset some of the drag from higher government-sponsored entities’ fees that have been recently levied, will likely lower the spreads between mortgage-backed and Treasuries and should put further juice behind the housing market.....The general effects of inducing more refinancing may aid housing and households in other ways. Lower mortgage rates could help improve the discretionary spending power of some homeowners. Underwater homeowners might have added incentive to continue meeting mortgage payments, spurring demand and preventing underwater mortgages from sinking the emerging housing recovery.”

Despite this optimism about a potentially favorable impact on housing, at a deeper level, Fisher is highly skeptical about the Fed’s latest QE program, and about ever more accommodative monetary policy in general. Let us consider several of his reservations.

(i) General Agnosticism:

“The truth, however, is that nobody on the committee, nor on our staffs at the Board of Governors, and at the twelve (regional) banks, really knows what is holding back the economy. No one really knows what will work to get the economy back on course. And nobody — in fact no central bank anywhere on the planet — has the experience of successfully navigating a return home from the place in which we now find ourselves. No central bank — not at least the Federal Reserve has ever been on this cruise before.”

Even if one agrees with this policy agnosticism, it is hard to leap from this stance to the conclusion that QE-3 is *poor* policy. Indeed, Fisher himself makes no such connection, despite his reservations about whether QE-3 will work. The root problem here is that the very complaints Fisher makes about the difficulty of conducting monetary policy in a “new” environment can also be made about important decisions that we all confront in daily life.

Consider the tough decisions that companies like J&J face in determining which R&D projects to fund (“these are new areas for the company and we are shooting somewhat blind in trying to prioritize them”), that individuals face in determining which person to take as a spouse, that

generals face in how to wage new forms of war, and so on. Yes, decisions of many kinds are, and always will be, highly risky.

To restate this in an academic context, ongoing structural changes of any kind imply that the analysis of historical data will *not* permit “models” to be quantitatively precise and to tell us what the “true” relationships we are looking for really are. We have stressed *why* this is true in our discussions of endogenous risk over many years.

Nonetheless, we do know a good deal when making decisions under subjective uncertainty, if only at a qualitative level, and judgments simply have to be made. Interestingly, nothing Fisher says here casts doubt on the central reality that good fiscal and monetary policy *in sync* (pace Tinbergen!) can indeed put the economy back on course. This is particularly true given that we *do* know what is wrong with the economy and why today’s recovery is so problematic.³ Our view here runs contrary to Fisher’s rather perplexing claim that “nobody knows what is holding back the economy.”

(ii) Excessive Increases in Liquidity: Fisher makes another criticism. He points out that banks held an unprecedented \$1.6 trillion in free reserves before QE-3, and that corporations and others have saddlebags of cash sitting on the sidelines. Given these realities, he asks:

“Why would the Fed provision to shovel billions of additional liquidity into the economy’s boiler when so much is presently lying fallow?”

His question is spot on, and Bernanke did not provide a satisfactory answer in his recent speeches endorsing QE-3. Will “still more liquidity” really matter on Main Street?

(iii) Inflation Jitters: Fisher notes that “over the past week, there has been a significant increase in the longer-term inflation expectations inferred from bond yields.” He goes on:

“These inferences can be volatile and are not always reliable, but a sustained increase would suggest incipient doubts about our commitment to the Bernanke Doctrine of sailing on a course consistent with 2% longer-term inflation. I believe that even the slightest deviation from this course could induce some debilitating ‘mal de mer’ in the markets.”

As is typical in most discussions of the link between monetary policy and monetary inflation, Fisher does not draw upon the critical distinctions and contingencies we introduced in discussing Topic 3 above. The policies he opposes *need* not cause any rise in inflation at all, for reasons we explained in depth. Of course, Fisher’s analysis took the form of a speech, and thus he had no obligation to delve deeper than he did into the links between Fed policy and future

³ Recall my discussion of “The Seven Headwinds” behind the present economy, published in these **PROFILES**, and also early in Chapter 2 of my 2012 book *American Gridlock*.

inflation. The problem, of course, is that in making the cursory remarks he did make, he strengthens the widely-held perception that QE policy is inflationary by nature.

(iv) Businesses at ‘Sixes and Sevens’ in Contemplating the Future: Finally, Fisher takes issue with the widely held view that “flooding the markets with liquidity will lift final demand, both through the ‘wealth effect’ channel, and by directly stimulating businesses to expand and hire.” In rebutting this view, he cites a recent Duke University survey and other sources to argue that Bernanke’s assumed transmission channels linking wealth effects and business encouragement to activity on Main Street are not valid in the current environment. Citing an unnamed CEO whom he much respects, Fisher quotes:

“We are in ‘stall mode,’ stuck like Velcro, until the fog of uncertainty surrounding fiscal policy and the debacle in Europe lifts. In the meantime, anything monetary policy induces in the form of cheaper capital will go to buying back our stock.”

In brief, further interest rate reductions and liquidity injections will not move businesses off dead center. This time really is different. The survey data Fisher cites are very important, and we believe that the story it tells is true. This is one of the reasons we have proposed the need for a government-initiated Marshall Plan to be focused on *public* sector investment which will stimulate Main Street. Waiting for business to pick up all the slack on its own will not work.

In the final part of his speech, Fisher impressively stresses the point we made in the Introduction to this essay. He points out in a section entitled “Our Dysfunctional Congress and Drunken Sailors” that the monetary policy cannot do it alone. We need proper fiscal policy as well, and escape from the gridlock in Congress. Pace Tinbergen yet again!

This completes our discussion of several of the myths and half-truths about QE policy.