QE *Undone*

Quantitative easing can boost the stock market, but not the real economy—or even inflation.

BY JOHN H. MAKIN

The two pillars of post-crisis recovery policy doctrine—fiscal austerity (higher taxes and slower government spending growth) and quantitative easing (central bank bond buying to offset austerity and boost the economy)—are crumbling. We have seen austerity undone by political backlash, especially in Europe, against the unemployment and slow growth that follows it, coupled with doubts about the Reinhart and Rogoff claim that gross debt-to-GDP ratios above 90 percent are associated with slower growth. In the United States, the gross debt-to-GDP ratio stands above 100 percent, with no discernible harm to growth.

Now quantitative easing is under attack, first because it has not worked to boost growth, and second because many, both inside and outside the U.S. Federal Reserve, believe that quantitative easing will either cause higher inflation (which it has not done) or result in an economic/financial collapse when it is unwound (which has yet to occur). The focus here is largely on a current U.S. policy dilemma, though the issues raised are important for other economies with high debt levels and central banks concerned about growth.

From a theoretical standpoint, the undoing of both fiscal austerity and quantitative easing is no surprise. At the zero bound, with policy-set interest rates virtually at zero, the economy is stuck in a liquidity trap. Large increases in bank reserves are simply held, resulting in an absence of a money multiplier whereby increases in the monetary base

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boost the money supply. Rising cash assets of the public (households and firms) are largely held. The observable counterpart of the rise in cash holding by the public is a drop in velocity, the ratio of nominal GDP to the money supply, which measures the pace of transactions turnover of the money supply. U.S. velocity dropped sharply after 2008 and has continued to fall since 2011, even after QE2 and QE3 were implemented (see Figure 1).

In a liquidity trap, fiscal austerity reduces output and employment more than normal because austerity results in no reduction in the already-zero interest rate. The International Monetary Fund has acknowledged this in its last two *World Economic Outlooks* as it counsels a retreat from austerity. The awkward corollary for deficit hawks is that, in a liquidity trap, fiscal expansion results in an extra-large boost in output and employment because, with interest rates stuck at zero, there is no crowding out from the usual rise in interest rates that accompanies the actual/expected rise in the supply of government bills, notes, and bonds issued to finance more government spending.

The question of what happens next with austerity out of fashion and quantitative easing seen as ineffective is a difficult one. The United States has actually raised taxes by about $180 billion a year in the "fiscal cliff" deal and cut spending starting in 2014 by about $120 billion per year in the sequester. The Fed has begun to talk about how it will exit quantitative easing. The lower growth resulting from tighter fiscal policy could be offset by easier money were we not stuck in a liquidity trap. The Fed speaks as if it believes there is no liquidity trap, tying the persistence and level of quantitative easing to attainment of an unemployment rate at or below 6.5 percent, substantially below the current rate of 7.5 percent. How will this play out?

THE CURRENT QE QUANDARY

The discussion of quantitative easing, whereby the Fed buys bonds from the banks with the aim of boosting growth, has lately focused largely on how the Fed will end it without collapsing the economy, or, more likely, the stock market. While quantitative easing very probably will have to be ended at some future date, events over the last several months have suggested that the Fed will confront a perceived need for still more quantitative easing than it presently contemplates before it has to think about exiting quantitative easing.

The probability that still more quantitative easing will be seen as necessary, even given the $2.2 trillion in quantitative easing since 2008 that has nearly quadrupled the Fed's balance sheet, makes Fed policymakers, Congress, and many serious economists quite nervous. For Fed policymakers on the Federal Open Market Committee, the nervousness stems from two sources. For FOMC doves, there must be a dawning realization that "massive" quantitative easing since 2008—save for the bounce during 2009 after the Lehman crisis prompted initial quantitative easing—has done virtually nothing to boost growth or to reduce unemployment. This disconcerting outcome is, as already noted, a manifestation of an American liquidity trap.

On the other side of the quantitative easing debate, Fed hawks who have persistently warned about the risks of higher inflation should be troubled by the steady downward drift of inflation after 2009 that produced a deflation scare in mid-2010, followed by two more quantitative easing boosts that pushed core inflation up only to 2.3 percent last year (see Figure 2). Now, in mid-2013, core inflation has dropped back to 1.9 percent even after QE3 was announced in late 2012 as the Fed promised—unprecedentedly—to keep quantitative easing in place until the unemployment rate dropped to 6.5 percent or below from the 7.8 percent in place at the time.

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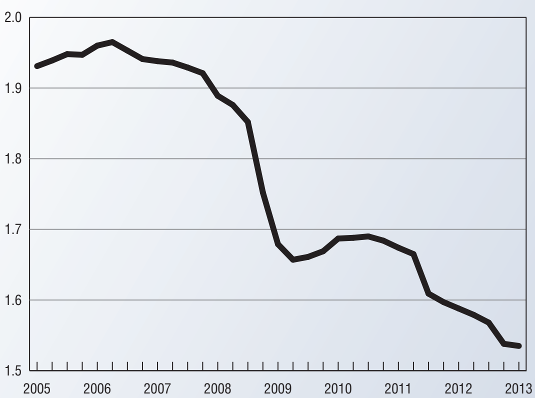
Another deflation scare could emerge by late summer, some three years after the last deflation scare prompted Fed Chairman Ben Bernanke to effectively announce QE2 in his speech to the annual August central bank gathering at Jackson Hole, Wyoming. Chairman Bernanke has already announced that he will not attend the Jackson Hole conference this year though he will still be Fed chairman until January 2014. FOMC doves—not to mention stock market bulls—may be worried that, with no one to announce QE4 in the event of a persistent deflation scare, the economy and markets may slump sharply.

Fed hawks and their academic supporters may be relieved at the prospect of no actual or prospective QE4, since they have not been deterred by an abundance of empirical evidence to the contrary that inflation is about to surge to dangerous levels that will require a rapid Fed exit from quantitative easing. Will they persist in holding that view if core year-over-year inflation drops back below 1 percent while the stock market collapses for lack of another dose of quantitative easing? Perhaps, but where will their victory lie? An end to further quantitative easing accompanied by intensifying disinflation and a falling stock market would test their conviction that higher inflation is just around the corner.

The most uncomfortable thing about the quantitative easing experiment—and it is surely an experiment—is that a massive expansion of Fed bond-buying and signaling of its persistence has not boosted actual or expected inflation, not to mention nominal or real GDP growth. Unemployment has come down modestly over the past year from 8 percent to 7.5 percent, but there are many structural reasons other than quantitative easing to account for that. The fact remains that this post-2008 economic recovery has been extremely tepid by all measures, save for the stock market, which has more doubled since its 2008 trough (see Figure 3).

Figure 1 Velocity of Money Stock



Source: Federal Reserve Board

The Fed speaks as if it believes there is no liquidity trap.

THE STOCK MARKET-ECONOMY DISCONNECT

The uncomfortable reality that has emerged from the quantitative easing experiment is this: quantitative easing can boost the stock market but it cannot help the real economy, and it cannot even boost inflation. And this troubling outcome has emerged during a 2008–2012 period of substantial fiscal stimulus averaging 3 percent of GDP annually. But in 2013, fiscal policy has shifted sharply towards drag equal to 2 percent of GDP. If quantitative easing cannot help the real economy—and there are sound theoretical and empirical reasons to doubt that it can—while fiscal policy in 2013 is slowing growth rather than boosting it, and stocks have risen by 22 percent over the past year, what will happen to stocks if/when QE4 is not implemented?

Notice that the rhetorical question does not ask about the effect of ending quantitative easing. Rather, it merely asks about the effect of not administering another, larger dose. If this sounds like an analogy to a question about the effect of denying another, larger dose of cocaine to an addict, be assured that it is meant to. There is no systematic evidence that has emerged since the March 2009 start of the quantitative easing experiment to suggest that the impact of quantitative easing has been anything other than to force investors to purchase riskier assets by driving the returns to holding low-risk assets such as Treasury bills and notes virtually to zero. Today, just short of five years after the Lehman collapse ushered in the financial crisis at a time when the yield on ten-year Treasury notes was 4 percent and core inflation was 2.5 percent, the ten-year yield is 1.7 percent and core inflation is 1.9 percent. Since 2009, growth has averaged just 1.9 percent despite unprecedented fiscal and monetary stimulus.

The yield on two-year Treasury notes today is about 0.2 percent, 5 basis points below the 0.25 percent the Fed pays banks on their $1.8 trillion in excess reserves (reserves in excess of required reserves). The Fed has pumped over $2 trillion into the banking system, 90 percent of which—$1.8 trillion—has been held by banks to earn 0.25 percent. Meanwhile, investors are earning

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virtually nothing on either bank deposits or Treasury bills. Little wonder that some are buying stocks whose value has risen 100 percent since the 2008 trough. It does not help to be reminded that a substantial part of the rise in stock prices has resulted from companies using accumulated cash or cheap borrowing to buy back their own stock. The underlying message is that there is a shortage of attractive real investment opportunities tied to capacity expansion.

WHY SHOULD QUANTITATIVE EASING WORK?

A more fundamental problem facing the Fed and other central banks is tied to the question of whether the rationale behind quantitative easing is sound. Should we expect, for example, a drop in the rate of unemployment to result from quantitative easing, the Fed's purchase of bonds owned by banks? The banks that sell their bonds to the Fed end up with excess cash reserves that the Fed pays them 25 basis points to hold, a return, as already noted, 5 basis points above the return on two-year Treasury notes.

The Fed posits two channels through which quantitative easing should work to boost the economy beyond the potential net export boost from a weaker dollar. First, a portfolio balance channel, whereby banks and investors who sell their bonds to the Fed see interest rates on safer assets fall, thereby causing them to buy riskier assets while banks are encouraged to lend more at interest rates above those on assets sold to the Fed. The result is higher asset prices, and still more borrowing and spending. So far, prices of some assets like stocks and real estate have been boosted by lower interest rates on low-risk assets. But such portfolio rebalancing has not been accompanied by substantially more hiring and investment such as normally occurs in an economic recovery. Rather, the public has just shifted into riskier assets given the need/desire to earn a return on accumulated wealth. The Fed is left with a dilemma/risk. What if more quantitative easing actually does boost spending

The United States has moved backward on policy-offense.

Figure 2 Consumer Price Index

Source: Bureau of Labor Statistics. All items less food and energy, year-over-year percent change, seasonally adjusted.

Figure 3 S&P 500

Source: Standard & Poor's

and growth and inflation starts to rise? Then will reversal of quantitative easing expansion produce an asset/growth collapse? The irony is that the inability of quantitative easing to boost either growth or inflation—outside of asset inflation—has left the Fed comfortable with continuing to use it to reduce unemployment, in spite of the fact that little evidence exists to suggest that it will succeed.

Undaunted, the Fed has posited another channel—the signaling effect—on the economy of monetary policy announcements about the persistence of quantitative easing. Last year, the Fed added to its commitment to keep policy interest rates at zero for "a considerable period" the assertion that policy would remain highly accommodative at least until the unemployment rate fell to 6.5 percent or below, and even then the Fed would be slow to remove monetary accommodation. By replacing a calendar-based commitment to maintaining zero interest rates with an outcome-based commitment, the Fed aimed to remove fears that it might exit the zero rate policy too early. The Fed even added that it would tolerate higher inflation, up to about 3 percent, if progress towards lower employment accompanied a "temporary" period of above-target (2 percent) inflation.

Since the Fed's new outcome-based initiative was announced on December 12, 2013, the growth rate has averaged a disappointing 1.6 percent, below the average 2008–2012 1.9 percent growth pace. Core inflation, as noted, has dropped from a pace of about 2.25 percent in mid-2012 to 1.9 percent today. Stocks have risen sharply by about 29 percent since mid-2012, while house prices have risen by about 9 percent over the past year. The portfolio balance effect has helped to boost the prices of riskier assets, but the economy has not improved. Growth has slowed while the rate of unemployment has dropped only modestly from 7.8 percent to 7.5 percent.

PAINFUL LESSONS

The persistent disappointing economic performance nearly five years after the financial crisis onset reminds us that the power of discretionary monetary policy and fiscal policy to boost growth and employment is limited. Repeated applications of fiscal and monetary (quantitative easing) stimulus suffer from diminishing returns while, in a liquidity trap, austerity—even that laudably aimed at deficit reduction—reduces growth and raises unemployment while the risk of deflation persists.

Sustainable higher growth does not result from discretionary changes in monetary and fiscal policy aimed at smoothing the path of output, unemployment, and inflation, not at permanently altering their levels. Sustainable higher growth will require structural adjustments including lower marginal tax rates financed by loophole closing, credible long-term—over decades—deficit reduction tied to redesigned entitlement programs, steady progress towards deregulation, and less uncertainty about the future path of the role of government in the economy.

The Fed's quantitative easing coupled with fiscal adjustments amount to a policy-defense aimed at avoiding bad outcomes. Policy-offense, aimed at boosting non-inflationary growth, requires real structural change that enhances economic efficiency.

It is fair to claim that the United States has moved backward on policy-offense. Trying to go on offense with more quantitative easing will not work. Eventually, we will get the higher inflation that so many have feared prematurely. Cassandra will be vindicated unless we do the heavy lifting required to effect positive structural change. ◆