



Evaluating QEII: A Rationale to Exit

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Whereas the Fed's alternative liquidity facilities and quantitative easing (QEI) responses to the financial crisis and deep recession were merited and effective, the rationale for QEII was muddled and the asset purchase program has been a stretch. When the Fed deliberated on QEII, the financial crisis had long ended and the economy had been recovering for over a year. The Fed's assessments of the benefits and risks of QEII were dominated by its perceived need to respond to last summer's "economic soft patch" and its excessive fears of a Japan-style deflation. Short-term cyclical concerns were put ahead of the significant long run-risks of massive purchases of US Treasury debt securities amid unsustainable government deficit spending, including potential undesired economic, inflation and financial outcomes as well as the sacrifice of the Fed's credibility and independence.

Fortunately, QEII has not jarred market expectations; mark that up to the lingering low inflation—a typical cyclical pattern following recession. Now, with economic performance clearly improving and inflation rising, the risks of this unprecedented monetary expansion are increasing. Consequently, the Fed must set out an exit strategy, including a framework for managing reserves and normalizing interest rates.

The Economic "Soft Patch"

The Fed was surprised and dismayed with the economic slowdown that unfolded beginning in May 2010. It believed that the slower growth was not just temporary, as it revised down its economic forecasts and raised projections of the unemployment rate (particularly in its June and November projections). This led the Fed to modify its rationale for quantitative easing. Even though inflation was low and expectations of low inflation were well anchored, the Fed perceived that the slow growth was inadequate to bring down the unemployment rate, which fueled deflation concerns.

This rationale for quantitative easing involved targeting economic growth, an objective that pushed the Fed beyond its capabilities. Although the Fed has acknowledged its limited ability to permanently lower the unemployment rate, it felt the pressure to "do something" since fiscal policy seemed frozen in the politically-charged Washington environment. Importantly, the Fed viewed higher unemployment largely as a cyclical phenomenon that could be remedied by more aggressive monetary accommodation. It gave insufficient weight to non monetary factors that had been inhibiting aggregate demand and job creation, including uncertainties related to health care, regulatory and tax policies; sector concentrations of unemployment (over 25 percent of net 7.5 million jobs lost were in the construction industry); or the related issues of skill mismatches and labor immobility stemming from negative equity in mortgages.

The Fed overreacted to the temporary soft patch. Economic growth has since strengthened, presumably in lagged response to the earlier monetary accommodation and QEII's boost to the stock market. The Fed quickly revised back up its forecasts. Such over reactions to the high frequency economic data are unfortunate for forward-looking policymakers.

Since formally adopting QEII in November 2010, the Fed has acknowledged that the unemployment rate may remain stubbornly high for "four or five" years, and different forecasters, including some within the Federal Reserve System, have significantly raised their estimates of the natural rate of unemployment. These changes suggest limited appropriateness and efficacy of aggressive QE, which was the wrong policy tool for reducing stubborn unemployment and poses ongoing risks to the economy.

Fears of Deflation

The Fed never forecast deflation in 2010, but it had a great fear of deflation—that it would be very damaging to the economy, and once established, would be very difficult to escape. Japan's sustained mild deflation was used as a benchmark to avoid. These deflation fears were overblown, and the perceived parallels between the US situation and Japan's mild deflation seem highly inappropriate and misleading.

Year-over-year CPI inflation decelerated through most of 2010, hitting a low of 1.0 percent in November (the core CPI fell to 0.6 percent in October), before rising. Even the low end of the FOMC's central tendency forecasts (the three lowest member forecasts) projected modest inflation, not deflation. The Fed acknowledged that expectations were well anchored to low inflation. Its overriding concern about deflation was based on the large measured slack in NAIRU and GDP Gap models, which have proved unreliable in the past.

When the Fed contemplated QEII, key indicators suggested that deflation would not occur. US domestic demand had clearly accelerated and nominal GDP growth was decidedly above potential growth. Real growth was also improving (the slump in real GDP growth to 1.7 percent in 2010Q2 was readily acknowledged by the Fed to be due to a temporary widening of the trade deficit). The US dollar had been falling, save for a temporary flight-to-quality spike following the financial crisis. Import prices (for non petroleum imports as well as energy) were rising faster than prices of domestic goods and services. Deficit spending was designed to lift the economy. Monetary policy had been accommodative since 2008, households were deleveraging but domestic demand was gaining traction. These trends, even amid ample slack as conventionally measured, are just not the environment for deflation.

Japan's malaise provided a convenient but inappropriate benchmark for assessing the probability of US deflation. Certainly, Japan's mild deflation stems from insufficient aggregate demand—its nominal GDP is roughly flat, below potential growth estimated by the Bank of Japan to be roughly 0.5 percent. But the primary sources of this weak demand are non monetary in nature: declining population (0.25 percent annually) and labor force (1.0 percent annually); widespread expectations of higher taxes to finance the bulging government debt; regulations and industrial structures that inhibit domestic demand; and diminished expectations of future growth prospects. The yen has strengthened significantly, raising concerns about Japan's traditionally heavy reliance on exports. These factors, rather than expectations of deflation, lead households and businesses to save rather than spend (in fact, even amid mild deflation, Japan's expectations of inflation have hovered around 1 percent). These characteristics contrast sharply with the US, where the population is growing rapidly and trendline labor force growth remains healthy, among other favorable trends.

The Fed's recent deflation fears are a repeat of mid-2003, when core inflation had decelerated to 1.5 percent and the unemployment rate exceeded 6 percent, and the Fed's worries about deflation stemmed largely from the measured slack in NAIRU and GDP Gap models. These concerns proved unwarranted. Nominal spending was accelerating, the US dollar had been falling and budget and trade deficits were high. In lagged response to stronger economic activity, inflation rose in 2004. Soon, the Fed's expectations of deflation dissipated, and it began hiking rates in mid-2004.

US inflation has risen from its recent low (CPI, 2.16%; core CPI, 1.09%), and is expected to increase further, due to a combination of base and economic effects. Import prices are accelerating sharply and the weaker US dollar and stronger aggregate demand will provide flexibility to both domestic and

foreign producers to raise product prices. Final sales to domestic purchasers have picked up and economic momentum has carried into 2011. Fed Chairman Bernanke stated in his semi-annual testimony to Congress on March 1 that “the risk of deflation had become negligible”. My assessment is that inflation risks are now skewed decidedly to the upside.

Economic Conditions

There is clear momentum in the economy, despite ongoing struggles in the housing sector and labor markets. Real GDP likely will grow 3.0-3.5 percent in 2011, restrained by higher energy prices. The lags between accommodative monetary policy and aggregate demand have been lengthy, as household balance sheets are repairing and households and businesses have been cautious following the financial crisis and recession. However, historically, once monetary stimulus gains traction, economic expansions become self-sustaining; that’s currently the case.

Consumer spending has accelerated since summer 2010, supported by increases in real disposable income (higher aggregate hours worked and modest wage increases) and the rising stock market (higher profits and a boost from QEII). Business expectations have improved, leading firms to increase production and employment, restock inventories and increase investment in equipment and software. Stronger gains in employment and disposable income are expected to sustain consumption increases. Export growth will remain strong, driven by global growth, the weaker US dollar and declines in US unit labor costs relative to other industrialized nations.

Economic recovery, particularly employment, has been inhibited by a host of non monetary policy factors, including household deleveraging and business caution following the financial crisis and recession, the substantial continued housing drag, uncertainties relating to tax and health care policies, sector job unemployment concentrations and skill mismatches. However, a lack of liquidity has not been an inhibiting factor. Sustained higher energy prices currently pose the largest risk to economic momentum.

Impacts and Risks of QEII

A proper assessment of the risks and benefits of a monetary policy like QEII requires taking into account the full probability distribution of outcomes under the policy and in the absence of the policy and the costs and benefits of the span of outcomes.

At the time the decision was taken, the Fed clearly thought the costs of either deflation or a double-dip recession, though considered low probability events, significantly outweighed the potential distorting impacts of QEII, including the costs of the Fed’s eventual policy exit, or of higher inflation or inflationary expectations.

Since Bernanke’s announcement of the Fed’s intention to pursue QEII at the Fed’s Jackson Hole symposium in August 2010, many of the influences that the Fed outlined have occurred, along with some unintended effects. The increased demand for risky assets has eased credit conditions and pushed up the stock market, and lowered the US dollar. Contrary to earlier expectations, Treasury bond yields have increased, commodity prices have soared and capital flows into fast growing emerging nations have increased, particularly into China and Brazil, contributing to larger global imbalances.

Many of the short-run outcomes have been positive—in particular, the economy has strengthened and inflation has risen from its trough—although it is uncertain that they can be fully attributable to QEII.

The higher stock market has helped support higher consumption, but the stronger economic growth to a large degree likely reflects the lagged impact of sustained monetary accommodation, and the jolt from the November 2010 mid-term elections that shifted expectations toward tax cuts. The higher commodity and food prices, in part generated by the Fed's QEII, have contributed to higher inflation.

The Fed gambled that its massive purchases of US Treasuries—accounting for roughly 70 percent of the government's deficit spending during QEII's implementation—would not trigger a spike in inflationary expectations. So far, the Fed has won this bet, as inflationary expectations have drifted up only modestly.

Such muted market responses may be contributing to current complacency underlining the suggestion that current monetary policy is sustainable. But it is not. In addition to the sizeable distorting impacts of QEII, the potential future risks of undesired outcomes and loss of Fed credibility loom large.

The lower US dollar stimulates exports, but also reduces domestic purchasing power, involving and reflecting a lower US standard of living. The weaker US dollar is particularly striking in light of Europe's ongoing financial woes and governing crisis, and the widespread turmoil in the Middle East. Are US dollar-denominated assets losing their allure as a consequence of unsustainable deficit spending and the Fed's unprecedented purchases of US debt securities?

The excess supply of US dollars has contributed to higher commodity prices that have pushed up global production costs and reduced real purchasing power. Significant inflation pressures have unfolded in emerging nations that have large weightings of food in their CPIs, and more moderate inflation has unfolded in the US, UK and EU. Global supply and demand factors affect commodity prices, but so do the accommodative monetary policies of the Fed and other leading global central banks.

The excess liquidity has fueled capital flows into select emerging nations, accentuating current and trade account imbalances and distorting global capital flows. The burdens and distorting impacts of the Fed's QEII affect US dollar-peg currency regime nations (i.e., China) as well as those with floating currency regimes (i.e., Brazil, European Union). Such effects may diminish the role of the US dollar as the world's reserve currency and damage the Fed's credibility as the world's leading monetary authority.

The bottom line is that excessive monetary accommodation is not costless. If it were, the Fed—and every other central bank—would buy all financial assets, including all government debt. Central bank balance sheets wouldn't matter. But history tells us otherwise: excessive monetary accommodation is costly, even if the costs do not appear immediately.

The biggest risks are higher future inflation or a spike in inflationary expectations, and the Fed's loss of credibility as an effective, independent central bank. Just because inflation and inflationary expectations have remained low to date does not insure they will not rise. Inflation is low in lagged response to the financial crisis and recession-related weak demand. However, monetary policy typically affects the economy with a lag and inflation with longer lags. The combination of excessive monetary accommodation, higher commodity prices and a lower US dollar, along with the economy gaining traction, clearly suggests a shift.

Once created, the excess reserves and liquidity generated by the Fed's QE do not disappear: they flow around global financial markets—bidding up prices of select financial assets and distorting capital flows and financial markets—until they drain out of the financial system (passively by maturing and rolling

off of the Fed's balance sheet or actively through Fed tightening) or they generate higher aggregate demand. When aggregate demand gets excessive relative to productive capacity, inflation pressures mount.

Even before QEII's \$600 billion purchases of Treasuries, there was \$1 trillion of excess reserves in the banking system as a result of the Fed's financial crisis-related alternative liquidity provisions and its first round of QE. Money multipliers have declined with the financial crisis and reduced bank lending, so growth of the broader monetary aggregates has been moderate. In the last year, M1 has grown 10.3 percent and M2, 4.4 percent. Following a dramatic decline, as aggregate demand has gained momentum, bank C&I loans have begun to rise modestly. Consumer loans continue to recede, as credit card usage adjusts down. As bank lending strengthens with the economic expansion, the money multipliers will stabilize and money supply will accelerate. Even then, excess money is a necessary but not a sufficient condition for inflation. Initially, the stronger demand will primarily add to real growth (as has been the recent trend), but subsequently, inflation pressures will mount. Whether the Fed is able to tighten monetary policy and drain the excess liquidity to constrain inflation pressures remains uncertain.

The risks to the Fed's credibility are sizeable. Some members of Congress are upset with the Fed's earlier credit easing and now QEII. The efficacy of QEII to stimulate the economy and create jobs, other than through pumping up the stock market, is questionable, and associated global distortions are criticized. Everyone, including Fed officials, acknowledges that current monetary policy is unsustainable. Moreover, QEII brings the Fed uncomfortably close to the federal government's unruly fiscal policy, creating a communications dilemma for the Fed. The Fed says it is not monetizing government debt, because debt monetization occurs when the Fed directly links Treasury purchases to specific deficit spending legislation. But the distinction is very subtle—too subtle for skeptics to buy and too subtle for the Fed to sell honestly.

Exit Policy

Chairman Bernanke has identified three criteria for the Fed to exit: economic momentum, improving employment gains and rising inflation. All three are unfolding. The Fed must do two things: signal to markets that it intends to conclude QEII in June, and articulate a strategy for how it will manage reserves as it returns to a sustainable, normal monetary policy.

The Fed has already described the tools it may use to exit and how it may sequence them, particularly that it can raise rates prior to draining reserves. The Fed likely will raise rates gradually, and paying interest on reserves will facilitate the tightening; this is likely to be accompanied by operations (repo and term deposits) that temporarily drain reserves.

The Fed has also stated that with rates constrained by the zero nominal bound, QEII is similar in nature to traditional increases and decreases of interest rates. Chairman Bernanke has said the Fed estimates that QEII's \$600 billion of Treasury purchases would provide a similar amount of stimulus as a 50-75 basis point cut in the Federal funds rate. Thus, an exit policy requires establishing a framework for managing reserves and the Fed balance sheet as well as normalizing interest rates.

At the end of QEII, the Fed's portfolio will have approximately \$2.7 trillion in assets, and bank excess reserves will exceed \$1.5 trillion. Barring a shift in market expectations, even a sizeable reduction in Fed assets and excess reserves would have virtually no impact on bank lending. At the same time, a sizeable increase in bank lending (that increases banks' risk weighted assets) would absorb only a

modest portion of the cushion of excess reserves. Through 2012Q4, an estimated \$350-\$400 billion of the Fed's portfolio of treasuries and MBS will mature. Currently, bank commercial and industrial loans are \$1.2 trillion; real estate loans, \$3.6 trillion; and consumer loans, \$1.1 trillion. A passive drain in the Fed's balance sheet would not constrain bank lending, even if loan demand rose sharply.

Reinvesting the proceeds from maturing MBS and Treasuries to maintain the peak level of assets in the Fed's portfolio would be a clear mistake. The impact of QEII on the term structure of interest rates has been highly uncertain, and purchasing more assets to further ease credit markets, to support the stock market or to lower the US dollar is a questionable proposition. Similar to the ending of QEI, markets will anticipate the gradual shrinkage of the Fed's balance sheet, leading to a smooth transition. The rationale with which the Fed justified QEII is no longer appropriate and further extending asset purchases would send the wrong signal to markets and risk a jarring shift in market expectations.

Bernanke has also emphasized that the unprecedented increase in the Fed's balance sheet is not new money creation. The Fed would bring clarity to this issue by linking its reserve management to bank lending, credit markets, and the monetary aggregates. As bank lending gains sufficient momentum, the Fed's massive increases in reserves will be associated with faster money growth.

Concluding Summary

The Fed's adoption of QEII was based on an assessment of risks and benefits that were skewed toward short-term economic concerns—particularly high unemployment, over which monetary policy has limited influence—and overstated fears of deflation. Fortunately, so far, while distortions to global financial markets have been substantial, inflationary expectations have remained tame. However, just because the potential costs of QEII have not been fully realized does not make the program costless or sustainable. A managed exit is urged.