What the Fed Must Be Thinking

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QE2, as the Fed's second round of quantitative easing is known, has now sailed. It is hard to recall a more widely anticipated but also heavily criticized central bank action. Central bankers are generally reluctant to launch ambitious initiatives in the face of overt skepticism, even outright hostility, on the part of their foreign counterparts, financial market participants, and the commentariat. That the Bernanke Fed is prepared to proceed in the face of such widespread doubts is extraordinary.

To understand what's going on, we must distinguish three questions. Why has the Fed taken this step? Will it work? And was there any alternative?

Mr. Bernanke, in a morning-after commentary in the *Washington Post*, invoked two rationales for the decision. First, economic growth remains disappointingly slow – too slow to bring down unemployment. Second, inflation, at barely 1 per cent, is running below the Fed's target of 2 per cent, the rate at which the central bank expects prices to rise in a healthy economy.

Neither rationale for QE2 is convincing. To start with the second, it is not obvious that 1 per cent inflation has costs or raises dangers that 2 per cent inflation would not.

And although no one disputes that faster growth would be better, it is questionable whether QE2 can deliver this. To the contrary, there is every reason to doubt that $600 billon of central bank asset purchases of short- and medium-term government bonds will boost the rate of growth or create additional employment. Those purchases will do little to revive the housing market, where mortgage interest rates are at historic lows and homeowners have already locked in fixed-rate mortgages. Improved affordability may encourage a few first-time homebuyers to jump into the market, but not in sufficient numbers to make a dent in an inventory of unsold homes twice normal levels.

Mr. Bernanke cites reduced costs of corporate borrowing as a second channel through which QE2 will work. Lower corporate bond yields, he suggests, will spur corporate investment. But corporate bond rates are already at rock-bottom levels, and the big banks with which large U.S. corporations do business are flush with funds that they are prepared to make available to corporations with attractive investment projects. It is hard to imagine that there will be much bang for the buck here.

Finally, Mr. Bernanke cites higher stock prices and the associated wealth effects as providing stimulus for additional spending. Even putting aside one's reservations about this Greenspan-like manipulation of the stock market, one can question whether $600 billion of Fed purchases will have much impact on a U.S. stock market with a capitalization of more than $14 trillion. And, in any case, most of the increase in stock prices occurred already when QE2 was under discussion but not yet unveiled without much discernible impact on the economy.

So why has the Fed embarked on this heavily-criticized course? The answer can only be that it is worried about a more alarming scenario in which inflation running below its target collapses into outright deflation. As a student of the Great Depression and of Japan in the 1990s, Mr. Bernanke understands that once an economy has fallen into a deflationary trap, it can be all but impossible to get it out.

QE2 is a down-payment on an insurance policy intended to prevent this from happening. The chairman has now formed a coalition within the Federal Open Market Committee that will support more if and when the threat of deflation materializes. We can be sure that the existing program of purchases will be ramped up, and quickly, if inflation shows signs of falling into negative territory.

It would seem prudent to take out insurance against events that could seriously damage the economy. So why has the Fed been criticized so harshly? For one thing, it has not clearly communicated the rationale for its action. It may worry that when central bankers speak openly about the tail risk of deflation, they will alarm the public. Firms and consumers may then stop spending, bringing about the very disaster that monetary policy makers wish to avert. As a result, the chairman and his colleagues are forced to invoke other, less convincing rationales for QE2, which exposes them to criticism.

Of course, had the Fed already agreed to unveil a massive program of asset purchases, of $2 trillion or more, in the event that signs of deflation materialize, then the chairman could have invoked the dreaded "d-word" without fear of creating a self-fulfilling deflationary crisis. Markets would have known that the Fed was prepared to respond to deflation with monetary "shock and awe." But here the fact that some members of the FOMC apparently remain reluctant to go beyond $600 billion prevents him from speaking.

The other basis for criticizing the initiative is its impact on other countries. No one doubts that QE2 will mean a weaker dollar. A stronger euro, which is the other side of this coin, will not be helpful for European growth or support governments' fiscal consolidation efforts. We have already seen the negative reaction of Irish and Greek sovereign bond spreads. QE2 will also mean more capital flows to emerging markets, stoking exchange rate appreciation, inflation and asset market bubbles there. The Fed is therefore the subject of increasingly harsh criticism from all sides.

But while criticizing is easy, specifying what exactly the U.S. central bank should do differently is harder. Would Europe and Emerging Asia really be better off if the Fed did nothing and, as a result, the U.S. succumbed to deflation and a double dip?

In principle, both America and the world would be better off if the U.S. adopted a targeted fiscal stimulus instead of quantitative easing. A payroll tax cut would get hiring going again. A federally-funded retraining scheme could be used to address the problems of the long-term unemployed and put more money in their pockets.

Married with a credible medium-term plan for balancing the budget, targeted fiscal stimulus would not excite the bond market vigilantes. It would be more effective than quantitative easing in getting the economy moving again. With more spending and more growth, the tail risk of deflation would recede. And unlike quantitative easing, targeted fiscal stimulus would not drive down the dollar and create difficulties for other countries.

The problem of course being that the Congress is not inclined to support a second stimulus, targeted or not. It was not inclined to do so before, and it is even less inclined to do so now in the wake of the Republicans' triumph in the midterm elections. This is what has put the Fed in corner. This is what has effectively made it policy maker of last resort.

Some argue that it would have been better for the Fed not to give in. It could have signaled its unwillingness to act in lieu of the Congress. The Congress would then have seen the need to act. Without the Fed to relieve the pressure, it would have had no choice but to pass a second stimulus. All would then have been well with the world.

Others will object that this argument attaches too much weight to the rationality of the Congress. Certainly, Mr. Bernanke and his colleagues appear to subscribe to this objection. We will never know whether they are right or wrong. The U.S. will now be using monetary rather than fiscal measures to address the threat of deflation and the weakness of its economy. And the world will be living with the consequences.

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