Money can’t buy me growth

Fed Governor Bernanke seems set to announce a new wave of quantitative easing next week, a move that has polarized opinions within and outside the FOMC and raised both hopes and fears to new highs. Some hope QE2 will turn liquidity into spending; others, like Kansas Fed President Hoenig, see it as “a bargain with the devil”. Savior or Mephistopheles, Bernanke seems ready for the gamble. He will likely find that money can’t buy you growth, at least not this time. The obstacle to a faster recovery is not lack of liquidity, but the need for a longer period of deleveraging. On the other hand, the larger the scale of QE2, the greater the risks down the line. One of the key lessons of the crisis is that it is naïve to think that enormous imbalances can be unwound in an orderly way—it would be similarly foolhardy to assume that we will be able to fine-tune the exit from massive monetary stimulus. Currently, with both employment and inflation below target, the Fed can aim to raise both—and finds it harder to justify inaction. Raising inflation, however, is going to be much easier than raising employment. If the gamble pays off, the Fed will deserve credit for having kickstarted a stronger recovery; if only inflation takes off, at least the Fed will be able to argue it did what it could. QE2 will help at the margin, and I hope its impact will be stronger and quicker than I expect; this would boost confidence, reduce unemployment, and allow the Fed to take a more prudent stance. For the moment, markets have already welcomed the prospect of QE2, and most US politicians and regular citizens will welcome the Fed’s effort. Money can’t buy me growth, but this time perhaps it can buy me love…

QE2 seems set and ready for launch next week. The Fed has carefully prepared the ground, starting with Governor Bernanke’s speech in Jackson Hole and most recently by surveying dealers’ expectations on the likely size and impact of further bond purchases. It seems most likely that the Fed will start with a target of about USD300-500bn over the next 6 months, deployed on maturities not longer than 10 years, and leaving open the option of doing several times more if needed.

This forthcoming policy step has polarized views within the FOMC and has raised both great expectations and deep concerns. Those in favor believe it will help pull the US economy out of a situation that New York Fed President Dudley defines “unacceptable”, with weak growth and persistently high unemployment; those against are skeptical about the growth impact and worried about the likely collateral damage—the strongest and most colorful warning has come from Kansas City Fed President Hoenig, which called further monetary easing “a bargain with the devil”.

Savior or Mephistopheles, Bernanke seems ready for the gamble. He will likely find, however, that money can’t buy you growth, at least not this time. The Fed’s own analysis suggests more than a measure of skepticism: banks are flush with cash which they are not lending, corporates are flush with cash they are not investing, and households are flush with debt they are trying to reduce. Furthermore, companies with access to the corporate bond market can already raise funding at low cost. Lack of liquidity is not the problem.

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QE2 will not work miracles, turning liquidity into spending. But it will help at the margin. It will reduce bond yields and financing costs somewhat—even though we are already at such low levels, with 10-year Treasuries yielding a paltry 2.5/2.7%, that the impact can only be modest. Some of the liquidity will find its way into loans and investments. The weak dollar will continue to give some oxygen to exports, even though in a large closed economy like the US, it would take an enormous acceleration of exports to shave 4-5 percentage points off the unemployment rate. And to the extent that it continues to provide an uplift to equity valuations, it will support household wealth and confidence. Given the persistently high unemployment rate and the discouraged mood which seems to have gripped the country, even a modest impact counts—especially if there is a chance that a modest improvement might be leveraged by a boost to confidence.

Are the risks worth the gamble? Perhaps. In my view, QE2 poses three main dangers:

First, if it is not handled well, it might backfire with a counterproductive negative impact on confidence. The launch of additional monetary easing signals that the Fed has little confidence in the recovery; if there is no acceleration in activity in the following months, consumers and entrepreneurs might conclude that not only is the situation more fragile than previously thought, but on top of this the Fed is powerless to improve it; confidence might then weaken further. The Fed’s best bet to avoid this scenario is probably to keep QE2 open-ended, signaling it will do more as necessary until the desired impact is felt.

Second, additional liquidity will likely exacerbate the market distortions and incipient asset price bubbles that have already started to emerge, and will put further stress on international policy coordination. Fears of near-term bubbles should of course not be exaggerated—after all, we are still in deleveraging mode, and we have just come out of a crisis that has made investors more aware of the dangers of financial froth. Nonetheless, liquidity has to go somewhere, and to the extent that it does not flow into real investment and spending in the US, it will leak out into asset markets. Emerging markets are likely to face stronger inflows and upward pressures on exchange rates and asset prices, on both the fixed income and equity side.

Third, the larger the scale of QE2, the harder it will be to tame the inflation monster when it finally materializes. This is obviously not a near term risk, given the weak growth and substantial output gap. The Fed indeed argues that inflation is too low, and is pondering additional tactics which could be deployed, if needed, to boost inflation expectations. One example is the idea of a price level target, which would imply that following a period of below target inflation rates, the Fed would target a period of higher inflation to make up for the lost ground. But if the economic recovery does take hold, inflation will eventually re-awaken.

One of the key lessons of the crisis is that once enormous imbalances have emerged, it is naïve to believe that the subsequent adjustment can be smooth. In 2007 we still hoped that the deleveraging could take place in an orderly manner; but the excesses in credit markets and asset prices were such that the adjustment proved impossible to control. Similarly, once monetary policy has injected an enormous amount of liquidity into the system, we cannot reasonably hope to fine-tune the unwinding. This is particularly true for the Fed, which has injected liquidity largely via asset purchases: unwinding this stimulus should therefore rely in part on asset sales, which in large amounts could have a disruptive impact on markets. Similarly, the idea that the Fed—or any other central bank—could credibly anchor expectations to a moving inflation target to reach a specific price level appears far-fetched.

If QE2 is substantial and protracted, there is a strong risk that it will eventually result in an uncontrolled surge in inflation, which will in turn trigger a delayed but drastic monetary tightening, with the predictable harsh negative impact on growth. But given that the Great Moderation was clearly over-rated, this is perhaps not such a bad scenario.

For the time being, assuming QE2 gets underway, I hope the positive impact on growth will be stronger than I expect and that it will materialize as rapidly as possible, helping to shore up consumer and business confidence. This would also allow the Fed to pursue a more cautious attitude, with an eye to the eventual unwinding of this extraordinary support.
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