THE JEROME LEVY FORECASTING CENTER

July 2011
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The Exaggerated Importance of Quantitative Easing

Why Worrying about QE2 or QE3 is Probably a Waste of Time

The end of the QE2 program in June 2011, with its ramifications for markets and the economy, was a matter of widespread concern within the financial sector, in monetary policy debates, and around the world. Now, people are speculating about the possibility of a new round of QE and what effects it might have. Yet many of the fears and hopes about quantitative easing come from an exaggerated sense of its potency. There was a pervasive belief that QE2 had a significant role in boosting economic performance, raising asset values, increasing headline inflation, and weakening the dollar. Some people have gone so far as to blame QE2 for the spike in global food prices, which helped ignite instability in North Africa and the Middle East. The reality is that QE2, given its scale and under the conditions of the contained depression, had minor and possibly insignificant direct effects. Indeed, its greatest influence may stem from the fact that markets believed it has a direct influence.

A recent column in *The Economist* reflects some of the popular beliefs about QE2's accomplishments:

> So what happened after Mr. Bernanke made it clear to markets that the Fed would act again? Growth accelerated, from a 1.7% annualized pace in the second quarter to 2.6% in the third quarter and 3.1% in the fourth quarter. Inflation expectations ceased falling and began rising back to normal levels. Confidence rose. And the pace of hiring improved meaningfully. In both February and March, private firms added over 200,000 jobs. Since the Fed's policy began, the unemployment rate has fallen a full percentage point.

Similarly, from Bloomberg ("Bernanke's QE2 Averts Deflation, Spurs Rally, Expands Credit," by John Detrixhe):

> Ben S. Bernanke's $600 billion strike against deflation is paying off, as stock and debt markets rise, bank lending grows and economists forecast faster growth.

Much of the above analyses fails to meet even the standards of naïve correlation, let alone to suggest causal mechanisms. Moreover, the mechanisms that economists *have* put forth to explain how QE2 has influenced the economy—and how QE3 would too, if instituted—are either weak or fallacious. These include directly inducing higher asset prices, thereby producing positive wealth effects; spurring bank lending; and raising inflation expectations.

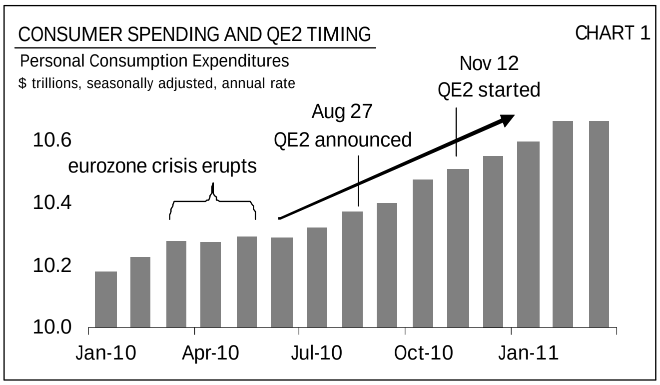
Additionally, a number of commentators—including foreign politicians—have portrayed QE2 as a ploy to cheapen the dollar. QE2's influence on factors that tangibly affect the dollar exchange rate is insignificant. If a cheaper dollar were the goal, QE2 or QE3 would hardly seem to be a promising way to pursue it.

Despite QE2 having dubious direct effects on the economy, perceptions of the impact of QE2 may have some important short-term effects. Quantitative easing of this sort (buying Treasuries) during a period of private balance sheet contraction may be nothing more than pushing harder on a string, but any Fed policy of this scale may influence the psychology of market participants and thereby stock prices, bond yields, foreign exchange rates, and commodity prices. However, such influence is temporary and is likely to be dwarfed by other developments in the economy.

Economy's Second-Half Reacceleration Was Underway Well before QE2

The Fed introduced the idea of QE2 in late August when the economic recovery appeared to be faltering and core inflation was dwindling. Since then, economic growth has picked up, core inflation has turned up, hiring has accelerated, and the unemployment rate has fallen—compelling evidence, according to many, of QE2's effectiveness. If A precedes B, then A causes B.

However, the notion that QE2 revived the economy in the second half of 2010 does not even get the A-precedes-B part right. The second-half reacceleration of personal consumption expenditures (following consumers' spring slump) was largely responsible for the pickup in the economic recovery, and it began in July, virtually two months before Chairman Bernanke first broached the subject of QE2 at the Fed's Jackson Hole conference on August 27, and was in full swing by the time QE2 actually began on November 12 (chart 1).



There is another timing problem even if we ignore the economic pickup prior to announcement or implementation of QE2. Economists may disagree on many aspects of the effects of monetary policy on the economy, but they broadly agree that monetary policy works with a lag of at least a number of months and perhaps as much as a year. Optimistically, one would think that monetary policy changes instituted in November would start to markedly affect the pace of expansion . . . about now. Therefore, QE2—which, after all, is substantively Fed open market operations involving longer maturities—must have broken free of the preexisting laws of monetary policy physics in order to rev up the economy in time for the holiday season. QE2 must have almost instantly pumped up a number of key economic variables, including, even more miraculously, some lagging indicators such as employment.

Logical Problems with How (Not Just When) QE2 Allegedly Boosted the Economy

Federal Reserve officials have identified three mechanisms through which QE can influence the economy:

(1) asset price gains and their wealth effect;

(2) increased lending; and

(3) heightened inflation expectations.

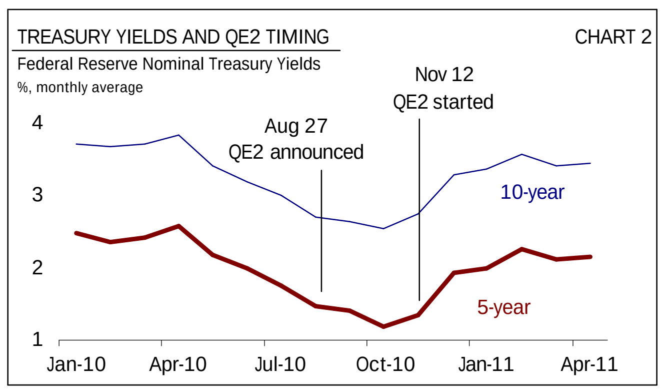
Each of these mechanisms can have some effect, but they require either circumstances drastically different from those of 2010 and 2011 *or* Fed asset buying far bigger than $600 billion. As things stand, QE2 may have had some positive effects, but not enough to importantly change the economy's trajectory.

Asset price gains and their wealth effects. The wealth effect depends on QE2 affecting asset prices. QE2 might have raised asset values by lowering interest rates, reducing the total supply of assets, or inducing a self-fulfilling belief among investors that it would cause asset prices to rise.

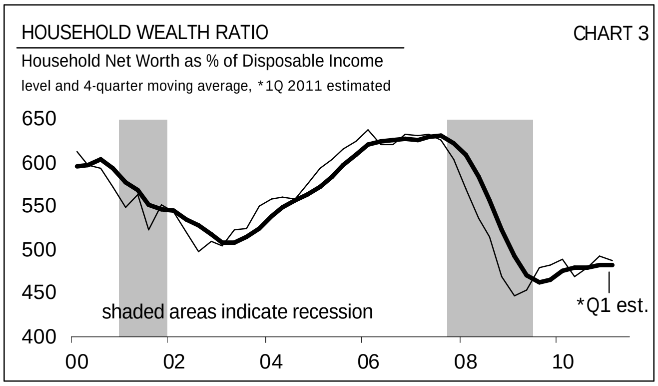
■ Medium- and long-term Treasury rates went up markedly, not down (chart 2), suggesting that any lowering effect QE2 might have had was overwhelmed by other influences on yields.

■ Reducing the supply of assets by buying $600 billion worth of Treasuries likely had some effect. Still, the total value of financial assets is more than 100 times this figure (counting only domestic assets and leaving aside international markets), so it is unlikely that the shrinkage in the supply of Treasuries would have had a great effect on asset prices.

■ If investors believed QE2 should make markets stronger, perhaps they bid up prices, but we are skeptical of a lasting effect.



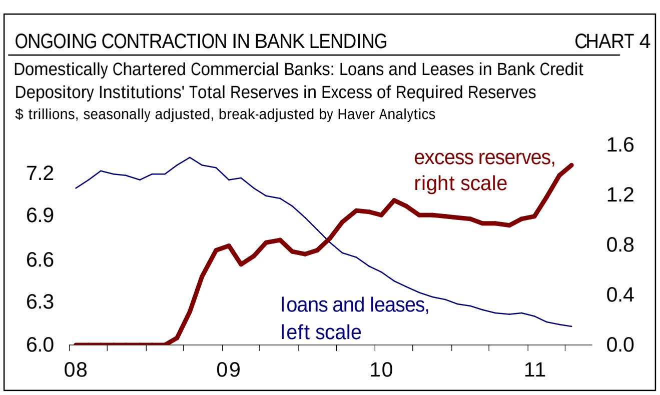
We can only roughly estimate the size of any wealth effects since the Fed announced QE2, but we have good information about what happened to asset prices. Stock prices rose sharply, home prices fell, Treasury and high grade bond prices fell, and junk bond prices rose. Overall, for households, the net-worth-to-income ratio was higher at the end of the first quarter than at the announcement of the program, but only modestly so (chart 3). The net wealth effect associated with this change—even using highly optimistic assumptions about lags and the size of wealth effects of housing and financial assets—added no more than 0.5% to the rise in consumer spending over this period (compared to a total rise in consumer spending



of roughly 3.5% during the same period). That 0.5% of extra spending, if the effect really was that large, represents a moderate boost to profits and the economy.

However, any wealth effects reasonably attributable to QE2 were much smaller. It is hard to argue that QE2 was responsible for even half of the asset gain. A plethora of factors—the stabilization of the eurozone crisis, profits gains that reflected the resurgence in profit sources ahead of any possible QE2 effects, spending out of the 2011 payroll tax cut, and so forth—provide plenty of justification for the stock market rally and gains in speculative fixed-income prices. Even giving QE2 considerable credit for the stock market rise and (charitably) assuming it did something to prevent housing from being even weaker, any household wealth effect from QE2 appears to have had a minimal influence on the economy.

Increased lending. If banks lend more, presumably they are financing economic activity (and the profit sources) or asset purchases. QE2 is supposed to have expanded credit by increasing excess reserves, lowering medium- and long-term interest rates, or both. As already noted, these rates went up, not down; the best we can say is that rates would have risen more without it. Moreover, increasing already vast excess reserves does not make banks any more willing to lend or to ease standards. The banking system has been flush with excess reserves since March 2009, but bank credit has been declining relentlessly during that time (chart 4).



Adding to excess reserves will have little influence on lending when the private sector is plagued by balance sheet problems. Lending is not being constrained by reserves but by inadequacy of bank capital, persistently high loan performance problems (even if they have shown some cyclical improvement), and the continued decline in the value of real estate collateral.

Even if banks were eager to lend, most households and businesses appear to be either unwilling or unable to take on more debt. Both household and nonfinancial business debt ratios are still close to record highs in a time of slow income growth and great uncertainty.

Therefore, in view of the rise in yields, bank capital concerns, and need for households and businesses to reduce their debt, it is hard to argue that QE2 generated much lending.

Heightened inflation expectations. Just how are higher inflation expectations supposed to have aided the economy? By inducing people to buy now to beat price increases and to see real borrowing rates as lower and more attractive. However, while that might have worked during the 1970s, when high rates of inflation did induce people to buy sooner ahead of expected price hikes, this mechanism falls flat in 2011. The moderate increase in inflation expectations that Fed officials envisaged and were willing to tolerate would not have had any meaningful impact on the timing of spending decisions; who would buy now instead of next year to avoid a possible 2% or 3% price hike? Moreover, with economic uncertainty and balance sheet woes swamping considerations of the time value of money, and with still wide spreads for household and small business borrowing, a modest boost to inflation expectations (lowering perceived real interest rates) is not exactly going to spark a stampede to the bank for consumption or investment loans.

The goal of raising inflation expectations when faced with the specter of deflation stems from a profound misunderstanding of deflation, its causes, and its remedies. The deflationary pressures that QE2 targeted are neither a pure "monetary phenomenon" nor the result of undesirable public expectations; rather, they are direct consequences of overcapacity, severe labor market slack, debt contraction, collateral liquidation, and other circumstances associated with the slow-motion implosion of the economy's massively over-expanded balance sheets.

Generally, deflation is a symptom of private sector balance sheet retrenchment. In the case of a full-fledged depression, a great economic collapse initiates deflation as part of a vicious cycle of debt contraction, asset deflation, vanishing profits, swelling overcapacity, soaring unemployment, defaults, and accelerating declines of goods and services prices. In the case of a contained depression, the process is slowed and limited, but similar. In our own present-day contained depression, government actions—running federal government deficits to support profits and stabilizing the banking system—have addressed, or at least contained, the underlying problems. As a result, so far disinflation, but not deflation, has prevailed. However, even as the economy expands, the process of working off overcapacity and debt hinders investment, and secular pressures for asset deflation persist, which means that more balance sheet adjustment—and further deflationary pressures—lie ahead.

Of critical importance to the secular disinflation-deflation dynamic is the vast labor market slack, which keeps pay raises trending downward. Although the cyclical expansion may have reduced the frequency of pay cuts and led to some catch-up raises, overall the downward pressure on pay rates has persisted, and any further weakening of labor markets will intensify it.

Under the circumstances, Fed actions, intentions, and exhortations aimed at directly raising inflation expectations may succeed temporarily among investors, but they will not have much impact on workers or their employers, who deal with the day-to-day realities of their own affairs. If workers experience more inflation, as they have regarding food, energy, and certain other costs, some of them may be able to extract bigger pay raises, but others will find it even harder because their own employers are stressed by margin pressures from energy and commodity costs.

In summary, it is hard to reason that QE2 had a strong impact on the economy. Whatever wealth effects it had were small at best. Whatever influence it has had on lending was through preventing rates from going up more than they did, and with the nonfinancial private sector needing to shed debt, such influence probably had little effect on lending volume. And while there must have been some people outside of the financial markets, academia, and monetary policy circles who actually had their inflation expectations raised by QE2—probably with the help of copious exposure to the financial media—good luck finding any of them who bought more goods or services because of it.

Crediting QE2 for the Second-Half-2010 Pickup Requires Overlooking a Lot

In reality, without QE2 there is no lack of an explanation for the economy's spring slowdown and summer reacceleration. The biggest reason why the economy sputtered in the second quarter of 2010 was the eruption of the European sovereign debt crisis, which sent stock markets plunging around the world and fostered fears of renewed global financial instability. The more affluent Americans, with significant assets and fluctuating portfolios, still had tender nerves, and they appear to have led the spring weakening in consumption. Retail sales actually fell for two months, with the most notable weakness among stores catering to high-end consumers. Factory orders fell rapidly, and businesses, still unusually risk-averse, were quick to curtail the growth in their payrolls and capital spending, contributing to the deceleration of the economy. However, the international financial markets and the global economy responded quickly to the stabilization of eurozone financial conditions, and the euro rebounded powerfully in July along with global stock markets. U.S retail sales picked up too, again led by upper-end consumers.

The Problems with Blaming QE for "Debasing" the Dollar

Some have argued that QE2 was recklessly debasing the greenback and endangering its status as the reserve currency. Worries about the external value of the dollar often bubble up when the global economy is picking up and risk perceptions are diminishing. Relatively buoyant international financial conditions are a green light for people to vent their fears and theories, valid or not, about the weakening dollar. Quantitative easing has now joined the ranks of the perennial favorites—the current account deficit, the federal government deficit, and the decline of American global preeminence—as a major cause for worry about the dollar.

Actually, QE2's influence on factors that tangibly affect the dollar's exchange rate was insignificant; it was significant only to the extent that international portfolio managers and currency traders *believed* it was significant.

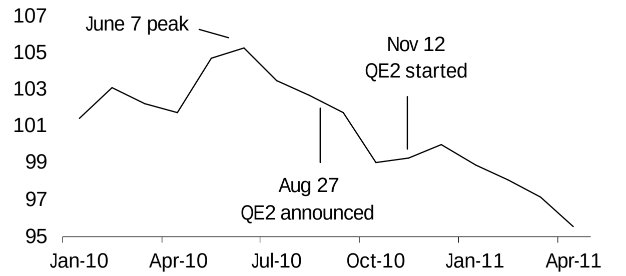
The dollar's role as the global reserve currency means that it rallies when global risk aversion is on the rise and it tends to wane when international financial conditions are stabilizing. Viewed from that perspective, the dollar's moves over the past year or so have largely reflected changing perceptions of global financial and economic risk, especially the ebb and flow of the eurozone crisis. Fears about the stability of the eurozone and the fate of the euro that had boosted the dollar in spring 2010 began to subside last July. The dollar peaked in early June 2010 and was already trending down before QE2 was announced over two months later (chart 5). The simultaneous pickup in the global economy further raised international confidence and reinforced the dollar's decline.

Although the dollar has depreciated further since QE2 began, the move is not especially large compared to those that occurred during other periods of global economic

DOLLAR VALUE AND QE2 TIMING CHART 5

Federal Reserve: Nominal Broad Trade-Weighted Value of the US$

monthly average, Jan 1997 = 100



recovery, periods when risk-taking was on the upswing and the dollar's safe haven premium was receding.

Market perceptions of QE2's effects, regardless of the realities, may well have influenced the value of the dollar. However, given that the dollar's current move began well before the Jackson Hole announcement and has been generally consistent with broader global economic and financial developments, it is hard to argue persuasively that QE2 had an important negative impact on the dollar—or, to disprove the notion that it has had little impact at all.

Quantitative Easing, Filling Needs

The federal funds rate target has not moved in over two years and is unlikely to budge for a long time. For the army of Fed watchers that has developed over the past quarter century to closely parse Fed-speak and analyze the central bank's every move or nuance, QE has come to fill the void. As a matter of self-preservation, the Fed-watching profession must find importance in evolving QE policy. However, QE of the scale pursued over the past two years—unless associated with critical lender-of-last-resort operations—simply does not have the same, influential real-world consequences as moves in the federal funds rate.

Indeed, the Fed's adoption of quantitative easing (beyond that which had been associated with lender-of-last-resort actions) reflected the central bank's effort to do more to help the economy after "running out of bullets" in its conventional monetary policy revolver. Like chicken soup, "It couldn't hurt." Moreover, the Fed—like its watchers—may well feel the need to keep monetary policy relevant, if only to maximize its ability to boost public confidence; people might be seriously unsettled during a crisis if they believed that a critical public institution had limited power to act. People want to believe that the Fed still has bullets. But, as we predicted when we first began warning of the bursting of the housing bubble and explaining why the Fed would have to cut rates to the floor, monetary policy has essentially become a non-issue, although the Fed remains critically important as a regulator and protector of the financial system.

The most significant influence of QE2 may well have involved market perceptions of its ramifications. Psychology can be a powerful market force, but with everything else that has happened and is likely to happen, the psychological effects of the ending of QE2 (or in expectations for QE3) probably will be short-lived.

So, for those wondering about the importance of a possible QE3, it would unlikely have an important lasting impact. Thinking too much about QE2 or QE3 from here on out is probably not a good use of time.

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