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Effect of QE2's End May Be Greatly Exaggerated

By RANDALL W. FORSYTH
The Federal Reserve has mapped out its return trip on QE2, and markets have been feeling queasy. That's evident from the recent reversal of fortune in the stock market's leaders and the persistent bid for the asset everybody hates, Treasury securities.

For the real economy, however, the assumed stimulus from QE2 may be less than assumed, so the effects from its withdrawal may be less than imagined.
Amid the fight just joined over the federal debt ceiling and the gnashing of teeth over budget deficits at all levels of government, the tightening of fiscal policy poses the greater challenge to growth in the near term.

Minutes of last month's meeting of the Federal Open Market Committee released Wednesday detailed the policy-setting panel's plans to exit from QE2, the Fed's program to purchase an extra $600 billion in Treasury notes, which winds down in June.

The process will begin when the central bank no longer reinvests the principal payments from its holdings of agency securities, mainly mortgage-backed securities issued by government-sponsored enterprises Fannie Mae and Freddie Mac, not an inconsiderable amount. During QE2, the Fed bought about $300 billion in Treasuries over and above the headline $600 billion to offset principal repayments; failing to do so would effectively constitute a tightening in monetary policy.

After that, the next step would be an increase in the federal-funds target rate, the Fed's traditional policy lever, from its current rock-bottom 0-0.25% range. According to our colleagues at Dow Jones Newswires, the fed-funds futures market is pricing in a 100% probability of an increase in the target rate to 0.5% by the June 2012 FOMC meeting, and a 60% chance of such a move by the April meeting.

Only after the funds rate target is increased will the FOMC begin to shrink its balance sheet actively through securities sales, as opposed to the passive reduction by the failure to roll over maturing holdings. Now we have the sequence. But so what?

Like news of Mark Twain's death, QE2's impact on the economy, has been greatly exaggerated, contends David A. Levy, chairman of the Jerome Levy Forecasting Center.

The economy's acceleration was well under way when Fed Chairman floated the idea of QE2 in late August, he points out. Moreover, no serious economist doubts the dictum that monetary policy works with long and variable lags. Indeed, gross-domestic product growth slowed to a 1.8% annual rate in the first quarter, from 3.1% in the fourth quarter of 2010.

Treasury yields actually rose after the Fed began purchasing notes in early November. While prices of risk assets such as stocks and junk bonds increased, the value of homes, investment-grade corporate and municipal bonds and government securities fell in the fourth quarter, leaving households less well off, Levy says. That undercuts the so-called wealth effect, the presumed positive effect of QE2.

Inflation expectations did rise, as the Fed desired, but bank lending didn't, he adds. All in all, Levy likens QE2 to chicken soup -- "it couldn't hurt."

The most important impact may have been psychological; because the market participants thought QE2 was affecting prices, they did. And so the dollar fell in response to the Fed's securities purchases, mainly because that's what traders, expected, he concludes.

At this point, I disagree in part with David. My hesitation reflects the wisdom of the Levy Forecasting Center has to Barron's for two generations, going back to the long-time dialog between his dad, Jay, and Robert M.Bleiberg, the magazine's late, great former editor and editorial director.

There is no argument that QE2 has had limited impact on economic growth so far, which no serious economist would assert was the case given the lagged impact of monetary policy. Moreover, data show no response in the money supply from QE2 as the Fed's Treasury purchases merely have expanded excess reserves in the banking system, as David Levy points out.

But, as I wrote a couple of weeks ago in the Gutenberg-technology format of Barron's, the excess liquidity the Fed has force-fed into the economy has directly raised prices without going through the textbook transmission process. In the 21st century of derivatives, traders can use the liquidity for margin, which leverage pennies into dollars of buying power for commodities.

The spigot on that hose will be turned off at mid-year, but the pool will remain. Which effect is more important is a matter of dispute; the Fed thinks it's the latter while financial-market participants favor the former.

Regardless, fiscal policy will become a restraint on the economy, notwithstanding the political drama being played out over the federal debt ceiling. David Levy estimates expiring fiscal measures will total, in round numbers, "a quarter trillion dollars." That's between the expiration of aid to states under last year's federal stimulus bill. During a boom, that would be no matter; with household balance sheets still under pressure, that will be meaningful.

That calls into question what happens in 2012. Will the payroll tax cut, which totals $120 billion, be rescinded in an election year? Especially, if according to Levy's numbers, it has mainly served to offset the rise in gasoline prices for working families?

QE2 has had negligible effect on the economy, at least so far. Any improvement in employment was the result of what happened months before the Fed started buying securities.

The impact on asset prices is less arguable; U.S. equities have increased in value by some $3.7 trillion since Fed Chairman Ben Bernanke announced plans for QE2 late last August. That was precisely the central bank's intent, as Bernanke wrote in a Washington Post op-ed after QE2 was launched in early November.

The end of QE2 may not have precisely the inverse effect. That will have to be addressed in another column as time and space have run out.