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# QE2 is risky and should be limited

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The Federal Reserve's proposed policy of quantitative easing is a dangerous gamble with only a small potential upside benefit and substantial risks of creating asset bubbles that could destabilise the global economy. Although the US economy is weak and the outlook uncertain, QE is not the right remedy.

Under the label of QE, the Fed will buy long-term government bonds, perhaps one trillion dollars or more, adding an equal amount of cash to the economy and to banks' excess reserves. Expectation of this has lowered long-term interest rates, depressed the dollar's international value, bid up the price of commodities and farm land and raised share prices.

Like all bubbles, these exaggerated increases can rapidly reverse when interest rates return to normal levels. The greatest danger will then be to leveraged investors, including individuals who bought these assets with borrowed money and banks that hold long-term securities. These risks should be clear after the recent crisis driven by the bursting of asset price bubbles. Although the specific asset prices that are now rising are different from last time, the possibility of damaging declines when bubbles burst is worryingly similar.

The problem now extends to emerging markets, a group not directly affected in the last crisis. The lower US interest rates are causing a substantial capital flow to those economies, creating currency volatility. The economies hurt by the increasing value of their currencies are responding with measures to protect their exports and limit their imports, measures that could lead to trade conflict.

Ahead, when the US economy does begin to grow, the increased cash on banks' balance sheets will make the Fed's exit strategy harder. It was previously "cautiously optimistic" it would be able to contain the inflationary pressures that could be unleashed by banks with a trillion dollars of excess reserves. This will be harder if the amount of excess reserves is doubled. This could lead to much higher interest rates to restrain demand or to an unwanted rise in inflation.

Why is the Fed doing this? It is of course worried by the weakness of the US recovery. Fiscal policy is sidelined by the deficits projected for the years ahead. Traditional monetary policy has already done what it can: short-term interest rates are close to zero, commercial banks hold a trillion dollars of excess reserves, and the money supply is growing more rapidly than nominal gross domestic product. But the Fed leadership does not want to be seen to be idle when the economy is in trouble.

Although its real focus is on reducing unemployment, much of the rhetoric of Ben Bernanke, the Fed chairman, is about preventing deflation because some members of the Fed's open market committee think the Fed should focus exclusively on price stability. But there is no deflation. Core consumer prices are rising and inflation is expected to average 2 per cent over the next 10 years.

Since short-term interest rates are already near zero, some economists advocate QE to reduce the real interest rate by raising inflation temporarily while holding the nominal interest rate unchanged. A 4 per cent expected rate of inflation for the next few years would turn a 1 per cent nominal interest rate into a

real rate of minus 3 per cent, thereby stimulating interest-sensitive spending. But doing that would jeopardise the credibility of the Fed's long-term inflation strategy.

Mr Bernanke's argument for QE is based on the "portfolio balance" theory which stresses that, when the Fed buys bonds, investors increase their demand for other assets, particularly equities, raising their price and increasing household wealth and spending. Equity prices have already risen by 10 per cent since Mr Bernanke discussed this approach. But how much further will equity prices rise and what will that do to GDP?

Neither theory nor past experience can answer the first question. Much of the share price increase induced by QE may already have occurred based on expectations. An optimistic guess would be another 10 per cent. Since households have about $7,000bn in equities, that would imply a wealth gain of $700bn, raising consumer spending by about one-quarter of one per cent of GDP, a welcome but trivially small effect on incomes and employment.

The other ways in which QE would raise GDP are also small. A 20-basis-point reduction in mortgage rates would have little effect on homebuying at a time when house prices are again falling. The increase in banks' liquidity would do nothing since banks already have massive excess reserves. Big corporations are sitting on vast amounts of cash. Small businesses that are not spending because they cannot get credit will not be helped, because the banks on which they depend have a shortage of capital.

The truth is there is little more that the Fed can do to raise economic activity. What is required is action by the president and Congress: to help homeowners with negative equity and businesses that cannot get credit, to remove the threat of higher tax rates, and reduce the out-year fiscal deficits. Any QE should be limited and temporary.

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