The Federal Reserve's Policy Dead End

By MARTIN FELDSTEIN

Quantitative easing hasn't led to faster growth. A better recovery depends on the White House and Congress.

The Federal Reserve recently announced that it will increase or decrease the size of its monthly bond-buying program in response to changing economic conditions. This amounts to a policy of fine-tuning its quantitative-easing program, a puzzling strategy since the evidence suggests that the program has done little to raise economic growth while saddling the Fed with an enormous balance sheet.

Quantitative easing, or what the Fed prefers to call long-term asset purchases, is supposed to stimulate the economy by increasing share prices, leading to higher household wealth and therefore to increased consumer spending. Fed Chairman Ben Bernanke has described this as the "portfolio-balance" effect of the Fed's purchase of long-term government securities instead of the traditional open-market operations that were restricted to buying and selling short-term government obligations.

Here's how it is supposed to work. When the Fed buys long-term government bonds and mortgage-backed securities, private investors are no longer able to buy those long-term assets. Investors who want long-term securities therefore have to buy equities. That drives up the price of equities, leading to more consumer spending.

But despite the Fed's current purchases of $85 billion a month and an accumulation of more than $2 trillion of long-term assets, the economy is limping along with per capita gross domestic product rising at less than 1% a year. Although it is impossible to know what would happen without the central bank's asset purchases, the data imply that very little increase in GDP can be attributed to the so-called portfolio-balance effect of the Fed's actions.

Even if all of the rise in the value of household equities since quantitative easing began could be attributed to the Fed policy, the implied increase in consumer spending would be quite small. According to the Federal Reserve's Flow of Funds data, the total value of household stocks and mutual funds rose by $3.6 trillion between the end of 2009 and the end of 2012. Since past experience implies that each dollar of increased wealth raises consumer spending by about four cents, the $3.6 trillion rise in the value of equities would raise the level of consumer spending by about $144 billion over three years, equivalent to an annual increase of $48 billion or 0.3% of nominal GDP.

This 0.3% overstates the potential contribution of quantitative easing to the annual growth of GDP, since some of the increase in the value of household equities resulted from new saving and the resulting portfolio investment rather than from the rise in share prices. More important, the

rise in equity prices also reflected a general increase in earnings per share and an increase in investor confidence after 2009 that the economy would not slide back into recession.

Earnings per share of the Standard & Poor's 500 stocks rose 50% in 2010 and a further 9% in 2011, driving the increase in share prices. The S&P price-earnings ratio actually fell to 17 at the start of 2013 from 21 at the start of 2010, showing the importance of increased earnings rather than an increased demand for equities.

In short, it isn't at all clear that the Fed's long-term asset purchases have raised equity values as the portfolio balance theory predicted. Even if it did account for the entire rise in equity values, the increase in household equity wealth would have only a relatively small effect on consumer spending and GDP growth.

There is one further puzzle about the quantitative-easing program. The Fed's purchase of Treasury bonds and other long-term securities has not been nearly as large as the increase in the government debt during the same period. The Fed's balance sheet has grown by less than $2.5 trillion since the summer of 2007, while the federal debt has grown by more than twice that amount just since the beginning of 2009. As a result, the public has had to absorb more than $2 trillion of net government debt during the past three years. At best, the Fed's long-term asset purchases reduced the extent to which the federal deficits crowded out equity purchases.

The Federal Reserve has rationalized its use of long-term asset purchases and its explicit guidance about future values of short-term interest rates by noting that conventional monetary policy-lowering the federal-funds rate - is not possible now that the fed-funds rate is very close to zero. With a dual mandate that includes growth as well as price stability, the Federal Open Market Committee apparently feels a compulsion to do something. Unfortunately, the evidence suggests that it hasn't worked.

Mr. Bernanke has emphasized that the use of unconventional monetary policy requires a cost-benefit analysis that compares the gains that quantitative easing can achieve with the risks of asset-price bubbles, future inflation, and the other potential effects of a rapidly growing Fed balance sheet. I think the risks are now clear and the benefits are doubtful. The time has come for the Fed to recognize that it cannot stimulate growth and that a stronger recovery must depend on fiscal actions and tax reform by the White House and Congress.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Reagan, is a professor at Harvard and a member of The Wall Street Journal's board of contributors.