Econbrowser

Analysis of current economic conditions and policy

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October 13, 2010

Why is the Fed doing this?

Most observers now seem convinced that the Federal Reserve will shortly implement QE2, a second round of quantitative easing. It's worth taking a look at what QE2 is and is not expected to accomplish.

The ability of the Federal Reserve to influence what happens in the economy is fundamentally limited. The ultimate power of the Federal Reserve is the ability to create money, and how much money the Fed creates is a key determinant of the purchasing power of an individual dollar bill. A very minimalist position on what the Fed should be doing is that it should aim for a rate of inflation that does not disrupt the economy's ability to use real resources in the most efficient manner possible.

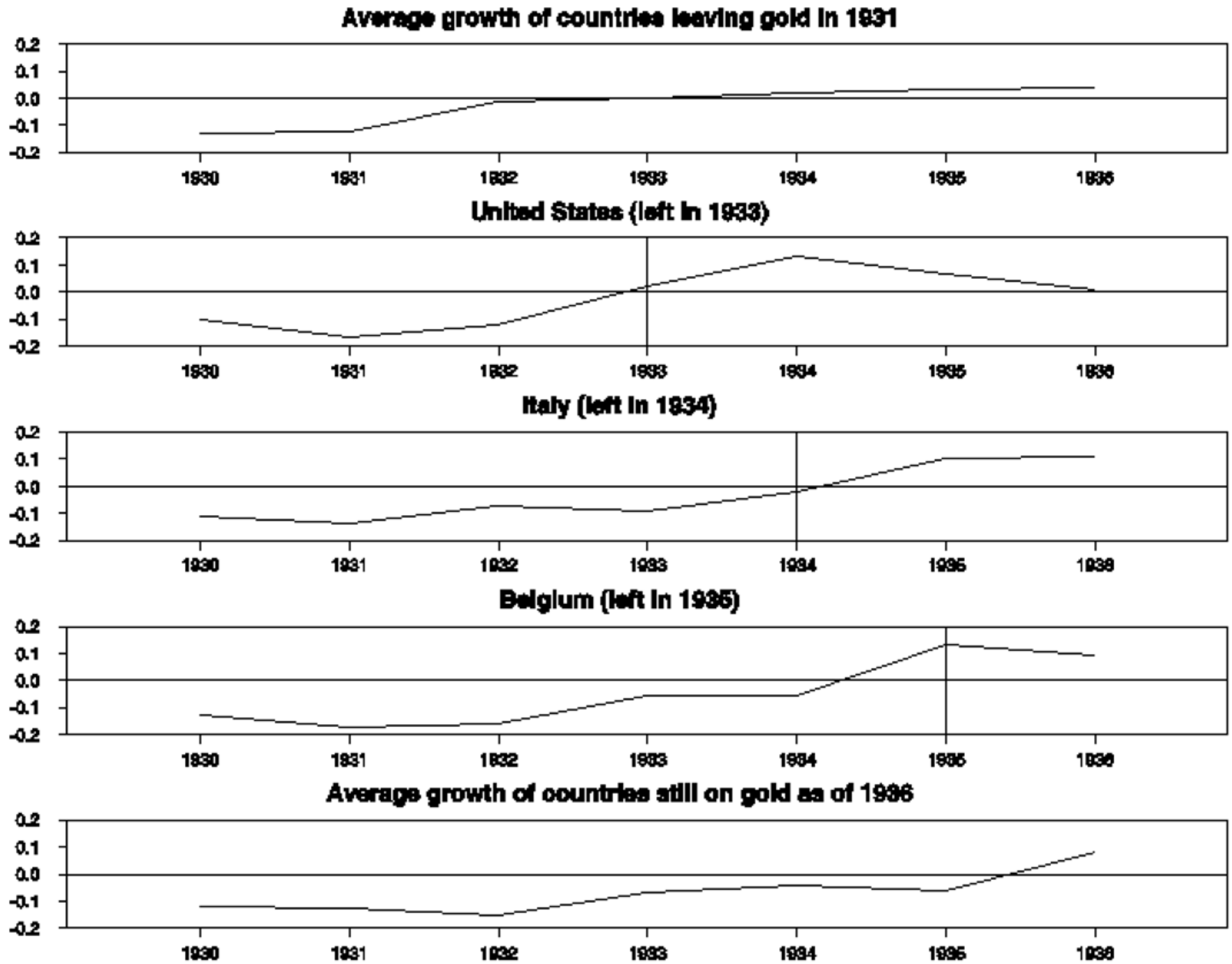
I think there would be broad agreement that a high and volatile inflation rate does not accomplish that objective. One reason why most of us can agree with that statement is that we have lived through times of high and volatile inflation and know first-hand the kinds of problems that environment can create.

It is also quite clear to me that deflation-- an increase in the number of goods you can buy with an individual dollar-- can be even more destructive. Since this may be less obvious to many readers, let me review some of the reasons why I say that.

For people struggling under debt burdens, deflation makes repaying the loan more difficult and less likely to happen. If that leads to a wave of bankruptcies, everyone, including creditors, can end up losing out. Debt burdens and delinquencies remain a significant problem holding back the economic recovery today. These problems would magnify enormously if a serious deflation were to get underway.

Deflation also means you can earn a positive rate of return just by stuffing money in your mattress. That creates an incentive for consumers, firms and banks simply to hoard cash rather than invest it productively. Even very sound investments can have a hard time competing for lenders' dollars when the alternative of hoarding becomes sufficiently lucrative.

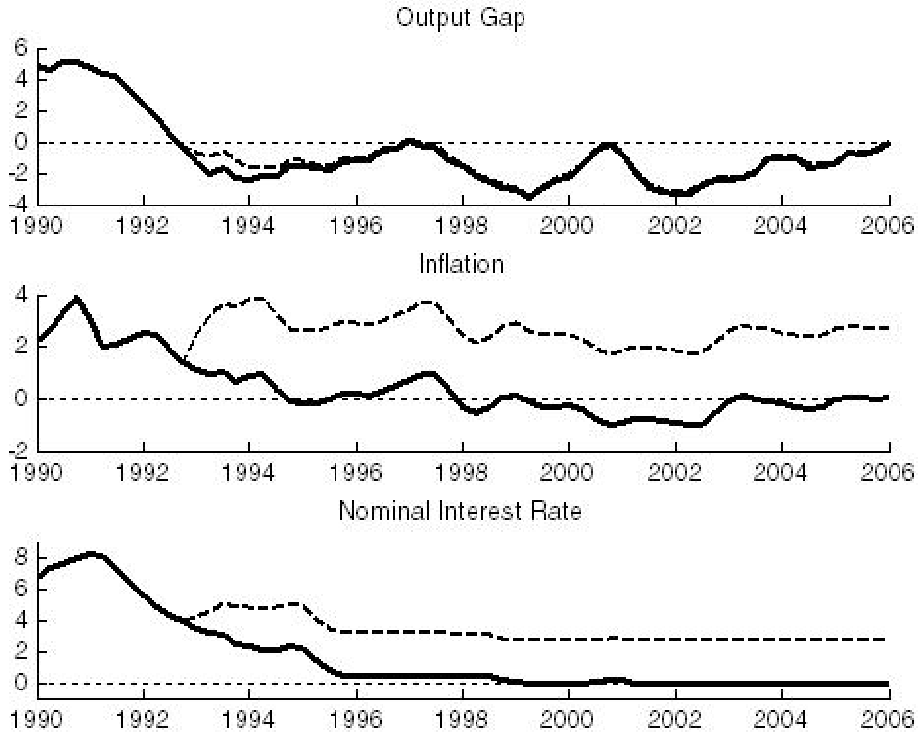
I'm personally persuaded that the 25% drop in the overall price level in the U.S. between 1929 and 1933 was one factor contributing to the depth and severity of the Great Depression. Our recovery began pretty dramatically when the U.S. reflated by dropping parity of the dollar with gold in 1933. Other countries had a similar experience-- things began to improve only after prices began rising.



Average real growth rates across different country groups, 1930-1936. Top panel: countries that left the gold standard in 1931. Second panel: growth rates for the U.S., which left the gold standard in 1933. Subsequent panels: countries leaving in 1934, 1935, and still on as of 1936. Source: Bernanke and James (1991).

But even if you agree that significant deflation can be a problem, we're not seeing deflation in the U.S. at the moment. We had 1% inflation, not deflation, over the last year. What's the harm in that?

One danger of low inflation is that, if it turns into deflation, the chain reaction can be difficult to stop before significant damage gets done. We're already at a point where, because of the very low inflation rates, the traditional tool that monetary policy would use to stimulate the economy, lowering the overnight interest rate, has no potency whatever, making it much more difficult for the Fed to arrest a significant deflationary turn should it arise at the moment. And with inflation this low, we're still seeing some of the problems with debt service and cash hoarding noted above. Many analysts point to Japan's experience of the 1990s as an illustration of the problems that this kind of low inflation or modest deflationary environment can cultivate.



Actual path (solid line) of output gap, inflation, and interest rate, and simulated counterfactual path (dashes) for Japan,1990-2006. Source: [Daniel Leigh (2010).]

And even if you don't agree with me that, given our current economic situation, a 1% inflation rate for the U.S. is destructive, maybe you'd at least agree that, if our inflation rate were to rise to 3%, it wouldn't be that harmful. On the other hand, there should be no question about the damage being done to people's lives by the continuing high rates of unemployment and wasted economic capacity. In normal times, we worry about trying to stimulate the economy too much out of concern about the negative consequences of a higher inflation rate. But if the downside for the latter is not that great, why not try to do a little more?

I grant that this is a little like the philosophy of driving your car into the garage until you bump up against the wall. Not generally a good guide for how to drive your car, but at least it is one very reliable way to know that you've done all you can. At the moment, I have a great deal of uncertainty, as I think other reasonable observers should as well, as to just how much we could stimulate the economy without producing inflation. I personally believe that we might reach that point sooner than many other analysts seem to be assuming. But the only way to know for sure is to try and see.

I emphasize that more expansion from the Federal Reserve may be of only limited help, and nobody should hope for too much from QE2. I urge the Fed to be carefully watching commodity prices as one indicator of just how far away the wall of the garage may still be.

I do not believe that the Fed can solve our economic problems. But I do believe that excessively low or negative inflation rates will make them worse, and that this is something the Fed can and should prevent.

Posted by James Hamilton at October 13, 2010 08:10 AM

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Comments

I presume in your view, people like [Dean Baker] are wrong about what printing money can achieve. Are you able to easily summarize why?

I would be very interested to hear your thoughts about other 'channels' through which QE may effect the economy - either positively or negatively. I'm thinking here of things like the effect on asset prices, such as shares, and perhaps also with regard to theories like "the banks aren't lending because they are trying to rebuild shareholder capital" - does QE have a role there?

Posted by: Luis Enrique at October 13, 2010 09:14 AM

Here is part of what Michael Hudson had to say from an article on Oct. 11, 2010 :

"The problem for all countries today is that as presently structured, the global financial system rewards speculation and makes it difficult for central banks to maintain stability without recycling dollar inflows to the U.S. Government, which enjoys a near monopoly in providing the world's central bank reserves by running budget and balance-of-payments deficits. As noted earlier, arbitrageurs obtain a twofold gain: the margin between Brazil's nearly 12% yield on its long-term government bonds and the cost of U.S. credit (1%), plus the foreign-exchange gain resulting from the fact that the outflow from dollars into reals has pushed up the real's exchange rate some 30% – from R$2.50 at the start of 2009 to $1.75 last week. Taking into account the ability to leverage $1 million of one's own equity investment to buy $100 million of foreign securities, the rate of return is 3000% since January 2009."

"Brazil has been more a victim than a beneficiary of what is euphemized as a "capital inflow." The inflow of foreign money has pushed up the real by 4% in just over a month (from September 1 through early October), and the past year's run-up has eroded the competitiveness of Brazilian exports. To deter the currency's rise, the government imposed a 4% tax on foreign purchases of its bonds on October 4."

""It's not only a currency war," Finance Minister Guido Mantega explained. "It tends to become a trade war and this is our concern."[7] Thailand's central bank director Wongwatoo Potirat warned that his country was considering similar taxes and currency trade restrictions to stem the baht's rise. Subir Gokarn, deputy governor of the Reserve Bank of India, announced that his country also was reviewing defenses against the "potential threat" of inward capital flows."[8]"

This is a must read article for anyone who is seriously interested in this subject. Dr. Hudson continues to get it right when most economists continue to get it wrong.

http://michael-hudson.com/2010/10/why-the-imf-meetings-failed/

Posted by: rayllove at October 13, 2010 09:19 AM

Shouldn't a distinction be made between CPI and wage inflation?

If the Fed creates CPI inflation through a fall in dollar/rise in commodities, and only much milder wage inflation, won't we be worse off?

And while a fall in mortgage rates will be inflationary, won't the loss to savers (including retirees, pensions, endowments, insurers) be deflationary? State pension funds have been lowering their expected returns for the last couple years, meaning more savings by the states, or lower benefits to pensioners, both are deflationary.

Frankly, I think it's rather obvious that absolutely no one can make a convincing case that they can predict what the net positive effects of this will be.

The effect of revaluing to the gold standard is thoroughly as anachronistic as the gold standard itself. We didn't have the burden of being tied to a fixed rate, and we can't expect to create the benefit leaving it.

Posted by: Bob_in_MA at October 13, 2010 09:25 AM

Tim Duy's recent post on the collapse of Bretton Woods 2 is also an important contribution to the subject at hand:

http://economistsview.typepad.com/timduy/2010/10/the-final-end-of-bretton-woods-2.html#comments

Posted by: rayllove at October 13, 2010 09:29 AM

But Professor Hamilton, why would they do more of something (QE2) that didn't work to generate inflation the first time (QE)? The only thing I can think of is that the Fed thinks it can raise inflation expectations by promising to "act irresponsibly" ... and that QE2 is irresponsible since the consequences of misjudging the wall will be far greater

Posted by: andrew at October 13, 2010 09:29 AM

Dr. Hamilton -
America's economic problems are directly related to price levels caused by inflation. Its impossible right now for an American manufacturer to compete against a Chinese competitor paying $1/hour for labor and operating at a 3% gross margin. Supporting existing price levels and adding to them with QE2 does not solve the problem.

Japan saw the handwriting on the wall ten years ago, and abandoned quantitative easing for deflation because they knew that they were in direct competition with China and Korea. 1000 Yen apples were not going to lead to prosperity. America on the other hand is addicted to the cheap fix... For forty years, we've relied on negative foreign trade, negative fiscal accounts, and geometric credit expansion. Now that we've crashed the economy due to credit excess and corrupt financial and industrial policy, we're playing the last card in a losing hand: Buying back impaired securities at inflated prices to keep the banking system from realizing its actual losses.

That's the rub- In order for the banking system to safely extend credit and the economy to again grow, we need to REDUCE the debt level in America. That necessarily means that non-performing loans have to be PURGED and impaired financial institutions have to be CLOSED.

I am beyond frustration that the FED board and academic economists believe that they can defy gravity. Safe banking and credit expansion can only occur with honest asset valuations, adequate capital ratios, and a capacity of the customer to service their debt. TIME FOR SOME TOUGH LOVE!

Posted by: MarkS at October 13, 2010 09:35 AM

Professor,

If you believe that inflation and deflation are always and everywhere monetary phenomenon then you must not confuse deflation with contraction. If government intervention creates a harsh economic environment where there is massive unemployment and lack of business investment you can have a decline in demand for goods and a crash in prices as happened during the Great Depression.

We are facing a similar event today and that is why QE1 had virtually no effect on the real economy, only on the stock market and the price of commodities and excess bank reserves. QE2 will also have no impact on the real economy even though it might temporarily spike the stock market. Once the stock market has to face reality even the market will not react to QE. Until demand side economists understand that we are beyond monetary events and into actual destruction of goods production we will continue in stagnation and perhaps even gretaer decline.

Posted by: Ricardo at October 13, 2010 09:58 AM

Trough several previous posts, Econbrowser and comments addressed the benefits of QE and possible causes and consequences.
Banks have ample reserves and do not lend, as they may not see a clear risk rewards through the actual imbalanced economies.
Banks are much more found of the "aggiotage" on the interest yield curve.States bonds are rewarding this strategy,as long as they buy there is no default.
Interbanks lending and borrowing is in autarky.
Instead of driving bonds prices and interest rates through Interest rates swaps,futures,options, physical assets are performing the same function and remain under the Fed control.
The OOCC derivatives report is clearly showing the profit attrition at the IRS chapter,the unwinding of the IRS swaps and the rising activities in the forex components attached to the swaps.
Intended consequences could be the clearing up of the derivatives in the banks books and the recognition of the proprietary trading by their shadow(s) owners.
QE may not not create full employment its 10 years track record is poor.
QE will not cure insolvency,the three last years of practice and the actual banks assets are a testifying for it.

Posted by: ppcm at October 13, 2010 10:02 AM

The most important idea missing from your view of deflation which seems all to common is whether deflation is actually beneficial to the economy longer term. Especially when you consider deflation is the result of lax central government fiat paper management, not some magical process morphed out of thin air.

Furthermore, deflation has a natural limit/floor (the amount of fiat paper circulating) and cannot continue forever. However, the opposite is true of inflation and money printing. It can go on for eternity or until society collapses.

The biggest problem with fighting balance sheet recessions with more fiat money is you never clear the bad assets and mismanaged corporations from the landscape and thus prolong the necessary adjustment.

Americans are too weak to endure the re-alignment of capital and resources our grandparents went through so we create new acronyms for the same old story of throwing good money after bad.

Posted by: defunktOne at October 13, 2010 10:04 AM

Thanks **Raylove**

Michael Hudson's [Why the IMF Meetings Failed] was a wonderfully concise and thorough description of US financial policy and its unintended consequences.

Posted by: MarkS at October 13, 2010 10:30 AM

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there is a lot of decent literature on this and it focusses on measuring the long rates rates reduction. Via observed rate declines on announcements, that were big, and the shrinkeage of the privately held bonds, estimated by one down 22% with QE 1

http://research.stlouisfed.org/wp/2010/2010-018.pdf
good findings and summarizes others.

a lot of folks never liked QE or stimulus, but its clear to me they both did work. the only one who says no is John taylor. that figures. But they may well be right eventually. QE and stim effects will eventually weaken and exhaust,side effects multiply, spend some time on that?

Framing this debate about deflation is pointless, the fed is nowhere near a pure deflation avoider, they are targetting jobs and functioning finance.
The rhetoric is mostly confidence building fluff.in my view its disinflation that hurts debtors, and there is nothing magic about the zero line.

As for the Fed. Its quite possible they are just jawboning about deflation/ QE2 now. if this gets rates down, they need not actually do it?

Posted by: AWH at October 13, 2010 10:43 AM

Jim: Remember that the inflation rate is an average. If the non-linear negative effects of deflation are family - by - family, then what we care about is not whether or not the average rate of change of prices

Posted by: MartyO at October 13, 2010 10:52 AM

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deflation is bad only for an economy where expansion is entirely debt induced. debt levels sooner or later reach the point of exhaustion: there is only so much debt that could be serviced with the present income.
at this point what is better: inflation or deflation? whatever leaves more disposable money to service the debt. through inflation you inflict even greater immediate pain, only after years of suffering and given a tight labor market, you can get a reprieve. inflation is not a quick fix.

Posted by: baychev at October 13, 2010 11:28 AM

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http://research.stlouisfed.org/fred2/data/CPIAUCNS_Max_630_378.png

Posted by: Anonymous at October 13, 2010 11:48 AM

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