

# The **GSE** REPORT™

*Tracking the Government's Role in the Financial Services Industry*

Special Supplement

**QE2:**

**The Federal Reserve Board's Last Ditch Effort  
to Prevent Deflation**

**November 24, 2010**

## QE2:

### **The Federal Reserve Board's Last Ditch Effort to Prevent Deflation**

The Great Recession, the worst financial crisis since the Great Depression, cost the U.S. more than 7 million jobs, a 4% decline in GDP and a \$13.7 trillion loss in household net worth. Congressional bailout efforts, coupled with the Fed's monetary policies that set interest rates at zero and provided \$1.7 trillion of quantitative easing, were successful in ending the recession and stabilizing the U.S. financial system. Nearly 18 months later, however, the economy's expansion appears to be losing momentum with a tepid 2% GDP and unemployment hovering around 9.6% throughout 2010. With federal fiscal stimulus programs winding down and states and municipalities facing budget cuts, policymakers are growing increasingly concerned about a further slowdown in economic growth. Federal Reserve officials are deeply concerned that weak demand and excess productive capacity may cause inflation to continue to fall, taking the country perilously close to disinflation.

On November 3, the Federal Open Market Committee (FOMC) adopted a second quantitative easing program (QE2) to (i) promote a stronger pace of economic recovery, (ii) achieve "maximum sustainable employment," and (iii) help ensure that inflation, over time, is at levels consistent with its mandate of achieving price stability. Specifically, the FOMC announced its intention to purchase an additional \$600 billion of longer-term Treasury assets through the second quarter of 2011 and reinvest principal payments from the Bank's securities holdings in longer-term Treasuries.

"On its current economic trajectory, the United States runs the risk of seeing millions of workers unemployed or underemployed for many years," said Federal Reserve Chairman Ben Bernanke.<sup>1</sup> The FOMC adopted QE2 in hopes of changing the country's economic trajectory.

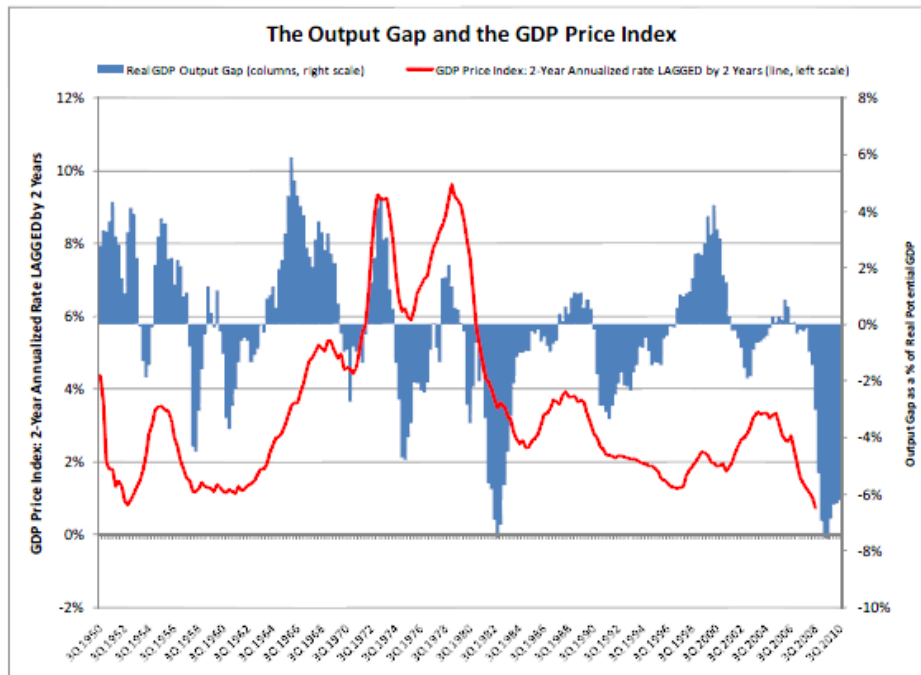
#### **CPI and the Output Gap**

In October, the Consumer Price Index (CPI) was 1.2% over October of last year with core inflation, which excludes volatile food and energy prices, of 0.6%--a post-war all-time low. The FOMC has established a goal of 2% core inflation, as being consistent with its mission of achieving price stability.



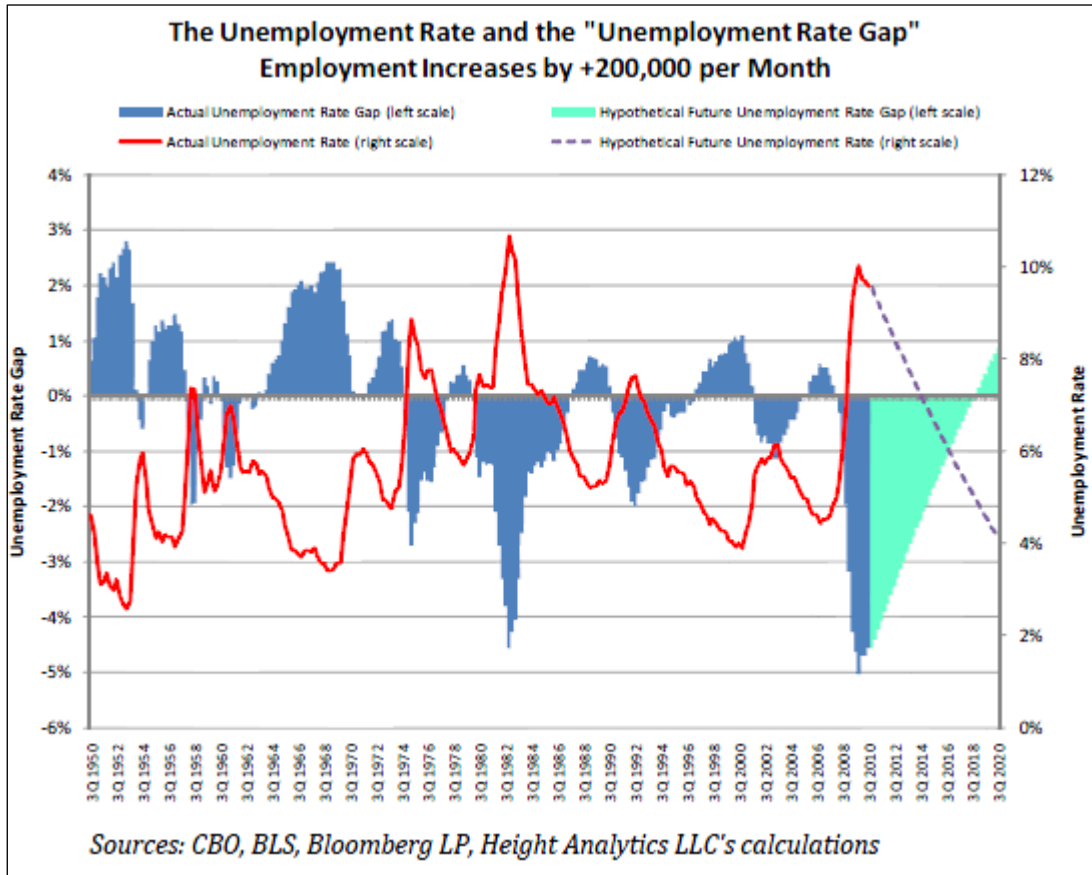
(Source: *Frontline Weekly Newsletter*, John Mauldin, 11/19/10)<sup>ii</sup>

Given the core inflation level's downward drift toward zero, Federal Reserve officials are concerned that further disinflation risks outright deflation, given the substantial excess capacity—or output gap, as measured by Potential GDP minus Actual GDP—that is embedded in the U.S. economy. (If this calculation yields a positive number it is called an inflationary gap and indicates the growth of aggregate demand is outpacing the growth of aggregate supply—possibly creating inflation; if the calculation yields a negative number, it is called a recessionary gap—possibly signifying deflation.<sup>iii</sup>) According to Height Analytics' calculations, the Output Gap for the third quarter was -6.21% of the potential real GDP—an improvement of 138 basis points from a year ago of -7.59, the lowest point of any other post WWII recession with the exception of the 1981-1982 downturn.<sup>iv</sup>



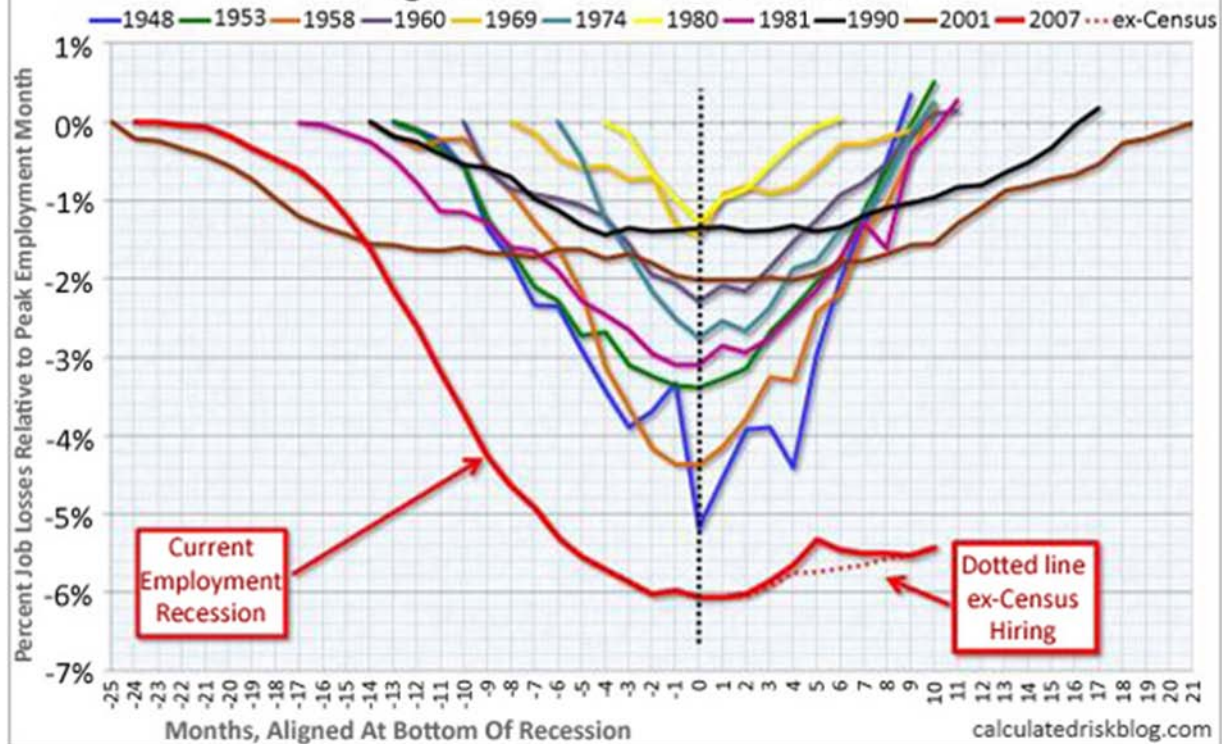
Sources: BEA, CBO, Height Analytics LLC's calculations

The Output Gap can also be measured by comparing the actual employment rate with the “natural rate” of employment (set at 5% through the end of this decade by the Congressional Budget Office). In the following chart, Height Analytics illustrates the “Unemployment Rate Gap,” assuming a +1.0% population growth, a labor force participation rate of 64.5%, and a month-over-month employment growth of +200,000 (119,000 *more* jobs per month than have been created, on average, over the last nine months). Using these assumptions, the U.S. unemployment rate would not decline to 5% or less until the fourth quarter of 2018.



After the 1981-1982 recession, the U.S. economy took 15 quarters for the unemployment rate to drop within 1% of the natural rate of unemployment (5%). According to Height Analytics’ analysis, it would take 30 quarters—or twice as long—for the unemployment rate to fall to 6% in the fourth quarter of 2016. Yet, “people argue that QE2 should be abandoned,” concluded Height’s analysts.

### Percent Job Losses In Post WWII Recessions, Aligned At Maximum Job Losses



(Source: <http://www.businessinsider.com/chart-of-the-day-percent-job-losses-in-post-wwii-recessions-2010-11>)

### The Fed's Greatest Fear: Deflation

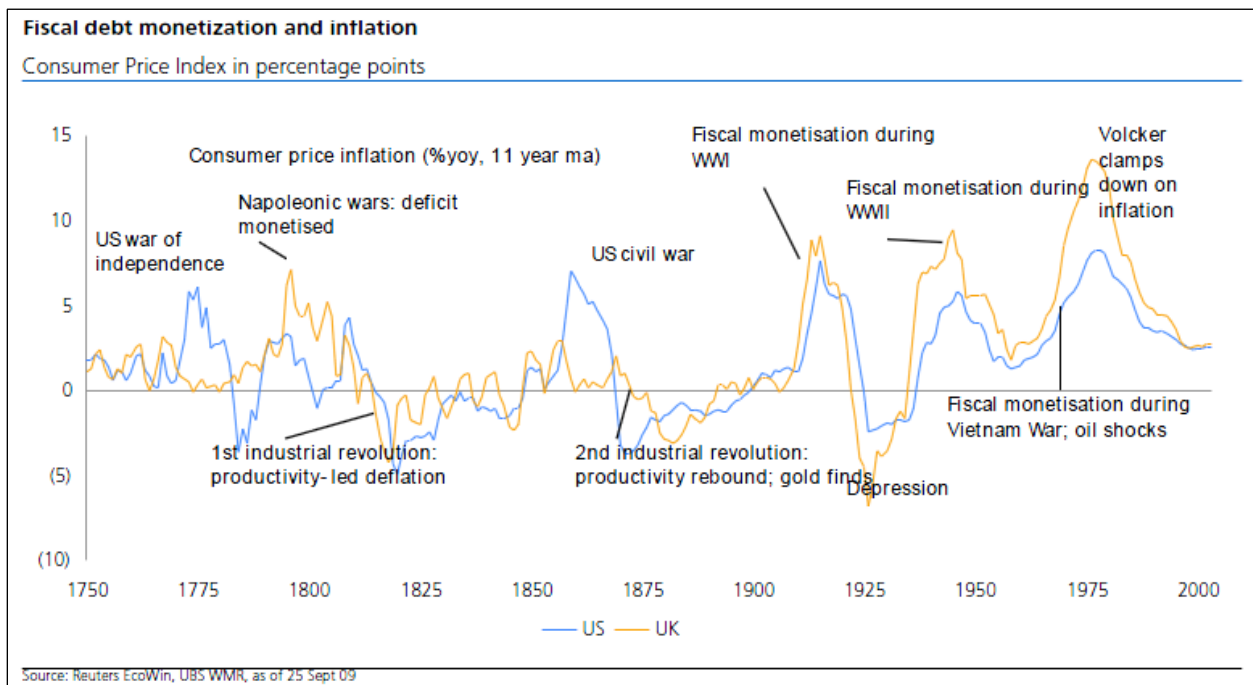
“A bout of deflation born of a financial crisis is of a different order altogether and may be far more dangerous and destructive,” cautioned Nouriel Roubini, professor of economics at New York University, in *Crisis Economics: A Crash Course in the Future of Finance*.<sup>v</sup> “...While deflation accompanied the global depression of the 1930s, it largely disappeared after that watershed event. Only in the 1990s did it resurface after the collapse of Japan’s asset bubble, and then during the brutal recession that hit Argentina in 1998-2001. Roubini added, “**Once a deflationary spiral has gained momentum, conventional monetary policy tends not to work.** Other weapons must be developed and thrown into battle.”<sup>vi</sup> [Emphasis added.]

In *The Age of Deleveraging: Investment Strategies for a Decade of Slow Growth and Deflation*, economist Gary Shilling points to eight factors that will slow global growth and increase the risk of deflation in future years:

- U.S. consumers will shift from a 25-year borrowing and spending spree to a savings spree, which will curtail imports of goods and services;

- The U.S. housing market will be weak due to excess inventories and loss of investment potential. (As a result, housing prices are projected to fall 8% nationally over the next 12 months);
- Financial deleveraging will reverse the trend that financed much of the global growth in recent years;
- Increased government regulation and involvement in major economies will stifle innovation and reduce efficiency;
- Developed countries are moving toward fiscal restraint and higher tax rates;
- Looming sovereign debt restructuring remains an overhang in the marketplace, while the fiscal risks of the U.S. federal government becomes more acute;
- State and local governments will contract, driving unemployment and the output gap higher; and
- Rising protectionism will slow, and may potentially eliminate global growth.<sup>vii</sup>

The following chart provides a historical perspective of fiscal debt monetization relative to inflation.

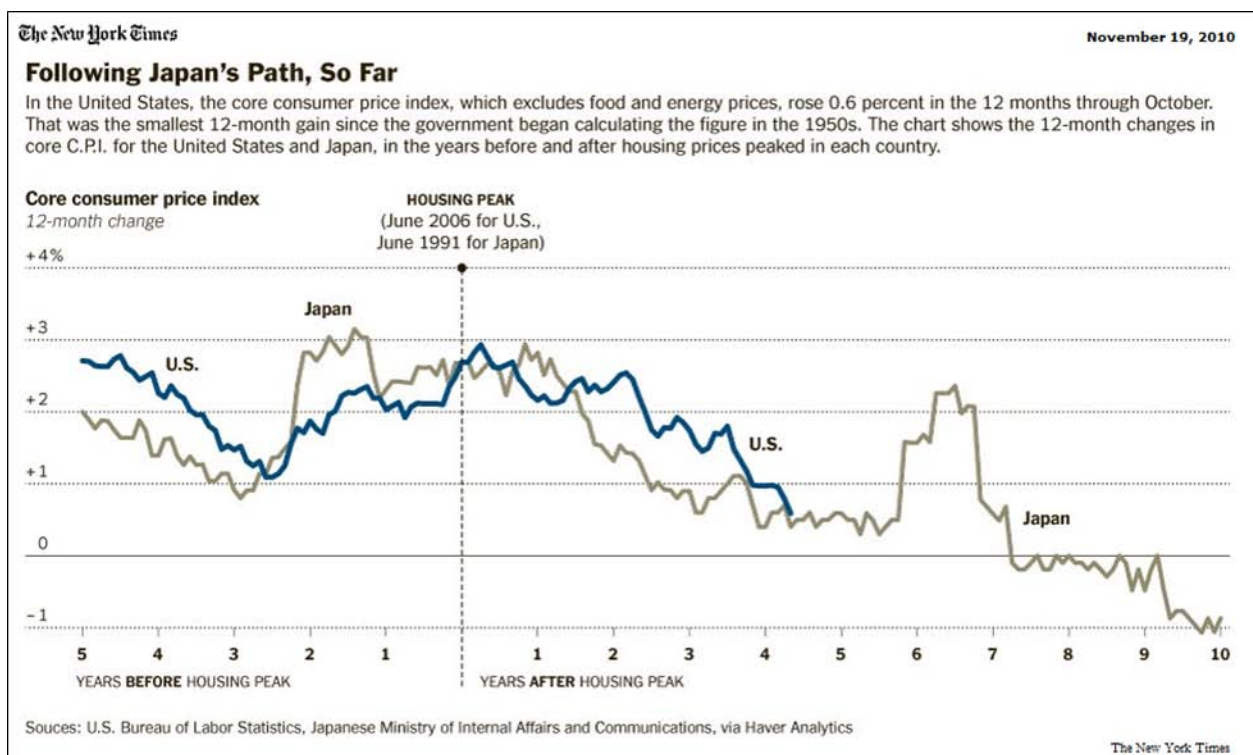


(Source: *Deflation-Inflation Knife-Edge*, UBS Wealth Management Research, 06/11/10)

## The “Japanification” of the United States?

Some economists believe the risk is increasing that the U.S. will enter a prolonged period of stagnant growth combined with a risk of outright deflation, similar to the environment that Japan entered in the 1990. Over the last 20 years, Japan experienced continuously deflating real estate and equity prices in which prices have fallen some 70% from peak levels. As a result, the general price levels in Japan are the same today as they were in the early 1990s.

“The U.S. is closer to a Japanese-style outcome today than any time in recent history,” wrote Federal Reserve Bank of St. Louis President James Bullard in the white paper, *Seven Faces of ‘The Peril.’*<sup>viii</sup>



Both the Japanese and the U.S. economies experienced rapid growth in debt, which fueled bubbles in residential and commercial real estate and equity markets, while income levels failed to grow fast enough to service the increasing debt load. In turn, delinquencies grew and asset prices fell, triggering a banking crisis.

The differences between the two countries' trajectory are also significant. The U.S. appears to be following a “high speed” version of the Japan's scenario with its economic crisis being more severe and unfolding more quickly, as evidenced in the U.S.'s higher unemployment levels and

larger output gap. The U.S. policy response—both fiscal and monetary—is also viewed to have occurred more quickly and with greater force than the Japanese response.

Some argue that there are demographic differences between the two countries that may portend a more favorable outcome for the U.S. The Japanese population is (now) significantly older and shrinking, while the U.S. still reports a nearly 1% growth in population. However, others argue that the demographic profile of the U.S. is similar to that of Japan, when it entered its Lost Decade in the early 1990s. A significant difference between the two countries is Japan's high savings rate (e.g., a "savings surplus country"), while the U.S. spends more than it earns every year. Many view the U.S.'s current account deficit as ultimately unsustainable, creating an added vulnerability and an important difference from the Japanese experience. On the other hand, the U.S. enjoys the benefits of having the world's reserve currency and maintains special borrowing privileges for the foreseeable future.

The limitations of the U.S. policy actions appear to mirror that of Japan's thus far. Despite record monetary and fiscal policy efforts, economic growth remains weak. Some argue that, similar to Japan, too much fiscal stimulus was dedicated to maintaining employment in noncompetitive industries (and government) and unproductive infrastructure. Conventional monetary policy has been exhausted with rates at zero, while the first round of quantitative easing expanded the central banks' balance sheet, but failed to expand credit and broader monetary creation. In Japan, the rapid withdrawal of fiscal stimulus led to their double-dip recession. Time will tell if the U.S. fiscal stimulus, scheduled to be withdrawn over coming quarters, will result in a similar outcome.

"In Japan, debt-financed government spending has prevented deleveraging on a national level," wrote PIMCO's Scott A. Mather.<sup>ix</sup> "Deflation caused the problem to become more ensconced. So far, the U.S. is headed down a similar path with private sector deleveraging being more than offset by government borrowing so that national debt is continuing to rise. Longer term, it is likely the U.S. (and indeed much of the developed world) will be plagued with a muted rate of growth (PIMCO's New Normal economic outlook) coupled with rising deflationary risks."

### **The Liquidity Trap**

"[T]he U.S. economy is best described as being in a bona fide liquidity trap," said Charles Evans, President of the Federal Reserve Bank of Chicago.<sup>x</sup> "...Risk-free short-term interest rates are essentially zero. Both households and businesses [and banks] have an excess savings relative to the new investment demands for these funds. With nominal interest rates at zero, market clearing at lower real interest rates is stymied."

"The Fed has been 'pushing on a string' to use the term developed for ineffective monetary policy in a liquidity trap," wrote AEI fellow John H. Makin.<sup>xi</sup> "The Fed boosts the monetary base by purchasing assets, but the money supply does not grow because the drop in the money multiplier tied to disintermediation by banks leaves money growth static. As uncertainty rises and inflation threatens to fall below zero (crossing the critical dividing line into deflation), velocity falls. With a static or falling money supply and falling velocity, nominal GDP growth

also falls because of a combination of falling output growth and, eventually, a falling price level or deflation. ...A deflation spiral emerges”

Makin added, “...Bernanke’s support for additional quantitative easing [in 2010], the prospect of which has weakened the dollar and boosted the dollar price of gold, is a reaction to a persistent drop in U.S. inflation since the onset of a financial crisis comparable in magnitude to the ones that precipitated the Great Depression and its deflation, as well as two decades of disinflation and deflation in Japan.” Makin also argued that the appreciation in the price of gold is more a measure of the market’s rising inflation expectation in Asia and emerging markets than it is in the U.S.

### **Critics contend that QE2 will trigger runaway inflation**

Critics argue that quantitative easing—or printing money—debases the U.S. dollar and may trigger runaway inflation. Others contend that with most areas of the U.S. economy characterized by overcapacity and high unemployment, an increase in the money supply will not be accompanied by price increases in domestically-priced sectors such as housing and various services that now comprise the lion’s share of the U.S. economy. Today, well over 70% of the U.S.’s total consumption consists of non-tradable goods and services. Thus, even substantial price increases for international goods consumed in the U.S. can only be expected to produce relatively modest—although non-negligible—overall increases in the CPI.<sup>xii</sup>

Other experts argue that the first round of quantitative easing has resulted in disinflation to date. Moreover, they contend that the Fed has the tools to contract its balance sheet before runaway inflation can occur. Specifically, the Federal Reserve created banking reserves that increased the monetary base by 133% in response to the financial crisis in July 2008. The vast majority of the Fed’s increase in the monetary base flowed through to the banks as increased excess reserves—in other words, money that sits idly in banks’ reserve accounts at the Fed. Net of banks’ reserves, “spendable money” (M2) increased by only 12.4% since July 2008.

To date, the pace of private sector credit creation is presently negative. If the pace of net private sector credit creation were to appear to be growing too rapidly, the Fed could reverse its quantitative easing program through the use of reverse repos, the Term Deposit Facility or by selling bonds that it holds on its balance sheet. Timing, of course, is everything.

### **Currency Manipulation**

Foreign countries argue that the Fed’s QE2 is a form of currency manipulation, which results in a stealth devaluation of the dollar that, in turn, stimulates U.S. exports. While the policy may over the short-term weaken the dollar, the Fed’s primary goals for QE2 are to stimulate U.S. growth and close the output gap, thereby reducing the level of unemployment. Engineering a weak dollar was not the central bank’s primary motivation behind either QE1 or QE2.

“The strategy of currency undervaluation has demonstrated important drawbacks, both for the world system and for the countries using that strategy,” said Chairman Bernanke in a November 19 speech in Frankfurt, Germany. “[China’s strategy of export-led growth] cannot ultimately

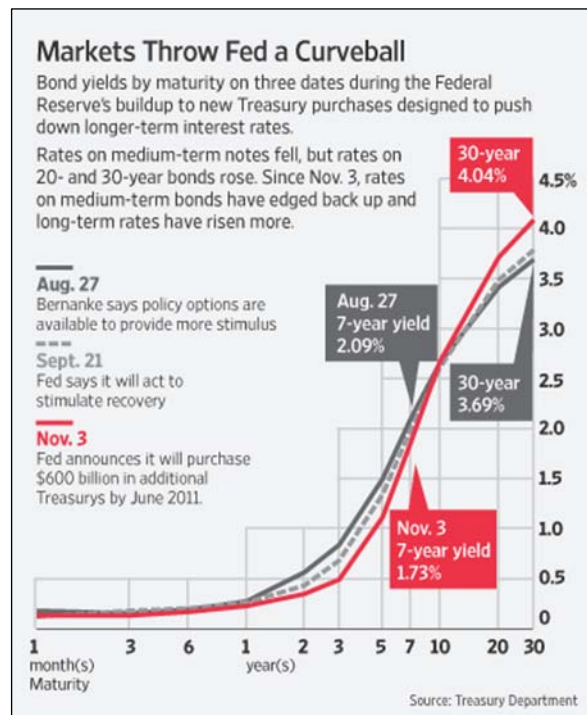
succeed if the implications of that strategy for global growth and stability are not taken into account. Currency undervaluation by **surplus countries** is inhibiting needed international adjustment and creating spillover effects that would not exist if exchange rates better reflected market fundamentals. Unfortunately, so long as exchange-rate adjustment is incomplete and global growth prospects are markedly uneven, the problem of excessively strong capital inflows to emerging markets may persist.” [Emphasis added.]

## **The market questions the Fed’s ability to keep interest rates low using QE2**

Harsh criticism of the Federal Reserve's QE2 policy appears to be muting the plan's potential benefits for the economy—at least during the first week of the program’s implementation. “[The harsh criticism] has raised questions about the Fed's ability and resolve to control the yield curve,” said Mohamed El-Erian, CEO of PIMCO. “The criticism has unsettled markets naturally inclined to worry about the politicization of the Fed and its loss of autonomy.” The success of QE2 largely hinges on the central bank’s ability to shape public and market expectations. If the public and investors believe the Fed is likely to keep buying bonds to keep long-term interest rates low, the more likely the markets will be to keep long-term rates from rising.

Moreover, rising interest rates will further hinder the Fed's ability to stimulate economic growth. “[The rise in real yields] will increase the cost of doing business in a still fragile economy,” said Stuart Thomson, a bond manager for Scotland’s Ignis Asset Management.<sup>xiii</sup> “The price effect of rising yields is to choke off growth because it actually represents a tightening of monetary policy. The rise in yields has been enough to slow the economy by the middle of next year.”

Some Wall Street analysts believe the market’s performance reflects a correction of technicals. “Bond markets are in the throes of a significant correction due to the need to adjust overly long positions built in anticipation of QE2,” wrote Royal Bank of Scotland analysts on November 19.<sup>xiv</sup> “...We caution that right now, they are signaling it has further to run. However, once the correction has run its course, we think the next major move in yields is down, not up. The 2011 bullish fundamentals include the reduced supply of high grade bonds next year due to QE2 and foreign central bank buying, the Fed's likely determination to push rates down to ease financial conditions and spur growth, continued financial problems in Europe that constitute a threat to global stability, and continued sluggish economic growth.”



## The slowing economy demands fiscal *and* monetary pro-growth policies

The Federal Reserve’s updated economic forecasts project only 2.4% to 2.5% growth for 2010, down sharply from its previous projection of 3% to 3.5%. For 2011, the central bank expects the economy to expand by 3% to 3.6% percent, again much lower than its June forecast. According to minutes from the Fed’s November meeting, unemployment, which has been “disappointingly slow” to fall, is expected to average from 9.5% to 9.7% in 2010, in line with October’s unemployment rate of 9.6%. The Fed’s 2012 projections are slightly more optimistic, largely due to the positive impact expected from QE2. The central bank’s darker outlook for the economy helps put into context the FOMC’s decision to launch QE2.

Variable	Central tendency <sup>1</sup>				
	2010	2011	2012	2013	Longer run
Change in real GDP . . .	2.4 to 2.5	3.0 to 3.6	3.6 to 4.5	3.5 to 4.6	2.5 to 2.8
June projection . . .	3.0 to 3.5	3.5 to 4.2	3.5 to 4.5	n.a.	2.5 to 2.8
Unemployment rate . . .	9.5 to 9.7	8.9 to 9.1	7.7 to 8.2	6.9 to 7.4	5.0 to 6.0
June projection . . .	9.2 to 9.5	8.3 to 8.7	7.1 to 7.5	n.a.	5.0 to 5.3
PCE inflation . . . . .	1.2 to 1.4	1.1 to 1.7	1.1 to 1.8	1.2 to 2.0	1.6 to 2.0
June projection . . .	1.0 to 1.1	1.1 to 1.6	1.0 to 1.7	n.a.	1.7 to 2.0
Core PCE inflation <sup>3</sup> . .	1.0 to 1.1	0.9 to 1.6	1.0 to 1.6	1.1 to 2.0	
June projection . . .	0.8 to 1.0	0.9 to 1.3	1.0 to 1.5	n.a.	

(Source: <http://www.thebondbeat.com/bondbeat/?p=16741>)<sup>xv</sup>

While not a magic cure, the Fed’s quantitative easing is necessary medicine for the ailing U.S. economy. With the Fed’s zero interest rate policy that has been in place for nearly two years, quantitative easing is one of the few remaining tools that the central bank has at its disposal. The risk that the economy may stall or even contract is real—while the risk of deflation is graver still.

Chairman Bernanke has urged Congress to institute pro-growth policies, which provide short-term stimulus through tax-cut or spending initiatives. “[I]n general terms, a fiscal policy that combines the near-term measures to enhance growth with strong, confidence-inducing steps to reduce longer-term deficits would be an important complement to the policies of the Federal Reserve,” said Bernanke.<sup>xvi</sup>

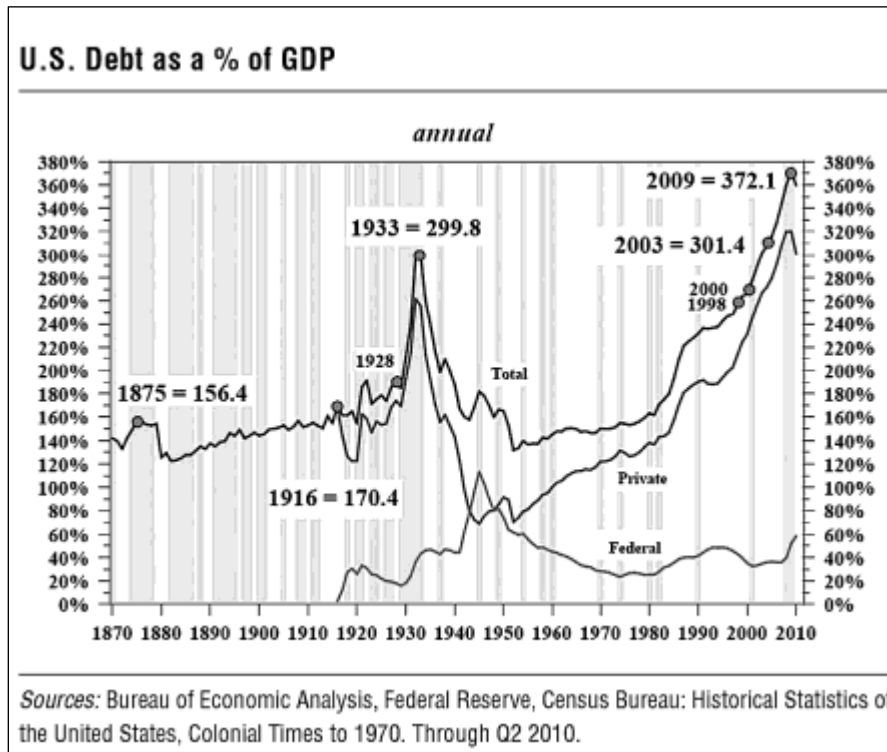
“Given what ails us, additional monetary policy measures are at best, poor substitutes for more powerful pro-growth policies” said Board Governor Kevin Warsh.<sup>xvii</sup> “...Other policymakers must bear their burden and do their part to encourage more-robust economic growth and establish conditions for stronger employment.” Specifically, Warsh called on policymakers to adopt pro-growth economic policies that would strengthen incentives to invest in capital and labor, including (i) reform of the tax code to make it simpler, more transparent, and conducive to long-term investment; (ii) reform in the conduct of regulatory policy by providing timely,

clear and consistent rules that allow companies to be innovative in the changing economic landscape and allow firms to succeed or fail, regardless of their size; and (iii) eliminate the “creep” of trade protectionism. “The Federal Reserve is not a repair shop for broken fiscal, trade and regulatory policies,” he added.

Over the long-term, Chairman Bernanke has also urged Congress to reform entitlement programs to enable American companies to compete more effectively in the global marketplace. Reforming entitlement programs, including the Medicare, Medicaid and Social Security, will be essential to lowering government spending and improving the U.S.’s long-term fiscal viability.

**This time isn’t different....**

“All too often, periods of heavy borrowing can take place in a bubble and last for a surprisingly long time,” cautioned Carmen M. Reinhart and Kenneth S. Rogoff in *This Time is Different—Eight Centuries of Financial Folly*.<sup>xviii</sup> “But highly leveraged economies, particularly those in which continual roll-over of short-term debt is sustained only by confidence in reactively illiquid underlying assets, seldom survive forever, particularly if the leverage continues to grow unchecked. ...[H]istory does point to warning signs that policy makers can look at to assess risk—if only they do not become too drunk on their credit bubble-fueled success and say as their predecessors have for centuries, ‘This time is different.’”



(Source: *The Little Book of Sideways Markets*<sup>xix</sup>)

## **The Bottom Line**

Chairman Bernanke's unusually blunt plea for fiscal help from Congress will probably go unanswered, leaving the economy too limp to put millions of the unemployed back to work any time soon. In today's political climate, most Republican lawmakers will be more focused on cutting short-term spending rather than approving tax cuts that would stimulate growth or additional spending for so-called "shovel-ready" projects. Lawmakers discovered with the last round of stimulus spending that the getting money to projects often takes longer than envisioned. The combination of environmental permits, which often take three years (or more) to secure, the Davis-Bacon requirements that were inserted into the last stimulus package, and other regulatory impediments, most "shovel ready" projects were simply not "shovel ready." The reality is that the federal government is often not capable of dispensing funds to the end project in a timely, efficient manner to jumpstart economic growth.

Realistically, the quickest way to stimulate economic growth is through tax cuts. However, Democratic policymakers appear to have limited, if any appetite, to extend all of the Bush administration's tax cuts—much less provide meaningful tax cuts that would stimulate the economy.

"If Congress and the president can reach a quick compromise on taxes in early December, it will be a sign that they can work together in at least a minimal fashion, and we believe should reduce some of the psychological headwinds in the economy," said Ethan Harris, an economist with Bank of America-Merrill Lynch.<sup>xx</sup> "On the other hand, if they agree to disagree, we believe downside risks to U.S. growth will likely intensify."

With lawmakers finding it difficult to reach an agreement on extending all or part of the Bush tax cuts, it is unlikely that Congress will reach an agreement on pro-growth tax cuts and/or stimulus spending that would provide an exemption from many of the regulatory impediments mentioned earlier. Short of an economic crisis, the stage is set on Capitol Hill for gridlock. If Chairman Bernanke is to get any help from Congress, it will probably be in the form of modest steps that preserve the status quo.

With economic growth slowing and gridlock likely in Congress, the FOMC adopted QE2 in a last ditch effort to stimulate economic growth. While QE2 is viewed as controversial and potentially risky, Federal Reserve officials concluded that the risk of doing *nothing* was greater than the risks posed by QE2.

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**Endnotes:**

- <sup>i</sup> *Prepared Remarks at the Sixth European Central Bank Central Banking Conference*, Ben S. Bernanke, November 19, 2010
- <sup>ii</sup> *Frontline Weekly Newsletter*, John Mauldin, 11/19/10
- <sup>iii</sup> *Economics*. Richard G. Lipsey and Alec Chrystal. Oxford University Press. 11th edition. January 2007. p. 423.
- <sup>iv</sup> *Macro Strategy: Why the Fed Will Stick to Its QE2 Guns*, Height Analytics, November 16, 2010
- <sup>v</sup> *Crisis Economics: A Crash Course in the Future of Finance*, Nouriel Roubini and Stephen Mihm, The Penguin Press, May 2010, p. 139
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- <sup>vii</sup> *The Age of Deleveraging: Investment Strategies for a Decade of Slow Growth and Deflation*, A. Gary Shilling, Wiley & Sons, Inc., November 2010; p. 182
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- <sup>ix</sup> Turning Japanese: The Risk of U.S. Deflation, Scott A. Mather, PIMCO, August 2010
- <sup>x</sup> *Remarks delivered at the Federal Reserve Bank of Boston’s 55th Economic Conference*, Charles Evans, October 16, 2010,
- <sup>xi</sup> *Bernanke Battles U.S. Deflation Threat*, John H. Makin, November 2010
- <sup>xii</sup> *Will QE2 Lead to High Inflation*, James Kastrohry, 11/01/10
- <sup>xiii</sup> *Wall Street Journal*, Min Zeng, November 22, 2010
- <sup>xiv</sup> *U.S. Rates Strategy Weekly*, Royal Bank of Scotland, November 19, 2010
- <sup>xv</sup> <http://www.thebondbeat.com/bondbeat/?p=16741>
- <sup>xvi</sup> *The Atlantic*, Derek Thompson, November 2010
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- <sup>xviii</sup> *This Time Is Different—Eight Centuries of Financial Folly*, Carmen M. Reinhart and Kenneth S. Rogoff, Princeton Press, September 2009, p. 292
- <sup>xix</sup> *(The Little Book of Sideways Markets: How to Make Money in Markets that Go Nowhere*, Vitaliy N. Katsenelson, Wiley, December 2010, p. xvi
- <sup>xx</sup> Reuters, Emily Kaiser and Andy Sullivan, November 23, 2010