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Bernanke's Dilemma: $4 Trillion in Quantitative Easing (QE)

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Ben Bernanke is in a real fix. His quantitative easing (QE) program is designed to boost stock prices, lower bond yields, and weaken the dollar.

But the market has already priced all that in, so when he announces the start of the program on November 3, there's a good chance that things will either stay the same or head in the opposite direction. That's bad for Bernanke. Just imagine if the dollar strengthens just as the Fed chairman begins buying-up Treasuries to push the dollar down. He'll look pretty foolish. But that could happen because the dollar has already slipped nearly 7% since August and is overdue for a rebound.

So, what should he do? Should he go ahead and launch his program anyway knowing it could backfire and further damage his credibility or scrap the whole deal and move on to Plan B?

The truth is, he has no choice. If he doesn't follow through now, investors will accuse him of "withdrawing liquidity" and send the market into a nosedive. So, he has to go forward and let the chips fall where they may. If QE2 turns out to be a bust, so be it.

A new report from Goldman Sach's economist Jan Hatzius figures that "the Fed will need to print $4 trillion…to close the Taylor gap." (zero hedge) That means it will take roughly $4 trillion for QE to do what it's supposed to do. New York Times columnist Paul Krugman's estimates are even higher. He thinks it will take $8 to 10 trillion of QE to push down long-term rates enough to sustain the recovery. Of course, no one is even considering expanding the Fed's balance sheet by that amount because it would put the central bank's future at risk and might not work anyway. Instead, Bernanke plans to take baby steps, purchasing $200 to $300 billion in Treasuries at a time, hoping that the smaller amounts buoy stocks and increase investment in the real economy. In other words, QE2 is not a really serious commitment of resources to address deflationary pressures, excess capacity or high unemployment at all. It's more like giving aspirin to a cancer patient. There may some temporary relief, but the overall effects will be negligible.

That's not to say that the Fed isn't a powerful institution. It is. The Fed controls short-term interest rates and short-term rates can either stimulate growth or send the economy into a tailspin. They can guide the economy to years of productivity and prosperity or generate gigantic speculative bubbles that end in disaster. But, in a liquidity trap–when interest rates are stuck at zero—monetary policy is largely ineffective so the Fed is dead-in-the-water. It doesn't matter how cheap money is when people aren't borrowing. And, people aren't borrowing because they're broke. The Fed doesn't have the ability to change that. Bernanke may wish he was "Helicopter Ben" and could drop bundles of greenbacks over America, but the truth is, only congress has that power and they're not taking advantage of it. They're more worried about deficits.

So, QE won't succeed because it doesn't address the real issue, which is demand. In theory, when the Fed buys bonds, it pushes investors into riskier assets, like stocks. That, in turn, inflates equities prices which (supposedly) triggers additional hiring and lowers unemployment. It's a persuasive theory, but it won't work. Here's an excerpt from an article in the Wall Street Journal which explains why:

"While more quantitative easing will help to keep interest rates low, primary dealer banks aren't fully convinced that the move will prove to be the U.S. economy's knight in shining armor.

"It may help to lower rates temporarily," said Ward McCarthy, chief financial economist and managing director of the fixed-income division at Jefferies & Co. in New York, "but is unlikely to have a significant beneficial effect on the economy."

That is because such a program won't ease credit conditions for small businesses that are dependent on banks for lending, he said, nor will it lower borrowing costs for homeowners who are unable to refinance their mortgages because home prices have fallen." (No Fix in Quantitative Easing, Deborah Lynn Blumberg, Wall Street Journal)

So, if QE doesn't help small businesses (which create most of the country's new jobs) or homeowners, than how can it lower unemployment, trim excess capacity, or increase aggregate demand? It can't. At best, it will merely boost asset prices and create more bank reserves while the real economy continues to languish in a near-Depression.

Naturally, the prospect of the Fed adding trillions of dollars to the money supply has trading partners in a panic forcing some to regulate capital inflows and prepare for a savage round of competitive devaluation. At this weekend's meeting of the G-20 in Gyeongju, South Korea, German finance minister, Rainer Brüderle lashed out at the Fed's QE program saying, "Excessive, permanent money creation in my opinion is an indirect manipulation of an exchange rate." The irony of the Brüderle's remarks were lost on Treasury secretary Timothy Geithner who used the meetings to point the finger at China and to make his case for "numerical limits" on current account balances. This is from Bloomberg:

"Seeking to find common ground on currency valuation, officials agreed to "move toward more market-determined exchange rate systems that reflect underlying economic fundamentals." And they pledged to "refrain from competitive devaluation of currencies" — an effort to calm anxiety over a wave of protectionism in which countries would weaken their currencies to bolster their own exports."

It makes you wonder how the attendees could listen to Geithner's disingenuous blather knowing that the Fed is planning to print up hundreds of billions of dollars that could wreak havoc in the currency markets?

Even so, Geithner is right to be worried about the widening trade deficits. The massive imbalances inevitably lead to crises as they did when Lehman defaulted and global trade plummeted. In the last decade, US exports to China have totaled just $417 billion while Chinese imports have soared to $2,160 billion. Much of China's earnings have been recycled into US Treasuries to keep the price of their currency artificially low while they add to their $2.6 trillion in reserves. This gives them an unfair advantage in competing head-to-head with better-paid US workers.

In August, the trade gap widened more than analysts had predicted to $46 billion putting more pressure on the Fed to weaken the dollar so that more US jobs are not lost to foreign competitors and so that monetary stimulus (designed to kickstart the US economy) is not siphoned off via the trade deficit.

The bottom line: Economic recovery is impossible unless exchange rate issues are resolved. Bernanke may think that QE2 will scare China into reversing its current policy (and agree to move toward more market-oriented exchange rate system) but it's just as likely that Beijing will follow the dollar downward buying up even more US Treasuries and undermining any hope for a rebound in the US. That means that congress must get involved and threaten to levy import duties and tariffs on China if they refuse to let their currency appreciate.

Congress also needs to acknowledge the limitations of monetary policy. QE is not the right tool for dealing with a "balance sheet recession". (when households are reducing their debts and slashing spending) A second round of fiscal stimulus is the only way to lower unemployment, increase spending, and lay the groundwork for a sustainable recovery.