What's Really Behind Quantitative Easing QE2? The Looming Threat of a Crippling Debt Service

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The deficit hawks are circling, hovering over QE2, calling it just another inflationary bank bailout. But unlike QE1, QE2 is not about saving the banks. It's about funding the federal deficit without increasing the interest tab, something that may be necessary in this gridlocked political climate just to keep the government functioning.

On November 15, the Wall Street Journal published an open letter to Fed Chairman Ben Bernanke from 23 noted economists, professors and fund managers, urging him to abandon his new "quantitative easing" policy called QE2. The letter said:

We believe the Federal Reserve's large-scale asset purchase plan (so-called "quantitative easing") should be reconsidered and discontinued. . . . The planned asset purchases risk currency debasement and inflation, and we do not think they will achieve the Fed's objective of promoting employment.

The Pragmatic Capitalist (Cullen Roche) remarked:

Many of the people on this list have been warning about bond vigilantes while also comparing the USA to Greece for several years now. Of course, they've been terribly wrong and it is entirely due to the fact that they do not understand how the US monetary system works. … What's unfortunate is that these are many of our best minds. These are the people driving the economic bus.

The deficit hawks say QE is massively inflationary; that it is responsible for soaring commodity prices here and abroad; that QE2 won't work any better than an earlier scheme called QE1, which was less about stimulating the economy than about saving the banks; and that QE has caused the devaluation of the dollar, which is hurting foreign currencies and driving up prices abroad.

None of these contentions is true, as will be shown. They arise from a failure either to understand modern monetary mechanics (see links at The Pragmatic Capitalist and here) or to understand QE2, which is a different animal from QE1. QE2 is not about saving the banks, or devaluing the dollar, or saving the housing market. It is about saving the government from having to raise taxes or cut programs, and saving Americans from the austerity measures crippling the Irish and the Greeks; and for that, it may well be the most effective tool currently available. QE2 promotes employment by keeping the government in business. The government can then work on adding jobs.

The Looming Threat of a Crippling Debt Service

The federal debt has increased by more than 50% since 2006, due to a collapsed economy and the highly controversial decision to bail out the banks. By the end of 2009, the debt was up to $12.3 trillion; but the interest paid on it ($383 billion) was actually less than in 2006 ($406 billion), because interest rates had been pushed to extremely low levels. Interest now eats up nearly half the government's income tax receipts, which are estimated at $899 billion for FY 2010. Of this, $414 billion will go to interest on the federal debt. If interest rates were to rise just a couple of percentage points, servicing the federal debt would consume over 100% of current income tax receipts, and taxes might have to be doubled.

As for the surging commodity and currency prices abroad, they are not the result of QE. They are largely the result of the U.S. dollar carry trade, which is the result of pressure to keep interest rates artificially low. Banks that can borrow at the very low fed funds rate (now 0.2%) can turn around and speculate abroad, reaping much higher returns.

Interest rates cannot be raised again to reasonable levels until the cost of servicing the federal debt is reduced; and today that can be done most expeditiously through QE2 — "monetizing" the debt through the Federal Reserve, essentially interest-free. Alone among the government's creditors, the Fed rebates the interest to the government after deducting its costs. In 2008, the Fed reported that it rebated 85% of its profits to the government. The interest rate on the 10-year government bonds the Fed is planning to buy is now 2.66%. Fifteen percent of 2.66% is the equivalent of a 0.4% interest rate, the best deal in town on long-term bonds.

A Reluctant Fed Steps Up to the Plate

The Fed was strong-armed into rebating its profits to the government in the 1960s, when Wright Patman, Chairman of the House Banking and Currency Committee, pushed to have the Fed nationalized. According to Congressman Jerry Voorhis in The Strange Case of Richard Milhous Nixon (1973):

As a direct result of logical and relentless agitation by members of Congress, led by Congressman Wright Patman as well as by other competent monetary experts, the Federal Reserve began to pay to the U.S. Treasury a considerable part of its earnings from interest on government securities. This was done without public notice and few people, even today, know that it is being done. It was done, quite obviously, as acknowledgment that the Federal Reserve Banks were acting on the one hand as a national bank of issue, creating the nation's money, but on the other hand charging the nation interest on its own credit – which no true national bank of issue could conceivably, or with any show of justice, dare to do.

Voorhis went on, "But this is only part of the story. And the less discouraging part, at that. For where the commercial banks are concerned, there is no such repayment of the people's money." Commercial banks do not rebate the interest, said Voorhis, although they also "'buy' the bonds with newly created demand deposit entries on their books – nothing more."

After the 1960s, the policy was to fund government bonds through commercial banks (which could collect interest) rather than through the central bank (which could not). This was true not just in the U.S. but in other countries, after a quadrupling of oil prices combined with abandonment of the gold standard produced "stagflation" that was erroneously blamed on governments "printing money."

Consistent with that longstanding policy, Chairman Bernanke initially resisted funding the federal deficit. In January 2010, he admonished Congress:

"*We're not going to monetize the debt*. It is very, very important for Congress and administration to come to some kind of program, some kind of plan that will credibly show how the United States government is going to bring itself back to a sustainable position."

His concern, according to The Washington Times, was that "the impasse in Congress over tough spending cuts and tax increases needed to bring down deficits will eventually force the Fed to accommodate deficits by printing money and buying Treasury bonds."

That impasse crystallized on November 3, 2010, when Republicans swept the House. There would be no raising of taxes on the rich, and the gridlock in Congress meant there would be no budget cuts either. Compounding the problem was that over the last six months, China has stopped buying U.S. debt, reducing inflows by about $50 billion per month.

QE2 Is Not QE1

In QE1, the Fed bought $1.2 trillion in toxic mortgage-backed securities off the books of the banks. QE1 mirrored TARP, the government's Troubled Asset Relief Program, except that TARP was funded by the government with $700 billion in taxpayer money. QE1 was funded by the Federal Reserve with computer keystrokes, simply by crediting the banks' reserve accounts at the Fed.

Pundits were predicting that QE2 would be more of the same, but it turned out to be something quite different. Immediately after the election, Bernanke announced that the Fed would be using its power to purchase assets to buy federal securities on the secondary market — from banks, bond investors and hedge funds. (In the EU, the European Central Bank began a similar policy when it bought Greek bonds on the secondary market.) The bond dealers would then be likely to use the money to buy more Treasuries, increasing overall Treasury sales.

The bankers who applauded QE1 were generally critical of QE2, probably because they would get nothing out of it. They would have to give up their interest-bearing bonds for additional cash reserves, something they already have more of than they can use. Unlike QE1, QE2 was designed, not to help the banks, but to relieve the pressure on the federal budget.

Bernanke said the Fed would buy $600 billion in long-term government bonds at the rate of $75 billion per month, filling the hole left by China. An estimated $275 billion would also be rolled over into Treasuries from the mortgage-backed securities the Fed bought during QE1, which are now reaching maturity. More QE was possible, he said, if unemployment stayed high and inflation stayed low (measured by the core Consumer Price Index).

Addison Wiggin noted in his November 4 Five Minute Forecast that this essentially meant the Fed planned to monetize the whole deficit for the next eight months. He quoted Agora Financial's Bill Bonner:

"If this were Greece or Ireland, the government would be forced to cut back. With quantitative easing ready, there is no need to face the music."

That was meant as a criticism, but you could also see it as a very good deal. Why pay interest to foreign central banks when you can get the money nearly interest-free from your own central bank? In eight months, the Fed will own more Treasuries than China and Japan combined, making it the largest holder of government securities outside the government itself.

The Overrated Hazard of Inflation

The objection of the deficit hawks, of course, is that this will be massively inflationary, diluting the value of the dollar; but a close look at the data indicates that these fears are unfounded.

Adding money to the money supply is obviously not hazardous when the money supply is shrinking, and it is shrinking now. Financial commentator Charles Hugh Smith estimates that the economy faces $15 trillion in writedowns in collateral and credit, based on projections from the latest Fed Flow of Funds. The Fed's $2 trillion in new credit/liquidity is therefore insufficient to trigger either inflation or another speculative bubble.

In any case, Chairman Bernanke maintains that QE involves no printing of new money. It is just an asset swap on the balance sheets of the bondholders. The bondholders are no richer than before and have no more money to spend than before.

Professor Warren Mosler explains that the bondholders hold the bonds in accounts at the Fed. He says, "U.S. Treasury securities are accounted much like savings accounts at a normal commercial bank." They pay interest and are considered part of the federal debt. When the debt is "paid" by repurchasing the bonds, all that happens is that the sums are moved from the bondholder's savings account into its checking account at the Fed, where the entries are no longer considered part of the national debt. The chief difference is that one account bears interest and the other doesn't.

What About the Inflation in Commodities?

Despite surging commodity prices, the overall inflation rate remains very low, because housing has to be factored in. The housing market is recovering in some areas, but housing prices overall have dropped 28% from their peak. Main Street hasn't been flooded with money; the money has just shifted around. Businesses are still having trouble getting reasonable loans, and so are prospective homeowners.

As for the obvious price inflation in commodities — notably gold, silver, oil and food — what is driving these prices up cannot be an inflated U.S. money supply, since the money supply is actually shrinking. Rather, it is a combination of factors including (a) heavy competition for these scarce goods from developing countries, whose economies are growing much faster than ours; (b) the flight of "hot money" from the real estate market, which has nowhere else to go; (c) in the case of soaring food prices, disastrous weather patterns; and (d) speculation, which is fanning the flames.

Feeding it all are the extremely low interest rates maintained by the Fed, allowing banks and their investor clients to borrow very cheaply and invest where they can get a much better return than on risky domestic loans. This carry trade will continue until something is done about the interest tab on the federal debt.

The ideal alternative would be for a transparent and accountable government to issue the money it needs outright, a function the Constitution reserves to Congress; but an interest-free loan from the Federal Reserve rolled over indefinitely is the next best thing.

A Bold Precedent

QE2 is not a "helicopter drop" of money on the banks or on Main Street. It is the Fed funding the government virtually interest-free, allowing the government to do what it needs to do without driving up the interest bill on the federal debt – an interest bill that need not have existed in the first place. As Thomas Edison said, "If our nation can issue a dollar bond, it can issue a dollar bill. The element that makes the bond good, makes the bill good, also."

The Fed failed to revive the economy with QE1, but it could redeem itself with QE2, a bold precedent that might inspire other countries to break the chains of debt peonage in the same way. QE2 is the functional equivalent of what many countries did very successfully before the 1970s, when they funded their governments with interest-free loans from their own central banks.

Countries everywhere are now suffering from debt deflation. They could all use a good dose of their own interest-free national credit, beginning with Ireland and Greece.

Ellen Brown is an attorney and the author of eleven books. In Web of Debt: The Shocking Truth About Our Money System, she shows how the Federal Reserve and "the money trust" have usurped the power to create money from the people themselves, and how we the people can get it back. Her websites are webofdebt.com, ellenbrown.com, and public-banking.com.