Insight

Quantitative Easing II

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The brouhaha over quantitative easing II (QE II) continues. The Fed plans to purchase over $600 billion of long-dated Treasury securities over a period ending in June 2011 — a policy known as QE II. As is now well known, I am among the signatories of a letter criticizing the policy, and I've seen continued misunderstanding of our critique and intent. Let me take this opportunity to respond to a few key attacks.

1) *Conservatives are politicizing the Fed*. I consider this the most ironic complaint of all. The letter makes a substantive critique of quantitative easing. It does not say "Republicans would run the Fed better" or "monetary policy decisions should be voted on by the Congress" or anything else that might be genuinely politicizing the Fed.

Instead, the issue became "political" the moment that the QE II defenders asserted that it was a political attack. It is disappointing that when presented with a serious critique by academics, think tank analysts, and market participants the immediate response is "it must be a conservative attack on the Fed." Note that implicitly this also carries the message: "I'd never consider that conservatives have ideas or that I might learn something from them." So sad.

And, seriously, if you don't want the Fed to be politicized, stop having the President and the Secretary of the Treasury defending it around the globe. Administrations should say nothing about the Fed when they disagree — or when they agree

2) *Conservatives want the Fed to ignore unemployment*. Another variant — voiced by former Fed governor Ric Mishkin on CNBC — is that conservatives want the Fed to ignore the real economy. Nonsense. Again, the letter that started all of this says nothing of the sort. More generally, there have been some calls to re-think the Fed's dual mandate in favor of an ECB-like inflation mandate. This is not the same thing as ignoring unemployment and the real economy. Instead, there is a rich body of research that suggests a simple inflation target would produce better economic performance, and thus be a more effective route to the same outcomes envisioned in the current mandate.

3) *Bernanke has to do this because fiscal policy is paralyzed*. The governance effectiveness of the next Congress remains to be seen, but it is important to recognize that the Democrats still control the White House and the Senate, and the White House always sets the agenda. In recent years, Democrats have engineered some dramatic fiscal policy triumphs with close votes — see health-care reform — they were just economically destructive. To my eye, the issue is not gridlock. It is the quality of the policy.

4) *Stop complaining, this is just what the Fed did during the crisis only much smaller*. The crisis was at its heart a financial panic and associated liquidity crisis. The Fed stepped in, purchased assets of all sorts in large quantities, and thus provided massive liquidity and lender-of-last-resort services to vast swaths of the financial services sector. That's exactly what a central bank should do during a crisis.

Now, there is no crisis. There is no liquidity crunch. There is no desperate need for lender-of-last-resort services. Instead QE II will merely move medium-to-long rates by 30 to 40 basis points (at best). That is a tiny benefit when compared to the costs.

5) *The Fed needs to aggressively pre-empt deflation*. This has been the most incoherent aspect of the discussion. The Fed avers that inflation expectations are “well-anchored.” If so, good. But that also means that *deflation* expectations are well-anchored and there is no need for a pre-emptive policy strike. Alternatively, perhaps they are not so well-anchored. If so, the ultimate inflation fears highlighted in the letter are legitimate and real. Critics can’t have it both ways.

The bottom line is simple. Fed policy is a fair subject for public debate. The Fed mandate is a fair subject for Congressional review. But ideas from both sides of the aisle deserve entry in the debate.

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