



Failed Models and the Real Costs of QE2

Joshua Rosner | November 17, 2010

Last spring, in an effort to support the banks and attempt to drive liquidity to the mortgage market, the Fed chose to take on fiscal policy actions and purchase \$1.25 trillion dollars of mortgages. While these actions appear to have provided a significant subsidy to the sellers of those assets, and to the marked values of assets held by investors, by increasing interest rate risk they effectively increased future systemic risks while doing very little for Main Street.

Now, as the Fed again launches another foray into an area that appears the domain of fiscal, not monetary authority, the supporters of the Federal Reserve's "quantitative easing II" program have come out in force, wearing their neo-Keynesian credentials on their sleeves and waving their macro-economic models around like Excalibur. The same Fed that just announced a new Office of Financial Stability "to spot financial bubbles before they trigger financial crises" does not want anyone to notice the truth, namely that their models failed to predict any of the bubbles of the past 25 years and that its current policies are already inflating new and dangerous asset bubbles. In a blog post in defense of QE2, Paul Krugman goes after those of us who are against it and taunts us with "but what is their model? How do they think we got into a crisis that has depressed employment all around the advanced world?". Mr. Krugman, my model looks at reality and it has been more than accurate. How have the macro models of the Fed held up?

The Fed's macro economists and their models failed to recognize that housing prices were unsustainable, that misallocation of lax money

supply had burdened American families with unmanageable debts, that the subprime crisis was not contained, and that the off-balance sheet leverage used by our largest financial institutions created clear and present danger to the very bedrock of our economic beliefs -- that winners should be allowed to win and losers should be allowed to fail without outside intervention from government.

Now, the Fed has failed to recognize the enormous financial losses that will likely result if QE2 is "successful" or the massive loss to both its own, and US, credibility, if QE2 fails. In either case, the benefits are not going to Main Street.

If QE2 succeeds and the economy gets sustainably better, we would expect to see a more normal Treasury yield curve, with short rates somewhere around 4% and long rates close to 5%. Given the current yields on the assets the Fed will be buying in QE2, if the economy resumes a stable growth rate, it will be forced to decide between selling the QE2 assets at a likely loss of several hundred billion dollars or allowing the assets purchased to roll-off over time - thus undermining the Fed's ability to effectively execute monetary policy. In a recent editorial, in defense of the Fed, former Vice Chairman Alan Blinder states "to create the fearsome inflation rates envisioned by the more extreme critics, the Fed would have to be incredibly incompetent, which it is not". He seems to miss the point, nobody would suggest the Fed is incompetent, maybe they are just impotent relative to the task at hand.



Of equal importance is the fact that for most of the last two decades, the macro-economists at the Fed failed to consider the importance of changes in the manner by which money moved through the system. Dollars on deposit at banks used to fund most of our economy, but by the early years of the last decade, almost a third was funded through capital markets and nearly another third through non-bank financial services. With the collapse of most of the asset-backed securitization market and the failures of hundreds of specialty financing companies, much of the financial intermediation that delivered money for real economic activity disappeared.

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It has been three years since the crisis began, and Washington, from White House to Congress, has done everything possible to prevent recognition of losses from troubled assets being held at inflated values on bank balance sheets. The Fed, whose independence is necessary to its authority, has increasingly become a policy tool in bidding for many of these bad assets. Rather than supporting effectively functioning market pricing of assets, as a lender of last resort, the Fed has crowded out the market's pricing mechanism by becoming a lender of first resort. This has resulted in losses to those private market participants who were most conservative in their risk management and gains to those who were least conservative. Even today, the Fed's actions interfere with prudential risk pricing. Market participants would buy conforming conventional mortgage backed bonds at around a 6% yield, but the Fed's actions, which have stimulated little new mortgage demand, create a subsidy to that rate.

The kabuki theatre has all been intended to create confidence in a few large banks that are too saddled with bad assets to lend and too connected to campaign financing of Washington to be forced to restructure or allowed to fail. But what good is confidence if banks know they continue to hold troubled assets at inflated values? So, instead of investing in the real economy, as banks have historically been expected to do, they use each incremental dollar the Fed manufactures not for long term lending but for short term trading of the yield curve or ever inflating commodity, emerging market and equity bubbles. After, all, they have no way of knowing when they might need to apply those dollars against unrecognized losses.

Investors know the score. They understand the "extend and pretend" overvaluation that the Fed, as regulator and monetary policymaker, supports for troubled first and second lien mortgage loans, mortgage backed securities, CDOs, and commercial loans. Investors understand that the Fed, through quantitative easing and debasement of the dollar, is trying to force them to take greater risk and bid for riskier assets. The problem with this notion is that until there are forced sales of large volumes of these risky assets to willing private parties at market-determined prices, unsubsidized private capital will not move out on that risk curve. Instead, investors will continue to press the trading desk at the New York Fed to overpay for the riskier assets, smile at their overvaluation and speculate on the assets of emerging bubbles rather invest in overvalued assets of already-burst ones.

There are natural limits to debt. There are also problems in this world that cannot be solved by monetary policy and there are times that excess supply cannot be absorbed. At those times, it would make more sense to employ policies that create incentives to write-down and accelerate the



shutting in of unproductive capacity and make room for new capacity. For almost forty years we have enjoyed three secular trends that were supportive of consumption, price appreciation and growth. All three of those have reached their end. The response must be a structural rebalancing, not an inevitable failure of a monetary cover-up.

- The baby-boom, which entered peak earning years in the 1980's are heading toward retirement with less equity in their homes than any prior generation, this represents a future burden on our Treasury that must be considered now;
- The move from one income to two income families, begun in the "women's lib" movement and accelerated by the asset price inflation and wage stagnation of the 70's has reached its end; and
- The "democratization of credit", or growth in revolving consumer credit, which began in the 70's is also reversing as overextension of credit has demonstrated danger.

Shouldn't policies that force private savers to spend out of fear of reduced future purchasing power of their dollars be questioned? Shouldn't we question policies that cause households with unsustainable amounts of revolving debts to take on larger amounts of debt that will ultimately crush them as rates rise? Shouldn't we question the rights of a central bank with no direct Constitutional authority to accept hundreds of billions of dollars in taxpayer losses and use those dollars to repair losses on banks balance sheets?