NEW YORK POST
Updated: Fri., Nov. 5, 2010, 4:32 AM

Bernanke's bond buy a likely bust

By GERALD P. O'DRISCOLL JR.

Last Updated: 4:32 AM, November 5, 2010
Posted: 10:02 PM, November 4, 2010

Central bankers are fond of using complex jargon for simple ideas, and "quantitative easing" is a case in point. It means the Federal Reserve, the US central bank, is going to buy long-term US Treasury Bonds.

The Fed did so once before: From December 2008 to this March, it bought $1.7 trillion of Treasury bonds and mortgage-backed securities. Since the just-announced purchases of $600 billion ($75 billion a month for eight months) worth of Treasury securities is the second round, it's being called QE2 for short.

The Fed hopes QE2 repeats the success of QE1. But there are good reasons to doubt it.

The bond purchases' immediate goal is to lower interest rates -- which the Fed hopes will stimulate spending, foster higher economic growth and drive down unemployment. By buying financial assets, the Fed injects money into the economy. It's the electronic equivalent of printing money -- call it "monetary stimulus."

Typically, the Fed only buys and sells *short*-term Treasury obligations -- ones that mature in a few days to a few months. But interest rates are near zero on short-term Treasury debt, so the Fed turned to long-term debt. There was nowhere else for it to go if it wanted to inject money into the system.

QE1 came in the depths of the great recession, when fear gripped financial markets. Those purchases helped stabilize those markets. They not only brought down the yields on Treasury debt, but also helped to bring down the high interest rates on privately issued debt, including corporate bonds and municipal obligations. In central-bank jargon, the Fed provided much-needed liquidity to markets.

The Fed did the heavy lifting needed in a recession and financial panic: It helped end the recession and calmed the panic. That is the classic job of a central bank.

But now Fed Chairman Bernanke is worried about the slow pace of the recovery. He's been tempted to try what worked once -- but it's doubtful he'll get as much bang for the buck this time, because circumstances have changed.

Interest rates are already low and can't come down much. Plus, some other nations -- notably in Asia and Latin America -- are growing sharply and represent attractive destinations for investment; interest rates are higher there, too. If returns on US investments fall further, more money will go to these other parts of the globe. That is, the US "monetary stimulus" will bring prosperity, but not necessarily here.

Foreign governments and their central banks don't always welcome a rapid influx of money. The money is viewed as "hot" -- here today and gone tomorrow. And such rapid inflows and outflows can disrupt the less-developed financial markets in those countries. For that reason, Brazil has already imposed capital controls to slow such inflows, and some East Asian countries are contemplating similar moves.

The Fed's policy was widely anticipated and has already driven down the dollar's worth measured in foreign currencies (the dollar's exchange value). Further greenback declines are widely anticipated.

The flip side of a cheaper dollar is a more expensive euro, British pound, Japanese yen and Chinese yuan. That puts exporters in those countries at a disadvantage to US firms in global markets. That intensifies demands in those countries for capital controls, trade barriers, etc.

China is an important trading partner and major creditor. We also seek its cooperation on many sensitive issues such as North Korea's nuclear ambitions. The Fed's easing complicates all those relationships.

In short, the Fed has stirred up a global hornet's nest with its latest round of easing. What was aimed at helping US firms and workers here may cause other countries to react adversely to our interests -- and the Fed doesn't seem to have factored international reactions into its decision.

For the US economy, QE2 may not be a stimulus but a bust.

Gerald P. O'Driscoll Jr. is a Cato Institute senior fellow and was formerly a vice presi dent at the Federal Reserve Bank of Dallas.

NEW YORK POST is a registered trademark of NYP Holdings, Inc.
NYPOST.COM , NYPOSTONLINE.COM , and NEWYORKPOST.COM are trademarks of NYP Holdings, Inc.
Copyright 2010 NYP Holdings, Inc. All rights reserved. Privacy | Terms of Use