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More Fed Bond Buying Won't Let 'Animal Spirits' Out of the Cage

If past is prologue, QE3 would act as a sugar rush to financial markets while spurring little if any growth.

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Markets will be hanging on every word in Federal Reserve Chairman Ben Bernanke's speech Friday morning in Jackson Hole, Wyo. That is because the minutes from the July 31-Aug. 1 meeting of the Federal Open Market Committee, released on Aug. 22, were widely interpreted as signaling some kind of further easing of monetary policy.

The minutes stated in part that "many members judged that additional monetary accommodation would likely be warranted fairly soon unless incoming information pointed to a substantial and sustainable strengthening in the pace of the economic recovery." And yet, one day after the minutes were released, St. Louis Fed President James Bullard said they were "a bit stale." This turned market sentiment around, sending equity prices down.

So will he send a signal favorable to "additional monetary accommodation"? Or will he endorse Mr. Bullard's comments?

Looking ahead to its next meeting on Sept. 12 and 13, the FOMC could decide to initiate a new round of "quantitative easing" through purchases of Treasury bonds, mortgage-backed securities or other unconventional asset classes, which has been its strategy since the fall of 2008. It might also choose to extend beyond the end of 2014 the period in which it anticipates holding the federal-funds rate near zero. These aren't mutually exclusive possibilities.

But whatever path Mr. Bernanke points the FOMC toward, further "monetary accommodation" of the type being discussed will be futile at best or counterproductive at worst.

Consider the kind of policies implemented by the Fed since the crisis began. One variety consisted of credit allocation, whether by direct lending to targeted financial institutions or even nonfinancial firms such as auto makers. Fed purchases of mortgage-backed

securities direct credit to favored firms and sectors rather than to the businesses that could make most productive use of it.

Subsidizing housing finance is especially problematic, as homebuilding clearly overexpanded in the early 2000s and needed to contract. If public policy subsidized a good into excess supply, further subsidies aren't the cure. The Fed has merely delayed adjustment in the housing and financial sectors by continuing to direct credit to them.

The Fed has also engaged in temporary infusions of money into the economy via two previous rounds of quantitative easing, QE1 and QE2. It did so after driving short-term interest rates to near zero, which limited the effectiveness of traditional purchases of short-term government debt.

Quantitative easing is the Fed's version of "stimulus," the complement to fiscal stimulus. The trouble with all forms of temporary spending is that they have no permanent effects. They delay needed adjustments in the economy.

Today's state and local governments are a case in point. Municipal and state spending was propped up by federal transfers of many billions of dollars in the president's 2009 stimulus package. But as this federal money has dried up, public payrolls are declining, ironically enough for this administration, close to the presidential election. President Obama received bad advice when he was told that government spending would prime the pump of the economy. Instead it had the effect of temporarily transferring resources from the productive private sector to a bloated public sector.

The Fed's version of temporary stimulus will likely involve purchasing government bonds. If past is prologue, this will act as a sugar rush to financial markets. There will be equity- and bond-market rallies. Wall Street will rejoice, but none of this will translate into "substantial and sustainable" economic growth, the FOMC's stated goal.

Bond purchases won't change any fundamental determinant of economic activity. And in the current economic climate, a crucial issue is that investors don't know what the tax code will be next year. Investments are made in anticipation of after-tax profits. If the tax rate is unknown, investment returns are unknown. That is a great deterrent to capital formation and job growth.

This is no secret: The FOMC minutes from its July 31-Aug. 1 meeting refer to fiscal and regulatory uncertainties as a reason for the Fed to take action. The minutes reported that some participants thought a new bond-buying program "might boost business and consumer confidence." It hasn't done so in this recession. No amount of quantitative easing at this point will stir what John Maynard Keynes called the "animal spirits"—"a spontaneous urge to action rather than inaction"—needed for growth.

What would stir the spirits of investors and employers would be some policy certainty, reining-in of out-of-control government spending, stopping ill-advised regulations, and clearing the air of antibusiness rhetoric. No repeat of a one-off round of bond buying by the Fed substitutes for the fundamental and permanent changes needed.

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