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ECONOMIC TALKING POINTS

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QE 3: An Unnecessary Risk for the Fed and the Economy

If the Federal Reserve proceeds with a third round of QE, the risks may well outweigh any benefits to the economy.

To begin with, there have been growing concerns that the Federal Reserve has already overextended itself by pumping so much liquidity into the economy, it will be unable to adroitly mop up the excess funds once growth and employment pick up. The issue is one of timing: If the Fed moves too slowly, then credit creation can surge and set the seeds for higher inflation. Should the central bank, in an abundance of caution, rush to tighten credit conditions, it risks asphyxiating an economy that is eager to grow. It all evokes an image of Fed chairman Bernanke balancing himself on a tightrope, where the wire gets progressively thinner with each additional QE.

We believe the Fed takes on unnecessary risk with QE 3.

Why? Once the November 6th election is over, business leaders, consumers and investors will likely shift focus away from the harsh rhetoric of campaign politics and react more to the improved fundamentals of the economy. (Yes, you can forget about the US economy falling off the “fiscal cliff” in 2013. We believe either the lame duck session of Congress or the new Congress will extend the deadlines on tax hikes and spending cuts for several months to give the new government a chance to work out a deal.) That pivot toward better economic fundamentals will, we believe, result in faster than expected growth in 2013 --- and for the Fed, it means dusting off their monetary "exit strategy" and preparing the daunting task to execute it.

To be sure, QE 1 and 2 have done some good. The financial sector is in better shape. The combination of monetary and fiscal stimulus did bring the recession to an end in mid-2009. We now worry less about deflation. The stock market has climbed 60% since the recession ended. Corporate profits remain strong. Companies are sitting on a near record pile of cash. And we have seen signs of life in the housing and auto markets. At the Jackson Hole Symposium last month, Bernanke pointed to research showing all those large-scale asset purchases likely raised the level of economic output by about 3% and lifted private payroll employment by more than 2 million jobs.

But here's what is so worrisome. At that same Symposium, Berrnake also said "the costs of nontraditional policies, when considered carefully, appear manageable, implying that we should not rule out the further use of such policies if economic conditions warrant.

*"**Appear** manageable?"* That's hardly encouraging. We wonder whether anyone at the Fed really knows with confidence how successful they will be in limiting credit growth once they begin to drain some $2 trillion in stimulus from the economy.

While there are many questions on the mechanics of withdrawing these funds in a timely manner, we have doubts on the efficacy of yet a third round quantitative easing.

First, the Federal Reserve has failed to make a case that these funds can actually bring the unemployment rate down! The central bank has been very successful in stabilizing inflation. But so long as there is paralysis on the fiscal side, all you have is lots of liquidity with virtually no place to go. Reducing joblessness is beyond the capabilities of the Fed when there is absolutely no help on the fiscal side. Thus the burden of proof still falls on the Fed that another round of QE will help achieve its second mandate of full employment. We don't think it can make that argument.

Second, won't QE 3 make it even more difficult to wean an economy off cheap credit? Remember, we have never seen interest rates so low for so long across the entire maturity spectrum. How quickly will market rates jump once traders realize a major source of demand (the Fed) is out of the market? Instead of more easing, shouldn't the Fed begin to *very gradually* remove funds at this time?

Third, let's assume the Fed is on the right track with QE3 and these additional funds do revive economic activity and lowers unemployment. Won't all this monetary accommodation create a moral hazard by reducing pressure on Congress to undertake genuine fiscal reforms? Will Congress come down even harder on the Fed and demand more unconventional monetary policies in the future when the economy stumbles during the next business cycle?

Bottom line:

Our concern is that QE 3 may end up tarnishing the Fed's reputation and harm the economy. Whatever "exit strategy" they have down on paper, the question still out there is how well they will implement it in the real world. Given the unprecedented amount of emergency liquidity provided so far, simply admitting that the cost of all this easing *"appear manageable"* is not all that comforting. Perhaps this is a good time for the Fed to back away from QE 3, since it will not do much to lower unemployment, and turn the harsh spotlight back on Congress in the final months of the year.
