

## Quantitative Easing and the Fed: Ghost Story II

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### The Slow Road to a Robust Recovery

The U.S. economy entered a recession in December of 2007 that officially lasted until June of 2009. This 18-month downturn was the longest in the United States since the dark days of 1981-1982. During that 16-month period, Paul Volcker, then chairman of the Federal Reserve Board of Governors, increased interest rates so high that the inflation spiral of the 1970s was finally curtailed, an accomplishment that had eluded presidents Nixon, Ford and Carter.

The U.S. economy today has been in recovery since 2009. But nearly everyone agrees that the recovery is anemic—too slow to reduce the high level of unemployment. In February 2011, the unemployment rate was at a historically high rate of 8.9 percent. The number of unemployed persons was 13.7 million for February. The jobless rate was down by 0.9 percentage point since November 2010. Real Gross Domestic Product (GDP)—the total value of all the goods and services produced in the United States—increased at an annual rate of 2.8 percent in the fourth quarter of 2010. Economists express concern that this level of economic growth is insufficient to create the number of new jobs required to reduce the unemployment rate.

When President Barack Obama took office in January of 2009, he faced a bleak economy. His economic team

recommended taking swift action for fear that things would become even worse. President Obama proposed, and Congress approved, an \$800 billion stimulus package, which primarily included a large increase in government spending. Such swift and unprecedented action, they hoped, would keep the recession shallow and the unemployment rate below 8 percent. Unfortunately, things did not work out as expected. Even after this massive dose of fiscal stimulus, the unemployment rate continued to climb toward 10 percent. Nonetheless, all was not lost. The recession officially ended in June of 2009 and GDP began to grow again. The Dow Jones Industrial Average rose above 12,000, helping many investors to recover their prior losses. However, no one believed that the economy was yet out of the woods.

### Enter Ben Bernanke

The person with the most influence over the economic recovery is arguably not President Obama, or any leader in Congress; rather, the chair of the Federal Reserve System's Board of Governors, Ben S. Bernanke, likely holds this distinction. Bernanke, as the most influential voice in the setting of the nation's monetary policy, had a great deal of authority and responsibility as the economy slowly recovered.

What should Bernanke and the Fed do now? After thoughtful study and debate within the Fed, Bernanke has launched a new program known as Quantitative Easing or QE, in two rounds. The latest round of QE, known as QEII, calls for the Fed to purchase about \$600 billion of additional U.S. government securities from U.S. banks over several months. When the Fed purchases U.S. government securities from banks, it gives banks more money to lend. These purchases provide banks with more funds that they, in turn, can loan out at lower interest rates, thus stimulating business lending and consumer spending. This increases the money supply—it's

the modern method of printing money without the need for running the printing presses. The desired results are to lower unemployment and expand GDP. Since inflation continues to be very low, the Fed is not particularly concerned that this increase in the money supply will cause an inflationary problem in the near future. The fifty-thousand-dollar (or is it \$600 billion?) question is, of course, will it work?

### Ben Bernanke Meets the Ghost of John Maynard Keynes

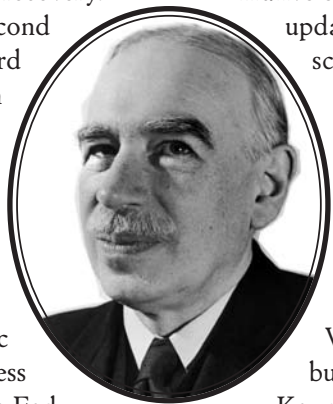
Readers may recall that Mr. Bernanke was “visited” by the ghosts of Adam Smith and John Maynard Keynes in the March/April 2010 issue of *Social Education*. The topic was economic recovery.

Here, we imagine a second visit with John Maynard Keynes and one with Milton Friedman.

Bernanke returns home after an exhausting day of examining the QEII plan with the White House economic team, members of Congress and his own staff at the Fed. After a late dinner, he finally retires to bed for some much deserved rest. But he only drifts into restless sleep, tossing and turning and hearing the voices of prominent economists giving encouragement and raising doubts. Bernanke has a vision: the ghost of economist John Maynard Keynes appears. Keynes offers reassurances to Bernanke that he is indeed on the correct path.

Keynes explains: “I see that the U.S. economy continues to show signs of weakness. That is most unfortunate.” Keynes reiterates his preference for expansionary fiscal policy as the remedy for weak aggregate demand—spending on all goods and services in the economy. Nonetheless, he explains that while a second stimulus plan would be his preference, he encourages Bernanke to remember the words he spoke in 1931 during the Great Depression:

*My remedy in the event of the obstinate persistence of a slump would consist, therefore, in the purchase of securities by the Central Bank until the long term market-rate of interest has been brought down to the limiting point ... the Bank of England and the Federal Reserve Board (should) put pressure on their member banks ... to reduce the rate of interest which they allow to depositors to a very low figure, say 1/2 per cent.<sup>1</sup>*



Lord Keynes reassures Chairman Bernanke that his current policy of quantitative easing is simply the correctly updated version of this 1931 prescription for the economy.

John Maynard Keynes is generally associated with Great Depression-era economics. His antidote for an economy experiencing reduced aggregate demand was aggressive fiscal policy.

When investment spending by businesses declined—a situation Keynes believed would happen frequently as business people’s “animal spirits” fluctuated—he taught that the government should pick up the slack. The immense federal government spending projects of the 1930s under President Roosevelt—commonly called the “New Deal”—present a perfect example of Keynesian economics.

In Keynes’s famous treatise, *The General Theory of Employment, Interest and Money*<sup>2</sup>, he laid out his ideas about macroeconomics—in fact, this book is widely accepted as inventing the field of macroeconomics. He supported increased government spending, tax cuts and the accumulation of budget deficits by governments during times of economic weakness, all aimed at ending the downturn and getting the economy on a strong footing again. He believed that these deficits could then be paid off

during the good economic times.

The economic policies pursued by the economists in the Obama administration have clearly been influenced by Lord Keynes’s ideas. The huge fiscal stimulus plan passed in 2009 is right out of this 1930s-era economist’s playbook. If the private sector won’t spend money, the government should, Keynes said, a policy many in the federal government have followed even to their political downfall.

What, then, would Keynes say about the Fed’s recent policy of quantitative easing? This policy of using newly “printed” money to purchase government securities in an effort to drive down their interest rates and increase investment spending would likely have garnered the famous economist’s support. While there is, of course, no way to ascertain what Keynes would make of today’s economic environment, it seems a safe bet that his preferred economic policy today would be a second round of fiscal stimulus.

Keynes was politically savvy and spent his time among London’s elite. He was famously a member of the Bloomsbury Group that included many well-known politicians and intellectuals, including the famous British author Virginia Woolf. He was close to powerful leaders in his time, including both American presidents and other European leaders, and would likely have understood the public’s disenchantment with the rising size of government debt around the world. For this reason, it’s likely Keynes would have supported turning to his second economic policy choice—quantitative easing.

As the quotation above makes clear, Keynes saw an activist role for a central bank during economic downturns. Keynes was very sensitive to what he believed was the inherent instability of business investment spending and would certainly see this tool as one that could be used in an effort to prop this spending up through lower interest rates for firms. It’s likely Keynes would be in Chairman Bernanke’s corner—writing articles, giving speeches and advising Fed and government officials—explaining that

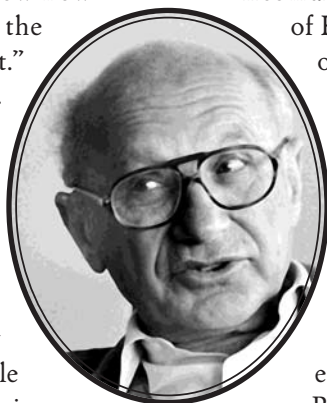
weak economies require drastic action by governments and central banks. You can almost hear Keynes saying something to the effect of, “If businesses won’t spend money, banks won’t lend money, and the government can’t spend any more money, it’s the role of the Federal Reserve to step up and give the economy the jolt it needs.”

### Ben Bernanke Meets the Ghost of Milton Friedman

Mr. Bernanke had drifted back to sleep only to be awakened again by an old acquaintance and famous economist, Milton Friedman. The ghost of Milton Friedman explained:

“You and I both know how important it is to get the supply of money right.”

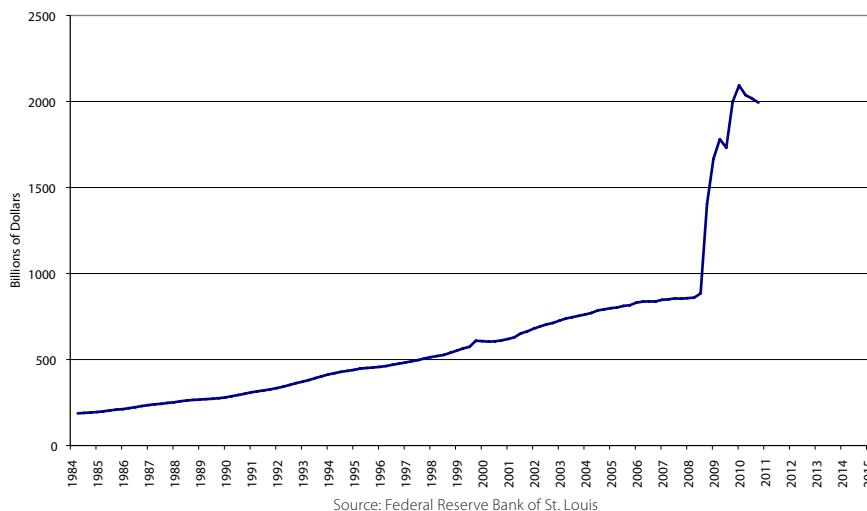
He reminded Mr. Bernanke that the economy works best when money grows at a constant, predictable rate. That way, the government does not introduce any extra uncertainty. People can make plans assuming that money will keep its value.



If money grows too fast, that will tend to cause inflation. But does that lead to an ironclad case against quantitative easing? Not so fast, warns Friedman’s ghost. There are issues about measuring how much money there is in the economy. By some measures, money has skyrocketed. By different measures, it seems money has not been growing fast enough in 2010. There are also some tricky behavioral issues to consider, such as: How fast will people spend any new money that is created? Friedman’s ghost closes with two pieces of parting advice: First, he says, consult my followers. They are proud to claim the label “monetarist,” and they can help you work out the details. Second, be sure to act quickly if inflation starts up.

Milton Friedman was the twentieth century’s most prominent advocate of

Figure 1. St. Louis Adjusted Monetary Base



free markets. Friedman is popularly recognized for being a monetarist. In defiance of Keynes, Friedman presented evidence in support of the quantity theory of money—the idea that the price level depends on the supply of money. Friedman’s ideas became widely accepted (even among Keynesians) when the stagflation of the 1970s—rising inflation combined with rising unemployment—was finally defeated under the leadership of Fed Chairman Volcker. Friedman is best known for his book *Capitalism and Freedom*, where he made the case for free markets and discussed the relationship between economic freedom and political freedom.<sup>3</sup> In 1976, he was awarded the Nobel Prize in economics.

But what are we to make of Friedman’s “advice” to consult today’s monetarists to help us understand QEII? While that sounds like good guidance, as Ben Bernanke becomes fully awake, he thinks it rings hollow. It turns out that today’s monetarists have conflicting views—not only on what to do, but even conflicting views on what Milton Friedman would recommend, were he alive today.

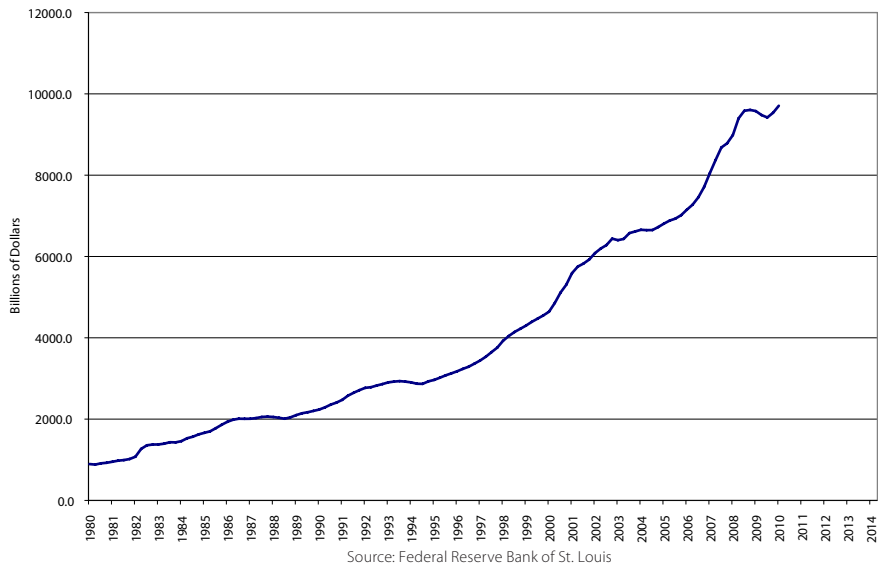
In opposition to large new Federal Reserve intervention, some monetarists today would point to the following Friedman arguments:

- The Fed’s proposed interventions amount to a big change in the amount of money in the economy. For most of his career, Friedman warned against erratic swings in the money supply because they created uncertainty. Large increases could set off inflation. Always wary about excessive money creation, he used to tell his students, “Only government can take perfectly good paper, cover it with perfectly good ink and make the combination worthless.”
- To get one measure of how much money there is, analysts add up the currency people are holding plus the currency held by banks or deposited with the Fed. This figure is sharply higher since 2008 (see Figure 1). The huge increase would surely have frightened Milton Friedman—or, for that matter, anyone who understands the principles of monetarism.

But in favor of QEII, other monetarists would also cite Friedman:

- Monetarists are always conscious of velocity, the speed at which money is spent.

Figure 2. MZM Money Stock



Velocity is measured by the number of times that a dollar turns over in a year. Although velocity is stable in ordinary times, the times now are anything but ordinary. Velocity has been falling sharply. That means that each new dollar created by the Federal Reserve has a lower impact—both on prices and on the economy in general. Friedman’s work can be read as favoring large swings in money when necessary to offset changes in velocity. If there ever existed a time when a large change in velocity needed to be offset, it would be now.

- Monetarists favor steady growth of money, but it is not easy to know how fast money is growing. Why? Because there are many different measures of money and it is not easy to know which one is relevant. Figure 1’s measure of money depends critically on what is in banks and ready to be loaned out. Other measures include bank money but they depend more on what has been successfully loaned out, as in Figure 2. The measure of money shown in Figure 2 actually started declining in 2010 before the Fed started QEII. When banks are holding large amounts of extra money, as they are now, different ways of measuring money give different answers to the question: Is money growing at a stable rate? For certain measures of money, QEII looks like a big increase in the growth rate. For other measures of money—those currently growing more slowly or even falling—QEII looks to be only a restoration of stable growth.

Monetarists following in Friedman’s tradition understand why it is important to act quickly if inflation threatens to turn upward. The Federal Reserve’s expansion of money in banks is something like a driver flooring the accelerator of a car stuck in “neutral.” If the transmission ever slips into “drive,” the car will take off, fast. In a similar way, Friedman warned, excessive money creation eventually generates inflation—but not always immediately.

### Conclusions

It is clear that economists are not of one mind when it comes to QEII. Yet, we think there are three points upon which Keynesians and monetarists agree:

- First, changes in monetary policy, like QEII, take time to work. So, this action should not be regarded as some sort of quick fix.

- Second, QEII might have a better chance of producing the promised benefits if it were paired with two other policies. Today, there is much discussion of deficit reduction. If Congress and the president were able to rein in deficit spending, the results would be a boost in confidence in the long-term health of the economy. This would almost certainly involve reforming entitlements such as Social Security, Medicare, and Medicaid. Also, holding off on tax increases would build confidence among employers who, up to now, have simply been unwilling to hire new workers. Both efforts, when combined with QEII, increase the chances for producing a robust recovery in economic growth.
- Finally, the Fed must be vigilant regarding inflation. At some point, the housing market will recover. Auto sales are already increasing. As people’s confidence returns, there will be an increase in aggregate demand. Since the 1980s, the Fed has been successful in keeping inflation under control. Can it continue to make the right moves after the full implementation of QE? Let’s hope it can. 🚗

### Notes

1. See Report of the Committee on Finance and Industry (Macmillan report), 1931 Vol II, p.386.
2. John Maynard Keynes, *The General Theory of Employment, Interest and Money* (New York: Classic House Books, 1936), 161.
3. Milton Friedman, *Capitalism and Freedom* (Chicago, Ill.: University of Chicago Press, 1962)

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