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First Trust

Sept 27, 2010

Monday Morning Outlook

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The Myth and Mistake of Quantitative Easing

Last week, the Federal Reserve said that it was "prepared to provide additional accommodation if needed to support the economic recovery." This was a signal about the potential for more Quantitative Easing (QE).

The original QE took place between September 2008 and mid-2009, when the Fed's balance sheet ballooned from $900 billion to roughly $2.4 trillion. Now, some are calling for QE-2, with a few market participants calling for another trillion dollars. This would be a colossal mistake.

Quantitative Easing does not boost real economic activity or inflation – it is not an injection of new money, like traditional monetary easing. Quantitative Easing is a wrong-headed approach to monetary policy that was born in the midst of a panic. It was only necessary because strict mark-to-market accounting rules made it difficult or impossible for private companies to hold risky assets. Now that these fair value accounting rules have been corrected, there is no further justification for QE.

So far this year, the Federal Reserve has earned $68 billion in profits from its portfolio. More than half of this should have been earned by the private sector. These profits, which rightly belong to the private financial system, could help explain why the economy is having a difficult time recovering.

At its root, the Fed's balance sheet is really no different than any other balance sheet. It has liabilities and assets and it can expand in one of two ways – through growth or by using debt. In the private sector, growth equals profits or income. For the Fed, growth means printing money. Currency is an organic liability, created by the Fed, which is then used to purchase assets. This is the traditional means of money expansion – the creation (or printing) of new money.

So-called quantitative easing uses *borrowed* money – which is not the creation of new money. The two largest sources of borrowed funds for the Fed are bank reserves and Treasury cash. Banks now earn interest on reserve balances and hold roughly $1 trillion at the Fed. At the same time, the Fed is borrowing $277 billion from the Treasury. It uses these funds to buy mortgages or Treasury bonds.

So, the Fed is borrowing money from banks and the Treasury to buy assets. All this does is shift what would have been held in the private sector onto the Fed's books. This is not the creation of new money and therefore does not create inflation or lift aggregate demand.

To understand how foolish some of this is, follow this link to see a chart of Fed liabilities on our blog which shows that bank reserves peaked in February 2010, at $1.2 trillion, and have since fallen by $252 billion. Banks seem to be taking back these funds to make loans or buy bonds. The Fed *should* let this process shrink its balance sheet, but instead has increased its Treasury borrowing by $239 in the past seven months, in order to keep the balance sheet size the same.

In other words, the Fed is borrowing money from the Treasury Department to buy Treasury bonds. This makes absolutely no sense and it is a myth that somehow this is providing a lift to economic activity. Milton Friedman is spinning in his grave.

Quantitative easing is not the reason the economy has returned to growth. Its efficacy is a myth and its use was a mistake. Zero percent interest rates are enough. The Fed grabbed power during the crisis and should give it back.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-28 / 9:00 am	Consumer Confidence - Sep	52.3	**51.8**		53.5
9-30 / 7:30 am	Q2 GDP Third Report	+1.6%	**+1.5%**		+1.6%
7:30 am	Q2 GDP Chain Price Index	+1.9%	**+1.9%**		+1.9%
7:30 am	Initial Claims - Sep 25	460	**459K**		465K
8:45 am	Chicago PMI - Sep	56.0	**54.9**		56.7
10-1 / 7:30 am	Personal Income - Aug	+0.3%	**+0.2%**		+0.2%
7:30 am	Personal Spending - Aug	+0.4%	**+0.5%**		+0.4%
8:45 am	U. Mich. Consumer Sentiment	67.0	**67.0**		66.6
9:00 am	ISM Index - Sep	54.5	**54.9**		56.3
9:00 am	Construction Spending - Aug	-0.4%	**+0.3%**		-1.0%
sometime	Domestic Auto Sales - Sep	3.7 Mil	**3.7 Mil**		3.7 Mil
during the day	Domestic Truck Sales - Sep	4.8 Mil	**5.0 Mil**		4.8 Mil