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QE Withdrawal: How Bad Will it Hurt?

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Douglas J. Elliott (delliott@brookings.edu)

Quantitative Easing: Desperate Measure for Desperate Times

- QE is a last resort, not an extension of normal monetary policy, because it carries serious costs and risks
- It was justified by the Great Recession following on the worst financial crisis in more than half a century
- We are lucky to have had a Fed Chairman who is one of the great experts on times like these
- But, withdrawal from QE, and tightening of monetary policy more generally after such loose conditions, will create problems
- The magnitude of these problems is hard to judge, because of the exceptional underlying conditions and the paucity of experience with QE

Withdrawal from QE is a Balancing Act

- The Fed would like to be able to stop QE and eventually restore more normal rates, because these very easy monetary conditions spawn economic distortions
 - » Encourages an over-leveraged nation to lever up
 - » Discourages federal deficit reduction
 - » Discourages private savings
 - » Encourages dangerous reaching for yield and asset bubbles
- But, QE was a response to dire economic conditions and the Fed is leery of moving prematurely. The memory of 1937 haunts the Fed and the Administration
- In theory, the Fed could ratchet QE up and down, but this raises real communications issues

Best and Worst Cases

- **Best case:** the Fed tapers off QE as natural economic growth accelerates; investors see it coming and trust the Fed; investors haven't done anything too stupid; and no external shocks occur
- In that case, natural growth replaces the effects of monetary stimulus and markets adjust fairly painlessly
- **Worst case #1:** investors are surprised; we get a more extreme version of the last few months and it turns out they've made some really dumb investments with easy \$
- **Worst case #2:** the Fed misjudges the economy and tightens out of false optimism. The economy heads towards zero growth and we lose the head of steam that increased business and consumer confidence was giving us

My Base Case

- I basically trust the Fed to get the timing right and to communicate pretty transparently and in advance
- I don't have as much faith in investors. Some will be surprised. As the song goes: "a man hears what he wants to hear and disregards the rest." Some will have gambled excessively out of ignorance, avarice, or desperation
- Higher interest rates will also have economic costs for the federal budget and for corporate profits, although the benefits for savers will partially offset this
- I believe that equity markets have gotten ahead of themselves and that withdrawal of QE will cause a re-evaluation. However, economic growth will ease the pain

Impact on US Economy and Politics

- I believe QE withdrawal will be driven by underlying economic growth and the Fed will pull back at a rate that allows some continued acceleration of that growth
- Thus, unemployment will continue to improve and this will be the main driver of political views
- However, higher rates may hurt housing more than better economic conditions help it. Luckily, the ongoing rebound in housing can probably survive a modest hit
- The dollar will probably strengthen considerably as a result both of higher interest rates and underlying growth. This depends, of course, on what happens overseas

Impact on US Investors

- US investors may be hurt by a combination of factors
 - » Higher funding costs and bogeys
 - » A re-evaluation of P/E ratios and risk tolerances
 - » Isolated fire sales as investor mistakes unwind
 - » Lower corporate profits in \$ on overseas operations
- A modest acceleration of underlying economic growth would partially offset these factors
- Cyclical stocks could do well, as the economic growth more than offsets the negatives
- Foreign investors may do very well, as they gain from dollar appreciation

Conclusions

- QE withdrawal was always going to be painful. There are good reasons central banks prefer to use interest rate targets instead of QE
- The Fed would like out of QE, but will wait until it is confident of growing economic momentum
- I think it will be smart enough to manage the process without choking off the economy's growing momentum
- BUT, there are many uncertainties and it is possible that the Fed will misjudge the situation or that investors have taken more extreme positions than we think
- There is also the risk of unanticipated consequences in a global system as complex as ours