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THE ETHICS OF QUANTITATIVE EASING

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Abstract: This paper describes quantitative easing (QE) as carried out by the United States Federal Reserve Bank since the 2008 financial crisis. The focus is on examining the metrics, goals, and results of QE followed by an ethical analysis of decisions made and actions taken. The goals and original intentions of QE were ethical. If economic theory had proven correct in practice, the greatest good may have been accomplished for the greatest number of people. The reality is that QE has not produced the desired consequences. The actual consequences lead many to argue QE has not been an ethical policy.

The 2008 Global Financial Crisis

The economic crises of September and October 2008 came as unexpected shocks. Americans, the US Government, and in particular, the Federal Reserve Bank, the country's central bank, had to rescue the country and perhaps the world, from the effects of catastrophic financial events. The Fed quickly and decisively injected money into the collapsing financial system and became the lender of last resort. In December 2008, Ben Bernanke and the Federal Open Market Committee (FOMC) announced a huge, unprecedented plan to jump-start the economy.

Most are familiar with Franklin Delano Roosevelt's New Deal and other reforms that came about during the Great Depression of the 1930s. Few realize the FOMC was formed as part of the Federal Reserve Banking system at that time. The committee would come full circle a few decades later, as the US faced another serious depression. The FOMC creates and sets monetary policy to meet two objectives: price stability and full employment. It is currently required by

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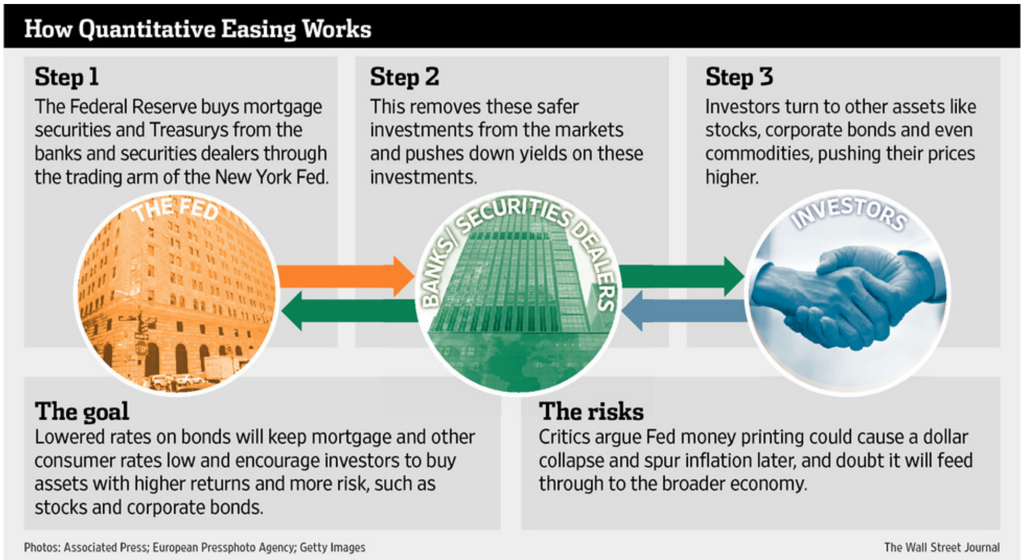
law to meet at least 4 times a year, although they have traditionally met 8 times annually, and gather for special meetings as economic conditions dictate. The Chairman of the Federal Reserve, Ben Bernanke, presides over members consisting of Regional Federal Bank presidents on an annual rotation and other members of the Federal Reserve Board of Governors. Notably, none of these are elected positions, and the Fed and FOMC can act without the approval of Congress or the President.

Quantitative Easing Explained

The latest and most discussed actions of the FOMC are its economic stimulus policy, entitled quantitative easing (QE). Quantitative easing is an uncommon monetary policy and except for the past 4 years, has been used sparingly. Monetarists believe this monetary approach, if designed and executed well, can prevent deflation, create a healthy level of inflation, and improve the labor market.

Under the direction of the FOMC, the Federal Reserve Bank of New York (FRBNY) goes to the open market and purchases financial assets, typically Treasury Bills (short-term debt issued by the US Government), and in recent years, mortgage backed securities, or MBS (groups of mortgages bundled into debt securities). The Fed does not raise funds or sell other assets to pay for these purchases. It funds the purchases by “expanding the balance sheet”. The Fed pays the banks that sold the securities through accounting entries and electronic transfers. This procedure may sound like some sort of creative accounting but in reality, it is equivalent to government printing money. This transaction serves to pull “safer” investment securities off the market. As supply falls, prices for these securities rise, driving down their yields (interest rate divided by the price of the bond). As yields fall, investors tend to search for other assets with higher returns, such as traditional stocks and commodities. As the Fed is purchasing these Treasuries and MBS from the open market, the selling banks receive a large inflow of cash, increasing their liquidity and their ability to lend. In short, QE puts money into the banking system and reduces interest rates.



Goals of Quantitative Easing

The main goal of recent QE is to create jobs. As cash is pushed into banks, lending rates are fall. The theory is both firms and individuals react to lower rates by increasing their borrowing for investments. Firms will make capital expenditures to improve or expand production, and individuals will consume a greater number of goods, including big ticket items such as cars and houses. This increase in production capacity and the increase of individuals' consumption create a ripple effect throughout the economy. As people demand more goods and services, firms will increase production. As production increases, the demand for labor increases. The resulting shortage of labor will eventually cause wages to rise. As more individuals become employed and their spending ability increases, they will demand more goods and services. This cycle will continue to build upon itself until the market reaches equilibrium. In a free market, interest rates rise with demand, and things get "back to normal" after an initial push from the Fed. While this theory is sound in itself, it does not take into account the irrationality of individuals and firms.

Consumer confidence and inflationary expectations contribute in large measure, to the health of the US economy. Yet, confidence or lack of it can become self-fulfilling. This effect has been shown time and time again in modern history, and continues to be the case in the past 4 years. While the Fed has created an incredible amount of liquidity (i.e. money) in the market, consumers and firms are not willing to take on additional debt because they lack confidence in the economy and because they already are highly indebted. Consumers see a stagnant economy, continue to be pessimistic, further hindering economic recovery, leading to less confidence, and creating a vicious cycle government intervention cannot seem to break. When firms and individuals get nervous, they tend to hold onto cash. If this occurs, QE is nullified and the policy will not meet its goals.

Side Effects of Quantitative Easing

Actions of the Fed do not stop with a reduction in lending rates for firms and individual consumers. When the Fed injects capital into financial markets, other consequences arise. We are able to predict many of these changes by applying the principles of Walras' Law. In particular, the value of the dollar will decrease as supply increases. The fall in value causes a net increase in exports because goods priced in US dollars become relatively cheaper to international consumers buying in non US dollar currencies. The increase demand for goods serves to increase the rate of inflation. Inflation and excessive money printing decrease the purchasing power of those holding US dollars. Shifts in currency markets impact all other financial markets. The Fed cannot expect to alter the labor market without impacting other markets.

Recent Quantitative Easing Actions

While the Fed is aware of the potential side effects, it has shown a willingness to accept many of them to improve the labor market. The Fed has publically stated it is willing to accept certain levels of inflation in order to reduce unemployment. During the past 4 years, the Fed has done three rounds of quantitative easing and a similar action through Operation Twist. Here is a brief look at each:

QE 1 (December 2008 to March 2010)

Purchase of $600b in MBS and agency debt	Unemployment rate rose to 9.8% (+1.5%)

Expanded to $750b in $300b respectively	FHFA 30Y fixed mortgage rates fell by 0.42% S&P500 Index gained 263 points

QE 2 (November 2010 to June 2011)

$600b purchase of long term t-bills $300b reinvestment from QE1 MBS proceeds	Unemployment rate fell to 9.1% -0.7% FHFA 30Y fixed mortgage rates rose by 0.41% S&P500 Index gained 75 points

Operation Twist (September 2011 to 2012)

$400b purchase of bonds with 6-30Y maturities
Sale of bonds with maturities of < 3Y
$267b added in June of 2012

QE 3 and 3+ (September 2012 to Present)

Open ended commitment to purchase $40b in MBS per month until labor market improves "substantially" In December the FOMC ushered in another round of QE, purchasing an additional $45b worth of "longer-term Treasury securities" on top of the $40b worth of MBS per month	Unemployment rate currently at 7.7% FHFA 30Y fixed mortgage currently at 3.76% S&P Index at 1569

Since the inception of QE1, the unemployment rate has increased, inflation has increased and is trending upward, the dollar has lost value, stock indices have risen, and mortgage rates have declined. The economy remains weak, and consumer confidence is still below pre-2008 levels.

An Utilitarian Measure of QE

Utilitarianism is a consequentialist ethical theory. That is, whether an act is good depends on the consequences of that act, regardless of original intentions. To measure the ethical value of an act using an utilitarian framework consideration is given to whether the act creates the greatest good for the greatest number of people. So how has QE faired? Has QE created the greatest good for the greatest number of people, as compared to possible alternatives? While difficult to measure in exact terms, clearly, QE has created winners, losers, and left a few as neither winners nor losers.

Quantitative easing has certainly created some winners. The banks that sold securities to the Fed saw an increase in revenue, profits, and liquidity. Creditworthy individuals who needed to borrow money also have benefited from QE because lending rates have fallen steadily over the past 4 years. Mortgage purchase and refinance rates are at all-time historic lows, which can save an individual thousands of dollars over the life of a home loan. The stock markets have responded favorably to the assistance and support of the Fed. Those who invested in equity markets during the time of QE1 have generally fared well, as both the DOW and NASDAQ have posted considerable gains.

As with most situations, whenever there are winners, there also are losers and this is no different with QE. A large portion of the American population is nearing retirement age, and has taken a hit to savings and retirement funding over the past 4 years. While not all attributable to QE, it has had an impact on savings rates. When individuals near retirement, it is common practice to move funds out of higher risk investments into safer options, such as certificates of deposit (CD), money market accounts, and traditional savings accounts. As QE has flooded the market with cash and driven down lending rates, interest rates on deposit accounts have also declined. CD rates have fallen on average by 65% over the past 4 years, often yielding rates of return that negligible. Current rates are lagging well behind inflation, forcing many retirement aged individuals to dip deeper into their principle balances, depleting nest eggs at a quicker rate than before.

Another large group that has faired poorly as a consequence of QE is the group originally supposed to be helped the most – the unemployed. The primary goal of QE was to improve the labor market, drive down unemployment, and in turn create upward pressure on wages. This has not happened. Where does this leave the unemployed? In most cases no better or worse off. Most people who are unemployed or underemployed are not interested or able to take out a loan to purchase a new car or buy a house. Low interest rates do not benefit them. Likewise, most individuals in this situation do not contribute to their retirement accounts. Nor do they, in general, invest in the stock markets. Again, the share price gains do not benefit them. Those out of work do, however, still need to eat, fuel their cars, buy clothing, and take care of other basic necessities as they seek employment. These activities are more difficult because inflation results in higher prices of basic goods while QE has causes a fall in purchasing power of the US dollar. The combination of not having a steady income, US dollar devaluation, and rising prices worsens their situation.

So was the policy of QE ethical? The goals and original intentions of QE were ethical. If economics in practice had gone as theory expounded, the greatest good may have been accomplished for the greatest number of people. The reality is that QE has not produced the desired consequences. The actual consequences could lead many to argue QE has not been an ethical policy. QE has not reduced unemployment in a significant way. The rate of unemployment has moved from 8.3 percent at the start of the financial crisis to 7.8 percent in 2012. Savers and retired people have suffered due to the negligible rates of interest. The value of the US dollar is being debased. Inflation has made goods more expensive making it especially hard on the unemployed and lower income groups. Low interest rates and high liquidity may be causing another bubble to form somewhere in the financial system. The case of QE offers an important lesson – even if original intentions and desired outcomes may have been ethical, actual consequences may not be.

So what could have been done differently? That question may be endlessly debated but one option for the Fed was to do nothing. Following the principles of classical economics and free market theory, the Fed could have chosen to allow the markets to correct themselves. While this may have been very painful for some market participants, it is plausible the economy and the general public would be in a better place now, rather than in a similar state of being as they were 4 years ago.

The reality is economics is not a hard science but a social science. An economic theory may work accordingly in certain contexts but no economic theory will work, borrowing from Aristotle, at all times, in all places, in all the right ways. Economics deals with human behavior and the psychology of groups. As such the discipline cannot fully account for the psychology and behavior of market participants in all situations. Where do we go from here? The Fed cannot lower rates any more as they are already near zero. Each round of QE has been less effective than prior ones, leaving little hope that further QE will serve its final purpose.

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