Latest Move by the Federal Reserve Raises Important Questions

With Federal Reserve Chairman Ben Bernanke's latest announcement of a new bond-buying program linked to unemployment data instead of the calendar, commentators called it a "historic move," "another innovation," and a "surprise" that amounts to a "complete reversal" from the Fed's days of using Fedspeak to disguise and obfuscate its moves.

After reviewing how the economy looks from the Fed's point of view, Bernanke announced that his Federal Open Market Committee (FOMC)

> will continue purchasing additional agency mortgage-backed securities at a pace of $40 billion a month.
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> The Committee also will purchase longer-term Treasury securities after its program to extend the average maturity of its holdings of Treasury securities is completed at the end of the year [Operation Twist], initially at a pace of $45 billion per month….
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> In particular, the Committee decided to keep [making those purchases] at least as long as the unemployment rate remains above 6½ percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored.

In short, the Fed will begin buying new government debt at the rate of $45 billion a month ($540 billion a year) until unemployment drops to 6½ percent, or inflation at the retail level reaches 2½ percent, whichever happens first. Then it will stop.

Bernanke explained that it's all about creating jobs:

> The conditions now prevailing in the job market represent an enormous waste of human and economic potential….
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> Part of the reason we are engaging in these policies is to try to create a stronger economy, more jobs, so that folks across the country … will have more opportunities to have a better life for themselves.

But he's not sure exactly when those new opportunities will arise. The new government bond purchase program will continue "if the outlook for the labor market does not improve substantially. We ourselves don't know what would define substantial improvement…. We'll be looking for … a better job market."

This is Quantitative Easing Program Number Four, or QE4, or as John Mauldin calls it, QE Infinity. Wrote Mauldin:

> The balance sheet of the Federal Reserve is now at a mind-numbing $1.5 trillion. Bernanke proposes to raise that by a half trillion dollars every year until we reach whatever is deemed an

acceptable rate of unemployment, as long as it is "achieved in a context of price stability."

So, the first of many questions has to be: What is that "acceptable rate of unemployment" that will trigger the end of QE4? What is so magical about 6½ percent? In January 2002, unemployment was at 5.7 percent and declined quite steadily to March 2007, at 4.4 percent. Why don't Bernanke and his FOMC shoot for that?

Second, at the current rate of job growth (using government numbers) of 150,000 new jobs a month, how long will it take to reach 6½ percent unemployment? Unfortunately, that depends on how many people "participate" in the job market over the next few years, and that number is very difficult to pin down. At present the participation rate (the ratio of the civilian labor force to the total population aged 16 and over) is 63.6 percent.

Mish Shedlock, writing at his Global Economic Analysis blog, says that if the participation rate continues to drop (it was 66 percent at the start of the Great Recession in 2007), it will take 100,000 jobs a month just to keep the unemployment rate *constant* (currently at an official 7.7 percent) *through the year 2020*.

If job growth averages 125,000 a month, the unemployment rate wouldn't trigger the end of QE4 *until the year 2020*.

Shedlock says that if enough people start entering the workforce to bring the participation rate up to just 65 percent, it "would require 200,000 jobs every month non-stop until 2020 to get the unemployment rate to 6.1%. Needless to say, 200,000 jobs a month is not going to happen."

In other words, Bernanke and his FOMC have just allowed themselves the opportunity to continue to purchase government debt for the foreseeable future.

But that raises another question: Who is going to buy the other half of the annual deficit currently being run up by the government? China? China is no longer buying U.S. government bonds. Japan? Japan is in a recession and has reduced its buying to just $100 billion a year.

Another fair question: What does QE4 have to do with creating jobs in the first place? The Keynesian theory is that if interest rates are depressed far enough for long enough, investors can be fooled into thinking that now is a good time to borrow. But this has been going on for years. The investors aren't being fooled.

The only way jobs can be created is by allowing the free market to give accurate dependable signals to investors, capitalists, and entrepreneurs so that they are willing to take the risks involved in creating new enterprises that hopefully will generate profits and justify the creation of new jobs. Buying government bonds from the government by the Fed has precious little to do with that and, in fact, distorts the market further, thus driving the very engines of job creation away from taking such risks. It is counterproductive.

All in all, then, the move to QE4 has as little chance of success in bringing down the unemployment rate as have the other programs of monetary intervention. All Bernanke and his FOMC have done is given themselves permission to buy government bonds forever, thus inviting the government to continue to spend and run up deficits forever.

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