Yellen's Coming Crisis

How has quantitative easing failed? Let me count the ways.

BY TADASHI NAKAMAE

Janet Yellen will face a daunting task when she takes the helm at the Federal Reserve: weaning the United States and the global economy off a highly addictive program of easy money. Quantitative easing creates economic and financial distortions. These often emerge in the form of asset bubbles, which can be seductive in the short-term, making policies to deflate them unpopular. Nonetheless, Yellen needs to craft policies which address these and other dangerous distortions.

Yellen could continue to flood the economy with more money. Or she could emulate Ben Bernanke, the departing head of America's central bank, who currently seems to have decided not to step up the program and merely manage the perceptions of market participants. Alternatively, Yellen could decide to wind down the central bank's asset purchases and face a painful, but necessary, period of adjustment.

For quantitative easing has not worked. Neither the Federal Reserve, which launched its ultra-easy policies at the end of 2008, nor the Bank of Japan, which started easing in 2001, has succeeded in accelerating economic growth or creating inflation.

Instead, the economy has become distorted. At home, quantitative easing has pushed up asset prices, especially equity

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prices. Stock markets have shot up; investment valuations, such as price-to-earnings ratios and price-to-book ratios, have risen even more. This phenomena is increasingly difficult to sustain. Big companies have raised their earnings by cutting costs rather than lifting revenues (a strategy that is limited), while many smaller companies have yet to see their earnings improve at all. The stubbornly weak economy also hurts. The Federal Reserve says the lackluster economy is why it has not tapered its quantitative easing purchases so far, a strategy that exacerbates the distortions that fuel these bubbles.

Quantitative easing will continue until the asset bubbles it has fueled finally burst. This will probably take place during Yellen's tenure.

The government bond market is also experiencing an artificial boom. With the Fed buying over $1 trillion worth of bonds a year against a fiscal deficit of $680 billion (the Bank of Japan is buying ¥70 trillion against a ¥50 trillion deficit), government bond market transactions are shrinking even as its prices are controlled by the central bank.

Quantitative easing has also created bubbles in emerging market economies. These countries have received huge amounts of capital as investors (using cheap dollars) look for higher returns. Emerging market economies have been able to rapidly accumulate foreign exchange reserves, increase their money supply, and accelerate investment-led economic growth. But now they are overextended, have large foreign debts, and face a weak global economy. This leaves them economically and financially vulnerable to tapering by the Federal Reserve.

Just because these adjustments will be painful, at home and abroad, does not mean they should be set aside. Central banks cannot continue to ease forever despite Japan's attempts to prove otherwise. Prolonging the inevitable is harming the economy. One of the biggest flaws of quantitative easing is that it lacks mechanisms to improve productivity, which is crucial for economic growth. Labor productivity growth in the United States and Japan has been slowing since quantitative easing policies were introduced, and is currently close to zero. Low productivity growth compels companies to cut labor costs, replacing full-time workers with part-time workers, or not at all. This creates a vicious cycle in which the falling quality of labor causes productivity to deteriorate further, forcing companies to seek even cheaper labor. This development has become a feature of the American labor market in recent years, and eerily is remarkably similar to Japan in 1990s.

Returns on capital are influenced by interest rates. In an uncertain environment, companies hoard cash rather than invest in new factories and equipment (which helps drive productivity growth). Ultra-low rates also prevent the economy from naturally reducing oversupply by enabling inefficient companies to survive. Healthier companies in these industries are weakened in turn as they lose pricing power. Misallocation of capital also damages potentially higher-growth industries with financial resources scarce.

This is partly because small businesses, vital players in these high-growth industries, are at the mercy of banks, which often find that spreads on interest rates are too small to make loans. Meanwhile, consumers have realized that low rates slash interest income, forcing them to cut consumption. Easy money also engenders risky behavior as banks, and consumers with enough savings, attempt to make capital gains in bubbly asset markets.

Central banks cannot continue to ease forever.

Tapering quantitative easing and sticking to it (and raising interest rates in a timely manner) has proved too difficult for any central bank governor so far. Yellen, who is said to be an inflationary dove, is an unlikely candidate to break the mold. Given the political hurdles and the (temporary) economic and financial hardships such a decision would entail, it seems even less likely that she would do so. Quantitative easing will continue until the asset bubbles it has fueled finally burst. This will probably take place during Yellen's tenure. The final word on Yellen may not be written until we see how she handles that crisis. ◆