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Fed Efforts to Revive Economy Find Critics

By FLOYD NORRIS

Can you remember when the Federal Reserve was above criticism? When politicians vied for Alan Greenspan's favor and fell all over themselves praising his wisdom?

Now poor Ben S. Bernanke, who succeeded Mr. Greenspan as Fed chairman, is being blasted from all sides. It is bad enough that his latest effort to revive the American economy has taken on a name previously used for a 40-year-old cruise ship that no longer sails — QE2.

He is attacked by Americans for printing money and by overseas officials for trying to help American trade by undermining the dollar. Some Republicans claim to believe the country would be better off without a central bank at all.

If the stock market were falling, you can be sure the Fed would get the blame. But it has been rising of late, and in some critiques that is proof of the Fed's perfidy. The Fed is creating inflation, its critics say.

Overseas, there is a widespread belief that the purpose of QE2, for the second round of quantitative easing, must be to depress the dollar and thus give the United States an unfair trade advantage. "It's inconsistent," thundered the German finance minister, Wolfgang Schäuble, in an interview with Der Spiegel, "for the Americans to accuse the Chinese of manipulating exchange rates and then to artificially depress the dollar exchange rate by printing money."

Oddly enough, the dollar rallied in the week after the latest plan was announced, even though the normal expectation would be for a weakening. The currency slipped after Mr. Bernanke signaled such a move was likely, but it seemed unlikely the currency was a major consideration in the Fed's decision. If the central bank does manage to kick-start economic growth, the dollar is likely to rise further.

The Fed did not deserve the praise it used to get. It presided over bubbles and huge debt creation. When things were good, it forgot the injunction of a former Fed chairman, William McChesney Martin, that the Fed's job was to "take away the punch bowl" when everyone was having a good time.

We would be much better off if the Fed had noticed there was a bubble inflating in housing, rather than take the doctrinaire position that there were no bubbles, or, if there were, no one could figure out if they were too big.

Some Fed officials say they have learned that lesson, and will act differently when something similar happens. Right now, we can only hope we'll get the chance to see if they will be wiser the next time. For now, there is no party at all, let alone one with spiked punch.

Yet no less eminent an economist than Martin Feldstein, a Harvard professor, former president of the National Bureau of Economic Research and chairman of Ronald Reagan's Council of Economic Advisers when the country was recovering from a severe recession in the early 1980s, is worried.

Anticipation of QE2, he wrote in The Financial Times, caused prices of commodities and common stocks to rise.

"Like all bubbles, these exaggerated increases can rapidly reverse when interest rates return to normal levels," he said. "The greatest danger will then be to leveraged investors, including individuals who bought these assets with borrowed money and banks that hold long-term securities. These risks should be clear after the recent crisis driven by the bursting of asset price bubbles. Although the specific asset prices that are now rising are different from last time, the possibility of damaging declines when bubbles burst is worryingly similar."

The threat of rising prices also was clear to Sarah Palin, the former Alaska governor, who asserted that "everyone who ever goes out shopping for groceries knows that prices have risen significantly over the past year or so. Pump-priming would push them even higher. And it's not just groceries. Oil recently hit a six-month high, at more than $87 a barrel."

Those worries seem excessive. The Fed is clearly more concerned about deflation than inflation, and it has a point. Inflation may be a longer-term problem, but that term is likely to be longer than you would guess from a lot of the commentary.

To be sure, some prices are up. But that could mean that markets are more encouraged about growth prospects than they were when the American recovery stalled this summer and brought on talk of a double-dip recession.

It seems that the third-quarter growth rate of gross domestic product will be revised higher from the 2 percent initially reported. Kamalesh Rao, the director of research for MasterCard Advisors SpendingPulse, which monitors retail sales, says those sales grew about 3 percent in October. "It is not an extraordinary rate of growth, but it indicates we are coming out of that summer lull," he said.

Near the end of 2008, oil traded below $35 a barrel and the Standard &Poor's 500-stock index, now around 1,200, fell below 800. What has changed since then is not inflation, or inflation expectations. The Consumer Price Index for September was a little below the figure for two years earlier. The arrival of Great Depression II seems less likely now.

Nor do markets seem to fear soaring inflation. Given the record-low interest rates on United States Treasury securities, it certainly appears that investors still trust Uncle Sam, even if Ms. Palin is worried that QE2 will be followed by QE3, 4 and 5, and that no one will be willing to lend money to the United States. A Chinese bond rating agency this week cut its rating of American government debt to single-A-plus, saying that "serious defects in the U.S. economy will lead to long-term recession and fundamentally lower the national solvency."

It is just such a long-term recession that the Fed is seeking to avoid. I don't know if it will work, but some action seems to be needed, and the politicians show no real interest in using fiscal policy to support the economy.

The action the Fed took was to announce plans to buy $600 billion of longer-term Treasuries by mid-2011. That is smaller than the purchases of 2009, but then there was a clear emergency. To a lot of people, this sounds like simple printing of money, and we all remember hearing that inflation is the result of having too much money floating around.

At the Fed, there are promises that the action will be reversed when conditions improve, but critics who once believed everything Mr. Greenspan said now doubt everything his successor says.

These are extraordinary times. If interest rates were at more normal levels, the latest Fed action would be roughly similar to a reduction of the federal funds rate by around three-quarters of a percentage point, or so some economists believe. Then the Fed would have bought Treasury bills to accomplish that goal. It would seem like a big move, but not a particularly unusual one.

Fed officials could have simply announced they were taking aim at a longer-term rate, like the five-year Treasury note, and were determined to get the yield on that down to some level they deemed appropriate. (That is essentially what Mr. Bernanke once advised Japan to do.) That might have sounded more like the old policy. But doing that could have raised fears that the Fed would have to buy a huge quantity of notes, and had made an open-ended commitment.

If we look at this as normal Fed policy in abnormal times, then we are back to another fear being raised now, that the move will not do much good because the Fed is "pushing on a string" and sending liquidity into an economy that will not make much use of it. Mr. Feldstein voiced that worry with calculations of the very limited improvement in G.D.P. that we could expect.

He may be right, of course. But in every recovery I can remember, there were similar worries. Then, seemingly suddenly, the economy took off and growth recovered. There is a cumulative effect from easing credit, but no easy way to know when it will kick in.

One area to watch is the junk bond market. Rates are down and borrowing is up. But little money seems to be going to support the kind of economic activity we would like to see, in which companies buy plants and equipment and hire workers. Instead, such companies as HCA, the privately held hospital chain, and Armstrong World, the vinyl flooring company, are borrowing to pay dividends to shareholders. That money may be recycled in new investments, of course, but its economic impact is limited.

If and when we see more money being borrowed at these low rates for projects based on expectations of a better economy, Mr. Bernanke may deserve the kind of praise his predecessor used to receive.

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