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How can Ben Bernanke manoeuvre the Fed out of QE without doing irreparable harm to the global economy?

By **JOERGEN OERSTROEM MOELLER**

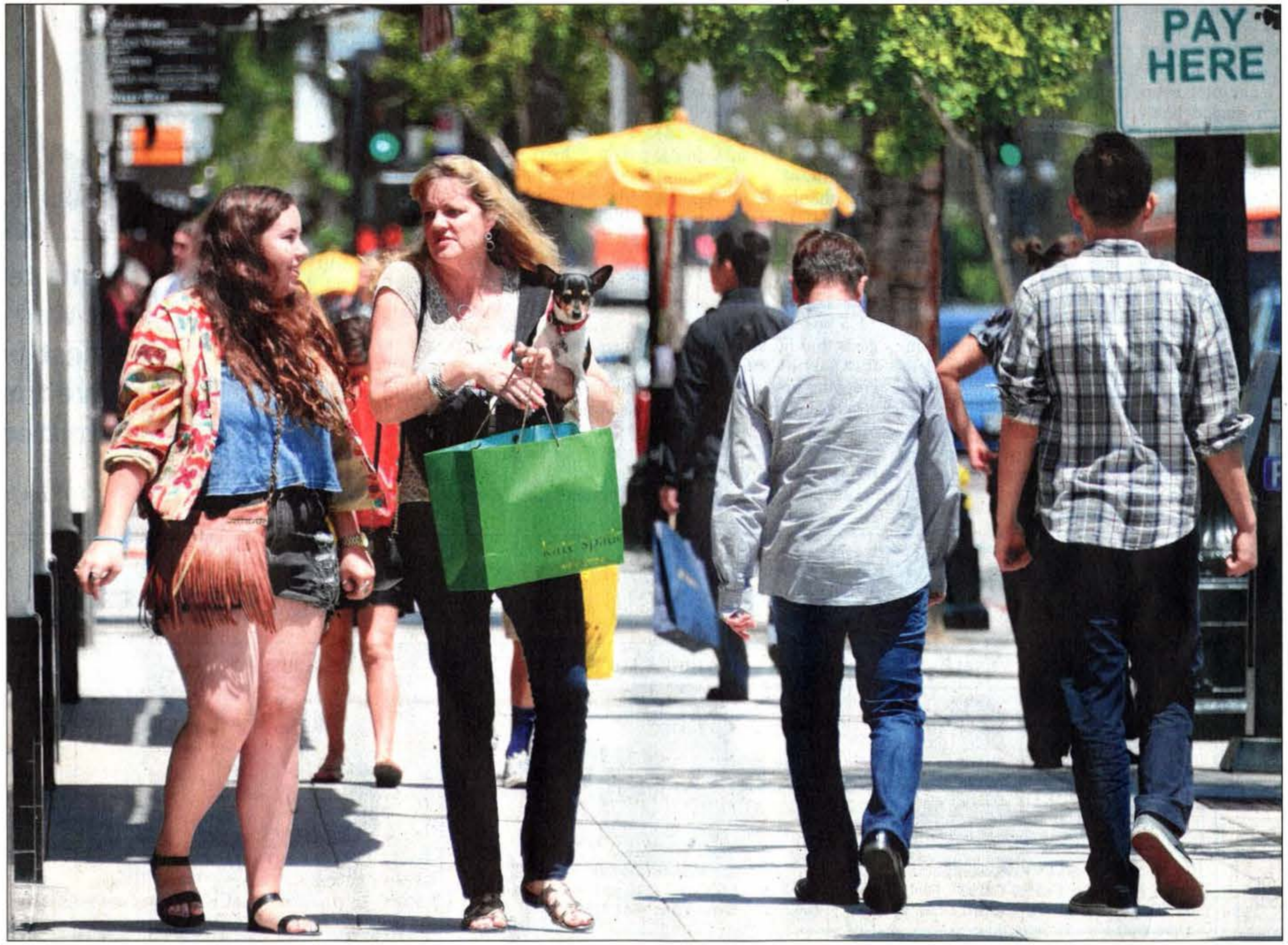
THE crucial phrase spoken by US Federal Reserve chairman Ben Bernanke at the recent hearing in the US Congress was: "A premature tightening of monetary policy could lead interest rates to rise temporarily but would also carry a substantial risk of slowing or ending the economic recovery and causing inflation to fall further."

Indeed, what next after quantitative easing (QE) with the Fed buying US$85 billion bonds every month to keep the US economy afloat, hoping and looking for a recovery not yet really in sight with conflicting economic figures coming in?

What Mr Bernanke revealed is actually not new. The tactic is to pump money into the economy expecting growth to take off and when that happens start to tighten monetary policy – reduce some of the liquidity deemed to be superfluous as its job has been done.

The deeply worrying and unsaid sequel to Mr Bernanke's statement is: Suppose that the economy does not start to take off, what then?

The global financial crisis in 2007/08 followed by the global recession dealt central bankers and governments a bad hand. After years of exuberance where few if any suspected anything wrong with what seemed an unstoppable system it suddenly started to unravel, almost imploded, and threatened the world economy.



Changing world: *Economic policy was based on observation of consumers and investors in Western countries – the US and Europe later to be joined by Japan. This was permissible and worked as long as these countries combined have the largest – by far – share of world GDP. This is not any longer the case.* PHOTO: AFP

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The response from policymakers including central bankers was to fall back on well-known theories and paradigms. Fiscal stimulus, monetary expansion, rescuing the banking system were a few of the instruments mobilised. They have worked sufficiently well to prevent a meltdown or repetition of what we saw in the 1930s, but not – far from it – well enough to restart the global economy still caught in a trend growth one or maybe two percentage points lower than before the crisis.

Unfortunately, policymakers still see the crisis as a blip on the curve. Their prescription is just to do what was done over previous crises of similar nature and fall back on academic writings including articles authored by Mr Bernanke when he was university professor specialising in monetary economics. He advised the Japanese government – among other things – to "drop money from a helicopter" exposing the economy to a shock.

The creeping suspicion is that this crisis is not a blip on the curve, but something much more drastic and dramatic – a shift in paradigm with new and unknown steering factors. Policy instruments become ineffective because it does not have the effect as assumed.

What is at stake here is the future of the well-known economic model which reigned supreme since 1945.

Economic policy was based on observation of consumers and investors in Western countries – the US and Europe later to be joined by Japan (the three major industrialised countries, G-3). This was permissible and worked as long as these countries combined have the largest – by far – share of world gross domestic product (GDP) with the largest share of economic growth.

China consumption pattern

This is not any longer the case. G-3 still stands for almost two-thirds of the global economy, but has relinquished the role of pace-setter for economic growth to non G-3 countries like China, India, Indonesia, and even if not much is written about it, Africa, and a number of mid-sized countries such as Turkey and Mexico.

Over the last decade, the talk has been of the Chinese consumer as the saviour or king of the world economy steaming in to replace the Americans as "consumer of last resort". Statistics are abundantly clear, however, that the Chinese consumer does not live up to these expectations.

Consumers in China do not act like American consumers excelling in spending. The consumption/savings function in the US cannot be used to predict savings and consumption in China. Family structure, social fabric, and traditions and culture steer the Chinese consumer towards another pattern than the one chosen by the American consumer.

Innovation has been a key to US growth since 1945 contributing with around half of registered growth. It is possible that innovation will continue to work like that, but it is not certain. There are many theories about short and long cycles, prognoses about new technology, and many other factors simulating innovation, investment, and growth.

Productivity and jobs

There is, however, also a respectable school of economists and researchers interested in technology, saying that the global economy is moving into a cycle of less innovation, less R&D-steered investment, and consequently lower productivity.

Dale Jorgenson of Harvard University and Khuong Vu of the National University of Singapore published an analysis three years ago predicting a fall in annual global productivity from 3 per cent in the preceding decade to 2.6 per cent in the coming decade with the US and Japan showing the strongest decline.

Even more worrying is a more recent analysis disclosing that from 1947 to 2000, productivity growth in the US was correlated with employment growth. Since 2000, they have diverged: Productivity going up, employment going down.

Investors have been lured away from productive investments to seek easy and fast returns in non-productive assets such as property, financial derivatives, and bonds keeping interest rates low with the risk of a steep rise when quantitative easing stops and forces them out of low-return investments.

Banks have used the liquidity to improve their balance sheets instead of stepping up lending. The idea, the purpose, behind quantitative easing was to make money available for productive investments stimulating employment, but investors are not taking the bait.

The liquidity has to be "parked" somewhere and it flows into assets of increasingly dubious quality or at least priced too highly. If, or when, central banks – with the Fed in the lead – start to reverse course a lot of this money will panic and seek refuge, but the unanswerable question is: Where?

To give the Fed chairman some credit: it is very difficult see what else he could have done. It is, however, even more difficult to see how he can manoeuvre the Fed and other central banks out of quantitative easing without doing irreparable harm to the global economy, killing the chances for a recovery.

So what can he do? There seems no other way than a gradual slowdown of quantitative easing, holding the breath, and hoping that an adroit combination of timing and judgement of how much or how little can keep the American economy at a growth pattern of 1.5-2 per cent in the expectation of a recovery that eventually will come even if it is less strong than most observers expect.

Sit and wait, hope for the best, and try not to commit mistakes. Perhaps that is what he meant, but could not say.

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