Quantitative easing and America's economic rebound

By Martin Feldstein

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CAMBRIDGE – There is no doubt that the American economy rallied strongly at the end of 2010. But how much of that was due to the United States Federal Reserve's temporary policy of so-called "quantitative easing"? And what does the answer mean for the US economy in 2011?

Until the fourth quarter of last year, the US economic recovery that began in the summer of 2009 was decidedly anemic. Annual GDP growth in the first three quarters of 2010 averaged only about 2.6% – and most of that was just inventory building. Without the inventory investment, the growth rate of final sales averaged less than 1%.

But the fourth quarter was very different. Annual GDP rose by 3.2% and growth of final sales jumped to a remarkable 7.1% year-on-year rate. True, much of that was due to a sharp decline in imports; but even the growth rate of final sales to domestic purchasers rose at a healthy 3.4% pace.

The key driver of the increase in final sales was a strong rise in consumer spending. Real personal consumer spending grew at a robust 4.4% rate, as spending on consumer durables soared by 21%. That meant that the acceleration of growth in consumer spending accounted for nearly 100% of the increase in GDP, with the rise in durable spending accounting for almost half of that increase.

The rise in consumer spending was not, however, due to higher employment or faster income growth. Instead, it reflected a fall in the personal saving rate. Household saving had risen from less than 2% of after-tax incomes in 2007 to 6.3% in the spring of 2010. But then the saving rate fell by a full percentage point, reaching 5.3% in December 2010.

A likely reason for the fall in the saving rate and resulting rise in consumer spending was the sharp increase in the stock market, which rose by 15% between August and the end of the year. That, of course, is what the Fed had been hoping for.

At the annual Fed conference at Jackson Hole, Wyoming in August, Fed Chairman Ben Bernanke explained that he was considering a new round of quantitative easing (dubbed QE2), in which the Fed would buy a substantial volume of long-term Treasury bonds, thereby inducing bondholders to shift their wealth into equities. The resulting rise in equity prices would increase household wealth, providing a boost to consumer spending.

To be sure, there is no proof that QE2 led to the stock-market rise, or that the stock-market rise caused the increase in consumer spending. But the timing of the stock-market rise, and the lack of any other reason for a sharp rise in consumer spending, makes that chain of events look very plausible.

The magnitude of the relationship between the stock-market rise and the jump in consumer spending also fits the data. Since share ownership (including mutual funds) of American households totals approximately $17 trillion, a 15% rise in share prices increased household wealth by about $2.5 trillion. The past relationship between wealth and consumer spending implies that each $100 of additional wealth raises consumer spending by about four dollars, so $2.5 trillion of additional wealth would raise consumer spending by roughly $100 billion.

That figure matches closely the fall in household saving and the resulting increase in consumer spending. Since US households' after-tax income totals $11.4 trillion, a one-percentage-point fall in the saving rate means a decline of saving and a corresponding rise in consumer spending of $114 billion – very close to the rise in consumer spending implied by the increased wealth that resulted from the gain in share prices.

None of this appears to augur well for 2011. There is no reason to expect the stock market to keep rising at the rapid pace of 2010. Quantitative easing is scheduled to end in June 2011, and the Fed is not expected to continue its massive purchases of Treasury bonds after that.

Without that increase in stock-market wealth, will the saving rate continue to decline and the pace of consumer spending continue to rise more rapidly than GDP? Will the strong economic growth at the end of 2010 be enough to propel more spending by households and businesses in 2011, even though house prices continue to fall and the labor market remains weak? And does artificial support for the bond market and equities mean that we are looking at asset-price bubbles that may come to an end before the year is over?

Only time will tell, of course. But these are the questions that investors and policymakers alike should be asking.

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