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Beware of the costs and psychology of QE3

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Earlier this month, America's Duke University asked the chief financial officers of 887 large companies how they might respond to falling interest rates. The results were noteworthy for economists, political pundits and investors alike.

Some 91 per cent of firms said a one per cent fall in interest rates would have no impact on their business plans, while 84 per cent professed indifference towards even a two per cent fall. "CFOs believe that a monetary action would not be particularly effective," the survey concluded; or not, that is, in terms of boosting investment and jobs.

This is sobering stuff. When Ben Bernanke, Fed chairman, unveiled his "QE3" measures last week – a promise to buy more mortgage-backed securities as part of quantitative easing – he justified this by pointing to the continued high levels of unemployment and weak growth. Most notably, by providing an open-ended commitment to buy securities, the Fed hopes to bolster demand and thus create more jobs.

Many observers (like my colleague Martin Wolf), would argue this is the right course to take. After all, as a senior official in Washington pointed out to me last week, the lesson of financial crises in recent years is that it pays to do more, not less, than appears necessary when faced with big headwinds. Nobody wants to repeat the mistakes of the 1930s "liquidationists", or 1990s Japan. And partly because of that, the Fed announced last week that 11 of the 12 voting members of the Fed committee backed Bernanke's move.

But what the Fed did not reveal was that while almost all of the voting committee members supported QE3, several non-voting members did not (under the Federal system, the regional presidents vote on a rotating basis.) Indeed, if you include those non-voting members, around a third of the committee was wary, if not unhappy, with QE3.

And that was not just because of fears that the timing of QE3 looked "political". The bigger worry is that the benefits of QE3 are so unclear, because the transmission mechanism is so muddled, while the potential costs are so high. "Anything that the Fed does is going to only have temporary effects," James Bullard, head of the St Louis Regional Fed told Reuters earlier this week. Or as Richard Fisher, head of the Dallas Fed, observed in a powerful speech on Wednesday (which cited the Duke survey): "Nobody on the [Fed] committee... really knows what is holding back the economy. Nobody really knows what will work to get the economy back on course. The very people we wish to stoke consumption and final demand by creating jobs and expanding business fixed investment are not responding to our [Fed] policy initiatives as well as theory might suggest."

Now optimists might retort that this last point about company sentiment is not so important. After all, the fact that the Fed decided to buy MBS, rather than Treasuries, say, suggests that the consumer, not CFO, is the main target.

Notably, by lowering mortgage costs, and raising stock markets, these extraordinary measures have the potential to make consumers feel considerably happier. And that might actually be more important for economic growth than anything CFOs say. After all, the boom in corporate profits that occurred in recent years has not had much "trickle down" impact on consumers.

In any case, optimists add, QE3 also provides a wider general psychological boost. As such, it might help offset the other downward drags on the economy, such as uncertainty about the looming US "fiscal cliff" or anxiety about China and the eurozone. On that last issue, it is worth noting that the US Treasury and White House are now steeling themselves for another three to five years of grinding uncertainty and possible volatility in the eurozone, irrespective of the recent, slight improvement eurozone news. Or, to put it another way, even if QE3 is not working through the conventional monetary transmission channels, it can still "work" in other ways, by acting as foam on the runway to soften bumpy economic landings.

The crucial problem, as Fisher noted with such unusual clarity this week, is that the psychology of this is still so uncertain. With anything between $2,000bn and $4,000bn of unused liquidity now swirling around the US financial system (depending on how you measure it), consumers and CFOs alike can sense that monetary policy is becoming less effective. And yet, the more the Fed announces unconventional moves, the more stock market investors appear to demand additional drama. With every new round of QE, expectations and fears are being ratcheted up, in equal measure.

That is not reassuring in any sense. Anyone who feels tempted to start celebrating the recent share price rally, in other words, would do well to read Fisher's bold speech – and then take a long, deep breath.