QE2: Quantitative Easing, Round 2

When the Fed began its fight against the financial crisis in late 2008, most economists supported the dramatic steps that they took. Most also agree that it was crucial in preventing a depression. However, when it chose to engage in a second round of quantitative easing in November 2010, many questioned whether it was the appropriate policy and were concerned about its potential side effects. Before we go further, it should be noted that when the term economists is used in this section, we're referring to practicing economists. What do economists think of QE2? A survey by the WSJ in November 2010 indicated that 64% of economists say they would have voted against QE2 if they were on the Fed.

What is QE2?

OK, what exactly is QE2? Normally, if the Fed thinks that the economy is too weak and inflation is too low, it will reduce the federal funds rate to try to stimulate the economy. It accomplishes this through open market purchases of government securities, thus increasing bank reserves. However, what can it do if the federal funds rate is already near zero? In that case, the Fed takes a similar action, but instead of lowering its target for the federal funds rate (which can't go any lower), it targets an increase in bank reserves. For QE2, the Fed announced that it intended to increase reserves by $600 billion over an 8-month period. Thus, even though many commentators refer to it as unconventional policy, it is implemented in a pretty conventional way. Other than targeting reserves, another difference between it and traditional monetary policy is that normally the Fed conducts open market purchases of short-term government securities (Treasury bills) while in the case of QE1, it purchased a large amount of mortgage-backed securities and in QE2, it purchased medium-to-long-term government securities (Treasury notes).

Why QE2?

So why did the Fed engage in QE2? Recall that its goals include low and stable inflation and sustainable economic growth (including full employment). As discussed elsewhere, though the Fed does not have an explicit inflation target, its implicit target for core inflation is between 1.7 and 2%. As of late 2010, inflation, whether overall or core, is below its target. Core inflation using the PCE index was 0.5% as of December 2010, the lowest since records started being kept in the late 1950s. Of course everyone knows that unemployment is high (9.8% as of Nov 2010), well above NAIRU. Given inflation is "too low" and the severe weakness of the economy, the Fed chose to ease monetary policy further. Given that the federal funds rate is already near zero, the only way to ease policy was to conduct open market purchases to increase reserves by a certain amount. It's hope is that this will make credit more available, helping the economy grow more quickly and reduce the downward pressure on inflation (avoid deflation). It also wants to convince participants in the financial system that it will prevent deflation (negative inflation) and thus encourage spending. Sounds reasonable? So why is it controversial? We will consider reasonable critiques of QE2.

Criticisms of QE2

Isn't this inflationary? The Fed is just printing money which makes money not worth as much. Too much money chasing too few goods leads to inflation. Though there's a chance of this happening, very high inflation is extremely unlikely. The Fed is not increasing the money supply, but instead is increasing the monetary base. As long as banks hold the new reserves, the money supply is not affected and thus inflation will not result. If banks do reduce their holdings of reserves and increase lending considerably, the money supply will increase and inflation may be a threat unless the Fed withdraws some of the reserves. Ben
Bernanke knows this and has stated that the Fed intends to reduce reserves if this begins to happen. The Fed may not act quickly enough and inflation may rise more than desired, but very high inflation is very unlikely. That said, there is reasonable concern that the Fed may not be able to withdraw reserves quickly enough in the future and inflation may rise above its goal. In the short term (2011), inflation is likely to remain contain as most firms lack pricing power due to economic weakness. Further details are available in this discussion of how the Fed's balance sheet affects the economy.

**Economic growth occurs from investment and increases in productivity, not printing money.** This is true in the long run, however easier monetary policy can stimulate the economy in the short run. Recall that productivity, based on technology, investment and enhanced human capital, drive economic growth in the long run. However, spending makes a difference in the short run. The policy is intended to give the economy a push by making credit more available and convincing people that deflation won't occur (fears of deflation can hinder spending as people hold back spending in anticipation of lower prices). However, increasing the money supply does not drive long-run economic growth, so the monetary stimulus must be withdrawn once the economy is strong enough.

**It will do little to improve economic growth and carries some risks.** Interest rates are already historically low enabling those who qualify for credit to borrow and spend (or refinance when it comes to housing). Making credit even cheaper is probably going to have a limited effect. In addition, the Fed doesn't directly control interest rates that matter to borrowing. It's hoping to reduce longer-term interest rates, but other factors may offset its actions. In fact, as of December 2010, yields on government securities have risen significantly, though risk premiums on corporate bonds have declined.

**Market Distortions:** Besides the risk of higher inflation, QE2 may distort credit markets. For example, mortgages may be loaned at low rates under QE. Once QE is withdrawn and the economy strengthens, interest rates may rise more than usual (i.e., interest rates rise as the economy strengthens and rise further as the Fed removes monetary stimulus). Thus banks will be stuck with low-rate mortgages while having to pay depositors relatively high interest rates. Banks may not have made the mortgage loans at the low rates under normal market conditions, but made loans at artificially low rates due to the intervention by the Fed. By purchasing certain forms of bonds, the Fed may distort the interest rates on bonds. For example, purchasing mortgage-backed securities may reduce mortgage interest rates relative to other interest rates (it gets complex). The Fed took this into account, but focused on purchases of mortgage-backed securities in the first round of QE since the market for mortgage-backed securities collapsed during the financial crisis. In QE2, the Fed purchased Treasury notes since they provide the benchmark for other bonds (thus, it was hoped that there would not be much distortion in relative interest rates).

**Exit Strategy**

As mentioned, the Fed will need to withdraw the monetary stimulus at some point. By engaging in QE2, its exit strategy becomes more complex, even if QE2 is justified. The more stimulus in the system, the more difficult and complex will be the exit strategy. Ideally, it would like to withdraw the stimulus gradually to allow for stable lending conditions and economic growth, while also preventing inflation. The balancing act becomes more difficult as the amount of stimulus gets higher.

The Fed's tools for managing its exit strategy include interest on reserves, allowing bonds to mature, and term deposit facilities. The Fed's asset holdings will naturally decline as some of its bond holdings mature (for example, a mortgage-backed security matures in December 2012 will no longer be on its balance sheet in January 2013). As of August 2012, banks are voluntarily choosing to hold an extremely high level of excess reserves (about $1.5 trillion). As the economy strengthens and the financial system heals, banks will resume...
more normal lending practices and reduce their excess reserves. At that point, the risks of QE become more of an issue. The Fed's main fear is that banks will begin lending their vast holdings of excess reserves at a rapid pace. To help ensure this doesn't occur too quickly, the Fed will increase interest on reserves to make it attractive for banks to maintain some reserves with the Fed. When you hear about the Fed raising interest rates in late 2013 or 2014, this is the interest rate that will increase. In addition, the Fed plans to introduce term deposit facilities, which are similar to CDs for banks. Banks will be offered higher interest rates (determined in an auction) if they agree to keep their reserves at the Fed for a specified period of time (for example, 3 months). This is designed to manage the flow of reserves into the economy.

When will the Fed implement its exit strategy? Most economists think it will begin in late 2013 or 2014 or even 2015, though this will be dictated by economic conditions. Will it be successfully implemented? Though this is a new experience for the U.S., the Fed has thought through the process and Japan successfully reversed its QE earlier this decade. Still, it's complex and may lead to market volatility. Proper timing and execution will be difficult.

Here is a recent explanation of the process of QE and the meaning of "printing money" from the WSJ.