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What is Fed's QE2, and what will it do? Experts explain in everyday English

Cheryl Hall **November 10, 2010**

QE2 sounds like a luxury ocean liner. But many wonder if the Federal Reserve's second round of "quantitative easing" would be more aptly named the Titanic.

A week ago, the nation's central bank announced that it would buy $600 billion in long-term U.S. Treasury bonds, ostensibly to push down long-term interest rates.

This comes on top of $1.25 trillion in mortgage-backed securities that the Fed has sucked up in the last couple of years. Despite its enormity, this intervention has done little to kick the economy back into action.

I'd be staggered by the numbers if they weren't so numbingly huge.

One of the great things about my job is that I can get private tutorials from people who actually understand this esoteric stuff. So I asked some of the sharpest minds on Federal Reserve weaponry to give me a QE2 primer.

I was surprised when a few declined the opportunity, saying they need help, too.

"I have no idea how to make a chart of this," said Michael Poss, the economist responsible for all of Ross Perot's famous presidential campaign graphics.

Three former high-ranking Fed insiders, two university business school deans and three investment fund managers answered the call.

"The book has not been written whether QE2 is a good idea or a bad idea," said Sam Manning, general partner of the Blagden Fund in Dallas. "There are many highly educated, brilliant minds on both sides of the argument."

But here are some basics about quantitative easing that just about everybody I talked with agreed on:

• Turning government bonds into circulating money is called monetizing the national debt.

• *Quantitative easing* is a euphemism for creating money out of thin air. In the vernacular, we call it "printing money," even though it really has nothing to do with the U.S. Bureau of Engraving and Printing.

• The way it's supposed to work is that the Fed buys securities in the open market, paying with a government "check." (That's how the money is created.) The sellers deposit those checks into their banks. The banks redeploy those deposits as loans to consumers and business. The money supply expands and, in turn, so does the economy.

Or so the theory goes.

• The money supply hasn't increased over the last two years from the first round of quantitative easing. The trillion-plus the Fed paid for mortgage-backed securities is still sitting in vaults as bank reserves.

"The system is clogged" is how Bob McTeer, former president of Federal Reserve Bank of Dallas, described it.

• Loan demand from creditworthy borrowers remains weak. Banks are still smarting from previous bad loans. And they are leery of lending money so cheaply when higher rates may be in the offing.

• Almost no one thinks QE2 will send folks scurrying to the banks to borrow.

"It is not as though you read the headline 'Fed to do $600 billion of QE2' and think, 'Oh, good, this will be good for our business,' " says Cece Smith, a retired venture capitalist and former chairman of the Dallas Fed bank.

"They are not going to add jobs based upon interest rates being lower. They will add jobs based upon increased demand for their products or services."

• The likely – and intended – effect is inflation.

The Fed is worried about deflation and the psychological effect of our seeing assets such as 401(k)s, houses and stocks devalue. It's the "wealth effect" in reverse. That's where we've been since the crash of 2008.

"We've been flirting with deflation for two years," says Michael Cox, former chief economist at the Dallas Fed bank. "That's really bad for the economy. This is a carefully engineered yet somewhat desperate attempt to get money supply to rise so that prices will rise."

The Fed's saying that it wants to hold down long-term rates is more palatable than saying it wants to use inflation as medicine. But some fear that the cure could be worse than the disease.

Dallas investment fund manager Kyle Bass describes the policy is a sleight of hand with the soaring national debt.

"We're trying to counter-cyclically spend. Push our problems down the road. And never face the fact that we were too leveraged as an economy," said Bass, who expects the dollar to take a whacking. "I don't know how many of your problems that you've kicked down the road ended up getting better later on. But in my life, it's almost none of them."

Frankly, McTeer, who is now with the National Center for Policy Analysis, thinks all this gnashing of teeth is overblown.

"Everybody's treating this as a very unusual, draconian thing that's extremely risky, probably won't work and likely to have adverse consequences. I think they're overdoing it."

But everyone agreed that the federal government is walking a tightrope over an economic chasm.

If successful, the action will create a manageable inflation rate that could push the stock market and housing prices higher, entice businesses to go ahead with projects and banks to lend to them.

If QE2 is too successful at unleashing money, inflation could shift into hyperdrive. Then the Fed will have to engage a completely different set of steering mechanisms.

Here's what the experts had to say.

Sam Manning, general partner, Blagden Fund

"The book has not been written whether QE2 is a good idea or a bad idea. There are many highly educated, brilliant minds on both sides of the argument.

"But if I were running the Federal Reserve of the United States of America, I would err on the side of being cautious. What we do not want more than anything else is to turn into Japan and have a deflationary spiral."

How is buying back $600 billion in U.S. bonds being cautionary?

"There is a demand for fixed-debt instruments. You're able to print money and keep interests rates low. Supply and demand. The federal government will be able to sell its Treasury bonds every week, every month, because the Fed is going to be there to buy them. That creates demand for the bonds, keeps interest rates down low, for now, until those bonds come due.

"It could create inflation, OK?

"But that could be a good problem to have. If we have a little bit of inflation, hopefully that means the economy is growing again. People are making money. Businesses are expanding. The economy starts overheating a little bit.

"You would much rather have that problem to deal with than deflation.

"In the '30s, people stopped spending money. There were plenty of people in the world who still had money but they wouldn't spend it, because they were so uncertain and they thought prices were going down.

"If you put people in the position where they have no confidence and don't want to spend money, then you create a deflationary spiral, which is much worse than having to worry about a little bit of inflation.

"If we do get inflation down the road, the Federal Reserve can always raise interest rates and slow things down.

"So [Federal Reserve chairman Ben] Bernanke is erring on the side of being cautious: Let's have a little insurance policy to prevent a deflationary spiral, which happened in Japan. That's turned into a disaster for the Japanese people."

Al Niemi, dean, SMU Cox School of Business

"The Fed is trying to put downward pressure on long-term interest rates. I do not think this will be very effective in the next six months or the next year. Long-term interest rates are already at historic lows. The cost of capital is not what is holding the economy back from a vigorous expansion.

"American households lost $14 trillion in their net worth in this recession because of the drastic fall in home prices and the decline in the value of their 401(k)s. Households are not spending because they are scared and trying to replenish some of their losses. Companies are not hiring because people are not spending.

"In addition, companies do not know what is going to happen to taxes next year, and they are not sure of what the changes in health care will do to the cost of labor.

"Tinkering with long-term rates does not address the real issues that are holding the economy down, so I think quantitative easing is much ado about nothing."

But could it become much ado about something in terms of inflation later on?

"Absolutely – which is why I think we would probably be better off if the Fed did nothing at this time."

Shad Rowe, general partner, Greenbrier Partners Ltd.

"Let's say you had some disease that you were trying to avoid. So you took an extra dose of chemotherapy if you had cancer or extra dose of quinine if you had typhoid. You're creating another risk, but you're insuring that you've dealt with the previous problem.

"QE2 is an insurance policy.

"As my son Adam points out, the one constant theme in American history is that politicians do not deal with future problems. They deal with current problems and leave future problems to future politicians.

"The current problem is there's money everywhere, but no one is doing anything.

"People are like quail sitting in their covey. They aren't moving. Bernanke is trying to shake them out of the covey and fly. And they will. They can't sit there forever getting no return on their money.

"QE2 is like a big troop of hunters and dogs coming through the fields. The covey of quail is going to flush.

"Wall Street is no longer a buy-and-hold kind of place. It's a hedge-fund kind of place.

"If this works, I'll tell you the direction that stocks are going. It's up. People who are short [in the stock market] are not going to like it."

Kyle Bass, chief investment officer, Hayman Advisors LP

"The reason they call it quantitative easing and not printing money is to obfuscate the truth as to what really is happening. The more you call it what it is, the more problematic it becomes.

"We don't want deflation to happen. We'd like to create asset price inflation. We want home values to move up again. And then the debt write-down to the banks will be less. And we'll go on our merry way.

"We're trying to counter-cyclically spend. Push our problems down the road. And never face the fact that we were too leveraged as an economy.

"Unfortunately, the debt of the United States is going to grow north of 90 percent of GDP this year. The interest expense is growing exponentially. We're going to have a much, much greater problem down the road. And unfortunately down the road is not that far away.

"I don't know how many of your problems that you've kicked down the road end up getting better later on, but in my life, it's almost none of them.

"In my household, when I spend twice what I make, I have to dial my spending back. But in this crazy world that we live in, when the U.S. is spending $3.6 trillion a year and we're only bringing in $2.2 [trillion], we decide to spend more and fund it by printing money."

So you think this is dangerous for the dollar?

"Let's assume my partners and I here at Hayman were Nobel Laureate chemists, and we've figured out a way to convert any base metal in the world into gold.

"And we make that press release. What happens to the price of gold the next day? There's got to be some skeptics because we haven't demonstrated that we can actually do it. But gold probably drops $100 to $200 on the announcement.

"Then we start turning lead into gold and tell everyone we've turned 10,000 ounces of lead into gold and say we're going to convert more. Now what happens to the price of gold?

"That's what the Federal Reserve is doing. They're printing money, and a lot of it. So the dollar drops.

"If you had a hundred dollars of currency in the system, and you printed $10, you didn't just devalue the dollar by 10 percent, you devalued it by 18 percent. There is the linear number or quantitative 10 percent. But then there's the qualitative aspect – the market's belief or disbelief in whether the system is working properly.

"When you look at the history of hyper-inflation, it's not the quantitative aspect that tends to tip the scale. It's when people start believing it's a problem.

"You're seeing very educated market participants having a fair amount of resentment toward the Fed for the enormity of its purchasing [of U.S. treasuries]. That's the qualitative slip that you have to worry about.

"You're going to see on the front page of newspapers here in the next 50 to 60 days that reads: 'The Federal Reserve Bank of the United States becomes the largest U.S. Treasury owner, ahead of Japan and China.'

"I don't know how the world is going to take that headline.

Where will we be a year from now?

"That's the proverbial trillion-dollar question."

Michael Cox, director of the William J. O'Neil Center for Global Markets and Freedom, SMU

"The Fed is trying to create some inflation. That's what the economy needs right now.

"Despite the fact that the Fed increased the base money from $825 billion to $2.3 trillion over the past couple of years, the money supply still did not rise. When the banks got that money, they did not loan it out.

"The bank reserve-to-deposit ratio jumped way up from what had been two-thirds of one percent to more than 14 percent. The bank reserve-to-deposit ratio had never been above 4.5 percent in the last 50 years.

"When the Fed 'prints currency,' they use that currency to buy securities typically held by commercial banks and then those commercial banks have more currency, so they have more reserves in their vaults.

"Then banks loan that money to businesses. Businesses take the money and invest in projects. Then they spend the money, and the money comes back into the bank. The money supply grows by multiples of what the Fed's injected.

"But none of that happened over the past two and a half years.

"When the Fed printed all this currency from $825 billion to $2.3 trillion, it did not result in any increase in the money supply. In fact, it fell a little bit.

"We've been flirting with deflation for two years. That's really bad for the economy. This is a carefully engineered yet somewhat desperate attempt to get money supply to rise so that prices will rise.

"It's not that the Fed is trying to get long-term interest rates down. It sells to say, 'We're going into the long-term market and hold down long-term rates.' But the real objective is to create some inflation.

"I think we're looking at 4 to 5 percent. I told the Fed when I left a year and a half ago to create some inflation.

"If the overall price level (as measured by the consumer price index) falls by 5 to 10 percent, prices of real estate will fall 10 to 20 percent.

"When the Fed let prices fall in this recession, they essentially helped drive down real estate price throughout the country. That turned people upside-down on their mortgages, caused bankruptcies and a lot of problems.

"There's a wealth effect on spending: The wealthier people feel, the more they tend to spend. When you reduce their wealth, you reduce their spending. You get a negative wealth effect.

"The Fed has to reverse both of those things that deflation caused. The solution is inflation.

"When interest rates get really, really low like they have recently, you get into a liquidity trap. It's like pushing on a string. You can push the front of a string, but you can't get the back part to move. The Fed can push currency into the economy, but they can't get the overall money supply to rise.

"Banks won't make loans because who wants to loan at such low rates?

"If you know rates are going up, you wait to loan money until they do. You don't want to have money loaned out at 3 or 4 percent interest when you think next year you might get 7 or 8 percent interest.

"This is exactly the right thing to do. The solution is higher interest rates. How you get higher interest rates is inflation.

"Once the Fed pushes enough base currency into the economy, eventually you're going to have inflation.

"It's a slippery slope. Once you get over the hump, you have the potential for a rapid increase in money supply. Then they'll have to pull the money back out of the economy to keep it from becoming rampant inflation.

"The $600 [billion] is a cautionary step. They can always do more later if they need to.

"Don't get me wrong. This is the least painful but not a painless solution. It's going to hurt people, particularly those on fixed-income pensions.

"Two years of 4 [percent] to 5 percent inflation will reduce the value of people's pensions by 10 percent in real terms. So at most, you want this kind of policy for two years to make sure you've done it long enough to be firmly out of this recession.

"Then you want to cut inflation back to the 2 [percent] to 3 percent range.

"Over the 87 years, from 1939 to 2009, we had about 3.8 percent inflation coming from the Fed. If you look historically at what effect that had on the business cycle, the number of business-cycle downturns got cut by more than in half.

"The message is: A little bit of inflation cures a lot of recession. And if we've ever needed a cure, we need it right now."

Norm Bagwell, chairman and chief executive, Bank of Texas

"$600 billion is not as large as the last round of easing – that was $1 trillion. But this may not be the end of this program. There could possibly be a similar move down the road if necessary.

"It looks like the Fed is trying to purposely increase inflation. The Fed is balancing the short-term risk of a double dip vs. the longer-term risk of inflation. They have chosen to risk the latter to prevent the former.

"This action can be viewed as a positive move in the short run.

"In theory, this type of move helps asset values that benefit from inflation (risk assets, commodities, etc.). Rising asset prices can actually have a positive impact on consumer confidence. The consumer is the key ingredient to getting the economy moving again.

"The lower dollar may possibly spark new business activity and exports.

"Inflation up to 1 percent is no big deal. Inflation from 1 percent to 2 percent is probably the warning zone.

"Most people believe the current economy needs some minimal level of inflation. Even with easing, the Fed appears confident that it can keep inflation in check. The Fed will need to be prepared to take aggressive action to prevent inflation from getting out of control.

"A year from now, unmanageable inflation would not have been worth the easing in my opinion."

Cece Smith, retired venture capitalist

"First, what is it? The Fed is going to buy up to $600 billion in government bonds to further reduce interest rates and increase liquidity in the system – in other words, print more money.

"Since interest rates are already essentially at zero, they can't use the usual methods in their tool box, so they are taking this more unorthodox approach.

"They are concerned about deflation and hope that these actions will increase inflation.

"Second, what will it do? While it will undoubtedly reduce interest rates somewhat further, I am not sure that it will have much impact.

"They also run the risk that they cannot calibrate inflation precisely, and it may end up higher than their 2 percent goal, which will cause other problems.

"If all of that will stimulate the economy and get growth going, I think it will only be at the very margin. Mortgage rates or car-loan rates may come down a little more and spur some housing or auto activity.

"Companies that are in a position to issue bonds or refinance debt will be able to do it at a slightly lower rate, which is always good, but many companies have already taken advantage of the current low rates to do that.

"There is no shortage of liquidity right now. When I think about the companies I work with, the Fed's decision to do this is not going to be useful as a planning tool.

"It is not as though you read the headline: 'Fed to do $600 billion of QEII,' and think 'Oh, good, this will be good for our business.' I don't think they will make decisions based upon additional easing. They are not going to add jobs based upon interest rates being lower. They will add jobs based upon increased demand for their products or services.

"The hope is that one leads to the other, but it is very indirect and more long-term. In addition, it continues to hurt savers, which no one ever thinks about."

Hasan Pirkul, dean, UTD School of Management

"However you measure it, $600 billion is a significant amount. It will have both short- and long-term effects, particularly when you consider it as a strong signal from the Federal Reserve that they will fight the 'double dip' with everything they have.

"Short-term effects are more predictable than the long-term effects.

"In the short run, it will help boost the economy that is already starting to show signs of improved recovery.

"Predicting long-run effects is more complicated because it depends on what will the government as well as the Federal Reserve do. If the Federal Reserve removes excess liquidity in a reasonable manner, and if budget deficits can be controlled, we might get away with this move. Otherwise the likely long-term effect is higher inflation."

Bob McTeer, distinguished fellow, National Center for Policy Analysis

"If you watch cable TV, you'll hear people talk about the Fed pushing down interest rates. I don't think that's their main goal. Their main goal is to stimulate the economy.

"They have stated that the inflation rate has gotten too low, and they're worried about deflation. The unemployment rate is too high. They're worried if they get too close to zero, they'll lose control and it will go below zero.

"I really regret them talking about getting the inflation rate up. To me, zero inflation is the ideal target.

"I don't agree with everything they are doing. I wish they had kept their mouth shut. If they needed to pump more reserves into the system, just do it. Don't talk about it. I don't think they should have announced an amount like $600 billion or a timetable like the middle of next year. I sort of understand why they did.

"There are two sides on inflation. Some people have been predicting for the past two years that the Fed is creating inflation. And what has inflation done? It keeps coming down. So that side has a proven record, and it isn't very pretty.

"When people hear about quantitative easing, they say, 'Oh my God! The Fed's printing money!' Well, yeah they are, but that's what they do. It's not that they're doing something so different. It's just a matter of degree.

"They say, 'Oh, my God! The Fed is debasing the currency! The dollar is going to weaken.' Well maybe, maybe not.

"My big gripe is everybody's treating this as a very unusual, draconian thing that's extremely risky, probably won't work and likely to have adverse consequences.

"I think they're overdoing it. There's nothing to fear.

"The difference today is the system is clogged. The reserves are getting into the banks, but the banks aren't able to convert it into money for two reasons. Number one: loan demand by really credit-worthy borrowers is weak. Number two: banks are still trying to protect their capital. They are very reluctant to turn loose of their reserves."

But it still might not shake the money loose, right?