NATIONAL CENTER FOR POLICY ANALYSIS

The Federal Reserve's Third Quantitative Easing: QE3 Sets Sail

Brief Analysis No. 777 by Robert McTeer November 1, 2012

Beginning in late 2007, the Federal Reserve eased monetary policy aggressively to deal with the emerging financial crisis and the recession that grew out of it. By the end of 2008, the federal funds rate — the interest rate targeted by Fed policy — had been reduced to a zero-to-quarter-percent range.

Dallas Headquarters:
12770 Coit Road, Suite 800
Dallas, TX 75251
972.386.6272

www.ncpa.org

Washington Office:
601 Pennsylvania Avenue NW,
Suite 900, South Building
Washington, DC 20004
202.220.3082

In addition, special lending programs and asset purchases during 2008 to thaw frozen credit markets expanded the Fed's balance sheet dramatically. With short-term interest rates about as low as they could go, the Fed continued to purchase Treasuries and other assets, such as commercial paper and mortgage-backed securities, in what came to be known as "quantitative easing" as distinguished from interest-rate easing. This program, later dubbed QE1, or Quantitative Easing number 1, lasted through March 2010.

The economy weakened following the end of QE1; so, on November 3, 2010, the Fed embarked on a program to purchase an additional $600 billion in treasury securities. This program, which lasted through June 2011, was dubbed QE2.

The Fed's lending and asset purchases during its conventional easing in 2008, plus QE1 and QE2, increased its total assets (and liabilities) by about $2 trillion, to about $2.8 trillion, where they have remained since mid-2011.

While its efforts reduced short-term interest rates, in an effort to reduce longer-term interest rates as well the Fed announced a maturity extension program in November 2011, which was promptly dubbed "operation twist." The Fed twisted the interest-rate structure by purchasing longer-term Treasuries and selling an equal amount of shorter-term Treasuries, thus putting downward pressure on long-term rates without increasing its total assets further.

During 2012, the already weak recovery from the recession weakened further. At the same time, inflation remained close to the Fed's new target rate of 2 percent. The Fed has a dual mandate from Congress to strive for both low inflation and low unemployment. It was meeting its low inflation mandate, but unemployment remained stuck above 8 percent, after having fallen from its peak of 10 percent.

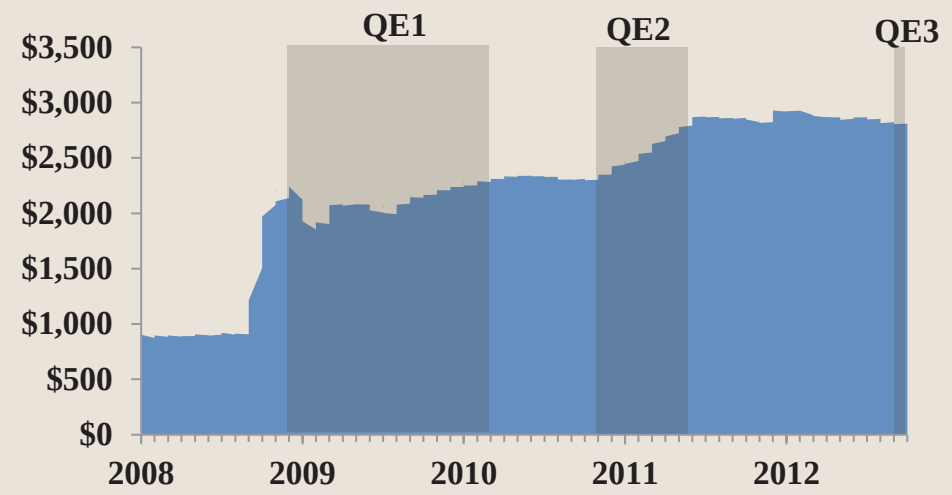
QE3. Because its dual mandate was getting further out of balance—inflation was tame, but unemployment was stuck above 8 percent—the Federal Reserve announced a third round of quantitative easing on September 13, 2012. The Fed said it would buy $40 billion of agency mortgage-backed securities per month until the unemployment rate declined substantially. The goal is to pump more liquidity into the economy in a way that will reduce mortgage interest rates further.

Financial markets reacted positively to the announcement,

and the anticipation of the announcement, but many critics fear that more "money printing" will trigger hyper-inflation and a collapse of the dollar. It may well be that another round of quantitative easing won't do much to stimulate the economy, but those fears are misplaced.

They are misplaced because "money printing" is a false premise. During the Fed's aggressive easing of monetary policy during the financial crisis and during QE1 and QE2, the Fed added about $2 trillion of assets to its balance sheet and an equal amount to its liabilities, mainly the reserve deposits of banks. Normally, such an expansion of bank reserves would trigger additional bank lending and investing until bank deposits—the main part of the public's money supply — grew by a multiple of the increase in reserves. However, given the stresses on banks during and after the financial crisis, they have held onto most of those new reserves as "excess reserves," thus truncating the money-creation process. For the past two years, the M2 measure of the money supply has grown only around 6-7 percent annually.

Thus, instead of creating lots of money as most critics assume, the Fed paid for its asset purchases by creating bank reserves, which the banks effectively "sterilized" by holding onto them. The bad news is that this sterilization meant that the stimulus to the economy was much less than intended. The good news is that money not created—usually called "printed" for effect — is not spent, and money not spent cannot cause inflation and a weakening of the dollar.



Source: Federal Reserve Balance Sheet Trends, 2012. Available at http://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm.

Most measures of inflation are near the Fed's target of two percent and the trade-weighted value of the dollar is about where it was before the financial crisis. The dollar rose substantially early in the crisis because it was considered a "safe haven" in times of international turmoil and has declined more recently. But, the net effect is little change.

Lesson from the Great Depression. Some critics of quantitative easing argue that if it is not having its intended effect of stimulating the economy, then why do it. Why pump more reserves into the banking system if the banks hoard them as excess reserves? The answer to that is if the banks are under such duress that they want to hold extra liquidity and capital for precautionary purposes, then, if the Fed weren't providing it, they would try to generate it themselves through shrinking of other assets, that is, reducing lending and investing. The Fed may not be generating much expansion, but it is preventing contraction.

There is a parallel to what happened during the Great Depression. The banks in the mid-1930s held large amounts of excess reserves as they do today. The Fed thought that reduced its influence on bank behavior; so, on two occasions, it raised bank reserve requirements to "mop up" excess reserves. What the Fed didn't understand was that the "excess" reserves were only excess in a regulatory sense. They weren't excess in the minds of the bankers. The banks responded to the loss of those reserves by contracting and making the depression worse. Chairman Bernanke, a scholar of the Great Depression and familiar with this unfortunate episode, is determined not to make a similar mistake today.

Robert McTeer is a distinguished fellow with the National Center for Policy Analysis.