**Policy Update**

Fed Launches Round Two of ‘Quantitative Easing’

By Renee Courtois Hal tom

What can monetary policy do to stimulate the economy when interest rates are as low as they can effectively go? Typical recession protocol would have the central bank lowering interest rates in an effort to boost investment and consumption, and therefore economic activity and employment. But the Fed’s main policy tool, the federal funds rate, has been at the so-called zero bound since December 2008. For the past two years the Fed has had to rely on alternative tools to ease lending conditions in an effort to stimulate the economy.

For years, the zero bound was only a hypothetical curiosity in the United States, though Japan in the 1990s provided a real-world case study of the zero bound in action. Then, as now, economists centered on “quantitative easing” as a policy option. The phrase has traditionally referred to when the central bank infuses the banking system with excess reserves. Under normal policy conditions, the Fed would carefully tweak the supply of reserves to achieve the target federal funds — the rate at which banks lend those reserves to each other — through the forces of supply and demand. But if the target rate is zero, the Fed can instead flush the banking system with excess reserves in hopes that banks will lend those reserves and, as a result, stimulate the economy.

The first round of quantitative easing started between November 2008 and March 2010 when the Fed purchased $1.75 trillion in agency mortgage-backed securities and longer-term treasuries. The economy remained weak by the end of 2010, however, with very high unemployment. To provide additional stimulus, the Fed announced its second round of purchases after its Nov. 3, 2010, policy meeting. This round has come to be known colloquially as “QE2.”

The Fed plans to purchase another $600 billion — just longer-term treasuries this time — by the middle of 2011, or about $75 billion per month. This is intended to lower longer-term interest rates in the economy through two primary channels. First, the purchases are ostensibly large enough to affect the overall market price for longer-term Treasury bonds, equivalently pushing down their interest rates, as well as rates on assets that are close substitutes. In this way the manner in which QE2 affects the economy — through indirect influence on overall market interest rates — is not largely different from normal monetary policy when the Fed is not facing the zero bound.

Second, QE2 is designed to be a complement to the Fed’s ongoing, stated intention to keep interest rates low for a long time to come. Long-term rates are partially a function of what financial markets expect future short-term rates to be. The Fed has said in its policy statements that it is likely to keep rates unusually low for an “extended period,” and through QE2 the Fed is quite literally putting its money where its mouth is.

As with any policy move, QE2 comes with risks. Perhaps the largest concern raised by critics is that QE2 could be inflationary. The Fed pays for the asset purchases by crediting the seller banks’ accounts with the Fed. If banks decide to lend those funds out, the money supply would increase, which tends to produce inflation, all else equal. But several Fed officials have argued that there’s little reason to expect banks to suddenly lend the new reserves; there are already plenty of excess reserves floating throughout the banking system that banks have thus far declined to lend. This might dampen the probability of increased inflation. Also, the Fed has tools — namely, the ability to pay interest on reserves — to very quickly induce banks to hold on to excess reserves rather than lend them. Given these factors, Chairman Ben Bernanke argued in a recent 60 Minutes appearance that the risks of inaction are far greater than the risk of inflation.

As noted, the magnitude of the effect of QE2 on long-term rates is uncertain. A New York Fed study found that the first round of asset purchases led to “economically meaningful and long-lasting” reductions in various types of long-term interest rates, while economists James Hamilton and Jing (Cynthia) Wu of the University of California-San Diego found a smaller but still negative effect. Explaining the uncertainty, at least partially, is that the first round of purchases took place in the tumultuous aftermath of the financial crisis, making it hard to single out the effects the asset purchases had.

Much of the strain of the financial crisis has since eased, so the effects of this round of easing on long-term rates may ultimately be easier to estimate. The effect on employment will be harder to discern. Would-be employers continue to grapple with a number of complications, not least of which is uncertainty surrounding the future course of the economy and, potentially, other policies both related and unrelated to the weak economy. For that reason, the Fed will keep an eye on the program — and potentially adjust the scale of asset purchases as economic conditions change.