QE2 to end with a yawn, they hope
Stephen Grenville
The Australian Financial Review
30 May 2011
P. 23

Federal Reserve chairman Ben Bernanke has announced that the Fed's $US600 billion second quantitative easing bond purchase program (QE2) will come to an end in June, as scheduled. Will this be a big deal or a big yawn?

The logic of QE2 is straightforward. The normal instrument of monetary policy is the short-term interest rate. Lower rates stimulate the economy, but when the Fed funds rate has been lowered to near-zero, what then? The monetary accelerator is flat to the floor, working powerfully, but with no possibility of stronger action.

The next step, in late 2008, was for the Fed to use its balance sheet to purchase financial assets from the public. Of course it had to pay for these. This gave rise to the erroneous idea that the Fed was "printing money": paying for the assets by issuing cash. Many financial market commentators, remembering their introductory economics lectures, saw this as inflationary. Didn't Milton Friedman say that printing money led directly to inflation?

Monetary policy, however, is no longer conducted through changes in base money, but instead through changes in interest rates. When the Fed purchased assets in the market, the money it paid flowed into the balance sheets of the commercial banks, in the form of bank deposits with the Fed. This extra base money couldn't drive interest rates down any more: they were already at zero. The extra base money didn't encourage banks to lend more: they were already lending to everybody who was creditworthy. In short, the extra base money in the system did pretty well close to nothing.

But the other "leg" of the Fed's 2008 transactions did have a powerful impact. The market for asset-backed securities (ABS) had essentially frozen because it was impossible to tell the good securities from the bad. The Fed's readiness to purchase ABSs served to unfreeze this market.

In 2009, however, the Fed ceased purchasing ABSs and instead began purchasing medium-term government securities. The initial logic was explicit: the Fed wanted to lower longer-term interest rates further out along the yield curve. The objective was to stimulate borrowing, particularly by corporates. QE2 was the second leg of this bond-purchase program, beginning in November 2010 (although it had been announced in August).

The Fed's purchases in the frozen ABS market in 2008 undoubtedly put liquidity back into this market. The government bond market, however, was not frozen. In any case the size of the QE2 transaction represents only 4 per cent of the total stock of government bonds. All it did was soak up the increase in government debt issued over this period.

Did this work? It's certainly hard to see any impact on interest rates. Just as QE1 left interest rates higher rather than lower, the 10-year bond yield is higher now than in either August or November last year.

Of course we don't know the counterfactual. Since the start of QE2, other things have changed (e.g. inflation is rising rather than falling). Without QE2, interest rates might be higher than they are. Pimco chief Bill Gross certainly argues that government bond yields are too low and must go up. But the

fundamental reappraisal that Gross has in mind hasn't occurred yet. When it does, the scale of QE intervention won't be big enough to stand against a fundamental reassessment.

Fed deputy chairman Janet Yellen certainly counts QE2 as a success. She says that QE2 "speeded the creation of 700,000 jobs". This is not quite the same as claiming that QE2 created 700,000 jobs, but it is still an ambitious assertion. Others, including Bernanke, have pointed to other clear positives, particularly markedly stronger equity prices. But no one specified this as one of the channels of operation of QE2 beforehand. Others have taken comfort from the weaker dollar (which will help activity in the traded-goods sector). They have done this quietly, however, partly because a "strong" dollar" is still the official mantra, and partly because the obverse of the weaker dollar - stronger exchange rates in emerging countries - is causing complaints that the US has started a beggar-thy-neighbour "currency war".

If QE2 didn't have much effect, then stopping it won't have much effect either. In any case, for those who believe in efficient markets, if QE2 was going to have a big effect on interest rates in June, then this would already be reflected in today's bond yields.

Where it probably had its greatest effect was in market psychology. QE2 was a strong signal that the Fed was still worried about deflation. It represented an official promise that policy would not be tightened soon. It does seem to have arrested the fear of deflation. As well, forward interest rates confirm that markets remain convinced that the Fed is not about to put interest rates back to normal levels.

In massaging the market's expectations and assuaging their fears, QE2 has been a success. Having shown the market that he cares, Bernanke can afford to cease expanding the Fed's balance sheet (maturing debt will be rolled over, so the balance sheet will not shrink).

But Bernanke still has to tread a fine line between showing that he cares about the still-high unemployment, and not leaving himself open to the charge that he is "printing money" and sowing the seeds of inflation. He is aware that these asset-purchase programs have been right on the edge of the important separation between monetary and fiscal policy, and he would doubtless heave a sigh of relief if he can halt the expansion of the Fed's balance sheet. He will not be looking for much impact when QE2 comes to an end (otherwise he would be planning a gentle tapering-off). All signs point to it being a non-event.

Stephen Grenville is a visiting fellow at the Lowy Institute for International Policy.