

The Federal Reserve's Quantitative Easing: Questions and Answers

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Recently, the Federal Reserve announced plans to resume monetary easing by purchasing \$600 billion in U.S. Treasury bonds by June 2011. Bonds purchases give the sellers additional funds in their banks, which adds to banks' reserves and lending ability. The Fed's goal is to expand money and credit and thereby stimulate the economy.



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Why is it called quantitative easing?

When the Fed announced in October that it would purchase longer term Treasuries in response to stubbornly high unemployment and falling inflation, people referred to the new round of asset purchases as QE2 — quantitative easing number 2 — because the Fed had engaged in an earlier round of asset purchases during the financial crisis. The goal of the earlier purchases was to unfreeze frozen asset markets; the goal of the new easing is to stimulate the economy and reduce unemployment. The term quantitative easing was first used when Japan embarked on a similar policy in the 1990s when their short-term interest rates were near zero, as ours are now.

If short-term interest rates are near zero, how is quantitative easing supposed to help?

The purchase of longer term Treasury bonds (as opposed to short-term Treasury bills) may put downward pressure on longer term interest rates. However, monetary policy is about growth in money and credit as well as interest rates. Money supply growth has been slow for the circumstances of a deep recession and slow recovery, so the Fed hopes to speed it up. It hopes that banks will

use the new funds to lend more to businesses and consumers.

Some critics argue that since banks already have excess reserves and large corporations are flush with cash, even more liquidity won't stimulate the economy but will cause inflation. What's wrong with that argument?

First, new money must be spent to be inflationary. If it is spent, then it should also (or primarily) stimulate the economy. Actual inflation is down to near 1 percent and there is a great deal of slack in the economy — manufacturers and businesses aren't utilizing all of their productive capacity and the unemployment rate is stubbornly high. Under these conditions, the Fed believes it can stimulate growth without much risk of high inflation. It also seems to believe that some inflation may be a good thing. It certainly wants to avoid a deflationary psychology, which would further curb needed spending by businesses and consumers.

Didn't the Fed's balance sheet grow dramatically during the crisis, creating lots of bank reserves? How is that not inflationary?

It hasn't been inflationary so far because, with all the turmoil during the financial crisis and the erosion of bank capital, banks have become very cautious, raising their lending standards (even as loan demand has declined) and holding onto excess reserves. The reserves are excess in the sense that they exceed regulatory requirements, but they aren't necessarily excess in

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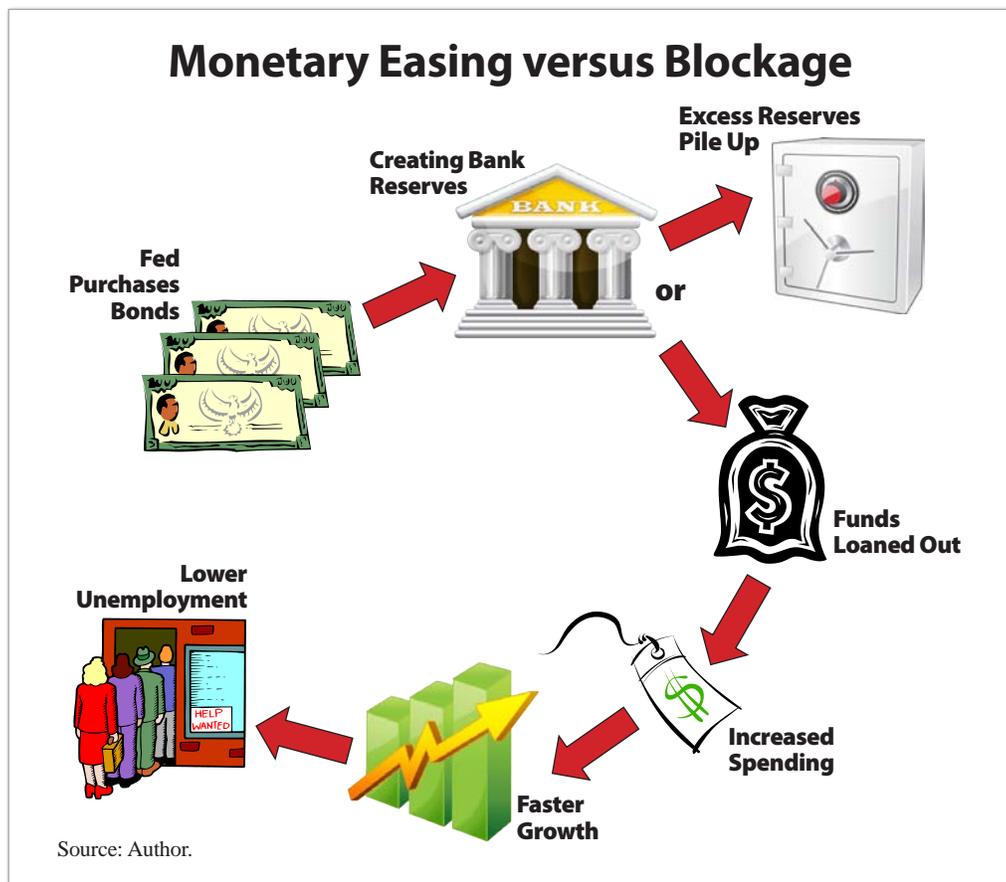
the minds of the bankers under recent circumstances. The same thing happened during the Great Depression and Fed efforts to “mop up” those excess reserves caused banks to lend even less.

But didn't the monetary base virtually explode along with the Fed's balance sheet during the financial crisis? Aren't large increases in the monetary base inflationary?

Normally, rapid money growth is inflationary, but not so far currently. The usual measure of the monetary base is cash outstanding (Federal Reserve Notes) plus bank reserves. So, the explosion of bank reserves discussed above has also made the monetary base grow. However, the monetary base is not money that consumers or businesses can spend. It is the raw material from which spending money is created. That process has been blocked by banks holding excess reserves rather than lending and investing to their maximum ability. The relevant measure of money in this context is not the monetary base, but M1 (demand deposits and currency) or M2 (M1 plus savings accounts.).

If the banks are awash in liquidity, or excess reserves, how is adding even more reserves through a second round of monetary easing going to make any difference?

It is always possible that it won't help much, but economic theory suggests that bank reserves, like most other things, have diminishing marginal utility. Thus, even if bankers get lots of utility or benefit from present holdings of reserves, even more reserves would add less and less to their utility relative to what could be exchanged for those reserves:



namely, more loans and investments. If bankers are thirsty for reserves, surely the solution is more reserves, not less.

Some people say that QE2 will flood the system with dollars and cause the dollar to decline in value in foreign exchange markets. They call it debasing the currency. Do you agree?

Just as new money must be spent on goods and services for it to cause inflation (or growth in output), it must be spent on foreign currencies for it to cause the dollar to depreciate. If the creation of new money is blocked by the logjam of excess bank reserves, QE2 won't help, but it won't hurt either.

If it generates new lending and increased spending, it will stimulate the economy, create more jobs and bring the unemployment rate down.

Whether it weakens the dollar in foreign exchange markets depends largely on the degree to which the new spending is on domestic goods or imports, and the degree to which spending on imports turns quickly into greater foreign demand for our exports.

Could you be wrong about all this?

Of course. The gold market seems to think so. Gold has reached record highs, and gold has traditionally been used to protect against currency debasement.

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