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QE2? Not QED.

Why most economists are not hopeful about "quantitative easing," the Fed's latest idea to help the economy.

By Annie Lowrey

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The U.S. economy's biggest problem, businesses and policymakers agree, is widespread lack of demand. If only people and companies would buy more stuff, the theory goes—a car, an office park, a forklift—then the stores and companies that make and sell that stuff would hire more workers, who would then spend more money, and just like that (or almost) —economic growth.

One way the Federal Reserve has spurred economic growth traditionally has been to lower interest rates, which has a known and a tested impact. If the Fed lowers rates, money becomes cheap and the economy heats up. But the federal funds rate, the Fed's main lever, is now near zero.

So the Fed is turning to a policy known as "quantitative easing." Essentially, the Fed is using its license to print money. (Technically, it doesn't have a license, but it knows someone who does.) On Nov. 3, the markets expect the Fed to announce that it has decided to create somewhere between $500 billion and $1.2 trillion that it will then spend to help goose economic growth. Rather than buying space in office parks or forklifts, though, the Fed—which purchases only government-backed assets, like bonds—will probably pick up long-term Treasury debt. The strategy has been termed "QE2" because it is the second time the Fed has used this arcane monetary policy tool. The Fed makes money *ex nihilo*, pulling it out of thin air rather than taking it from its coffers. Then, it pushes the money into the economy by buying up assets from banks.

The problem is that the strategy is indirect. The Fed cannot just buy up goods and services, so it is trying to convince investors to invest and banks to lend more, creating more economic activity. And a many prominent economists, ranging from the wonks at the libertarian Cato Institute to liberal Nobel-winner Joe Stiglitz, are skeptical. Even Fed Chairman Ben Bernanke sounds uncertain. "Monetary policymaking in an era of low inflation has not proved to be entirely straightforward," he sighed in a speech earlier this month.

QE largely succeeded the first time the Fed used it, Bernanke says. From late 2008 through 2009, the Fed created about $1.7 trillion and used the funds to purchase debt in housing-finance firms like Fannie Mae, Treasury bonds, and a whole lot of mortgage-backed securities—tripling the size of its balance sheet to $2.3 trillion. That helped clean some bad assets from the banks' books and reassured spooked markets. But in 2009, the government was trading cash for mortgage-related assets nobody wanted. In 2010, it wants to try to trade cash for an asset that is essentially as safe as cash. If QE2 is to work, it will have to work differently than QE did—and probably won't work as well.

So how might it work? One hope is that by giving banks cash in exchange for assets, the Federal Reserve will induce banks to lend. With more cash on hand, the banks will be more willing to make loans to homeowners and businesses. But the reason for the banks' current stinginess has little to do with the size of

their reserves—banks are sitting on excess capital, as are the big companies they like to lend to. Banks are not making loans because they don't see anyone or thing worth lending money to. Just because they have $500 billion or even $100 trillion more to lend doesn't mean they will decide to lend it.

Another hope is that by trading non-interest-bearing assets (cash) for interest-bearing assets (bonds), the Federal Reserve will reduce the supply of bonds and make them more expensive, prodding big institutional investors to invest less in government debt and more in the American economy. The problem with this theory is that the bond market is huge—really huge—and international. To have any sort of impact, the Fed would need to buy a lot of bonds. Economists worry it won't buy enough. Paul Krugman, for one, says the Fed would need to buy $8 trillion to $10 trillion to have an effect.

A third hope is that by pushing up the price of bonds, the Fed could improve the balance sheets of some big investors. (Firms like PIMCO, for example, already hold hundreds of billions of dollars in government debt.) That might make them feel wealthier, increasing their appetite for risk. The problem here is that the Fed isn't changing the economic fundamentals. If big investors thought there was money to made in the economy right now, they'd be out there making it—just as if banks thought there were worthy lenders, they'd grant them loans.

There are a few more channels through which QE might work, about all of which economists remain skeptical. For instance, flushing dollars into the economy should increase expected inflation. If businesses and investors believe that inflation will be higher in the future, they have an incentive for more investment now rather than later, when a dollar will be worth less. But inflation is so low, and the economy so big, that impact might not register. It also might raise exports by weakening the dollar—though only if other countries do not counter the currency effect.

Notably, the first round of QE did not work primarily through any of these channels. Indeed, Bernanke himself prefers not to call it QE, instead using the term "credit easing," a "conceptually distinct" policy aimed at easing banks' worries about bad assets and helping to steady the cratering housing market. Bad assets aren't today's problem. Today's problem is a crummy economy that has created excessive demand for safe assets.

And in the face of that crummy economy, QE is one of the few tools the Fed has left. The country's central bankers might hope for more direct ways to goose growth with the mint in their basement—whether buying houses or forklifts or lipstick. But right now, all they can do is try to persuade banks and businesses to look to the rest of the economy for ways to invest.

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*Annie Lowrey reports on economics and business for **Slate**. Previously, she worked as a staff writer for the* Washington Independent *and on the editorial staffs of* Foreign Policy *and* The New Yorker. *Her e-mail is annie.lowrey@slate.com.*

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