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Quantitative Easing and Government Intervention

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This week, the Federal Reserve will meet to consider possible steps to further expand the money supply as a way to combat the recession. Republican Congressional leaders took the unusual step of writing a letter to Bernanke warning him against further action:

It is not clear that the recent round of quantitative easing undertaken by the Federal Reserve has facilitated economic growth or reduced the unemployment rate. To the contrary, there has been significant concern expressed by Federal Reserve Board Members, academics, business leaders, Members of Congress and the public. Although the goal of quantitative easing was, in part, to stabilize the price level against deflationary fears, the Federal Reserve's actions have likely led to more fluctuations and uncertainty in our already weak economy…

Ultimately, the American economy is driven by the confidence of consumers and investors and the innovations of its workers. The American people have reason to be skeptical of the Federal Reserve vastly increasing its role in the economy if measurable outcomes cannot be demonstrated.

For readers who aren't up on central banker lingo, let me briefly review what "quantitative easing" means. Ordinarily, central banks conduct monetary policy as follows. If they want to pump more money into the economy, they buy short-term government bonds, a process that pushes down short-term interest rates. Conversely, if they want to take money out of the economy, they sell short-term bonds, pushing up interest rates. This is usually described as "lowering interest rates" and "raising interest rates," respectively, because the policy is usually described in terms of a target interest rate. But what the Fed actually does is buying and selling treasury bonds with short-term maturity dates.

For technical reasons I don't fully understand, this process, known as "conventional monetary policy," becomes ineffective when interest rates get close to zero. The Fed can keep buying bonds, but the new money doesn't make it into the economy. So “quantitative easing” is a way for the Federal Reserve to continue injecting money into the economy after short-term interest rates have fallen to 0 percent. It works like this: the Fed buys long-term treasury bonds (which currently have a higher interest rate) rather than short-term ones. The reason it’s called “quantitative easing” is because the policy is described not based on the target short-term interest rate (which is already zero) but based on the quantity of money the Fed will spend. In the last round of quantitative easing, the Fed spent $600 billion.

So with that background in mind, what do Congressional Republicans mean when they talk about the Fed “vastly increasing its role in the economy?” It’s really not clear. I think there are legitimate grounds to complain that the Fed’s actions in late 2008, when it bought illiquid “toxic assets” from banks on the verge of bankruptcy, represented an unprecedented intervention of the economy, because it gave the Fed the power to pick winners and losers among private firms. But quantitative easing isn’t like that. If the Fed pursues a new round of quantitative easing, it will be buying a highly liquid commodity at market rates. There’s little danger of market-distorting favoritism in that kind of arms-length transaction. More to the point, it’s hard to see any principled difference between buying long-term bonds and short-term ones.

Perhaps the Republican leaders simply mean that expanding the money supply in itself represents an expansion of the Fed’s role. But this doesn’t make any sense. The Fed always controls the supply of money; its “role” is exactly as large when it is buying treasury bonds as when it is selling them, and whether it’s buying short-term bonds or long-term ones. Maybe it would be better if we had a monetary system in which the supply of money was regulated in some other way. But philosophical arguments about the merits of central banking have nothing to do with the practical question facing Ben Bernanke right now: is monetary policy currently too tight or too loose?