EVEN before the Federal Reserve unveiled its second round of quantitative easing (QE) on November 3rd, critics had already denounced it as ineffectual or an invitation to inflation. It cannot be both and it may not be either.

The announcement of “QE2” was hardly breathtaking. The Fed said it will buy $600 billion of Treasuries between now and next June, at about $75 billion a month, although it also said it could adjust the amount and timing if need be. That was about what markets expected but far less than the $1.75 trillion of debt it bought between early 2009 and early 2010 in its first round of QE. Yet QE2 seems already to have exceeded the low expectations it has aroused. Since Ben Bernanke, chairman of the Fed, hinted at it at Jackson Hole on August 27th, markets have all done exactly what they should (see chart).

Under QE the Fed buys long-term bonds with newly created money. This lowers long-term yields and chases investors into riskier, alternative investments. The real yield on ten-year, inflation-indexed Treasury bonds has fallen from 1.05% to 0.5%, a result of relatively flat nominal yields and a rise in expected inflation. The yield on their five-year cousins is negative (see Buttonwood). Share prices are up by 14% in the same period. Lower yields make the dollar less appealing: it has duly fallen by 5% against the Japanese yen, by 9% against the euro and by 5% on a trade-weighted basis. “You can declare QE to be a success already,” says one hedge-fund economist. “Whether this translates into real activity remains a question-mark. But the question of whether the mechanism would work has been answered.”

With a bit of a lag, these easier financial conditions are supposed to boost growth through three
channels. First, lower real yields spur borrowing and investment. This channel is bunged up: many households cannot borrow because their homes have fallen in value and because banks are less willing to lend. But the remaining two channels remain open. Higher share prices have raised household wealth by some $1.4 trillion, which will spur some spending. And the lower dollar should help trade. American factory purchasing managers reported a sharp jump in export orders in October and a drop in imports.

Macroeconomic Advisers, a consulting firm, reckons that the Fed will eventually buy $1.5 trillion of debt under QE2, and that this will raise growth next year to 3.6% from 3.3% without QE. That’s not exactly overwhelming: the firm thinks the Fed would have to buy $5.25 trillion of bonds to achieve the equivalent of a –4% federal-funds rate, which is what the economy needs. The Fed will not do that for fear of unknown consequences, among them the response of Congress’s newly empowered Republicans. In a Bloomberg poll, 60% of self-identified tea-party supporters favoured overhauling or abolishing the Fed.

Could QE work too well and drive inflation expectations to dangerous levels? “The odds aren’t zero,” says Don Kohn, a former Fed vice-chairman, but they’re small. There’s more risk that expectations could rise once credit loosens up and spending accelerates. That, however, would be a signal that the Fed has succeeded; it can then tighten policy.

Other countries complain that QE is merely bringing them overvalued currencies and bubbly asset markets by pushing investors to seek higher returns elsewhere. But that may be unavoidable given their divergent growth paths. Both India and Australia raised interest rates this week despite rising currencies.

A damaging round of beggar-thy-neighbour currency interventions cannot be ruled out. But the Bank of Japan, after intervening directly to weaken the yen in September, has struck upon a more benign response. It had been scheduled to release details of its own QE at a regular policy meeting in mid-November but moved the date forward to this week. Analysts suspect this was to counteract upward pressure on the yen because of the Fed’s move. If central banks all print money in unison, and don’t mop up excess liquidity, then the result could be a worldwide monetary fillip. QE’s benefits should not be over-egged. Nor should they be dismissed.

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