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QE3: What is quantitative easing? And will it help the economy?

By Brad Plumer , Updated: September 13, 2012

On Thursday, the Federal Reserve released a statement announcing a third round of "quantitative easing," or QE3, to stimulate the economy. So let's do a quick run through of what that means. (*Note:* I've updated this post at the bottom to discuss the Fed's actions today.)

What is quantitative easing?

Short answer: It's an unconventional monetary tool used by central banks to stimulate the economy.

Answer that might make sense: Normally, when there's a recession or the economy is limping along, the Federal Reserve will reduce short-term interest rates in order to spur more lending and spending. But right now, the Fed has cut interest rates as far as they can go and the economy is still struggling. This is known as the "zero bound." The Fed can't go any lower.

So, instead, the central bank can try quantitative easing. Since the Federal Reserve can just create dollars out of thin air, it can buy up assets like long-term Treasuries or mortgage-backed securities from commercial banks and other institutions. This pumps money into the U.S. economy and reduces long-term interest rates further. When long-term interest rates go down, investors have more incentive to spend their money now. In theory.

Hasn't the Fed already tried quantitative easing?

Yes. Twice in fact. In late November 2008, after the financial crisis hit, the Fed started buying up mortgage-backed securities and Treasury bills in order to boost the economy. By June of 2010, the bank had bought about $2.1 trillion worth of assets.

At this point, the Fed halted its actions, figuring that it had done enough. But when the economy started weakening that summer, Bernanke resumed the program in August 2010, buying up Treasury bonds in order to maintain the Fed's balance sheet. (Remember, the bank is holding a bunch of debt that slowly matures, so if the Fed does nothing, all that money it had injected into the economy will eventually get sucked back out again.) This was known as "QE2."

Did QE1 and QE2 actually boost the U.S. economy?

Academics have been churning out plenty of research on this question. The first round of quantitative easing appeared to be effective in preventing the economy from sinking into a giant depression. Economists say this was because everyone realized the Fed would do whatever it takes to avoid deflation. It was essentially a giant confidence boost. The economy stopped sliding and inflation slowly rose. But the effects seemed to dwindle as the years went by. Experts are much more divided on how much QE2 has helped.

In theory, quantitative easing should work in two ways. First, it injects more cash into banks, allowing them to lend more. And second, it lowers interest rates — if the Fed buys up a bunch of mortgage-backed securities, for example, that should make it cheaper to borrow money to buy a house. In practice, interest rates do drop. But it's hard to figure out whether this translates into a boost in the actual economy. After all, low mortgage rates can only do so much if banks are scarred by the housing bubble and remain tightfisted about lending.

So what will QE3 look like?

There are a whole slew of options for the Fed, many of which Cardiff Garcia lists here. The central bank could try to buy up even more mortgage-backed securities in another round of QE3. It could promise to keep short-term interest rates low for an even longer period of time, until 2015. Both of those would be considered big steps.

Let's say that Bernanke goes big today. Would QE3 help the economy?

That's… less clear. In his testimony to Congress in June, Bernanke explained why QE3 might bolster the economy. It would reduce the cost of borrowing money for corporations, bring down mortgage rates even further and potentially boost the stock market, increasing wealth effects for consumers to spur more spending. (He did say, however, that he'd much prefer to have additional help from Congress.)

Not everyone's convinced, though. In early September, Michael Woodford, a preeminent monetary theorist at Columbia University, released a long paper arguing that more quantitative easing was likely to be ineffective — because Bernanke is acting too sporadically. The Fed will buy up $600 billion worth of assets, hoping for a jolt, but people in the economy have no clear sense of what Bernanke's goals actually are. Does he want a certain level of inflation? Will he start hiking interest rates if the economy starts growing? If so, when? That level of uncertainty can be paralyzing.

Is there a way to make QE3 work better?

One possibility, as Robin Harding discusses here, is that the Fed could engage in open-ended asset purchases. Instead of saying "we're going to buy up $600 billion in assets and hope that works," the Fed could say something like, "we're going to *keep* buying up assets, and we're not going to stop until either inflation hits 3 percent or unemployment sinks below 7 percent." The idea is that this would shift expectations and bolster confidence about the future course of the economy — much as Bernanke did back in the dark days of 2008 — and economic growth would leap as a result.

***UPDATE*: QE3 has been announced! So what does this mean?**

Well, the Federal Reserve has now released its statement and the central bank actually did two things to try and improve QE3. First, the Fed will keep short-term interest rates low until mid-2015. Second, the central bank will buy up $85 billion worth of assets each month between now and the end of the year. But, unlike QE1 or QE2, this new round of purchases will be more open-ended. That's an important change. Here's the key bit from the Fed statement:

If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved

The purchases will continue until morale improves. What's more, the Fed noted that it will

continue its policy of easy money "for a considerable time after the economic recovery strengthens."

In essence, Ben Bernanke is now taking Michael Woodford's advice—or at least part of it. (Note that the Fed didn't set an explicit target for the economy, it left that vague.) The Fed's not just buying up a fixed quantity of assets and hoping that the economy lurches forward. It's saying that it will keep buying up assets and won't stop until things look better. Now we'll see if that actually shifts expectations and bolsters growth.

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