



Hope over Experience: the Fed's QEII Experiment

Samuel Johnson's quip that "a second marriage is the triumph of hope over experience," is the appropriate context for judging the FOMC's policy announcement today. There is a great deal of hope in Washington (and NY) that this expansion of the Fed's balance sheet will "work." There is considerably less empirical evidence to support that hope. Today, hope trumped experience.

Many economists are dubious that the launch of QEII will have propitious consequences. Extreme doubters feel that QE will have little or no effects, but the increase in the size of the Fed's balance sheet could be very troublesome for a future Fed exit or in terms of possible inflationary consequences...or possibly both! Certainly, there are reasonable doubts concerning the connection between increased reserves and a stimulus to real economic activity. That said, Mr. Market's initial reaction of caution was overcome by hope at the close. The S&P rose some .37% to lead the broad averages. While this is not a definitive evaluation, if investors wish to contest the Fed's expansion, they will have to climb nearly a trillion dollars of QEII to be spent over the next six months. One has to think at some point the Genie gets out of the Bottle!

The FOMC voted (with one dissenter)¹ to increase its balance sheet by some \$600 Billion dollars and to spend an additional \$250-300 Billion from anticipated repayment and interest earnings from the runoff of prior Fed private security purchases on a broad distribution of Treasury issues. The expansion is to take place over the next six months (a total of some \$110 Billion per month). The NY Fed provided the expected distribution below.

Nominal Coupon Securities by Maturity Range							TIPS
1 1/2-2 1/2 years	2 1/2-4 Years	4 1/2-5 Years	5 1/2 - 7 Years	7-10 Years	10-17 Years	17-30 Years	1 1/2 - 30 Years

How successful is the Fed likely to be? That depends upon what we specify as success parameters. If it is the unemployment rate, the Fed must somehow convey to the market what tradeoffs it thinks exist and what it is prepared to accept in terms of inflation or inflationary expectations. The unemployment rate is a "real" variable and the Fed only controls nominal variables. The Fed is constrained by the so-called "zero lower bound" so it must postulate some connection between interest rate levels and the types of reserves it holds and the behavior of the unemployment rate. At best this is a leap of faith (hope?). Possibly, the Fed has some predictive model for connecting reserve changes to observed inflation and imputed inflationary expectations, but we are dubious that any such model is likely to give a robust forecast.

Beside a triumph of hope over experience, we also have the triumph of Authority over Rules, no matter how 'transparent' the purchase program may be. Suppose no observed change occurs in the unemployment rate occurs over the next six months? Where does the Fed go from here? Or, to take the bright side, suppose the unemployment rate does begin to decline? Is that because of QEII or in spite of it and at what point does the Fed say "enough?" Hope now and revelation later?

The New York Fed gave the market a dose of transparency by publishing (at the same time as the FOMC

¹ Hoenig of the Kansas City Fed continued with his dissent.



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announcement) its intended distribution of purchases and the mechanism (auctions through the primary dealers) for purchasing various Treasury issues. The largest quantity of the intended purchases are to be in the 1-1/2 to 10 year range (some 91%) with the largest concentration from 2 ½ to 10 years. Presumably, the Fed wishes to bring the middle of the curve down to assist business and mortgage lending. The NY Fed “anticipates that the assets purchased will have an average duration of between 5 and 6 years.” To accomplish its goals, the NY FED is relaxing its 35 percent per issue limit on its own holdings. The market will see the results of the auctions as well as an intended schedule of purchases to take place through the middle of the next month. Results of the operations will be published on the NY FED website.

The critics of quantitative easing are very uncomfortable with a Fed that asserts that this new program of QE can be halted in sufficient time to avoid an excess of inflation. We have not been here before so macroeconomic forecasting models are almost surely going to give us erroneous predictions. Surely there will be some change in the expectations of economic agents as a result of this severe measure, but going down the road spelled out by the Fed today is very much “wing and a prayer” economic policy making.

Chairman Bernanke has long touted the virtues of inflation targeting. What is remarkable with this policy announcement is the absence of any declared or precise inflation target. Is it a price level target or will it be a rate of change of the price level that is targeted? Unfortunately, nearly all monetary economists would agree that there will be some lag between Fed action and observed changes in the market, but no one is in position to know definitively what that lag might be.

The FOMC statement today attempts to connect its actions with a monitoring process in fulfilling its dual mandate. The Committee professes to be willing to “provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate.” That provides considerable leeway for the Fed to do as it sees fit, and such a wide exercise of authority must sooner or later discomfort some economic agents. We can only hope that this ‘second marriage’ works.