Quantitative Easing 2
Defined

- The purchase of $600 Billion in US Treasury bonds by the Federal Reserve.
- Goal: Introduce inflationary pressure on the economy.
1. Fed funds rate falls from 3% to 0-0.25%
2. First round of quantitative easing ($1.7 trillion in mortgage-backed securities, government agency debt, and Treasury bonds)
3. Second round of quantitative easing ($600 billion in Treasury bonds)
Why?

- Weak economy: consumer spending falls throughout 2008, so does growth (GDP)
- Fear of replicating Japan’s economic performance throughout the 90’s.
- Keynesian economic theory states that such action (money injection) will indeed create inflation.
- History has shown that injecting money into the economy is the most effective way of creating inflation.
• Throughout history, short-term interest rates have been lowered to induce (minimal) inflation.
• However, these rates were already near zero, but the economy continued to stagnate.
• Solution: lower long-term interest rates. This induces (expected) inflation by increasing consumer confidence.
• Lower rates stimulate consumers to take out mortgages or other bank loans by lowering their repayment on the loan. Consumption of overall goods thus increases.
How the Fed Open Market Committee Works

• The Federal Reserve has a “dual mandate” imposed by Congress: “The Congress established two key objectives for monetary policy--maximum employment and stable prices--in the Federal Reserve Act.” (Source: federalreserve.gov FAQs)

• Federal Reserve Chair proposes a monetary policy to the rest of the board: William Dudley, James Bullard, Elizabeth Duke, Sandra Pianalto, Sarah Raskin, Eric Rosengren, Daniel Tarullo, Kevin Warsh, Janet Yellen, and Thomas Hoenig.
How the Fed Open Market Committee Works (cont’d.)

• Process is much like the proposal of a law in the Supreme Court.

• There is discussion of the proposed policy among the board members.

• The policy goes up for a vote; dissenting members formally express their objections.
Passing of QE2

• Bernanke proposes the purchase of $600 billion in Treasury bonds.
• All in favor, except Thomas Hoenig.
• Hoenig’s dissent: the induced inflation would spiral out of control, causing more harm than good.
Bottom line

• Why did QE2 occur?
• The Federal Reserve wished to prevent prolonged deflation (in order to prevent a Japan-in-the-90s style deflation).
• Standard monetary policies were exhausted.
• Drastic measures had to be taken.
• More abstractly: Keynesian economic theory pervaded through the entire decision process.