"Explained: Quantitative Easing"
Peter Dizikes (2010)

An unconventional financial tool is getting more attention as the Fed tries to jump-start the U.S. economy

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Central banks, such as the Federal Reserve in the United States, wield considerable economic clout by setting crucial short-term interest rates, which influence the cost of business loans, among other things. Lower rates tend to spur lending, spending and economic expansion, while higher rates limit lending, thus curbing growth and inflation.

Currently the economy — worldwide and in the United States — is showing sputtering growth. However, the Fed's short-term interest rates are already near zero, making significant further cuts unrealistic. Given these circumstances, central banks, including the Fed, can try to spur growth through another financial tool, which is increasingly the subject of public discussion: quantitative easing.

At its core, quantitative easing is the attempt by a central bank to inject more money into the economy and to keep long-term interest rates low through the purchase of large amounts of assets, often held by financial institutions. In March 2009, for instance, the Bank of England, the U.K.'s central bank, engaged in quantitative easing by buying U.K. government bonds as well as debt issued by private companies. The means those firms now have more cash on their hands, which in theory makes business lending easier.

Quantitative easing may also lower the rates on five- or 10-year bonds. The Federal Reserve undertook a large quantitative easing measure by buying about $1 trillion in long-term Treasury bonds in March 2009. Taking bonds out of circulation might raise demand for the bonds left in the market, hence raising their prices and lowering their yields (bond prices and yields move in opposite directions) because the bond issuers do not have to promise higher yields in order to entice buyers. These lower rates should make further business investment more likely.

Alternately, economists note, long-term bond rates may stay low not because of the way quantitative easing affects the supply and demand of bonds, but because the central bank uses easing to send a clear policy message.

"It is not clear whether the size of a Fed intervention is large enough to affect these rates materially," explains Ricardo Caballero, the Ford International Professor of Economics, Macroeconomics, and International Finance at MIT, and head of MIT's Department of Economics. "If it does affect rates, it is probably not

just the consequence of the direct, ‘quantitative’ intervention, but also of the signaling that the Fed will do whatever it takes to keep rates low until the economy is out of the woods.”

On the downside, quantitative easing should in theory create inflationary pressures (since central banks are in effect making new money to buy assets). But inflation has remained low, and indeed dropped, since the March 2009 quantitative easing efforts in the United States and Britain.

“I don’t think there is any major risk involved in quantitative easing,” notes Caballero. “It may be ineffective, perhaps, but not harmful.”