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Quantitative Easing: Uncharted Waters for Monetary Policy

For the past year, the Federal Open Market Committee has maintained its target for the federal funds rate at a level only fractionally greater than zero. During the same year, it moved monetary policy into the uncharted waters of “quantitative easing.” Although definitions differ, quantitative easing most often is defined as a policy strategy of seeking to reduce long-term interest rates by buying large quantities of financial assets when the overnight rate is zero.

At the end of 2008, some analysts argued that the FOMC was “out of ammunition” when overnight interest rates reached zero because nominal interest rates, ordinarily, do not go below zero. (There were some exceptions during the Great Depression, and negative nominal rates occasionally are observed in financial markets when penalties are included.) This assertion, however, ignores one important fact: The Fed can continue to purchase assets so long as the public is willing to accept deposits at the Federal Reserve banks in payment. Central banks that engage in quantitative easing purchase only high-quality assets with suitable collateral margins; doing otherwise would be to dabble in fiscal rather than monetary policy. Economic theory suggests, however, that central banks need to purchase very large amounts of such assets (relative to the size of the economy) if quantitative easing policies are to affect economic activity.

From the beginning of 2009 until early December, the Federal Reserve under the auspices of its Large Scale Asset Purchase program had bought approximately \$300 billion in Treasury securities, \$150 billion in debt securities of Fannie Mae and Freddie Mac, and \$1.1 trillion of fixed-rate mortgage-backed securities (MBS) guaranteed by Ginnie Mae, Fannie Mae and Freddie Mac. Additional purchases of agency debt and MBS are in-process. When completed, the Federal Reserve’s total assets will likely reach

\$2.6 trillion, and the Federal Reserve will own between one-fifth and one-fourth of the total outstanding amounts of Treasury and agency-guaranteed MBS. The monetary base perhaps will reach \$2.4 trillion, of which \$1.5 trillion will be deposits of depository institutions at the Federal Reserve. Two years ago, in December 2007, the monetary base was approximately \$830 billion, with only \$10 to \$15 billion held by banks as deposits at the Fed.

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The United States is not the only country that has pursued such massive expansionary policy during 2009. The Bank of England, for comparison, initiated quantitative easing in March 2009 and has purchased more than £175 billion in British Treasuries; it also holds more than one-quarter of all such securities outstanding. Although used infrequently, central banks worldwide during the past two decades have used major increases and decreases in their balance sheets as a policy instrument in a variety of circumstances.

A forthcoming article by Richard Anderson and others in our Research division compares the experience of a number of countries, including the United States, the U.K., Sweden, Switzerland, Japan and Australia.¹ Their



study suggests two lessons for policymakers that contribute to the success of such policies. First, communication matters: It is important that the public be told why the increases are occurring and be assured that the increases are temporary, not permanent. Second, it is essential that the increases are reversed as soon as possible after the conditions that caused the adoption of a quantitative easing policy fade. Doing both appears to forestall increases in expected inflation that might otherwise cause increases in actual inflation, derailing the anticipated expansionary impact of the asset purchases.

Although final determination of the effects of quantitative easing awaits further research, it is likely that quantitative easing did assist economic recovery during 2009. Economists have yet to develop macroeconomic models with financial sectors adequately detailed to explore the channels through which quantitative easing boosts economic activity. But quantitative easing has a risk—if offsetting policy actions are not taken in a timely fashion, the increased monetary base will fuel an undesirably large acceleration of credit and, in turn, undesirably large increases in inflation. An important part of the mechanism must be stability of inflation expectations. Credible commitment to maintaining low future inflation provides a central-bank policymaker with the flexibility to double or triple the central bank’s balance sheet while not unhinging inflation expectations. [Q](#)

ENDNOTES

¹ Anderson, Richard; Gascon, Charles; and Liu, Yang. “Doubling Your Monetary Base and Surviving: Some International Evidence.” Forthcoming, Federal Reserve Bank of St. Louis *Review*.