Fed Charts a Course for “QE2”

By Editor Test *Tue, Sep 28, 2010*

If the economy needs a second dose of quantitative easing, the Fed might try an alternative to the "shock and awe" approach of 2009-10.

Federal Reserve officials are considering new tactics for the purchase of long-term U.S. Treasury securities. Rather than announce massive bond purchases with a finite end, as in 2009, they are weighing a more open-ended, smaller-scale program, the *Wall Street Journal* reported yesterday.

The Fed hasn’t yet committed to stepping up its bond purchases. After its meeting last week, the Fed’s policy committee said it was “prepared” to take new steps if needed. A move to resume the purchases would be a big step for the Fed, which just a few months ago was talking about how to reduce its portfolio.

A decision on whether to buy more bonds depends on incoming data about economic growth and inflation; if the economy picks up steam, officials might decide no action is needed.

From March 2009 to March 2010, the Fed bought $1.7 trillion worth of Treasury and mortgage-backed securities. Researchers at the New York Fed estimate that the program reduced long-term interest rates by between 0.3 percentage point and 1 full percentage point.

Under the alternative approach gaining favor inside the Fed, it would announce purchases of a much smaller amount for some brief period and leave open the question of whether it would do more, a decision that would turn on how the economy is doing. This would give officials more flexibility in the face of an uncertain recovery.

Economists at Goldman Sachs estimate the Fed will purchase at least another $1 trillion in securities, pushing long-term interest rates down by a further 0.25 percentage point.

The Goldman economists estimate that an open-ended, small-scale approach would have less impact on bond markets than a large one-time approach, because investors wouldn’t be certain about whether such a program would continue.

“The more you commit to large amount of purchases up front, the bigger effect you’re going to get,” says Jan Hatzius, Goldman’s chief economist.

A leading public proponent of a baby-step approach is James Bullard, a 20-year Fed veteran who has been president of the St. Louis Federal Reserve Bank since 2008.

Under a small-scale approach, Mr. Bullard says, the Fed might announce some still-undecided target for bond buying—say $100 billion or less per month. It would then decide at each meeting whether more purchases were needed, based on whether “we’re making progress toward our mandate of maximum sustainable employment and inflation at our implicit inflation target.”

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