Are the Markets Defying QE2?

Joseph E. Gagnon says that rising interest rates are not evidence of the failure of the quantitative easing program (QE2) but are caused by the new tax package and other economic developments that are boosting prospects for growth.

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Steve Weisman: With medium- and long-term interest rates heading up somewhat, there have been a lot of different interpretations about what that means. Do they justify criticism of the Fed for its quantitative easing policies? Or are they a harbinger of growth? Joseph Gagnon, senior fellow at the Peterson Institute for International Economics, is here to discuss the issue. This is Steve Weisman.

Joseph Gagnon: Steve, good to be here.

Steve Weisman: What is happening with rates? Let's start there.

Joseph Gagnon: Interest rates, especially longer-term interest rates, have gone up a lot in the past two to three weeks. It seems to be mainly a response partly to good economic news, better than expected, but mostly to this budget agreement and tax deal that President Obama reached with the Republicans, which is actually significant.

Steve Weisman: That agreement is going to add to the projections of economic growth next year, according to some analysts. Do you agree?

Joseph Gagnon: Yes, most analysts think it will raise US economic growth next year by half to a full percentage point, and perhaps some more in the following year too. And so it's quite noticeable.

Steve Weisman: Some commentary suggests that the markets have rebuked the Fed for its policy of quantitative easing, its program to purchase medium- and long-term securities in order to bring interest rates down. If rates are going up, it must mean the markets are somehow defying Ben Bernanke.

Joseph Gagnon: I think that's silly. The Fed has never promised to target any particular interest rate. It's not committed to holding interest rates at any particular level, except for the short rate, which they do hold at essentially zero. What they said was they were going to buy long-term bonds. Of course, based on supply and demand, when you increase the demand for something, its price goes up.

Steve Weisman: But they didn't want the price to go up. They wanted rates to go down.

Joseph Gagnon: Interestingly in the bond world, the interest rate is the inverse of the price. If you want the price of the bond to go up, [what] that means is you want the interest rate on the bond to go down.

Yes, the Fed wanted interest rates to go down by buying bonds, raising their price. That would lower the interest rate. And that did happen.

Steve Weisman: When did it happen?

Joseph Gagnon: The key thing is that you have to look at what markets did when they first began to believe the Federal Reserve would do this. And interestingly enough, I just did some research on what the journalists were writing about the markets in the past few months and it seems that markets began to believe the Fed would do quantitative easing back at July 30 or the first week of August. President [James] Bullard of the St. Louis Fed gave a speech on July 30 in which he said the Fed might do more quantitative easing. That seemed to catch the markets by surprise. Then there were news reports the next week about this being a possibility at the upcoming Federal Open Market Committee meeting.

Vincent Reinhart, who used to be Secretary of the Federal Open Market Committee and Head of the Monetary Affairs Division at the Fed, made a public statement saying the Fed should do this. At the very end of July or beginning of August, there was a sharp drop in long-term bond yields. I think that was the beginning of the effect of QE [quantitative easing], even though the Fed didn't announce it officially until November 3. Fed people started speaking more about it, the chairman gave a speech at the end of August, and then further at the end of October. It fluctuated and grew over time, but the major news that the market was concerned about was actually the very beginning of August.

Steve Weisman: Quantitative easing has only begun. Are they going to go through the whole $600 billion in purchases that were authorized?

Joseph Gagnon: I think they're going to go through the whole $600 billion. Just before President Obama reached this deal with Republicans, Ben Bernanke and Janet Yellen, the vice [chairwoman] of the Federal Reserve, both came out about as explicitly as I've ever seen and asked for fiscal stimulus. Then they got it in this deal with the Republicans two weeks ago. So they wanted that. Even with their $600 billion in quantitative easing, the Fed actually was not comfortable with the forecast for the economy and the economic outlook.

Steve Weisman: What do you mean?

Joseph Gagnon: Their forecast for economic growth, even with their $600 billion of quantitative easing, was too low for their comfort, too low for their objectives. You might say, "Why didn't they do more quantitative easing?"

Steve Weisman: Their objectives being in favor of growth, as well as curbing inflation.

Joseph Gagnon: Right, in favor of keeping the US economy on an even keel. So they welcome this fiscal stimulus. They're happy about the rise in interest rates because that came along because of it. And it doesn't mean they're not going to do their quantitative easing. The fact is the US economy is still weak and going to be weak for a long time, even with all this good news.

Steve Weisman: And without quantitative easing, the interest rates might be even higher?

Joseph Gagnon: Oh, absolutely. Clearly interest rates are very low right now, and the important thing to note about the quantitative easing is even with all the good news we've had lately—even

with this fairly large fiscal stimulus—the real long-term interest rate on index bonds, which is really what matters for the economy, is unchanged since late July. That can only be explained by quantitative easing. The fact that—despite all this good news about the economy, despite a big fiscal stimulus—real long-term interest rates have not gone up: that is the effect of quantitative easing.

Steve Weisman: Just remind me what we mean by real interest rates, as opposed to nominal.

Joseph Gagnon: Real interest rates mean the nominal interest rate minus the expected rate of inflation. We actually have a very good measure of that because the Treasury issues index bonds, which are bonds that guarantee you a real rate of return because they give you a real rate of return plus whatever inflation turns out to be. So that you don't have to worry about what inflation is, because you'll get your real rate of return on top of that. And that real rate fell when expectations of quantitative easing started to rise, when people began to expect quantitative easing. It has come back with all the news of fiscal stimulus, which is what you'd expect. But interestingly, even with the new fiscal stimulus announcement, that real rate is only back to where it was before quantitative easing. In other words, the two effects have roughly cancelled out. Quantitative easing has pushed real rates down, and the fiscal stimulus has pushed real rates up, and they've roughly cancelled out. What quantitative easing has done is raise expectations of inflation a little bit, but they were too low earlier. The Fed was not happy with how low inflation was before this happened, and now inflation implications have come back up to where the Fed wants them.

Steve Weisman: Which is the range of what?

Joseph Gagnon: It depends, but for a 10-year bond, the inflation compensation is now 2.3 percent. That is, the difference between a nominal 10-year bond and an index 10-year bond is 2.3 percentage points. The Fed has a target of inflation of about 2 percent. Normally there's a little bit of extra compensation in there because of the inflation risk, which we don't need to get into. But typically these are around 2.5 percent, and that's where they are back to. So that's good.

Steve Weisman: The size of the stimulus package is roughly $800 billion over two years? But some of that is just extending existing policies. What would be your estimate of the actual portion that's going to stimulate the economy?

Joseph Gagnon: You see all kinds of numbers. It depends on what you're comparing it to. Most people expected that most of the Bush tax cuts would be extended. If that's your baseline, then the additional stimulus in this is less, but it still looks to be about $300 billion over two years. That's about 2 percent of GDP or 1 percent per year, which is pretty big. It's not real large, but it's probably moderate.

Steve Weisman: Let me ask you, in closing, a political question about the independence of the Fed and the role of the Fed. This has been a very unusual period. You've had almost unprecedented criticism of the Fed from unusual quarters on Capitol Hill. The incoming chairman of the House Committee [Ron Paul] has written a book saying the Fed should be abolished. You were at the Fed for a long time. Do you worry about the Fed maintaining its independence?

Joseph Gagnon: I don't worry about it in the next two years because I think President Obama and the Democrats in the Senate are not likely to allow any serious attack on the Fed. Of course, that could change over time. In the long term it may be a risk. I think in the next two years it's not really a risk. What is true is that, as you say, the new chairman of the House Committee is a longtime opponent of the Fed. He could make life uncomfortable for people at the Fed by calling up to testify frequently and making lots of requests and subpoenas and stuff. So I think the Fed is concerned about it, but I think in terms of actually changing the laws like governing the Fed, actually micromanaging Fed policy and actions, I don't see that as a realistic possibility in the next two years. But who can see beyond that, I don't know.

Steve Weisman: There was a suggestion in one of the articles I read that somehow the Fed was wary of being criticized and may have reduced the size of the quantitative easing they were planning. Do you see any evidence of that?

Joseph Gagnon: No. As I said before all this came out, they might have chosen a larger number if they had really felt no constraint. They might have chosen more than $600 billion. I think they probably would have wanted to. There were a number of reasons why maybe they didn't choose a large number. That left them in a position where they felt the economy was not going to grow fast enough for their objectives. Even with all the good news and even with the stimulus policy, they were in a position where they would have liked to have done more. There's no sense in which they would want to do less. They're just less uncomfortable right now with the slow growth prospects of the economy than they were, because now they think it will be better. But I think they still think the economy is going to be weaker than they would like. And the fact is unemployment has not budged in a whole year. That's incredibly bad news for this economy, and in a historical perspective very unusual.

Steve Weisman: And with growth experiencing an uptick of maybe 1 percent with this stimulus program, do you think that will make a dent on the unemployment?

Joseph Gagnon: Yes, I think it will. And I think it makes them happier about where they are. But by no means are they close to wanting to do less, to scaling back QE—no, that I don't see.

Steve Weisman: Joe, thank you very much.

Joseph Gagnon: Okay.