Will Quantitative Easing (QE3) Do the Trick? Part I

Joseph E. Gagnon explains how the latest Federal Reserve action, more robust than many anticipated, is intended to work to boost the housing market.

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Steve Weisman: The Federal Reserve and the Federal Open Markets Committee (FOMC) have spoken. QE3, Quantitative Easing, the third phase, has been announced. Joseph Gagnon of the Peterson Institution for International Economics, who has advocated this very step for some time, is here to explain the consequences and the mechanics. This is Steve Weisman.

Joe, first, what has been announced?

Joe Gagnon: The Federal Reserve announced several things yesterday [Sept. 13] and most people expect that they would do some additional actions, but I think it's fair to say that the number of different actions and the nature of them was more than people expected.

Steve Weisman: More than you expected.

Joe Gagnon: And more than I expected. I was expecting them to do something. The quantitative easing part was pretty much what I expected. They're going to buy $40 billion a month mortgage back securities, I actually thought it could be a little more than that, so to me, it was a slight disappointment, but the market seemed to think that was good.

They're trying to push mortgage rates down for homeowners. By itself, I think this will do a little bit of that, but at best a quarter of a percent on the 30-year mortgage rate may show up in the next few weeks. The mortgage rates tend to be a bit sluggish to respond to these things. So I think that was, to my mind, what I expected.

But in addition, they did a few other things. They said, "This is open-ended. There's not a limit on this." And they actually said explicitly that they would accelerate it if they need to. It's not a matter if the economy slows further, they will do more. It's actually stronger than that. It's that they expect the economy to accelerate, and if it does not, even if it stays growing at the rate it has been, that's just not enough for them and they will do more.

I think that has really captured the market's imagination, the fact that they said clearly, "Even if we get quite strong growth and even if inflation goes a little bit above its target, we will not pull back. We will not tighten." I think that's been the problem in the past where they do QE1, QE2, operation twist and each time, if it seemed like the economy is running a little fast or more job creation or even a little more inflation coming back up to 2 percent, they would pull back, they would stop.

And I think now they're saying, "No, we're not going to pull back. We're going to keep going." And I think the words they used were, a "considerable time after robust recovery begins."

Steve Weisman: Let me ask you some mechanical questions. How does the Fed's purchase of existing mortgage-backed securities push down interest rates for future mortgages.

Joe Gagnon: A good question. In fact, they're not buying mortgages that are already owned by existing institutions. They said they're going to be focusing on the mortgage futures market. In other words, they will be telling people who are in the process of writing new mortgages that they will buy those mortgages as soon as they are completed. As soon as people go to settlement and close them, they will buy them.

Steve Weisman: And this comes at a very sensitive moment in the housing market which is showing signs of life, at least in some states. Explain how it might impact on housing.

Joe Gagnon: It will certainly improve affordability of homes for new buyers, at least a modest amount. If the mortgage rates were about 3.7 percent for a 30-year prime mortgage, I would expect this would push it back down to 3.5 percent -- not a huge amount. That's why I think they could have done more. I wish they would have.

But every little bit helps. Every little bit makes the affordability calculation for a borrower better. It also actually makes it easier for a bank to lend to you because if your payments are lower, then you don't need as much income to qualify for a loan. So it actually improves the ability of people to borrow as well as the cost of borrowing.

And that goes into the calculation of buying a new house, especially at a time when house prices are seen to be turning up everywhere. There are a lot of people out there who have been holding back, thinking maybe house prices might continue to fall. If you tell them, "No, they've stopped falling, they're actually rising and moreover you'll never get a lower financing rate than now," that really is a strong signal: get in the housing market now.

Steve Weisman: What about refinancing; will this lead to that?

Joe Gagnon: Yes.

End of Part One