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

Joseph E. Gagnon says it will take at least six months to see if the latest Federal Reserve action stimulates the economy as hoped, and he assesses the other actions the Fed has announced.

Transcript of interview recorded September 17, 2012.

Steve Weisman: This is Steve Weisman with Joseph Gagnon at the Peterson Institute for International Economics, talking about quantitative easing and the latest announcement by the Fed to undertake the third phase of what is known as quantitative easing (QE) -- QE3.

Joe, the markets, as you pointed out in the Part One of this interview, responded very positively. What other signs should we be looking for to see if this brings positive effects?

Joe Gagnon: I think the market reaction already has some real effects, because if mortgage rates go down, as I expect they will, then we know that has the effects we talked about earlier. Then the question is: how many people are taking advantage of these lower rates? I think we start to see mortgage origination data, monthly coming out in the next few months, which should show some pickup.

It might translate into more home sales, but it takes time to shop for a house. Then once you buy a house, a contract lasts several months before it shows up in the data. But it should increase home sales. Then there should be a ripple effect with the economy because when people buy houses, they tend to buy appliances and other things.

Down the road, we think that monetary policy generally affects the economy with a bit of a lag. Typically, it takes about six months or two quarters to really see any effect in the overall data of employment and growth. Then that effect strengthens over about a two-year period. So in terms of what we really care about in employment, we're talking really six months to two years.

Steve Weisman: You have noted that Chairman Ben S. Bernanke [of the Fed], in discussing this, has listed the concerns that people have. But there are still some people who feel that any central bank, including the Fed, should keep its eye on inflation and not on unemployment. What persuaded the Fed to take its action?

Joe Gagnon: It's been building all year that they've been unhappy. The year started out well. Growth was close to their forecast and actually employment was growing even faster than they expected. So they were happy, and inflation was coming back up to 2 percent, so that was OK. We started off the year, and they were thinking, "OK, that's good." And as the year has gone on, there's been disappointment after disappointment as the rate of growth ticked down and ticked down and employment was stagnating. We need employment growth faster than we've had, just to keep pace with population growth. We haven't been doing that.

So they've increasingly become frustrated. Over time, they did a small action, a moderate action, in June, which was to extend their maturity extension program to the end of the year. But I think they knew even then that was not enough and they started to think about doing more at the last meeting in August. And the minutes of the last meeting in August were quite clear that they were preparing to do more. So I think it's been a process of adjusting to the disappointment they felt as the year was going on.

Steve Weisman: What were the other significant steps that they announced?

Joe Gagnon: There was QE3, $40 billion a month in the mortgage market. They said, "No, indefinite, no end to that." It could be adjusted, potentially even upward, as needed. They committed to not raising interest rates until a considerable period after recovery gets going strongly, even a strong recovery. And they said that they don't anticipate, even with a strong recovery now forecast in 2013 and 2014, that they will raise interest rates until the middle of 2015, which is a pretty striking thing. It says they're not taking their punch bowl away from the party until long after the party gets going.

Steve Weisman: There's always a danger in the height of a presidential campaign that this could become a political issue. Some Republicans have been warning that monetary policy should not be used to stimulate growth.

Joe Gagnon: I think Mitt Romney was even more explicit actually in saying that he was very disappointed in this. He felt this was just uncalled for. Governor Romney I believe explicitly criticized the Fed's move, according to what I read this morning.

Steve Weisman: How concerned is the Fed about putting itself in the political campaign? Do you think that was the reason for its delay?

Joe Gagnon: No, actually, I don't think so. I think the reason for the delay -- when the data came in disappointing, they were not inclined to immediately respond to it because they kept hoping that it would turn around. And so it took them some time to finally accept that, "Look, this is not turning around." So that was one of the reasons for delay.

The other reason for the delay is that they've been nervous about unexpected costs of these, a fact which we talked about in an earlier Peterson Perspective. Chairman Bernanke devoted his Jackson Hall speech to talking about these causes. I think they were doing some studies over the summer and they kind of wanted to have those studies be completed and digested before they felt comfortable that the cost of this kind of action were not too large to justify. Doing—

Steve Weisman: Due diligence.

Joe Gagnon: —due diligence. I think that was the main reason they didn't act in August or June. They would have acted in June or August if they had had these studies on hand. is my guess.

Steve Weisman: Thank you very much, Joe.

Joe Gagnon: You're welcome.