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09/28/12: Does QE3 Matter to You or the Economy?

On September 13, Federal Reserve Chairman Ben Bernanke announced that the Fed would undertake a new program to stimulate the U.S. economy--and the move was immediately dubbed "QE3" by pundits and columnists. But what, exactly, is it, and how is QE3 likely to affect you and the rest of us?

"QE," as you probably know, stands for "quantitative easing," a term which refers to a surprisingly simple tool that any government's central bank can use to put new money into its economy. In most cases, the central bank buys government bonds and puts them on its balance sheet. A more complicated example is the Federal Reserve Board's response to the 2008 global economic meltdown, which is now called QE1. Before Congress had finished squabbling over the political ramifications of putting out the fire, the Fed purchased $600 billion of toxic mortgage-backed securities (pools of home loans) whose values had gone into free-fall on the balance sheets of large lending institutions. When that didn't completely stabilize the banking system, the Fed subsequently bought roughly $500 billion more bank debt off of troubled banks' balance sheets and became an active purchaser of short-term Treasury obligations.

This accomplished three things at once. First, it took a lot of toxic securities off the books of large banks and prevented them from collapsing--averting what most economists at the time thought would be a prelude to disaster. Also, when the Fed became an aggressive new bidder in the Treasury auctions, it created more demand for short-term Treasuries, lowering the interest rate that the government had to pay on its burgeoning debt while the government decided how else to shock the economy back to health.

Finally, the transactions amounted to printing money, since the Fed could simply buy the securities based on the full faith and credit of the U.S. government. In all, $2 trillion of new money entered the U.S. economy, and the hope was that this would result in more lending, more buying and a quick exit to the recession.

QE2 started in November of 2010, when the Fed purchased another $600 billion of Treasury securities. Once again, new money entered the economy and the U.S. government's borrowing costs were driven down to near zero levels. Perhaps more importantly, this initiative also caused the value of the dollar to drop, making U.S. exports cheaper, stimulating export activity and counteracting efforts by Japan and other countries to artificially make their own exports more attractive on the global market.

Later, starting in late 2011 and continuing through the end of this year, the Fed extended QE2 with something that has been described as "Operation Twist," which was basically an effort to reduce longer-term interest rates. Under Operation Twist, the Fed has been selling $700 billion worth of its short-term Treasuries and is using that money to bid on longer-term government bonds. Once again, the central bank has increased demand for bonds, driving down longer-term rates and reducing the government's longer-term borrowing costs.

So what, exactly, is QE3, and why is everybody so excited about it? In its third round of stimulus, the Fed has pledged to buy $40 billion worth of mortgage-backed securities a month--or, to put it another way, to inject $40 billion a month into the pool of money that banks can lend to homeowners, so they can either buy new homes or refinance the homes they already own.

This is not a trivial sum; it amounts to fully 10% of the value of new mortgage activity in the U.S. economy. And it very precisely targets one area of the American economy that has shown little sign of recovery since the 2008 downturn. Total U.S. mortgage originations in the U.S. have fallen from $600 billion a month in the relative boom times of 2007 down to $370 billion currently. That translates into a lot of homes not being purchased.

If QE3 works as expected, the additional money will drive down mortgage rates, which would make homes more affordable. That should attract new buyers of homes and stimulate the moribund construction industry. Greater demand for newly-constructed homes could move the job market needle by creating work for all the professions that rely on home construction and housing, including realtors, contractors, architects, attorneys, appraisers, plumbers, roofers, carpenters, producers of lumber, sheetrock and concrete.

At the same time, QE3 will put a little extra money in the pockets of people who refinance their current mortgages at lower rates. If they spend some of that money, then that, too, will help spur additional economic activity.

How is it working so far? Interestingly, mortgage rates have hardly budged since the first QE3 money began filtering into the marketplace. Economists believe that 30-year rate fixed-rate mortgages will eventually come down from 3.55% to somewhere around 3.25%, and 15-year fixed-rate mortgages could drop from 2.85% to 2.75%. But that hasn't happened yet, in part because banks haven't relaxed their tight lending standards, in part because many banks currently have so many refinancing applications on their desks that they can't process any more.

As a result, the pernicious initial effect has been to give cheaper money to banks without lowering mortgage rates. Instead of lending more money at lower rates, banks are simply taking a larger spread on the loans they do make. That's why you sometimes hear that QE3 has been a government welfare program to large, solvent lending institutions.

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The biggest impact, so far, has been on stock prices. As the Fed buys mortgage pools, QE3 is driving down the returns that investors can get on Ginnie Mae and Fannie Mae mortgage-backed bonds. These had been among the most attractive fixed-income vehicles in a marketplace starved for yield, delivering higher-than-historical average spreads over Treasuries of comparable maturity. As those investments deliver lower yields, stocks, especially those of dividend-paying companies, become relatively more attractive.

The last and perhaps most effective stimulative effect is psychological. Unlike the QEs of the past, the Fed has put no time or dollar limits on QE3. The formal announcement of the program promised that it would continue until the Fed has decided that there is "substantial improvement" in economic growth and the unemployment rate. These are not exactly precise terms, and of course commentators have been trying to parse out exactly what "substantial improvement" means. In real terms, however, it appears that the Fed has lost patience with corporations hoarding cash rather than investing in their own (and the economy's) growth, and banks that have been sitting on all the cheap QE money that is available to borrow and re-lend at a profit to homeowners and corporate borrowers. If these companies stay on the sidelines and refuse to participate in the economic growth that the Fed is determined to engineer, then they'll be left behind and forced to answer to their shareholders.

How much growth are we talking about? In the report that accompanied the announcement, nine out of the twelve Fed districts reported modest or moderate economic growth. Before QE3, the Fed's projections for GDP growth in 2012 was somewhere in the 1.7-2% range, which is clearly below long-term averages. The Fed had projected 2.5-3% GDP growth for 2013 and 3.0-3.8% for 2014--again without taking QE3 into account.

If the housing market and construction industry can be lifted off the ground, one would have to assume that those numbers will go up. Estimates vary, but the U.S. economy needs to reach 3% annual GDP growth before hiring levels absorb new job market applicants and start to reabsorb the people who lost their jobs in the downturn. The Fed seems to have decided that reviving the construction industry is the most focused possible way to bring about the growth that economists would expect America to achieve by 2014 without the benefit of a stimulus.

One more thing: how much does QE3 add to the national debt? Zero. For the money it created, the Fed owns interest-bearing mortgage-backed securities and pools of mortgage debt, which can be sold at any time, and it earns a return on the money it magically created in the meantime.

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