The Fed feels compelled to experiment

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This week's release of the **minutes of the September 21 meeting** of the Federal Open Market Committee points to an activist Federal Reserve that is in policy experimentation mode – an institution that feels compelled to take additional measures to energise the American economy yet is uncertain about the potency of its interventions. This mix, of a highly engaged institution having to operate with imperfect instruments, has implications that are felt well beyond the US.

Judging from the minutes, it is virtually a foregone conclusion now that the Fed will announce on November 3 that it is re-engaging in "unconventional policies" – **a new programme of quantitative easing**, nicknamed QE2. By buying securities, the Fed will be looking to "push" others into taking more risk – to push investors to move out on the risk spectrum and buy corporate bonds and stocks; to push banks to use their large excess reserves to make loans; and to push large companies to deploy their record cash balances to purchase equipment and hire people.

Most people do not like to be pushed into doing anything, let alone into taking more risk. They would rather be "pulled" by the underlying attractiveness of the activity. Because of this distinction, the minutes indicate that some within the FOMC feel "that the economic benefits could be small in the current circumstances".

As a body, the FOMC recognises that the benefits of QE come with potential costs and risks (including unintended consequences). Despite this tricky and uncertain balance, it feels compelled to act for at least three reasons: we are in the middle of yet another round of downward revisions to America's growth projections; inflationary pressures are subdued and could tilt towards price deflation; and other economic agencies, particularly fiscal ones, are limited in what they can do (either by choice or by constraints imposed on them).

Financial markets have understood that the FOMC may be forced to act. Accordingly, the dollar has depreciated and virtually every other asset – including bonds, equities, gold and other commodities – has rallied strongly in the last few weeks in anticipation of an announcement.

Policymakers in many other countries are less enthusiastic about the FOMC's likely course of action. Some of the scepticism is philosophical, linked to the view that the US authorities should be facilitating the required balance sheet adjustment rather than obfuscating it. Most of it is because many other countries do not want to deal with the negative externalities.

The more the Fed pumps liquidity into the US system, the greater the negative spillover to other countries in terms of large capital flows, asset bubbles and inflationary pressures. Countries not wishing to see their currency appreciate feel that they are being forced into one of two evils, if not both: impose capital controls and/or engage in what the Brazilian finance minister labelled "**currency wars**".

Having signalled their intention, Fed officials now face the difficult

challenge of specifying how they will actually implement a new asset purchase programme. Will they target a level of purchases or a particular objective; and if it is an objective, will it be a market interest rate or a specific growth and inflation outcome?

The FOMC's natural inclination will be to retain as many options as possible. After all, it is navigating the economy through an "unusually uncertain outlook". Let us hope that such constructive ambiguity will also be enough to meet the considerable market expectations while limiting the already-high scepticism of policymakers in other countries.

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