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Monetary policy: An unconventional tool

By Martin Wolf Author alerts

The Fed's quantitative easing raises questions about whether it has worked and its legacy

Since September 2008, the balance sheet of the US Federal Reserve has expanded by $3.5tn to close to 25 per cent of US gross domestic product. This month, the Fed is expected to end its experiments with policies, particularly "quantitative easing", that have had this result. QE is contentious. So what have the Fed and other central banks done? Has it succeeded? What problems does it bequeath?

QE involves the creation of central bank money on a large scale. That makes it "quantitative". It is one of a family of unconventional policies employed in the aftermath of a crisis that damaged the financial system and caused a deep recession. As the International Monetary Fund has noted, "central banks in advanced economies responded with unconventional tools to address two broad objectives: first, to restore the proper functioning of financial markets and intermediation, and second to provide further monetary policy accommodation . . . The two objectives, while conceptually distinct, are closely related."

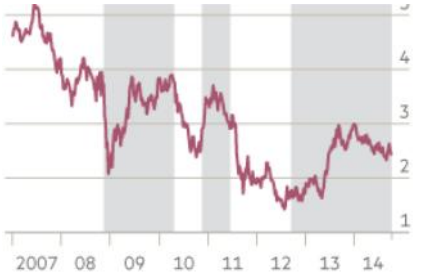
The Fed had to be particularly imaginative because the US financial system was more complex and more dependent on "shadow banking" – intermediation outside the banking system – than were those of other advanced economies. Liquidity provision was extended to non-bank entities, for example, such as securities firms.

In addition, central banks purchased assets outright. The purchase of private assets was expected to support markets and improve the impaired balance sheets of banks and other financial intermediaries. The purchase of government bonds was expected to persuade the holders to shift their portfolios towards riskier assets.

Such large-scale asset purchases were an element in a set of policies aimed at restoring a degree of normality to financial markets and financial institutions. This has been called "credit easing".

Asset purchases are also designed to reinforce monetary policy. The justification has been the reduction of conventional central bank intervention rates to the "zero lower bound". That is where the rates of the Fed and Bank of England have languished since 2009. It is where the European Central Bank has reluctantly placed its rates. The Bank of Japan's rates have been near zero for two decades. Central bank asset purchases are a way to make monetary policy effective when short-term rates are already at the zero lower bound. Such QE is held to affect monetary conditions via a "scarcity channel", a "duration channel" and a "signalling channel".

By reducing the availability of assets, QE causes investors to shift towards assets deemed close substitutes. This should raise prices and lower yields.



Source: Thomson Reuters Datastream

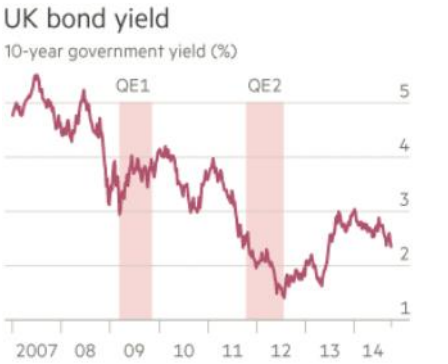
By limiting access to long-maturity financial assets, QE lowers the riskiness of investors' portfolios. That should increase prices and lower yields for all maturities, not just those of the assets the central bank purchases.

Finally, QE puts the central bank's money where its mouth is, thereby reinforcing credibility. For this reason, it is a complement to another unconventional policy, namely "forward guidance" on future short-term interest rates.

The pioneers

The BoJ pioneered QE's use as a tool of monetary policy in 2001, But it used it in a relatively limited way. In the present crisis, however, the Fed, the BoE and, from 2013, the BoJ have used it extremely aggressively.

From November 2008 to November 2009, the Fed purchased Treasuries worth $300bn, as well as debt of government-sponsored mortgage agencies valued at $175bn and mortgage-backed securities worth $1.25tn. This came to be called QE1. It was more credit easing than quantitative easing. The Fed put QE2 into effect from November 2010. It had purchased $600bn of Treasuries by June 2011.



Source: Thomson Reuters Datastream

The Maturity Extension Programme – commonly known as "Operation Twist" and worth $667bn – ran from September 2011 to December 2012. In this the Fed sold short-term Treasuries in return for longer-term ones. The final stage, QE3, began in September 2012. Initially, it focused on the mortgage-backed securities of government-sponsored enterprises. It followed up with purchases of Treasuries from December 2012. This had a predominantly monetary purpose: it was no longer to restore the financial sector to health. Its aim was to prevent excessively low inflation and restore the economy to health.

In the UK, the BoE launched its first QE programme, worth £200bn, in January 2009, adding a second, worth £175bn, in October 2011. In both cases, the Bank bought only government bonds, or gilts. Its QEs, then, were monetary. The UK's policy for credit easing was Funding for Lending, organised with the Treasury and launched in July 2012. The expansion of the BoE's balance sheet, relative to the size of the economy, has been almost identical to that of the Fed.

The BoJ introduced its "comprehensive monetary easing" in October 2010, intended to be worth Y76tn by the end of 2013. After the election of Shinzo Abe as prime minister, it launched its "quantitative and qualitative easing" (QQE), in April 2013. This aims to increase the monetary base by between Y60tn and Y70tn annually.

The signalling channel

Credit easing played a role in restoring US financial markets to health. But how far has QE worked?

This question is hard to answer. QE is far from the only reason long-term interest rates have remained low. In the UK, for example, long-term rates stayed low after it ended. The explanation is the belief that the economy would stay weak and so the need for accommodative policies would prove long-lasting.

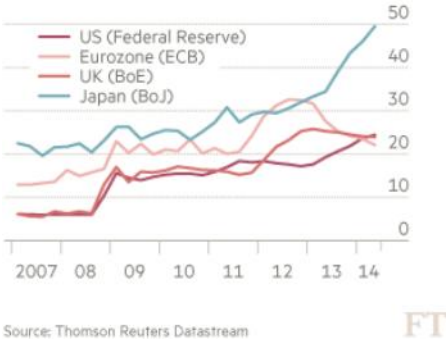
One authoritative survey, by John Williams, president of the Federal Reserve Bank of San Francisco, states: "First, although individual estimates differ, this analysis consistently finds that asset purchases have sizeable effects on yields on longer-term securities. Second, there remains a great deal of uncertainty about the magnitude of these effects and their impact on the overall economy."

Mr Williams concluded that $600bn of asset purchases tended to lower the yield on 10-year Treasuries by 15 to 25 basis points. That is roughly the size of the move in longer-term yields one would expect from a cut in the federal funds rate of ¾ to 1 percentage point.

Similarly, the IMF concludes that: "In the US, the cumulative effects of bond purchase programs are estimated to be between 90 and 200 basis points
(0.9 and 2 percentage points) . . . In the UK, cumulative effects range from
45 basis points to 160 basis points." In Japan, purchases of government bonds under CME and QQE reduced 10-year yields by a little over 30 basis points.

Central bank assets
As a % of GDP

The IMF also argues that the signalling channel was the most important, at least in the US, although the portfolio balance channel seems to be important in the UK, perhaps because



markets are more segmented from one another.

What effect has this had on economies? Economists largely agree that QE has raised asset prices, including equity prices, and affected economies positively. For this reason, the IMF has recommended aggressive QE, including purchases of government bonds, by the ECB. Moreover, there is some evidence that these effects, too, are strongest via the signalling channel, probably because QE was seen to cut off the tail risks of a still deeper slump

QE has then proved itself to be a useful instrument under slump conditions. That is the view of most policy makers and academics. It is not universally shared: complete agreement on policy is impossible.

One line of criticism is that QE works mainly by distorting asset prices, particularly those of long-lived assets, such as equities. But the distortions will necessarily unwind, so creating a new round of difficulties. The argument against this is that it is an objection to active monetary policies, not QE alone.

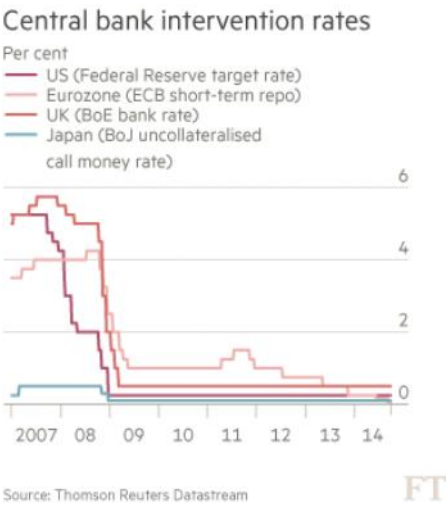
Another criticism is that buying bonds has adverse distributional consequences, benefiting rich owners but damaging subsequent returns on long-term savings. Yet, again, this effect is largely due to ultra-low interest rates. QE is just the icing on that cake. Moreover, if interest rates had been substantially higher, economies would have been far weaker, resulting in far more bankruptcies. That, too, would have created large losses, including for many savers.

Keeping zombies alive

A closely related line of criticism is that QE is preventing the deleveraging of the private sector and keeping “zombies” (both corporate and governmental) out of bankruptcy or default. More broadly, these policies are reducing the pressure for radical restructuring and reform necessitated by the unsustainable pre-crisis trends and post-crisis legacy. These are legitimate concerns. But, again, they are not about QE per se but rather about ultra-easy monetary policy. They amount to demanding still deeper depressions.

Another line of criticism is that QE, particularly by the Fed, guardian of the world’s principal reserve currency, has disruptive global spillover effects. Emerging economies, notably Brazil and China, have made these complaints particularly strongly.

Again this is more a criticism of the entire stance of monetary policy rather than of QE in itself. But the most important point by far is that another great depression or even a far weaker recovery would have been much worse. The early interventions were unquestionably of benefit to everybody. Moreover, in a world of floating exchange rates, countries have to prepare themselves for changing monetary policies and fluctuating exchange rates elsewhere. One
has to hope emerging economies are now properly prepared for the ending of QE.



According to the IMF, QE1 did raise asset prices, including those of foreign currencies. Later ones seem to have had a smaller effect. But, in the US, the case for a weaker dollar and an adjustment in its external balance was strong. Nor does it make any sense to expect the US or other crisis-hit countries to stick in recession for the (often imaginary) sake of other countries.

Part of what lies behind this set of criticisms is a struggle over the balance of financial power. Creditor countries believe they are morally entitled to dictate to deficit countries. But they cannot dictate to the country that issues the global reserve currency. So the US was able to force adjustment upon others, including China, by pursuing policies that were in its own interests. Inside the eurozone, the creditors have far more power: this has not gone well.

Wild accusations

A far wilder, albeit popular, criticism is that QE must lead to hyperinflation or at least very high inflation. This misguided criticism is based on a mechanical application of the outmoded idea that bank lending is dictated by availability of banking reserves.

QE is an extreme version of traditional open-market operations of central banks. So it does increase banks’ reserves. Yet no mechanical link exists between reserves and lending in a modern banking system. Institutions know the central bank will provide them with the money they need, to provide customers with cash or settle with other banks, so long as they stay solvent. The determinant of bank lending and so their creation of money is their perception of the risks and rewards of lending, not the size of their reserves.

If these criticisms are mostly misplaced or exaggerated, QE still creates significant risks.

Exit is the obvious one. Yet many ways of handling it exist. Interest rates can be increased, by raising rates paid on reserves. Term open-market operations ("reverse repos" or other liquidity absorbing instruments) can be used to drain excess reserves. Central banks do not have to sell the assets they have bought either: these can mature. The main risk is that raising rates from ultra-low levels might be disruptive.

Central banks can also leave reserves permanently higher. This would turn QE into a form of "helicopter money", retrospectively. By this is meant scattering money across the population, suggested by Milton Friedman. That option has not been employed. Yet, done on a suitably large scale, helicopter money would, as Willem Buiter, chief economist of Citi, argues, end deficient demand. In irresponsible hands it could also cause hyperinflation. But it need not do so.

What of the immediate future? While the US and UK are thinking about exiting from ultra-easy policies, Japan is still struggling to banish deflation and the eurozone is fighting with itself on what sort of monetary policy to pursue, as risks of deflation rise. The ECB might yet find itself forced to buy large quantities of government bonds.

The legacy of the crisis has included a wide range of experiments, of which QE is one. This tool would be used again if such times recurred. The alternative is to avoid getting into such straits again. That might mean something yet more unpalatable – a higher inflation target. Unconventional times call for unconventional remedies. That is the lesson we have learnt since the crisis.

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