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QE-2: Is it the Right Move?

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Synopsis

The US Federal Reserve Bank (Fed) has decided to increase liquidity through quantitative easing of US$ 600 billion from now to June 2011. What is QE, why does the Fed resort to it and what are the implications?

Commentary

WITH SLUGGISH economic growth and unemployment in the United States stubbornly close to 10 per cent, the Federal Reserve decided to intervene by purchasing long-term Treasury securities. This technique of injecting liquidity is known as quantitative easing or QE.

What is QE-2?

The new round of quantitative easing (QE-2) involves US$600 billion to be disbursed from now to June 2011. The first one was US$1.7 trillion, which was disbursed between January 2009 and March 2010. In addition, the Fed will also use the proceeds from its holding of mortgage-backed securities of US$280 billion.

By purchasing long-term securities it is hoped that their prices will go up and their yields go down – leading to lower long-term interest rates. A lower long-term interest rate would lead to higher expenditures, which in turn will stimulate economic growth and employment. This seems to be logically neat. Unfortunately a lower interest rate is not a guarantee for expenditure to increase or demand to rise. The Japanese experience in the 1990s showed that most of the corporations still preferred to repay their previous debts rather than making new investments in a similar condition. This is known in finance as *de-leveraging*, which could slow down further the economy.

Why QE?

If the issue is to increase demand in the economy, why not do it more directly through fiscal stimulus? In 2009 the US government launched a fiscal stimulus that was followed by many other countries. This coordinated fiscal stimulus was lauded as a great success in steering the world economy out of the depression. Economic rationale would definitely justify a fiscal stimulus. Believers in market fundamentalism would accept it on grounds of efficiency. Those who believe in traditional Keynesian economics' discretionary fiscal policy see this as an answer to sluggish economic growth.

But a fiscal stimulus has to be politically decided in the Congress that currently is overwhelmed by the size of the budget deficit -- of around 11 per cent of GDP. Further more, the recent mid-term elections that brought back the Republican Party as the majority in Congress would rule out fiscal stimulus as a strategy, at least for the time being. Thus, it is left to the Fed to step in. It has to decide on a policy that is within its jurisdiction and will achieve the objective of stimulating the economy while reducing unemployment. Hence the option of quantitative easing.

Other central banks, both in developed as well as emerging market economies,have adhered to the post-Asian financial crisis pattern of solely achieving and maintaining stability. But the Fed is still pursuing the twin functions of ensuring stability and growth.

For some time the US interest rate has been very low. The Fed has been designing monetary policy at near zero interest rate (the *liquidity trap* in economic jargon). This is done through the purchase of long-term Treasury securities to raise their price, which in turn reduces the yield or interest rate. A lower long-term interest rate will create expectation for lower interest rate in the future. This will stimulate spending for consumption and investment, and thus growth and employment. However, even if it works the impact would be weak or needs a longer time. In addition the longer run impact of the injection of liquidity is on prices -- inflation.

Impact on emerging market economies

But as finance is global and funds could flow freely, one should also look at its global impact. In today's global finance the popular destinations of funds are the emerging market economies. The different interest rates between the Fed's facilities and those in the emerging market economies, which are higher, act as an incentive for currency transactions through carry trade. There have been complaints by monetary authorities from emerging economies, including China, about the recent influx of short-term funds. The additional liquidity at this time is like pouring gasoline onto the fire.

In addition different authorities have been mentioning the possibility of resorting to capital controls. Still some central banks have intervened in the currency markets to defend their national currencies from appreciating which otherwise would jeopardise exports. Thus, a currency war is already a reality. Non-action is not an option, while any action poses a dilemma.

Questioning QE-2's Wisdom

Be that as it may, it is still curious to see why Chairman Ben Bernanke seemed eager to execute the QE2 with relish. Wouldn't he risk his reputation should it fail? It should first be noted that in the vote at the Federal Open Markett Committee (FOMC) nine governors and presidents of the Fed banks were for and only one was opposed to the motion. The single vote against it was from the president of the Federal Reserve Bank of Kansas City, Thomas Hoenig.

Maybe the explanation lies somewhere else. Chairman Bernanke is a monetary economist and a student of depression economics. He must remember very well the strong criticism of the monetarists led by the late Milton Friedman who blamed the Fed for not being forthcoming in providing the economy with liquidity in the wake of the great crash of 1929. According to this argument, this had caused the Great Depression of the Thirties.

As a monetary economist and firm believer in this thesis, Bernanke may have decided on QE-2 so that he will not be blamed for putting the US economy into a long deflation *a la* Japan or even the Great Depression. On the global imbalance he is known to argue that its major cause is the savings glut in China and other economies. By doing QE-2, Bernanke will achieve a higher growth rate and lower unemployment. This hopefully will reduce the global imbalances leading to a strong, sustainable and balanced growth of the world economy.

Will he get his wish? We hope so, but it is hard to bet on it at this point.

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