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Fed's QE2 lacks power to break up global ice

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The Australian Financial Review | 15 Nov 2010 | Page: 23 | Market Wrap

US Fed chairman Ben Bernanke has announced further support for the lacklustre US economy, through a second instalment of quantitative easing, popularly dubbed QE2.

At the height of the global financial crisis, the US Fed bought well over a trillion dollars of asset-backed securities (ABS) to revive the ABS market, which funds housing finance. At the time, buyers of ABSs did not know whether their collateral was a mortgage with good prospects of repayment or a "lemon", so they had priced all securities as if they were lemons. The Fed's massive intervention performed the vital function of keeping the mortgage market alive.

This time around, the plan is to buy government securities rather than private sector ABS securities. The Fed sees this working through reducing interest rates on government bonds, flattening the yield curve. This in turn might be passed through to banks' lending rates, thus stimulating borrowing.

But the effect of this is likely to be small. The shape of the government bond yield curve is largely determined by the market's expectation of what the policy rate will be in the future. The extra demand from the Fed will have a minor effect in shifting the curve. In any case US yields are already so low that they can't be inhibiting borrowing: the five-year bond yield is around 1 per cent.

Some commentators see QE2 as a tactic to stimulate the US economy by weakening the dollar. If US interest rates fell substantially this might encourage additional outflow of capital, which would weaken the dollar. But if the interest rate fall is trivial so too will be the effect on capital flows. Even without QE2 there is the prospect of sustained low interest rates for some years ahead, which has already provided substantial encouragement for capital outflow and weakened the dollar. An implicit promise of "lower for longer" will add to these flows, but a few more basis points off interest rates won't make much difference. There may be other channels of influence. There is, of course, the traditional policy strategy of incantation: if the Fed chairman says this is a powerful instrument, the markets might believe him.

If so, it could have significant real effects.

Even without incantation, financial markets may themselves hold the view that QE is a powerful instrument. This is, however, largely based on a misunderstanding of how monetary policy works. QE is often described in market commentary as "printing money", with the implication that this must be inflationary.

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The markets are full of old-fashioned monetarists who believe that QE works by adding base money to the system. They carry the outdated baggage of introductory-economics courses: the belief that when central banks increase base money, this gets multiplied by the banking system in the form of credit growth. But these days banks have already lent to all the borrowers they consider bankable. Extra base money just piles up in the balance sheets for the banks.

But this sort of misapprehension is understandable when there is so much ambiguity and confusion about the concept of liquidity. There are (at least) three different types of liquidity. First, central banks use the term to refer to base money, comprising cash held by the public and banks' deposits at the central bank. Second, many commentators talk about liquidity when they mean lending. And third, a portfolio manager regards liquidity as an attribute of an asset that can be readily sold with little change in the price.

The Fed's QE2 operation is clearly an increase in liquidity, in the central bankers' use of the term. But extra base money in itself doesn't have much effect.

It may also increase liquidity in the sense of bank lending, but the effects are weak and uncertain. To the extent to which lending rates are lowered, this may increase the demand for borrowing. It may increase the supply of bank loans if the banks, finding themselves with excess base money, lower their lending standards and take on more risky borrowers.

The original Fed QE, back in 2008, added very significantly (and beneficially) to the liquidity of the ABS market, in the third sense of the term (market liquidity). But the government bond market has not been suffering from the sort of illiquidity experienced by the ABS market.

In the discussion of QE2, the first two concepts are hopelessly confounded (usually with the implication that there will be "too much money chasing too few goods" and that inflation will be the inevitable result), and the key point -- that market liquidity was central to the effectiveness of the first QE but is absent in QE2 -- seems to be ignored.

What is missing from this debate is any analysis of the two examples of QE2-style actions that have been done elsewhere: in Japan from 2000 to 2004, and in the UK in 2008.

The consensus on the Bank of Japan QE episode was that the effect was minuscule on the bond rate and undetectable in the real economy. Credit started growing again when, and only when, companies had restructured their balance sheets. The Bank of England claims significant effects from its buying up of one-quarter of the outstanding stock of government securities. But they would say that, wouldn't they? The economy remains in the doldrums.

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It's hard to get away from the feeling that, in countries seriously affected by the global crisis, policy instruments are doing about as much as they can. While the current accommodative policy settings are appropriate for flaccid economies, these unconventional measures rely on incantation rather than substance.

The concerns that QE might trigger inflation seem misguided, but so too are the hopes that it is a miracle cure.

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