Investment Terminology 2
Quantitative Easing

Introduction

The Credit Crunch, explained in Investment Bulletin 5, has galvanised governments and central banks across the globe into action. The current solutions for kick-starting the global economy are many, but Quantitative and Qualitative Easing are terms frequently used in the press and by industry professionals without a widespread understanding amongst the public of what they mean.

Before taking a closer look at how these work and the impact they may have on the wider economy, it is worth explaining the key economic fundamentals that form the basis for this approach.

What is the business (or economic) cycle?

The business cycle is the fluctuation in production and economic activity over several months or years.

The level of demand for goods and services will fluctuate depending on which stage of the business cycle the economy is currently experiencing, increasing during periods of expansion and decreasing during recessions.

How is a recession measured?

A recession is a slowdown in economic activity in a country or region over a sustained period. Gross Domestic Product (GDP) is the market value of all goods and services produced by a nation in a year and a key economic measure of activity. Falling GDP, consumer spending, household income and business profits combined with an increase in unemployment all represent recessionary indicators. Officially, two consecutive quarters of falling GDP signifies a recession. Governments aim to prevent recessions by using various policies available to them, including fiscal policy and monetary policy.

What are fiscal policy and monetary policy?

In free market economies, found in most of the developed world, governments have two types of economic policy to control and create demand for goods and services – fiscal policy and monetary policy.

The aim of the government is to achieve and control the economic objectives of price stability, full employment and economic growth. By increasing spending and/or reducing taxes, a government can try to boost an economy. Conversely, governments can reduce spending and increase taxes in order to attempt to control an economy that is expanding too rapidly.

Fiscal policy is the use of government spending and revenue collection (taxation) to influence the economy.

In contrast, monetary policy is the process by which the government or central bank controls the supply, availability and cost (i.e. interest rate) of money. Monetary policy is referred to as being expansionary or contractionary, depending on whether the supply of money in the economy is increasing or decreasing. Controlling the supply of money and the availability of credit is a key tool for stimulating or restricting growth.

What is Keynesian economics?

The economist John Maynard Keynes is credited with inventing the concept of fiscal policy in the 1930s. He argued that adjusting government spending and tax rates were the best ways to stimulate overall demand and, therefore, maintain the growth and stability of an economy.

Keynesian economics argues that private sector decisions can lead to inefficiencies in the overall economy, which requires monetary and fiscal policy actions to stabilise. A perfect example is the Credit Crunch generated by the financial institutions which has led to the current situation, requiring governments to intervene.

What is Quantitative Easing?

Central banks lower the interest rates at which they lend to private banks in an effort to increase borrowing and subsequently the cash flow in the economy. When the interest rate is at or close to zero and banks remain unwilling/unable to lend sufficiently to stimulate the economy, a situation we are currently experiencing in the UK; other solutions, such as Quantitative Easing (QE), may be employed.

QE is the process of creating money and is used to ease the pressure on banks by injecting it in to the economy. The UK Government is currently implementing QE.

A government, or central bank, will use the new money generated by QE to buy back government bonds, such as gilts, in the open market, from banks or financial institutions in exchange for cash. More recently, the new money has been used to purchase corporate bonds to provide money directly to companies.

A government must have control over its own money supply to employ QE. One of the issues facing the Euro zone, for example, is that individual countries cannot unilaterally use this policy tool, but must rely on the European Central Bank to implement it.

Has it been used before?

QE was a tool of monetary policy that the Bank of Japan (BoJ) began using to fight deflation in the early 2000s. The BoJ lowered interest rates to zero in February 2001 and started its program of QE a month later, ending both policies in 2006.

The BoJ found that despite lowering short-term interest rates to zero, it could not get the Japanese banking sector to lend. This created the need for the BoJ to begin buying Japanese government bonds with newly created money.

In Japan's case, the mechanics were simple. The BoJ added reserves to the banking system by buying government securities from banks and directly from the market. The size of the bond-buying operation was used to increase the level of private bank cash reserves available, as short-term interest rates were fixed at virtually zero already.

When the economy deteriorated further, the BoJ increased the amount of government debt they purchased, to further increase reserves. At its peak, reserves reached around Y35,000bn of which only around Y8,000bn were required.

Does Quantitative Easing work?

It is a matter of debate whether or not QE had much impact on the Japanese economy, even though it coincided with the longest expansion in Japan's post World War II history (2002-2007). Many economists and commentators would point to evidence that suggests not, as this expansion was largely self-financed by corporations from their own cash flow, making QE almost irrelevant in this case.

Even before QE began, capital injections and guarantees to the banks had largely cured them of liquidity problems, however, they simply used the capital to further bolster their balance sheets. One of the significant observations from Japan's use of QE was that they appeared to start it too late. The country had already experienced a decade-long recession and neither consumers nor corporations had the appetite to borrow more.

The impact of high oil and other commodity prices ended headline Consumer Price Index deflation. The economy cured, on its own, most of the structural problems such as excess capacity and too much debt associated with the deflationary environment.

What is Qualitative Easing?

The Credit Crunch has also given prominence to the term 'toxic debt', highlighting the poor quality of some assets on the balance sheets of many global banks.

As QE is the process of buying good quality debt and/or assets from banks in return for cash to bolster reserves, Qualitative Easing refers to improving the quality of assets on a bank's balance sheet by taking control of poor quality or riskier assets.

In the US, Congress authorised $700bn of taxpayers' money to fund the Troubled Assets Relief Program (TARP). TARP allows the US Treasury to 'ring fence' these lower quality assets, to free up cash flow for the institution which has these assets and encourage recovery and growth. TARP allows the Treasury to take on the liability of both troubled assets and any other asset deemed necessary, in order to further economic stability. Troubled assets include real estate, mortgage-related assets and the various financial instruments created from these.

Whilst primarily focussing on the major banks, the TARP exercise can be extended to other troubled sectors such as the automotive industry. In essence, the US Government has taken on the risk of default on these assets so that financial institutions do not have to make provision for this risk by keeping high cash reserves.

On this side of the Atlantic, the UK Government has unveiled plans for an insurance scheme to try to get banks lending to individuals and businesses, as a means of controlling the current economic crisis. Under the terms of the scheme, the Government will insure banks against losing more money from loans and investments. It was the fear of such losses that stemmed the original flow of credit and stopped banks lending to each other, helping to fuel the global credit crunch.

What are the risks of Quantitative Easing?

QE is seen as a risky strategy that could trigger higher inflation than desired if not properly managed and if too much money is created.

Some economists warn that any creation of money will inevitably devalue a currency, regardless of what that money is used for.

Again considering Japan, to date it has not suffered any significant side-effects, inflation is low and the Yen is strong but admittedly the economy and markets are not buoyant. There have been more extreme examples of ‘money printing’ where the results were disastrous. These include the collapse in value of the German Reichmark after World War I and the Russian Rouble after the fall of communism and also the current hyper-inflation in Zimbabwe.

Many developed economies, such as the UK and US, are in a much better position, so it can be argued that such alarming consequences are unlikely however, central banks may lack the appetite to engage in ‘quantitative tightening’ when the economy begins to recover.

Summary

Comforted by the initial success of the UK’s money-creating program, the United States, Switzerland and the European Central Bank have recently announced or expanded similar schemes. The impact of QE can only be measured over time – its success, or otherwise, will only become evident after a number of months, or even years.