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Citation

Singapore Management University. Easing Up on Quantitative Easing. (2014).

Available at: https://ink.library.smu.edu.sg/pers/69

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Easing up on Quantitative Easing

Published: 22 Jan 2014.

The U.S. Federal Reserve has pumped trillions of dollars into the economy. Is it finally going to stop the flow of cheap money?

In his final press conference as U.S. Federal Reserve Chairman, Ben Bernanke finally answered the question financial markets had been asking for months: tapering of Quantitative Easing (QE) starts in January 2014. The Fed's bond-buying programme has been cut by US$10 billion each month, but the markets can still expect US$75 billion to flow from the Fed each month until Bernanke's successor, Janet Yellen, decides otherwise.

Now that tapering of QE has come to pass, are homeowners in the U.S. – and eventually, worldwide – doomed to struggle with a painful jump in interest rates and higher mortgage payments?

"There is fear of that happening, and the Fed does not want that to happen," says **Thomas Sargent**, Professor of Economics at New York University, and the winner of the 2011 Nobel Prize in Economics.

“The Fed’s hands are tied”

Sargent, who was the Keynote speaker at the recent *4th Annual Sovereign Wealth Fund Conference* hosted by SMU’s Sim Kee Boon Institute for Financial Economics, explained why it took so long before the Fed finally decided to scale back its bond-buying.

“The pressures from the threat of higher interest rates have tied the Fed’s hands. The Fed was surprised by how a little bit of talk about tapering – not even doing anything, just talk – caused interest rates to rise quite a bit.”

It has, indeed. On May 21, 2013, a day before Bernanke testified before the Joint Economic Committee that the Fed was “prepared to increase or reduce the pace” of the US$85 billion-a-month bond-buying exercise, the yield of 10-year U.S. Treasury notes closed at 1.94 percent. By September, it breached three percent and has since hovered between 2.5 percent to three percent.

While the Fed surprised markets by starting tapering before new Fed chief Janet Yellen takes office in February, Sargent says the expectation of QE tapering has already been priced into the 10-year bonds. However, after injecting nearly US$4 trillion into the American economy, inflation is still some way below the Fed’s two percent target. Is the U.S. heading for deflation?

Quantitative Easing explained

In a bid to boost the flagging U.S. economy following the global financial crisis of 2007-2008, the U.S. Federal Reserve injected trillions of dollars into the economy by buying U.S. government bonds. The move in November 2008 was called “Quantitative Easing (QE)”, and it has been repeated twice. The latest QE, QE3, buys up US$85 billion in government bonds every month, and is scheduled to run until the Federal Reserve decides to stop it when the U.S. economy recovers sufficiently. Because of its open-ended nature, it has earned the nickname “QE-infinity”.

“I doubt we are heading for deflation,” Sargent asserts. “Two things: first, the central bank – if it wants – knows how to stop deflation and it knows how to generate inflation. The second thing is: the people who are on the Federal Reserve don’t want deflation. They would fight it very hard, and they have the tools to do so.”

The Fed has been deploying those tools since 2008, with the buying of U.S. government bonds being the primary weapon of choice. Real GDP in Q3 grew at an annual rate of 3.6 percent, surpassing government estimates of 2.8 percent. While those figures are encouraging, the fact remains: banks are not lending the trillions of dollars to businesses to create jobs, nor to individuals.

Liquidity trap

U.S. banking rules require banks to hold 10 percent of deposits as “required reserves” on which the Fed pays 0.25 percent interest; that 10 percent works out to about US$80 billion.

Banks can also choose to hold “extra reserves” with the Fed, which also pays 0.25 percent interest on them. After selling US$85 billion worth of bonds to the Fed every month, the banks have chosen to stash over US$2 trillion to earn that 0.25 percent instead of lending the money. In effect, the Fed is paying

interest on money which they have created, and the economy is not receiving the stimulus for which QE was designed to deliver.

“It has to be in the interest of the banks to lend money to parties to whom they lend,” Sargent explains. “It’s not just in America, but more so Europe where banks are lending mostly to governments but not SMEs (small and medium enterprises).”

He adds, “You could put regulatory pressure on banks to rectify that. You could get interest rates up to incentivise banks to lend, but it’s complicated."

So what would he do to solve the problem if he had total control of the U.S. economy?

“The proper answer to that is: Heaven forbid that any single person would have full control over an economy. Economics is about the Invisible Hand. You want competition, and you want market forces giving people opportunities as well as discipline. When you interfere with those, you get problems.”

In other words: Over to you, Miss Yellen.