The end of the big easy

***Paul Wallace** discusses the phasing out of quantitiative easing in major economies. The quantity is not in doubt, but how effective has the policy actually been?*

An extraordinary experiment is drawing to a close. Led by the US Federal Reserve, central banks embarked upon quantitative easing (QE) – buying financial assets with newly created money – in response to the 2008 banking crisis. By the end of 2017, the Fed, ECB, Bank of Japan and Bank of England (BoE) had together made $11tn of purchases. Now the Fed is leading the way in phasing out QE. The ECB, the last big central bank to adopt the policy, will stop its purchases at the end of this year. What has the experiment proved?

One thing it has certainly shown is that central banks can do more than move short-term interest rates, their main policy tool. They resorted to QE precisely because they had already brought short-term rates down as far as possible in their efforts to foster a recovery after the deep crisis-induced recession and to combat deflationary pressures. That limit is set by the "zero bound", arising from the fact that depositors charged negative rates can switch into cash, which at least does not lose money. Although both the ECB and the Bank of Japan pushed rates below zero, their foray into negative territory was limited.

QE broke new ground by enabling central banks to bring down long-term interest rates, such as yields on bonds with maturities of 10 years or more. Previously, they had been able to affect long-term rates only indirectly as markets incorporated changes in current and expected short-term rates into bond yields. Indeed, when long-term rates failed to respond to the steady tightening in US monetary policy in the mid-2000s, the Fed's long-serving chairman, Alan Greenspan, called it "a conundrum".

By contrast, QE allowed central banks to influence long-term rates directly. By purchasing sovereign bonds on a large scale – "safe" assets that many investors need and want to have in their portfolios – they would push up their prices. That in turn would push down their yields since they are inversely related to prices. The effect of the purchases would ripple out beyond government debt markets. Investors would move into riskier assets such as corporate bonds and equities, and that influx of capital would, in principle at least, spur growth. Long-term borrowing would be cheaper; the prices of financial assets more generally would rise. Overall, there would be a boost to the economy.

Working out the precise effect of QE is tricky. As the St Louis Fed points out: "The theory is muddy and the empirical evidence is open to interpretation." Studies isolating the policy's contribution show a sizeable though not overwhelming impact. For example, research at the BoE in 2010, when the stock of gilts bought stood at £200bn – equivalent then to more than a tenth of GDP – suggested that the purchases had cut long-term yields by a percentage point. The effect was not uniform, occurring mainly at the start of the programme. Further buying in 2011 and 2012 that added another £175bn had little impact on yields, according to subsequent research.

That may underplay the role of QE since it does not respect national borders. In general, the policy tends to depreciate currencies but there are other effects, too. Research by the BoE in 2016 suggested, for example, that the Fed's QE had a powerful impact on equity prices in the UK. Whether or

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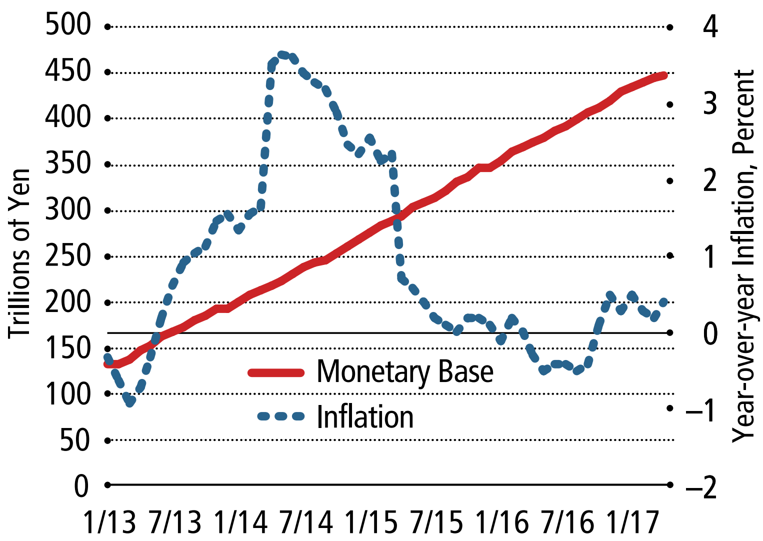
not the BoE or the Fed was responsible, the rebound in UK financial markets during the first phase of the BoE's QE was remarkable. Equity prices rose by 50 per cent between March 2009 and May 2010 while the spreads between corporate bonds and government bonds narrowed sharply over the same period. The rally might not have been wholly because of QE but it is hard to imagine that it would have happened without it.

Even so, the wider effect of QE on the economy has been more modest than many originally expected. The BoE's purchases of gilts eventually reached £435bn. But fears that the policy would ignite inflation proved to be well off the mark. Inflation has recently been above the 2 per cent target in the UK but that mainly reflects the big devaluation in sterling following the vote to leave the EU. Inflation was around zero in 2015 and a mere 0.5 per cent in June 2016 when the referendum was held.

In the eurozone, the ECB has more than doubled the scale of its asset-purchase programme, from €1.1tn to €2.6tn. The buying, originally due to run from March 2015 to September

2016, has been extended in stages to the end of 2018. Yet inflationary pressures remain subdued. The headline rate has recently gone above the bank's target of "below but close to 2 per cent" but that is mainly because of higher energy prices. Core inflation, which strips out volatile components such as food and energy, is only around 1 per cent, little higher than at the end of 2014, when it stood at 0.7 per cent.

Japan Monetary Base and CPI Inflation



Source: St Louis Federal Reserve

No central bank has done more QE in the past few years than Japan, the original pioneer of the policy in 2001. Not content with massive purchases of bonds, the Bank of Japan has also committed to keeping the 10-year bond yield at around zero, a pledge reiterated this summer, although with a slightly wider band. Its balance sheet has soared by around 60 per cent of GDP, to a total of around 98 per cent of GDP as of end June 2018, far more than that of the three other big central banks where expansion has been of the order of 20 per cent of GDP. Yet inflation remains stubbornly tepid.

Despite these apparently modest effects, it can be argued that QE, together with rock-bottom interest rates, averted a disaster. The BoE estimated that the initial £200bn of QE pushed up GDP by between 1.5 and 2 per cent and inflation by 0.75-1.5 per cent. The ECB calculates that its measures – mainly QE – between mid-2014 and October 2017 will have pushed up GDP and inflation by 1.9 percentage points cumulatively between 2016 and 2020.

No central bank is keen to highlight one of the most important effects of QE – its impact on the public finances. Governments have benefited from lower interest rates on new borrowing since the purchases began. Although national treasuries continue to pay interest on the bonds bought through QE, they also gain from the bumper profits they get from their central banks, which are financing the purchases at negligible interest rates. Although many Germans rail at the ECB's policy, its effect in lowering borrowing costs has contributed to Germany's budget surplus and falling public debt.

QE has shaped financial markets in the past decade and will continue to do so for years to come. The purchases may be ending (although not yet in Japan), but central banks will retain bloated balance sheets for a long time. The ECB is set to follow the BoE in preventing any automatic rundown in the assets it holds by continuing to repurchase the amount that matures. The Fed is the only big central bank that is actually shrinking its pile of assets. It is doing so not through direct sales but by gradually reducing the amount of maturing debt it repurchases.

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For the time being, the experiment appears to have worked. But it is too soon to reach a definitive judgment. The worry about QE is that, together with ultra-low interest rates, it has fostered a renewal of the risky behaviour that led to the financial crisis in the first place. There are also arguments that it has increased inequality by massively boosting the wealth of asset holders. If the happy days end in tears again, the final verdict on QE may be that it worked too well for its own good. ■

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