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Was quantitative easing best way to boost US economy?



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The US Federal Reserve building in Washington, D.C..

By Kenneth Rogoff MARCH 01, 2015

In the years since the financial crisis, the central banks of most advanced countries have been trying to restore growth by pumping money into their economies and buying up government debt and other assets, a process known as quantitative easing.

The scale of the interventions has been eye-popping: The balance sheet of the US Federal Reserve Bank has ballooned from around \$700 billion at the outset of the financial crisis to peak at more than \$4 trillion. So far, this massive “money printing” has not led to inflation because bank lending has not grown proportionately.

Nevertheless, some worry there will be big effects as the economy normalizes; others worry that “QE” has distorted the prices of stocks and other assets, creating a giant bubble waiting to pop, perhaps leading to another deep recession.

These concerns are probably overblown, although quantitative easing is still an experimental policy and there are many unknowns.

When interest rates go to zero

Central banks influence interest rates throughout the economy by manipulating their policy short-term interest rates up and down. But once the short-term interest rate reaches zero, it becomes harder to make credit any easier when activity is sluggish. In the years since the financial crisis, this “zero bound” has been a real problem for central banks in most advanced economies.

This is not to say that central banks have “run out of bullets.” Most important transactions in the economy involve longer-term interest rates, ranging from a five-year car loan to a 30-year mortgage. The central bank can still try to “talk down” these rates — which are not yet zero — by insisting it plans to keep short-term rates low for an extended period even after the economy recovers. The problem is, it’s hard for any central bank to promise what it is going to do in the distant future, especially given leadership turnover and changing economic pressures.

Quantitative easing attempts to shortcut this credibility problem by directly sucking long-term debt out of the market and replacing it with “money” or an equivalent — very short-term government debt. In principle, the reduced supply of long-term debt tilts the balance toward long-term borrowers and drives down the interest rate they pay.

There is also a “signaling” effect because the central bank stands to register large paper losses if long-term interest rates rise sharply, and it gets stuck holding a lot of old low-interest bonds if that happens. Of course, to the extent the central bank is simply buying government debt, these losses have little economic meaning. The government — the supplier of the debt — happens to own the central bank — the holder of the debt. Indeed, this observation begs the question of why central banks have been stuck doing the heavy lifting, instead of, say, government treasuries just issuing shorter-term debt. Perhaps it

is because in practice, central banks know they will get politically roasted for having paper losses, so stuffing their portfolios with low-yielding long-term debt helps convince investors they will keep short-term interest rates low for as long as possible. No one knows for sure.

We do know lower long-term interest rates stimulate growth. For example, low rates help induce firms to invest more and consumers to buy more on credit, raising demand for cars, computers, refrigerators, and of course, homes. Unfortunately, this normal channel has been less potent in the wake of the crisis, with many still skittish to invest. At the same time, tighter credit standards have cut off many lower-income consumers from borrowing entirely.

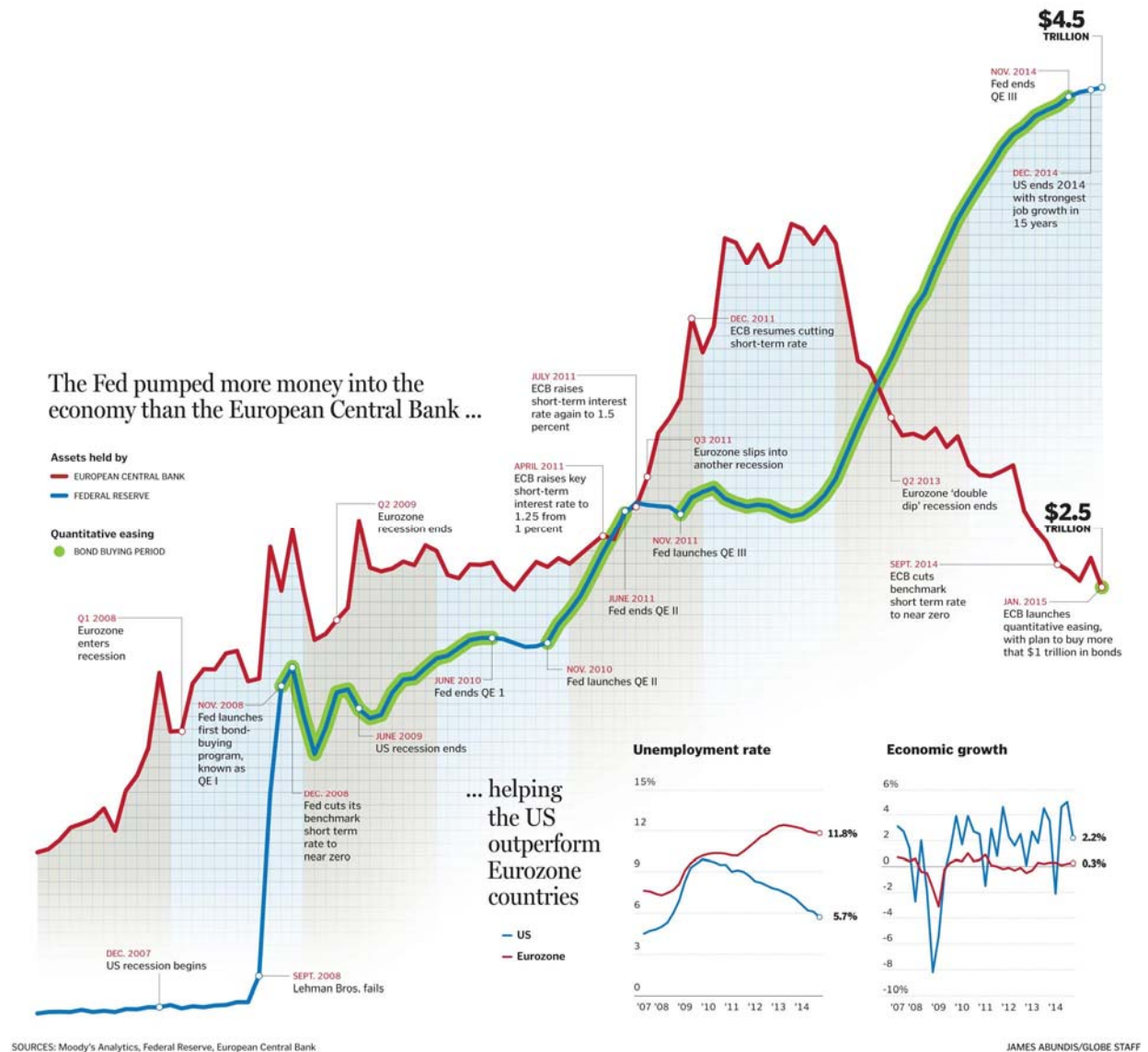
Nevertheless, low rates on long-term bonds have almost certainly helped bid up the prices of other assets such as stocks and housing. Some of this wealth gets spent, raising demand and inflation, and ultimately increasing jobs. This is something of a trickle-down effect because the wealthy obviously benefit disproportionately from rises in asset prices.

Of course, central bankers are quick to point out that a large majority of people own homes and benefit from higher stock prices through their pension funds, 401(k) plans, insurance contracts, and the like. Still, to make it more even-handed, some central bankers might want to just print money and hand it out to lower-income individuals. But most central banks don't have the right to do this; they can only intervene in financial markets, and only in a limited way. The job of redistributing income is for Congress and the president.

Why doesn't the government just finance its entire debt at zero interest? Wouldn't that free up public funds for other uses and save the taxpayers a lot of money? Yes, but here's the rub: As the composition of government debt shifts to more short-term debt, the public finances become more exposed if some external factor drives up global interest rates. If all debt were very short-term and interest rates unexpectedly rise, taxpayers would suddenly face vastly larger interest costs as the debt gets rolled over at higher rates.

This is not a likely scenario but because a country like the United States intends to be in business for many centuries to come, it is not one to be totally dismissed — as some pundits would do. The argument is the much the same as why it is imprudent to let overall government debt drift up inexorably, although of course it makes sense to run deficits in recessions.

In my mind, QE was worth taking the added risk entailed by having more short-term debt. But as the recession abates, the calculus of risk and benefit changes.



Size matters

Quantitative easing has to be massive because as a tool, it is a weak and uncertain instrument compared with normal interest rate policy. I have long compared being at the zero bound to being caught in a sand trap in golf. If you just tap the ball, it is not going anywhere. You need to take a full swing. Once the ball is out of the sand trap, even if in a rough, you can start to gain control again.

If monetary policy is too aggressive and expectations of inflation start to rise, so too will interest rates. Like the golfer back on grass, the central bank can then use normal interest-rate policy to rein things in. The main problem with QE recently is precisely that central banks have been reluctant to take a full swing, to do “whatever it takes” to restore inflation expectations. The problem is more acute in Japan and Europe than in the United States, though it has been a problem here, too.

So far, all the new money hasn't created inflation — but it would if banks started unloading the massive holdings of reserves they received from the Fed. As long as those holdings remain bottled up in the banking system, there is no direct effect. Central banks assure us not to worry because if things ever do heat up, they have more than adequate tools to deal with the problem before inflation spikes.

The central banks are almost certainly right in theory, though one can imagine practical circumstances where exiting from QE could get tricky. Obviously, central banks can simply reverse the process as the global economy strengthens, selling off long-term bonds to soak up reserves. Then that money doesn't get into the economy to cause inflation.

And if all else fails, the central bank does have other tricks up its sleeve. For example, the Fed might be able to invoke financial stability concerns to force banks to temporarily hold much higher reserves. Such a move would be hugely controversial, but in emergency situations, central banks are used to that.

Is there a better idea than quantitative easing? For example, if bank reserves are being bottled up and not getting out into the economy, why make the interest rate paid to banks negative, pressing them to lend out the funds?

The main problem, perhaps surprisingly, is that central bankers fear that pushing policy interest rates too deeply into negative territory will set off a run into paper currency, which pays no interest. This creates all sorts of problems, but mainly the paper currency option effectively prevents rates from getting too negative.

The Swiss National Bank has recently decided to test the limits of negative rates by pushing its central rate down to -0.5 percent. The Danish Central Bank went further, pushing short term interest rates to -.75 percent. The Swiss and the Danes probably figure if they don't push it too far, there won't be a flight to currency on a grand scale that would undermine their policies. After all, holding large piles of cash has its own risks, including theft. Still, it is a real question how much further central banks could dip into negative interest rate territory without creating massive problems.

There are ideas out there for making it easier for central banks to charge negative interest rates in a deep recession, albeit slightly futuristic. The simplest idea is to phase into a new world where the central bank issues traditional currency electronically instead of by paper. This would be a complex transition involving many institutional changes, particularly to allow privacy in smaller transactions and to subsidize credit services for lower-income individuals.

Phasing out large-denomination notes might prove to be sufficient — roughly 80 percent of US paper currency is \$100 bills. With only electronic currency, there would be no constraints on paying interest on money. In normal times, interest rates could be positive; in a deep recession, interest rates on currency could be negative.

But obviously this kind of institutional change, even if inevitable, cannot be implemented anytime soon. So the zero bound is a real problem.

Bottom line benefit

It does appear that QE has, in the end, been at least a modest success — particularly in the United States and the United Kingdom, two countries that were early adopters of QE and today are doing better than most.

But policymakers or economic pundits who absolutely assure you that there is no risk are engaging in hyperbole. We don't know the endgame, including risks from asset bubbles that might pop violently at some point, or from budget problems if global interest rates unexpectedly tighten quickly.

My guess is that history will judge quantitative easing a reasonable risk where there was no complete safe path to recovery. Still, let's hope that before the next financial crisis happens, hopefully in the distant future, central banks will have found a better approach.



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The Fed decided to end quantitative easing in October.

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