Global Insights

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Quantitative easing, a successful strategy?

Central banks are set to unwind the extraordinary accommodation put in place since the global financial crisis. The US Federal Reserve (The Fed) has commenced its transition from Quantitative Easing (QE) to Quantitative Exit and the European Central Bank (ECB) is preparing to taper its asset purchases. While investors are assessing how the uncharted waters of quantitative exit will affect their positions, economists are still analyzing whether QE has indeed been successful as a monetary policy strategy or if this unconventional policy was unnecessary.

This week's BNR Global Insights offers an overview on Quantitative Easing (QE). We seek to explain what it is, why it was introduced and whether it has been successful as a policy tool.

Quantitative easing Defined

Quantitative easing (QE) can be explained as the unconventional form of monetary policy where a central bank creates new money electronically to buy financial assets, such as government bonds. Central Banks buy assets, mainly government bonds, from banks and other financial institutions. The sellers of these assets (banks and other financial institutions) can then use the extra funds from the Central Bank to spend on other investments, or lend to households or businesses. This process aims to directly increase private sector spending in the economy and help in pushing inflation to target.

Following the financial crisis, ultra-low interest rates in many advanced countries failed to reduce deflationary pressures, and due to the zero lower bound constraint, Central Banks could not cut rates beyond zero and therefore resorted to unconventional policies such as QE. This programme of large-scale purchase of public and private assets using central bank money was aimed at injecting money into the economy in order to boost spending and thus help driving inflation higher.

Has quantitative easing been effective?

In their 1929 book, Friedman and Swartz argued that quantitative easing was necessary to lift the US economy out of the great depression. QE helps to provide addition cash to the system where there is a shortage and at the same time boost the confidence in the economic system, which as a result stimulates economic activity.

Presently however, there is no consensus among economists that QE has been successful. The Bank of England for example notes that quantitative easing has helped to support the economic recovery, because it provided liquidity to the market and put banks in a position to lend, although some argue that this has not been the case. They point to the fact that small businesses, the main parts of the economy that need money to stimulate economic activity have not benefited from this approach since cash (in QE), is only given to big financial institutions which are reluctant to lend to smaller institutions.

The supply side and demand side challenges

Monetary authorities assumed that providing liquidity to big financial institutions through QE should provide excess money for banks to lend, thus increasing overall lending to support economic activity in the real economy. However, this assumption did not take into consideration other constraints banks face that could force them not to lend. Following the financial crisis, there was an increase in financial oversight and regulation. The Basel III and MiFID I and II required banks to maintain certain capital and liquidity requirements. Since banks were required to hold a certain threshold of capital to meet regulatory requirements, additional liquidity for these banks would not necessarily increase their lending.

In order for banks to lend, there has to be demand for credit from consumers and businesses. It is important to note however that QE was introduced in the great recession when consumer sentiment and optimism was very low. Weak consumer confidence and business sentiment weakens demand for credit since most businesses and consumers are not willing to take on loans to invest in new ventures, because during recessions, people are unable to spend and therefore investment is unattractive. With little or no demand for credit, additional liquidity for banks was therefore obsolete since it wouldn't trickle down to the consumers to stimulate economic activity.

Additionally, one of the causes of the 2008 financial crisis was that most individuals and businesses defaulted on their debt obligations. Banks were therefore risk averse and reluctant to lend during the recession because of such experiences. Creating additional liquidity for banks through QE did little to improve risk profiles of customers and therefore did not encourage lending.

QE; a policy tool in vain?

The only undisputed effect of QE is that it led to low government bond yields. In all countries where QE was used, long-term bond yields declined at every announcement of asset purchases. However, this is inconclusive to determine whether QE has been successful since there is a weak link between low bond yields and real economic activity. It is also important to note that alongside QE, Central Banks simultaneously deployed various monetary policy tools such as ultra-low interest rates, negative interest rates, Targeted Long-Term Refinancing Operations (TLTROs) among others, which makes it difficult to determine which of the tools was responsible for the dissipation of deflationary pressures that Central Banks were looking to control.

Way forward?

Whether QE has been successful or not, the planned Quantitative Exit by major economies will have significant implications to the global economy including on Rwanda. Since it is the first time in history, the world is set to experience such a situation, many economists, analysts and investors are unsure of what the likely implications will be and how they will unfold.

In our next issue of BNR Global Insights, we will provide a deep dive into QE, explain how QE Exit will unfold and assess the likely implications it will have on the global economy and Rwanda in particular. *Watch this space!*