QE or not QE?
Quantitative Easing: a primer on its impact

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QE or not QE? How might it work…

1. Stronger Credit Growth
   - Purchases leave banks with excess reserves, which encourages them to lend.

2. Lower Funding Costs
   - Purchases drive down long term interest rates, encouraging investment and reducing government debt servicing costs.

3. Higher Asset Prices
   - Cash received is switched into other assets such as stocks and corporate bonds, driving up their prices.

4. Lower Exchange Rate
   - Exchange rate falls as relative supply of domestic currency is boosted and interest rate falls.

5. Stronger Expectations
   - QE fuels expectations of higher inflation and growth, stimulating spending.

What is Quantitative Easing?
A central bank aims to stimulate the economy by buying financial assets. It starts by creating money for its own account, which it exchanges for the assets, thereby boosting the amount of money in the financial system. This is an alternative to cutting short term interest rates.
QE or not QE? The story so far… (1)

Evaluating the impact of QE so far is very hard…*

- Measures taken are unprecedented
- In volatile economic and market conditions, isolating the impact is tricky

1. Credit Growth – no sign of improvement
   - Bank lending has been falling
   - …overall credit is still primarily being supported by the government

2. Funding Costs – lower, but how much is due to QE?
   - Although government bond yields have fallen recently, the first round of QE saw yields rise after an initial fall

3. Asset Prices – stocks, bonds and even commodities appear to have benefited from QE
   - Corporate bond spreads lower
   - Stock prices have gained, despite talk of a ‘double dip’

* Click here for more information on this topic
QE or not QE? The story so far… (2)

4. US dollar has fallen
   - Falls have been greater than might be expected from interest rate differentials…
   - …perhaps indicating changed perceptions about US FX policy and the future scale of QE

5. Inflation expectations are rising
   - Given the declines in inflation, this is clear sign that the policy-makers’ message is getting across
   - This is driving down real yields, which policy-makers hope will lift growth
QE2: “steady as she goes”, not “shock and awe”

- Unlike the first, the second round of Quantitative Easing (QE2) from the Fed will focus on buying Treasuries...
- ...and since catastrophe isn’t imminent, this will be done step-by-step, not with the “shock and awe” of an unexpectedly big programme
- BUT even the Fed doesn’t expect enormous effects...
- ...and the markets are already pricing in at least $500bn in purchases over the next six months
QE or not QE? How it might go wrong

1. Asset price bubble
   - Prices are pushed to unsustainable levels, setting the scene for an even more damaging crash. This would also expose the central bank to big losses on its asset purchases.

2. Bond vigilante backlash
   - Bond investors react badly to the central bank’s attempts to stoke up inflation and the prospect of government debt being monetised. Inflation expectations become unanchored and long term interest rates surge.

3. Market distortions
   - Central bank purchases distort financial markets' price signals, deterring investment and creating volatility.

4. Currency wars
   - Other countries resist the currency depreciation, through intervention or capital controls. This might also trigger damaging trade conflict.

5. Inflation surge
   - Inflation expectations turn self-fulfilling. Currency weakness and soaring commodity prices ignite inflation, which is then sustained as banks finally start to lend and activity takes off.

BUT - QE fans argue problems can be averted by reversing it in a timely fashion...
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