

Some comments on Quantitative Easing (Q.E.)

*At the IMF seminar, "Japan's Policy Response to Its Financial Crisis:
Parallels with the United States Today"*

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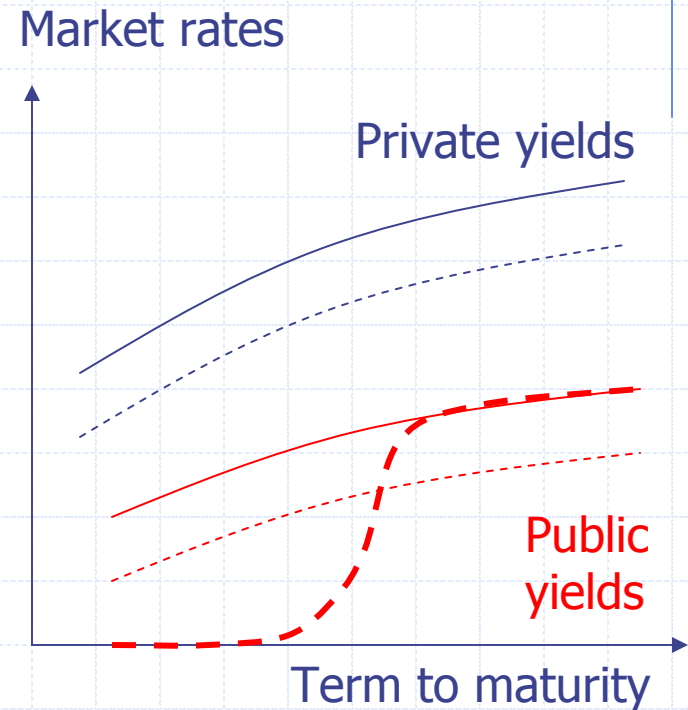
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Q.E., Q.E.D.

The composition and size of a central bank's balance sheet can influence financial markets and the economy over and above the effects of the current level of the policy rate.

Asset accumulation

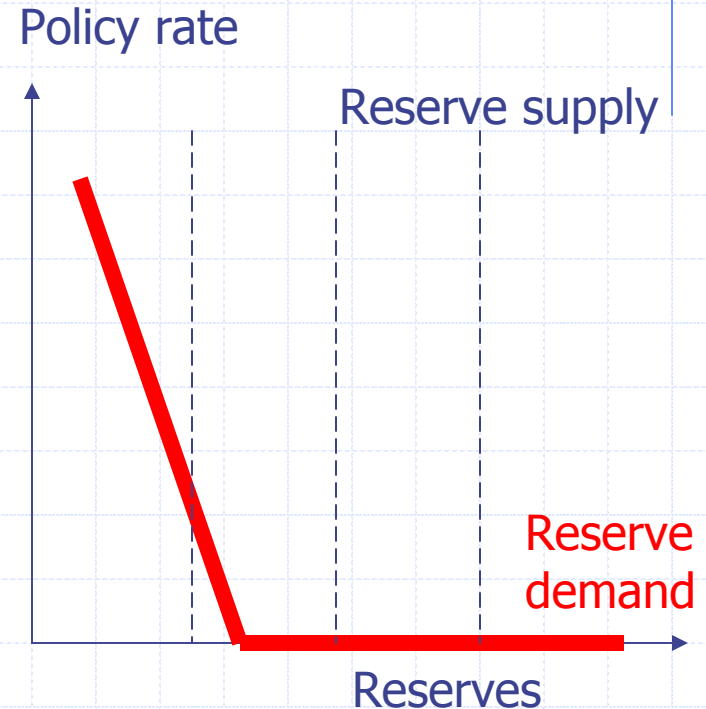
- ◆ Supports the prices of certain assets
 - Private or public securities?
 - Neutral across maturities or sector specific?
- ◆ May generate revenue that provides “fiscal space”
 - If you build it, will they come?



Reserve creation

◆ Reserve creation

- Directly encourages the expansion of the balance sheets of commercial banks
- Commits to keeping the policy rate low for a long time (the policy duration effect)





Potential pitfalls

Q.E. is built on a strong theoretical base, but will it work and what are the longer-term consequences?

Communication

- ◆ Channels are hard to quantify, both ex ante and ex post
- ◆ Ex ante, Q.E.
 - does not have the clarity of a policy rate announcement
 - Relies in part on quantities that are not part of standard macroeconomic models
- ◆ Ex post, Q.E. has been assessed through event studies, but
 - Which financial price?
 - What is the counterfactual?
 - How wide should the event window be?

Other potential pitfalls

◆ Governance

■ Board vs. FOMC

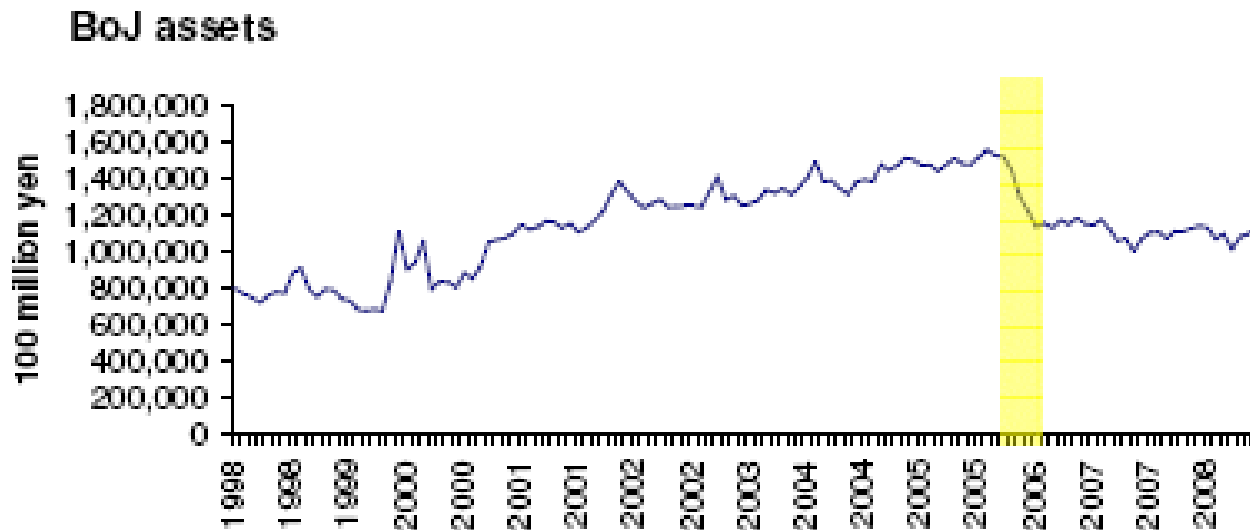
- ◆ Started QE in October '08
- ◆ Embraced QE for macro reasons in December '08

◆ Risk of political interference

◆ Difficulties in unwinding

About the unwind . . .

- ◆ The BoJ did it, sort of



	2005.12	2006.05	Change yen	percent
Total assets	1,556,071	1,227,935	-328,136	-21
of which:				
Bills purchased	440,899	279,140	-161,759	-37
Government securities	989,175	840,124	-149,051	-15

About the unwind . . .

- ◆ Will the Federal Reserve be able?
 - Some long-lived assets might no longer have markets
 - Political pressures might be intense
 - Treasury's contribution of a first-loss tranche (to limit credit risk) might give Treasury some influence on the FR balance sheet
- ◆ The Federal Reserve might ask for the authority to issue debt
 - Why would the swap matter?
 - What are the political risks?

Assets

Liabilities

Assets

- Δ Reserves

+ Δ Debt

My preferred solution,

- ◆ Don't let the possibility that the Fed will not do the right thing in the future prevent it from doing the right thing now
- ◆ Put mechanisms in place that force good behavior in the future
 - Inflation goal
 - Harder floor on deposit rates
 - Term limit on holding private credit risk funded with reserves

Duration of real per capita GDP cycles around banking crises

Country	Year of banking crisis	Duration in years	
		Peak-to-trough	Peak-to-pre-crisis-peak
Finland	1991	4	8
Japan	1992	1	2
Norway	1987	1	3
Spain *	1977	0	0
Sweden	1991	3	5

Source: Reinhart and Rogoff (2009)