

## Limits of Quantitative Easing

By Marek Dabrowski

The recent decision of the U.S. Federal Reserve Board (Fed) to increase its assets by purchasing \$600 billion worth of Treasury bonds is unlikely to boost economic growth or employment prospects in the U.S. Instead, it will cause major damage throughout the world economy, especially in emerging markets, where the U.S. dollar remains a leading reserve and transaction currency. If this decision is not corrected soon, the Fed's policy may cause another macroeconomic and financial crisis in the very near future.

### A Bit of Recent History

When examining the origins of the recent global financial crisis, one cannot omit the role and responsibility of the U.S. Fed. Let's not forget the Fed's unjustified fear of deflation in the beginning of the 2000s, which kept the Federal Fund Rate (FFR) at a very low level (1%) for far too long. This led to a spike in asset bubbles as well as decreased perceptions of risk. Paradoxically, when the asset bubbles burst and the financial system collapsed in 2007-2008, the Fed responded with increasingly aggressive monetary easing in order to avoid a deflationary spiral similar to the kind experienced during the 1930s. Generally, this was the correct response because the rapidly decreasing money multiplier had to be compensated via a much larger volume of reserve money (see Figure 1).

As the FFR dropped to almost zero, further monetary easing had to be conducted through the Fed's purchasing of various financial assets, the so-called quantitative easing. Looking back, this policy achieved its goals, i.e. shortened the overall length of the recession and prevented deeper deflationary shocks. However, it reached the limits of its effectiveness. Specifically, it cannot be repeated under the new economic realities of 2010-2011 without a serious risk of economic distortions and turbulences.

### More Money More Problems

The Fed justifies its new round of quantitative easing (QE2) as upholding U.S. domestic policy priorities, specifically supporting economic growth and reducing unemployment. Its main concerns are deflation and double-dip recession,

reminiscent of the 2002-2003 debate.

At this stage, however, it is doubtful whether additional (cheap) money can help stimulate the U.S. economy. Most borrowers, especially households, face an excessive debt burden as real estate prices (home owners' main collateral) remain low and employment perspectives are highly uncertain. In this environment interest rate levels really do not matter all that much. To put it simply, borrowers are still hesitant to borrow, and banks are reluctant to lend. Most probably, only a fraction of the \$600 billion injection will be absorbed domestically while the majority will flee abroad to various emerging markets (see below).

Ultimately, the monetary stimulus cannot help solve the long-term macroeconomic or structural challenges faced by the U.S. economy. For example, if the U.S. wants to eradicate its high current account deficit than it must increase its net savings rate. Monetary easing will not help achieve this goal. The same concerns structural changes such as reducing the share of leveraged economic activity (like the housing industry). These kinds of changes are socially and politically painful. They take time to correct and expansionist monetary policy will do little to alleviate the sting.

### Stimulating Risk Appetite and New Bubbles

Expansionary monetary policy is also unlikely to help steer the financial sector towards more prudent practices. If investors cannot expect a real positive rate of return on standard bank deposits they will seek higher-yield but more risky financial instruments. Demand for such instruments will have to be met by the financial industry in one way or another, tougher regulatory standards notwithstanding.

Thus, new economic distortions and asset bubbles seem to be the unavoidable result of a continued lax monetary policy. One can only speculate where they are going to appear. True, a new housing bubble in the U.S. does not seem to be possible in the near future, but stock and/or

commodity bubbles look like a highly probable scenario.

### Exporting Inflationary Pressure

As mentioned earlier, cheap money will flow from the U.S. to other countries in search of higher investment yields. This will cause a lot of problems for the latter, especially for developing market economies. Larger capital inflows and increasing commodity prices will generate overheating as well as inflationary pressures similar to those observed in 2005-2008. They may also contribute to the creation of various local bubbles, especially in countries with weaker financial sector regulation.

Although inflation does not seem to be a real threat in the U.S. in the short-term, higher inflation worldwide will have to have an impact on U.S. domestic inflation rates over the long-term, among others, through a commodity price channel. Furthermore, the Fed's reduced credibility (as a result of its excessive involvement in quasi-fiscal operations and deteriorating balance sheets) can increase inflationary expectations. This will be a very dangerous moment for the entire global economy. The Fed will have to tighten its monetary policy sharply and, as it happened in the early 1980s or mid 1990s, overheated emerging markets will face the threat of both currency and debt crisis.

To cushion the damaging impact of increasing financial inflows some emerging market economies have already started to build a protective wall against them by introducing various types of capital controls, sometimes under the heading of so-called macro-prudential regulations. However, in the contemporary world of sophisticated financial engineering they can be easily circumvented. And as any type of protectionism they generate beggar-thy-neighbor policies, i.e. they redirect capital flows to countries, which have yet to

introduce capital controls. They also distort the allocation of financial resources.

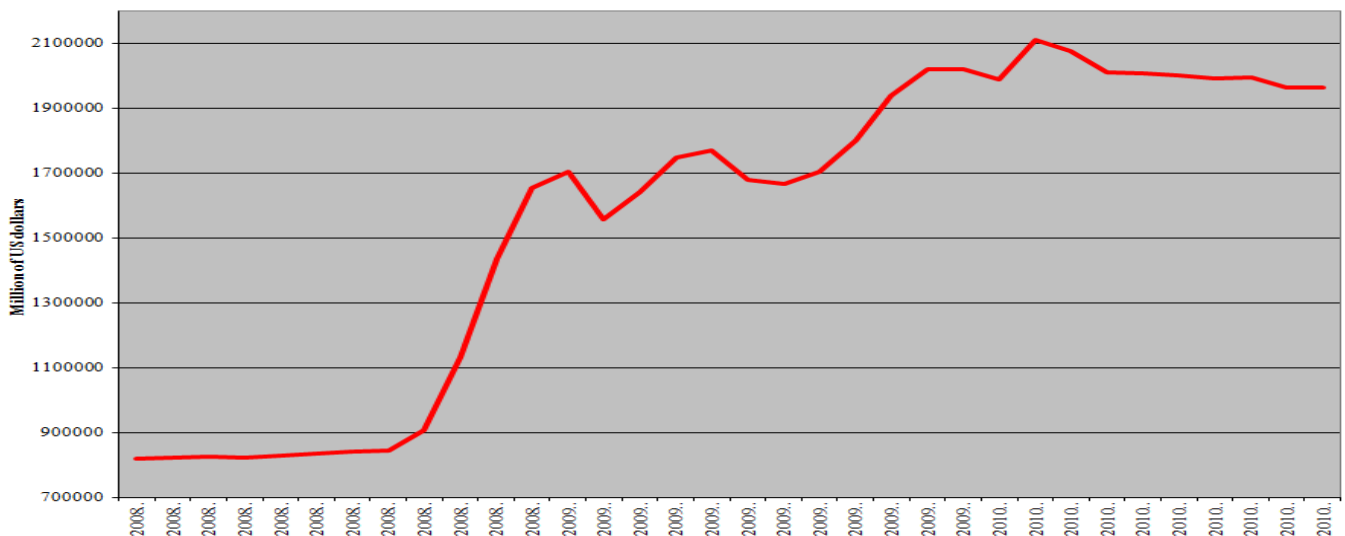
### The Dangers of Protectionist Spirals

The key danger in relaxing U.S. monetary policy is that it weakens the U.S. dollar, other things being equal. Even if unintended (the U.S. government confirms its commitment to a strong dollar and rejects accusations of intentional currency manipulation) this will cause serious turbulences in the world economy and may result in future political controversies within the G20.

Currencies with floating exchange rates will appreciate, harming growth prospects of their respective countries and regions. This is a particularly serious challenge for stagnating or slow-growing high-income countries such as Japan and most of the Euro area. Countries which continue to peg their currencies to the U.S. dollar will not lose their trade competitiveness and may even gain a short-term advantage in relation to countries with appreciating currencies. On the other hand, they are more exposed to inflationary and overheating consequences of a weak dollar.

Ironically, this kind of asymmetric adjustment makes things worse from the point of view of rebalancing the world economy, which seems to be a top policy objective of the G20 and IMF. The countries which can be expected to reduce their current account surpluses such as China, India, or oil-rich economies have their currencies pegged to the U.S. dollar. Moreover, a weaker dollar means further depreciation of their real effective exchange rates (measured against a trade-weighted basket of transaction currencies) at least in the short-term. In the long-term higher imported inflation may erode these gains.

FIGURE 1: U.S. FED'S RESERVE MONEY, SEASONALLY ADJUSTED, 2008-2010



SOURCE: U.S. Federal Reserve

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The tensions generated by a weak dollar may easily lead to explicit trade protectionism in the form of higher tariff and non-tariff barriers, with all its damaging effects as experienced in the 1930s. In the short-run the increased volatility of exchange rates between major currencies also has an adverse impact on trade and financial sector stability, especially in economies with high foreign-currency exposure.

True, emerging market economies with persistent trade and current account surpluses should allow their currencies to appreciate in nominal terms. This is important not only for reducing current account imbalances between major trading partners and regions but also for maintaining domestic macroeconomic stability of emerging market economies (i.e. reducing the imported inflationary pressure) without resorting to capital controls and increasing costs of domestic financial intermediations (for example, through higher reserve requirements). Historical experience vastly demonstrates limits of mercantilist policies and their damaging impact on global trade.

On the other hand, changing exchange rate policy in countries such as China or India is a politically sensitive process and requires time. It requires not just the correction of the exchange rate or the exchange rate regime, but rather deeper change within the country's economic growth strategy. External pressure, especially in the form of unilateral monetary policy decisions of central banks (like the Fed), is unlikely to help in the process.

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