From Quantitative Easing to Tightening. Or not?

The U.S. Federal Reserve has put an end to its QE "4" (Quantitative Easing) and is even considering reducing the size of its balance sheet. A perilous exercise.

Quantitative Easing is coming to an end in the US. But can the Fed afford to move into Quantitative Tightening?" In today's focus, we take a look at the effects of the decade long experiment that was QE, and what comes next.

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While most eyes are focused on Russia and Ukraine, many people may have missed that the U.S. Federal Reserve conducted its latest Permanent Open Market Operations (POMO) last week, one of the most popular tools of the quantitative easing (QE) process.

POMO operation 9th of March 2022

Results 3/9/2022

	AMOUNT ($Millions)	
	Submitted	Accepted
Operation Type	Par Value	Par Value
Outright Coupon Purchase	**17,398**	**4,001**
Operation Date:	Wednesday, March 09, 2022	
Settlement Date:	Thursday, March 10, 2022	
Maturity/Call Date Range:	Saturday, June 15, 2024 - Monday, August 31, 2026	
Operation Method:	Multiple Price	
Release Time:	10:10 AM	
Close Time:	10:30 AM	

Source: New York Fed

On March 9th at 10.30am New York time, the Fed bought $4 billion in bonds. With this latest injection of liquidity, it is nothing less than the end of QE, an experiment that has led the Fed to inflate the size of its balance sheet by nearly $6 trillion over the past two years. Some 580 purchases of Treasury bonds and 1,200 purchases of mortgage debt have been conducted by the Fed since the beginning of the pandemic.

About QE

As a reminder, quantitative easing (QE) is a monetary policy in which a central bank buys predetermined amounts of government bonds or other financial assets (corporate bonds, stocks, mortgages, etc.) to inject money into the economy to jump start activity. Quantitative easing is considered as an unconventional form of monetary policy, usually used when inflation is very low or negative and when standard monetary policy instruments such as lowering interest rates have become ineffective.

> The term “QE” was first used by the Japanese central bank in 2001. The objective was to escape the deflationary spiral in which the country was trapped.

Quantitative easing stimulates economic activity in the following ways:

- It leads to the creation of new reserves, which increases the money supply. As the money supply circulates in the economy, additional activity is generated.
- Medium and long-term interest rates decline, giving a boost to sectors such as real estate.
- Governments are able to borrow more cheaply over the long run, making it easier for them to implement economic stimulus policy.
- Lower bond yields may encourage some investors to move into riskier assets. This makes capital available for sectors that can stimulate economic growth.

Ben Bernanke was one of the main proponents of QE. It was under his chairmanship that the Fed launched this strategy in 2008. Other central banks (ECB, SNB, Bank of England, etc.) have since followed.

QE 1, 2, 3 and 4

As mentioned above, it was during the great financial crisis that the first wave of QE was launched. At the end of November 2008, the Fed began a program to buy mortgage-backed securities (MBS) for $600 billion. In June 2010, the Fed's balance sheet peaked at $2.1 trillion.

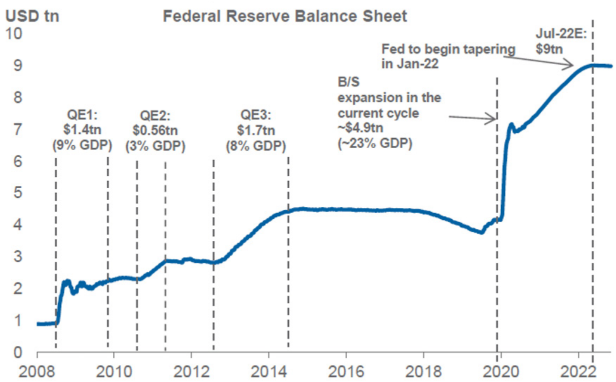
QE2 was implemented in November 2010 as the monetary authorities had to acknowledge that economic growth was not as strong as expected.

QE3 was announced in September 2012, this time with the objective of buying $40 billion per month worth of bonds, following an "open-end" process, i.e. the Fed could allocate its purchases according to the type of bonds and maturity desired. The program was nick-named "QE-Infinity" by some market participants.

The "end of the game" came in June 2013 when Ben Bernanke announced a "tapering" - a reduction in the pace of bond purchases - as economic growth improved. It wasn't until October 2014 that the Fed's bond purchases were halted, as the size of the Fed's balance sheet had reached $4.5 trillion in assets by that time.

QE4 was launched in March 2020, at a time when covid-19 was paralyzing the global economy and caused a crash in financial assets. The program of buying $120 billion assets per month was not reduced until January 2022. Today, the Federal Reserve's balance sheet is close to $9 trillion.

Fed's balance sheet to peak at US$9 trillion in 2022



Source: Federal Reserve, BEA, Haver Analytics, Stanely Research

The Vices and Virtues of QE

The effectiveness of QE is the subject of intense debate among researchers because it is difficult to separate the effect of quantitative easing from other economic and policy measures that have been put in place since the great financial crisis.

In July 2012, former Fed Chairman Alan Greenspan tried to make the case that QE 1 and QE 2 had "very little impact on the economy." However, other central bankers have stated that quantitative easing measures "played an important role in supporting economic activity."

Several studies published in the aftermath of the crisis found that QE in the U.S. did help lower long-term interest rates on a variety of securities as well as reduce credit risk. This boosted GDP growth and slightly increased inflation (an observation that was indeed valid before 2021...).

But other studies point to the negative consequences of QE. For example, QE may fail to stimulate demand if banks remain reluctant to lend money to businesses and households.

QE has also had the effect of directing investment capital into risky assets, inflating the value of stocks relative to the underlying value of goods and services, and increasing the wealth gap between the rich and the middle class. Mortgage debt buybacks - keeping borrowing costs artificially low - could also be the source of a new US housing bubble.

For some analysts, the current surge in inflation is not only due to supply chain constraints and the Russian-Ukrainian conflict. The massive increase in the money supply over the past few years has also had an impact on inflation.

Another undesired side-effect of QE and artificially low bond yields has been the surge of debt worldwide. To take the case of the US, debt to GDP has now reached a ratio of 130% and is prompting the US authorities to pursue a strategy of deep negative real rates (aka “financial repression”) to avoid a debt crisis.

After more than a decade of QE, the US is facing an unprecedented situation: an overvaluation of assets (stocks, real estate, etc.) worthy of the 1990s bubble, an inflation rate almost comparable to that of the 1970s and a debt level reminiscent of the 1940s. This explosive cocktail is also the result of the moral hazard created by QE. The very low cost of financing has not encouraged governments to implement the necessary structural reforms, preferring instead to resort to fiscal and monetary stimulus.

Finally, QE also creates a reputational risk for central banks. What will happen to bond yields the day investors lose confidence in the central bank?

Is it time for Quantitative Tightening (QT)?

TAs mentioned above, QE has its merits but also its limits, creating dangerous imbalances. With a booming job market and an inflation rate well above the Fed's target, it seems logical that the US central bank would want to put an end to this "experiment".

Moreover, there is talk of QT, i.e. a sale of the bonds held by the Fed and/or the non-reinvestment of maturing bonds. This new step was announced at the end of January of this year by Fed Chairman Jerome Powell. While the duration and the amount of the reduction have not been clarified, many economists have suggested July 2022 as the start date for QT. Regarding the amount, some are talking about 20% of US GDP as a target size for the Fed's balance sheet. In order to reach this target, no less than $2 trillion worth of liquidity would be withdrawn by the Fed via QT.

A perilous exercise

There is no real roadmap for conducting quantitative tightening. While QE is often referred to as an "experiment" by many observers, we have even less history to calibrate the coming phase of QT, and the precedent we do have is not necessarily very encouraging.

In October 2017, the Fed announced its intention to reduce the size of its balance sheet. At that point, interest rates had been rising for nearly two years. The process was to proceed along a set path to give the markets a clear picture of how demand for government bonds would evolve. At the time, the plan was to reduce the Fed's balance sheet by about $1 trillion over several years.

The Fed is not even halfway there. By mid-2019, money market conditions suggested that liquidity was becoming scarce. QT ended prematurely...and soon after, the pandemic forced a reversal of the process right back into QE.

As a new QT is considered, the Fed faces an even more complex situation than in 2019.

On the side of the arguments for QT, the fact that the Fed's balance sheet is now twice as large as it was at the beginning of 2020. But also that the inflation rate has reached levels that very few experts - including the Fed - had anticipated.

However, there are a few things that should cause the Fed to be very cautious about deploying QT. First, the Russia-Ukraine conflict is creating new risks for the global economy: falling confidence, further supply bottlenecks, a loss of consumer purchasing power, etc. Over the past two decades, the Fed has tended to inject liquidity during crises (2008, 2012, 2020). Is it appropriate to take the opposite path in these uncertain times?

And there is also another serious constraint to the implementation of QT: the huge level of US government debt. It is estimated that the Fed has bought between 20 and 30% of new Treasury issues in recent years. In the event of a reduction in the balance sheet, who will be the buyer of last resort for US debt? Reduced demand poses a risk of higher bond yields that could threaten the creditworthiness of many borrowers.

Conclusion

As we explained at the end of 2021, the Fed has a window of opportunity this year to normalize its monetary policy. Given the runaway inflation, we believe the Fed has no choice but to end QE and initiate a rate hike program. However, the implementation of QT remains hypothetical. Given recent events and the flattening of the yield curve, many economists are already talking about a QE5...

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