

Quantitative Easing: Its' Impact on and Lessons for the Vulnerable Indian Economy

**NIYATI BATISH,
Research Scholar,
Department of Economics,
H.P. University, Shimla, (H.P.), 171005**

Abstract

A monetary authority or a central bank or the reserve bank of a country is an institution set up to manage the money supply, currency and interest rates in the economy. All the commercial banks come under the jurisdiction of this central monetary authority.

In order to improve the growth rate of an economy a Central bank can employ a number of policies. Such policies adopted by the central bank must strike a balance between the long-term market expectations and short-term improvements in the economy. The economy might enter into a recession if the central bank tapers its activities too quickly. On the other hand inaction on the part of the central bank with regard to tapering might be inflationary in nature. In the context of India it will be wise enough if timely steps are taken to strengthen the economy to safeguard it from such external changes. There is an immeasurable impact on fiscal credibility and policy confidence when a country acts in advance without being forced to do so.

Key Words: Monetary Policy, Quantitative Easing, Taper, MBS.

Introduction

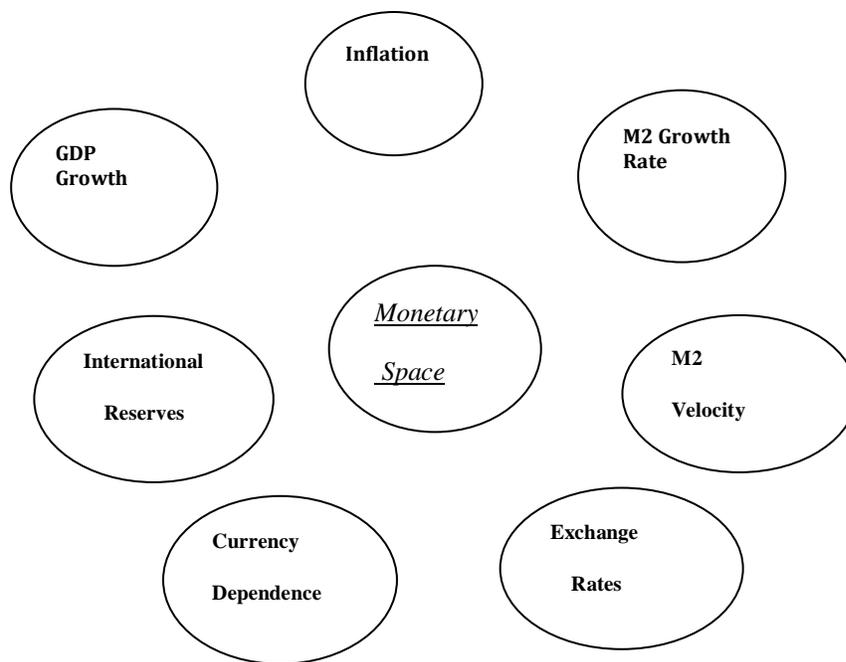
Monetary Policy:

Monetary Policy is an instrument through which the macroeconomic objectives can be achieved. For a lay man monetary policy may appear as measures taken up by a country and decisions implemented by a particular government in order to control the influence the level of interest rates, credit, volume of money, use of money in the economy and also the public expenditure. Broadly speaking it is representative of a monetary system that deals with all those monetary and non-monetary measures and decisions that have monetary effects. It ensures an efficient operation of the economic system by manipulating the supply, availability and cost of money in the economy.

G.K. Shaw defines monetary policy as “any conscious action undertaken by the monetary authorities to change the quantity, availability or cost of money”.

Fig. 1

DETERMINANTS OF MONETARY SPACE



Tapering:

It is the process through which a central bank gradually winds down its activities in order to revive growth in the economy. It primarily focuses on interest rates and future expectations of the investors regarding those interest rates. It may be brought into effect through the conventional central bank activities such as adjusting discount rate, manipulating CRR (Cash Reserve Ratio), SLR(Statutory Liquidity Ratio), Repo Rate, reverse repo rate etc., or using more unconventional ones, such as quantitative easing (QE). Central banks reduce market uncertainty by outlining their approach to tapering, and under what conditions that tapering will either continue or discontinue.

A Brief Overview of Conventional Monetary Policy:

➤ A *restrictive monetary policy* is adopted when a country's economy becomes 'overheated' that is the inflation reaches dangerous levels. The central bank will tighten the money supply through its restrictive monetary policy and also raise the rate of interest at which this money is made available to the economy. This would make loans more expensive and would increase borrowing costs, resulting into a fall in the demand for cash and cash instruments. To achieve this, the central bank may also resort to raising the CRR (Cash Reserve Ratio), SLR

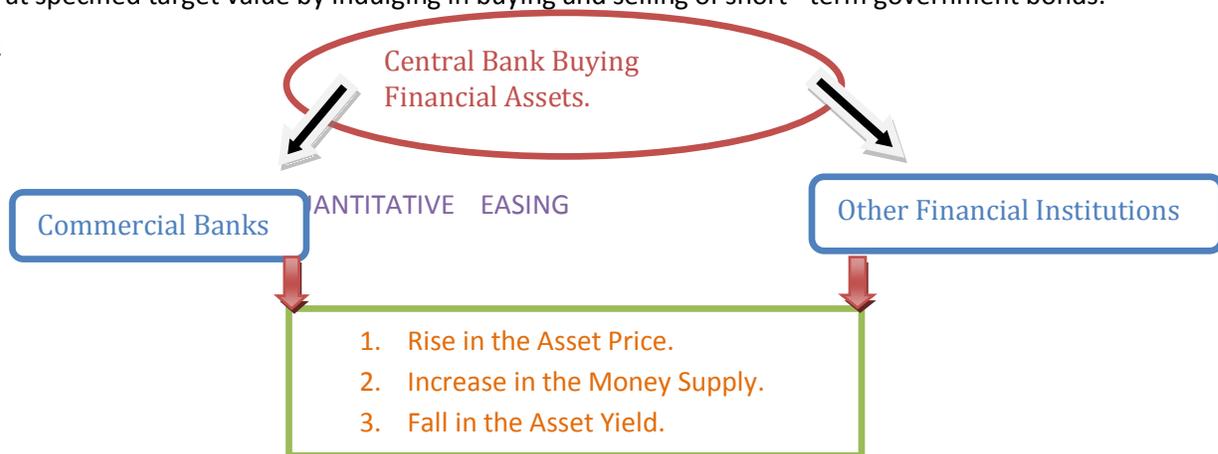
(Statutory Liquidity Ratio), adopting open market operations, moral suasion *et.al.*

➤ An *Expansionary monetary policy* can be adopted in case a country is experiencing recession. The central bank in this situation would want to raise demand in the economy for which it will want to increase the money supply. Rate of interest will be brought down to make funds easily available for the economy, CRR, SLR etc. can be brought down so that sufficient funds are available with the commercial banks for lending to the public. Bonds may be bought in the open market for newly created money. An expansionary monetary policy is adopted when the central bank wants to lower the short-term market interest rates. For this the Central Bank buys short-term government bonds. But an expansionary policy is rendered ineffective when the interest rates approach or reach zero. In such a situation the alternative available would be quantitative easing. Here monetary authorities buy long-term government bonds unlike the conventional monetary policy and thus bring down long-term interest rates.

Quantitative Easing:

QE is an unconventional method adopted by the central bank to stimulate the economy when the regular/conventional/standard monetary policy is rendered ineffective. Quantitative easing is implemented by the central bank by buying specified amounts of financial assets from commercial banks and all the other financial institutions in order to raise the prices of the assets thus bought and simultaneously increasing the money supply in the economy and negatively impacting the return on these assets i.e. reducing their yield. This is different from the usual policy of maintaining interbank interest rates at specified target value by indulging in buying and selling of short-term government bonds.

Fig. 2



Unconventional Monetary policy: Scope and its tools

Conventional monetary policy and its tools either become ineffective or are limited in their usefulness in times of deep recession or economic crisis. Nominal Interest rates cannot be reduced below zero and CRR, SLR cannot be made so low that the commercial banks face the risk of default. There is a risk of the economy falling into the liquidity trap whereby people have no incentive to invest and they prefer hoarding money instead of buying bonds. This would hinder the process of recovery in case the nation is facing an economic crisis. Expansion of money supply through open market operations (OMO) will also not be a feasible solution as in periods of crisis, because of their perceived safety, government securities tend to become bid up.

❖ Therefore the central bank will instead prefer purchasing other securities in the open market outside of government bonds. That is adopting quantitative easing ultimately.

❖ In the normal course the markets for non-government securities operate free from central bank intervention and are bought only in times of need. Under the QE program securities bought are usually in the form of bonds or debt instruments owned by financial institutions including mortgage backed securities (MBS). It may even include purchase of long-term bonds while selling long-term debt in order to raise bond prices. This would help in propping up housing markets which are financed by long-term mortgage debt.

❖ The central bank may even take up credit easing by buying private assets such as corporate bonds.

❖ Propping up equity markets through active purchase of shares of stocks in the open market is another unconventional route that may be taken up by the central bank if the usual quantitative easing fails. This measure was actually taken up by the central banks around the globe, after the financial crisis, through their engagement in the equity market to some degree.

❖ In order to boost investor confidence that would ultimately trickle down to the broader economy and subsequently promote demand the central bank may make its intentions clear regarding keeping interest rates low for prolonged periods of time or engaging in new rounds of QE.

In a situation where all the other measures fail, the central bank can even attempt to institute a negative interest rate policy (NIRP) in which instead of the banks paying an interest on the cash deposited with them the depositors have to pay to the banks an interest for keeping their money safe. The whole concept is to motivate people to spend or invest the money they have rather than getting penalized for holding it with them. Such a policy can be very dangerous as it punishes people for making savings.

QE and the Japanese revival (2001 -2006):

In 2001 due to a situation of faltering growth faced by the Bank of Japan the first monetary policy experiment was carried out in Japan for the revival of the economy. This is where QE finds its roots. Initially a number of OMO (open market operations) were carried out to lower the interest rates to near zero. Then the focus shifted to the outstanding balance sheets of the commercial banks and a target was

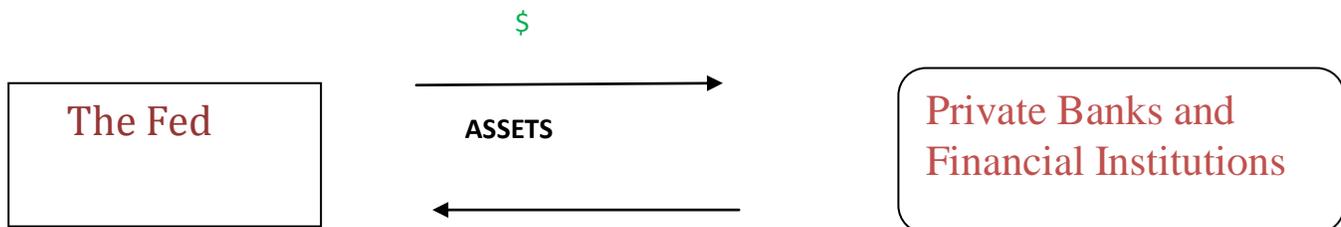
set to expand the balance sheet from 1¥ to 5¥ trillion which was further revised to 35¥ trillion between March 2001 and December 2004. This increase in liquidity in the Japanese Banking system created a solid base from where the process of resurrection of the Japanese economy could begin. Apart from this the policy also aimed at stimulating long term investments through bond purchases by the Japanese government so that ultimately interest rates can be brought down in the longer run.

The results of the QE took a little longer to show in case of Japan because the policy was formulated for a sick economy with a crippled banking sector and a major requisite for its effectiveness was stable economic conditions

QE adopted by Federal Bank (post 2007-2008 crisis):

The idea behind QE is that in order to generate money for an ailing economy the central bank need not print more currency. The usual method adopted by the Federal Bank is to cut down the interest rates that banks charge each other for their overnight loans, this result in the availability of cheaper loans to businesses. Since the Fed had already lowered that rate of interest to zero five years ago and more was needed for improvement in the economy it began buying long-term bonds with a view to bring down long term interest rates which were otherwise out of its control. Quantitative easing is not a new concept but it was the first time it was adopted on such a massive scale. The period after the crisis was followed by a purchase of \$ 1.75 trillion in bonds by the Federal Bank also known as QE1. In 2010 when signs of improvement were seen another \$600 billion were bought under the name QE2. With still high and stagnant unemployment rates, in September 2012 under QE3, the Federal bank began snapping \$85 billion a month in Treasuries and mortgage backed securities. The Fed's purchase plan was declared to continue till there were substantial improvements in the labor market. In 2013, Ben Bernanke commented that the Federal Reserve would lower the amount of assets purchased by the Fed each month if economic conditions namely inflation and unemployment were favorable. The motive behind this was to send a message that the central bank would continue to support the economy at lower interest rates and would gradually taper its QE program. This would spur demand in the economy and revive economic growth simultaneously.

Fig. 3



Source: Author's own creation

The QE program started by the Fed happens to be the biggest emergency economic stimulus in history and has finally ended. The program was finally wrapped up by October 2014. By then it had added more than \$3.5 trillion to the Fed's balance sheet. Quantitative easing program that started in 2009 and the Fed's decision to taper QE in 2013 had both been controversial and were hotly debated too. Even after winding up this program the Fed continues to pump support into the economy by holding its interest rates near zero. According to the International Monetary Fund and various economists, some adverse effects of the global financial crisis of 2007-2008 could be mitigated by resorting to quantitative easing

QE in the European context (2015 onwards):

The President of the European Central Bank, Mario Draghi, announced the QE program in January 2015 and it actually commenced in March 2015. Consequently the Euro fell in value making European Union exports much more competitive than they were months ago. A worldwide fall in the oil-prices aided the process of quantitative easing in the energy-dependent Europe. The QE in the EU amounts to €1 trillion and has helped drive credit, jobs and economic growth and has performed even better than any optimistic banker could have anticipated. After witnessing revival in the first quarter the second quarter was a little disappointing owing to France and Italy's underperformance. Nevertheless, the recovery and performance of Europe in totality was sufficient enough for the European Commission to revise the growth targets upwards.

Impact on India and Lessons that need to be learnt:

In the recent times QE has been seen to create panic among the investors not just in India but the emerging economies worldwide. A mere announcement by a Central Bank in a developed economy and the markets come crashing down, the Rupee weakens, outflow of capital and so on and so forth. What is called for at the moment is to safeguard the economy to the extent that such external incidents do not cause unmanageable/ irreparable damages to the economy. Implying thereby, to strengthen the economy to protect it from such external blows that might lead to an economic crisis like situation.

Following are a few of the measures that the country can adopt as part of a policy program in order to stay strong in times of external factors induced Economic Crisis:

❖ In the present global scenario, where India seems to be oblivious to the carnage wracking the world market the country needs to prepare itself rather than celebrating temporary reliefs in the form of quantitative easing by Fed or falling oil prices. We have a better Macro Environment compared to the rest of the world. What is required is to focus on our capital inflows and their quality. We need FDI or real money portfolio flows and not more of hot money. For this there is a dire need for consistency and stability of investment policies. Investment decisions do not depend primarily on whether the concerned sector is under automatic approval route or not but on clarity of investment rules.

❖ Another important factor that is contributing to spooking foreign investors in India is our tax policy. The government needs to focus on implementing an investor friendly policy stating its rules and take on taxes clearly. There's an urgent need to remove retrospective taxation and implementation of GST (goods and services tax). Execution capacity is something that is lacking in our economy and needs to be built up to reap the benefits of the global economic conditions.

❖ We can take advantage of the falling oil prices and use it for narrowing down our twin deficit and external vulnerability. This can also be used as a platform for continuing plan expenditure. (We would save around Rs. 18,750 Crores this year on account of falling oil prices.)

All these steps would help in building up our reserves and making the country strong and less vulnerable to external crisis and actions taken up by other countries to tackle their respective problems.

Conclusion:

With QE one thing can be ensured that the rate of inflation will not fall below a set target. But in a situation where this policy is more than effective very high inflation rates would follow in the long run due to increased money supply in the economy. On the contrary it may be rendered ineffective if the additional reserves thus created are not lent out by the banks. Government intervention can only bolster an ailing economy but cannot solve the fundamental problems. Policy diktat cannot be depended upon forever as the ultimate means for reviving growth. If it was then the Japanese economic problems would have been solved many years ago. The lack of easy policy options means that the world faces an unknown period of low, below trend growth. The era of capital driven unlimited growth surely has come to an end and the world needs to think and come up with a relatively sound plan for reviving and ensuring sustained growth.

References:

1. Brett W. Fawley and Christopher J. Neely ,(2013), “ Four Stories of Quantitative Easing”, Federal Reserve Bank of St. Louis Review, January/February 2013, 95(1), pp. 51-88. <https://research.stlouisfed.org/publications/review/13/01/Fawley.pdf> (Accessed 06/09/2015)
2. Hayes, Adam, (2015),”How Unconventional Monetary Policy Works”, Investopedia. <http://www.investopedia.com/articles/investing/022415/how-unconventional-monetary-policy-works.asp#ixzz3l314fuar> (Accessed 05/09/2015)
3. Hodges, Paul,(2013),”Quantitative Easing – where it all went wrong”, Economic Growth, Chemicals and the Economy. <http://www.icis.com/blogs/chemicals-and-the-economy/2013/11/quantitative-easing-went-wrong/> (Accessed 10/09/2015)
4. Kearns, Jeff,(2015),”The Fed eases off tapering to the end of a gigantic stimulus,” Bloomberg Quick take. <http://www.bloombergtake.com/quicktake/federal-reserve-quantitative-easing-tape> (Accessed 08/09/2015)
5. Kapadia, Sudhir, (2013),”Attracting FDI is key to India's future growth prospects,” *Economic Times* http://articles.economictimes.indiatimes.com/2013-09-16/news/42114429_1_fdi-policy-india-story-independent-india(Accessed 08/09/2015)
6. Pujari, Saritha,”Monetary Policy: Meaning, Objectives and Instruments of Monetary Policy”, Your article library. <http://www.yourarticlelibrary.com/policies/monetary-policy-meaning-objectives-and-instruments-of-monetary-policy/11134/> (Accessed 5/09/2015)
7. Smith,Lisa,(2014),”Quantitative Easing: Does It Work?” ,Investopedia. <http://www.investopedia.com/articles/economics/10/quantitative-easing.asp> (Accessed 08/09/2015)
8. Shinohara, Naoyuki,(2014), “Unconventional Monetary Policies: Looking Ahead”, Speech in Tokyo. <https://www.imf.org/external/np/speeches/2014/012314.htm> (Accessed 09/09/2015)

9. "The quantitative easing experiment is ending in global recession", The Conversation (2015)
<http://theconversation.com/the-quantitative-easing-experiment-is-ending-in-global-recession-47104> (Accessed 08/09/2015)
10. "A Brief History of Quantitative Easing", The Market Mogul(2015) <http://themarketmogul.com/brief-history-quantitative-easing/> (Accessed 09/09/2015)