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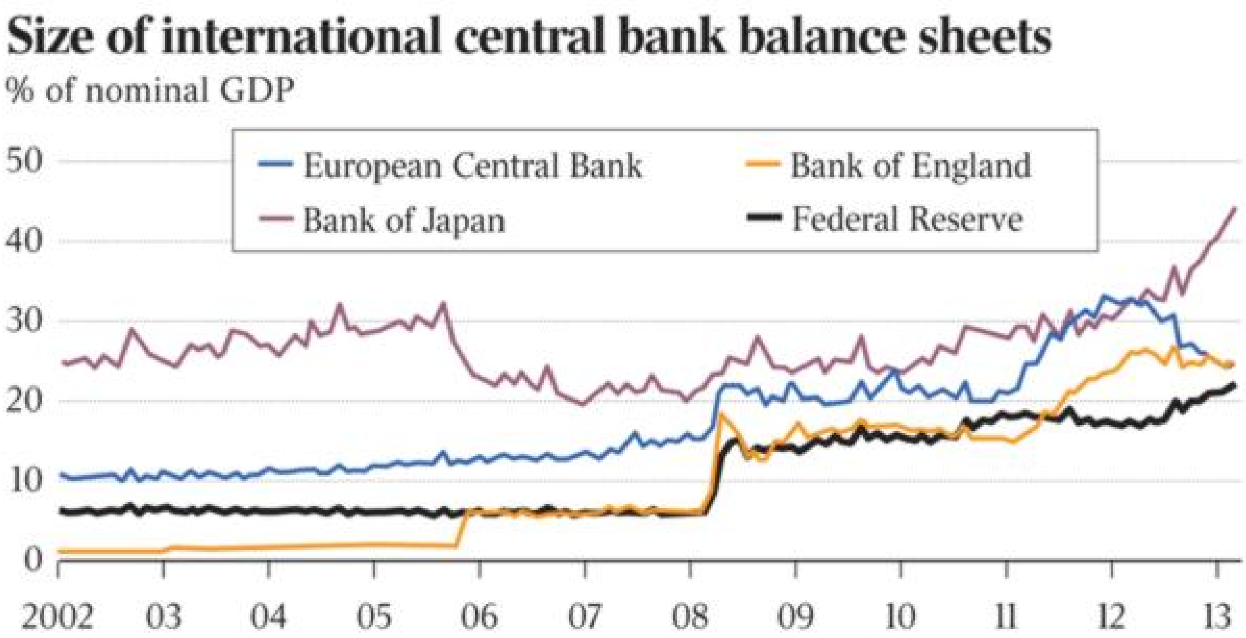
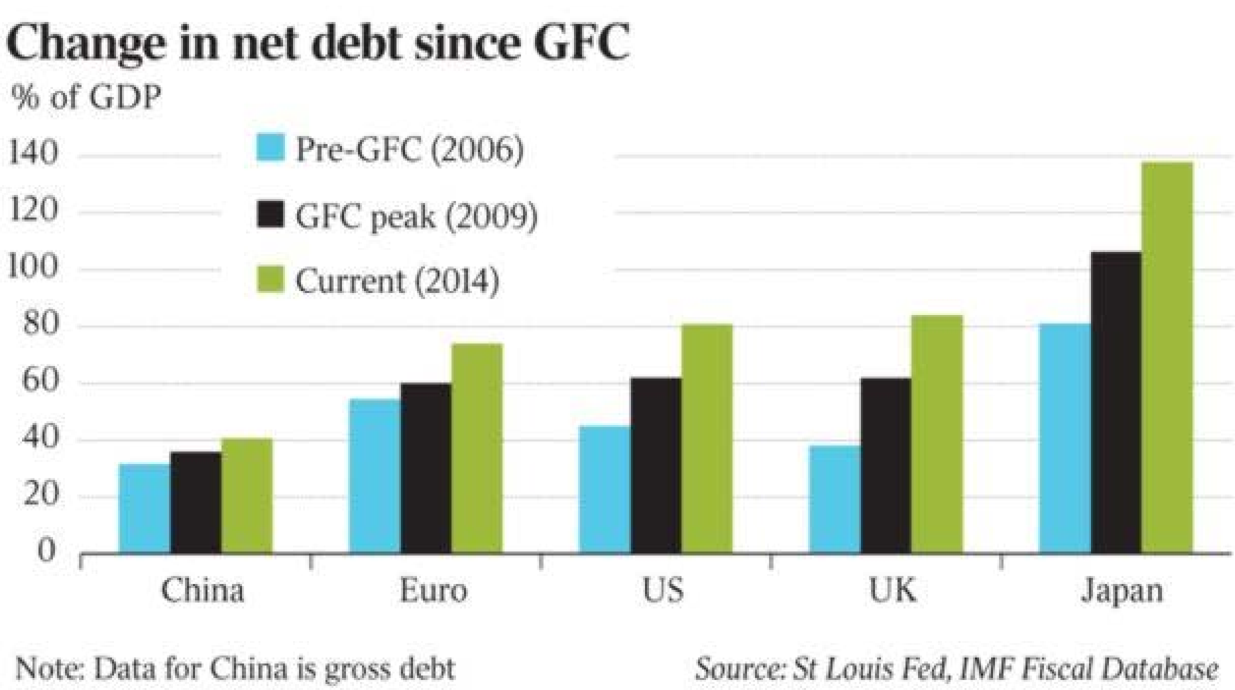
# Over-reliance on monetary policy risks adverse unintended consequences

**HENRY ERGAS** THE AUSTRALIAN NOVEMBER 01. 2014 12:00AM




applause at the New York Stock Exchange. Source: AFP




Change in net debt. Source: TheAustralian

**THE decision by the US Federal Reserve to end quantitative easing does not close the era of easy money in the world's largest economy.**

After all, interest rates in the US remain at historic lows, as they are throughout the advanced economies. And while the Fed has signalled that continued growth in the US means rates will eventually start to rise, a return to the monetary policy environment that prevailed before the global financial crisis still seems a long way off.

Moreover, with the eurozone struggling, the European Central Bank is only just beginning a further round of "unconventional monetary policy", while the Bank of Japan, in its efforts to shrug off long-term stagnation, remains engaged in a massive quantitative easing experiment of its own.

Little wonder then that the lead-up to the Fed's decision has rekindled the debate about the impacts that aggressive monetary policy has had and could yet have, not merely on the level of economic activity but more broadly on our economies and societies.

That central banks expanded the armoury they used after the GFC is unsurprising. Once the crisis struck, interest rates were quickly slashed, with the Fed pushing its rates to near zero by December 2008. As rates approached that "lower bound", officials looked for other ways in which monetary policy could help end the downturn. Seeking to stimulate activity by buying up financial assets soon emerged as the most attractive option.

While very sparingly used until then, that approach had a long pedigree. Before he turned to government spending as his instrument of choice, John Maynard Keynes had proposed QE as a key element in responding to the Depression.

"We cannot hope," Keynes wrote in 1930, "for a complete or lasting recovery until there has been a very great fall in the long-term rate of interest throughout the world." The problem, however, was that left to its own devices, achieving that fall was likely to prove "a long and a tedious process". The answer was for central banks to "reduce the rate of interest to a very low figure", while buying "long-dated securities either against an expansion of central bank money or against the sale of short-dated securities until the short-term market is saturated".

The Fed did just that two years later, with Milton Friedman, in the monumental monetary history of the US he co-authored with Anna Schwartz, crediting the policy with an important role in stabilising the American economy.

However, in the inflationary environment that prevailed after World War II, nominal interest rates typically remained quite high, so that central banks could rely on cutting those rates when activity needed a boost. Direct purchases by central banks of financial assets were therefore not needed. The Fed did use them to lower long-term rates during the Kennedy administration; and with the Japanese economy stuck in a rut, Japan's central bank began a program of buying financial assets nearly 15 years ago. But it took the shock of the GFC, and the resulting fall in official interest rates to zero, to put QE squarely back on the agenda.

When it returned, however, it was with a vengeance. Keynes had called for the policy to be pursued "a outrance" (to the utmost); and as their burgeoning balance sheets show, the Fed, along with its British and Japanese counterparts, certainly took his advice.

Their underlying logic was straightforward. When a central bank purchases assets (such as government bonds) it increases the money holdings of the sellers, who will then use some of those funds to buy other financial assets, including shares and corporate bonds, raising their price. Those higher asset prices increase the net wealth of asset holders and also imply lower yields, which should bolster confidence and reduce long-term borrowing costs for firms and households, stimulating demand and pushing up economic activity. And those effects will partly spill overseas, reducing the exchange rate and boosting financial markets internationally.

How effective the intervention has proven to be in practice is, however, much more controversial. Perhaps the best estimate is that the Fed's successive rounds of QE lowered long-term US interest rates by around 0.2 percentage points. That may seem a very small amount, but it is broadly equivalent to the effect of a cut in the Fed's official (short-term) rate of 0.75 to one percentage points.

Such a cut, supporters of QE argue, is hardly insignificant and (with short-term rates near zero) could not have been achieved by other means. But the degree of uncertainty around those estimates is at least twice as great as that for conventional monetary policy. Moreover, the policy carries risks that are still poorly understood and may have had serious unintended consequences.

Among the most contentious are the impacts on the distribution of income and wealth. QE, critics argue, increases the size and profitability of the financial sector, which benefits its relatively highly paid executives; and even more importantly, by lowering interest rates on government bonds, induces investors to shift into riskier financial assets, notably equities, increasing asset prices and providing windfall gains to their largely wealthy owners.

At the same time, low interest rates penalise small savers and pension funds (which are especially reliant on investing in government bonds), particularly if their initial holdings are not sufficient to cover their long-term liabilities. As these impacts add up, the overall effect would be to disproportionately enrich the "one-percenters", worsening an already serious problem of income inequality.

While these criticisms have their merits, much depends on what would have happened without QE. At the most superficial level, if QE did indeed put downward pressure on long-term interest rates, that may have reduced unemployment, with estimates made using the Fed's macro-economic model finding the Fed's second round of large-scale asset purchases lowered the unemployment rate by about 0.25 of a percentage point.

As job losses so heavily affect low-income earners, that impact would lead to less inequality, not more. And since QE in the US and Britain coincided with significant fiscal consolidation, it may be that QE cushioned the adverse effects reductions in public spending would otherwise have had for poorer households.

Nor are the distributional consequences of changes in asset prices as straightforward as the critics of QE contend. QE may, for example, have fuelled increases in house prices, particularly in Britain; rather than the "one-percenters", that would have benefited middle-income families, much of whose wealth is invested in property. And because older people are especially likely to own their home, it is the distribution of wealth by age, rather than by social class, that QE would have primarily affected.

Additionally and also controversially, it may be that QE had less impact on the extent of changes in asset prices than on their timing. In particular, even if QE reduced interest rates on safe securities such as government bonds, it could have merely accelerated a fall that would have occurred in any event.

As best one can tell, the decline in real interest rates seems to have set in after the Asian financial crisis of the late 1990s, with the GFC simply marking another step in the structural trend. Yields on British index-linked securities, for example, never recovered to where they had been pre-July 1997.

To that extent, while central banks helped the fall in rates play itself out, and speeded up the shift of investors' portfolios from debt to equity, they did not cause the underlying trend.

But even were those arguments accepted, they cannot justify complacency about QE. Central banks should not be in the business of trying to influence the distribution of income; indeed, the sheer complexity of the effects monetary policy has on that distribution makes it difficult to think of a less appropriate instrument for achieving distributional goals. Rather, central banks' objective should be to provide, as efficiently as possible, a predictable monetary context for the decisions of economic agents.

QE poses many difficulties in that respect. To begin with, as a result of QE, taxpayers face greatly increased risk, as they will incur losses should price falls slash the value of central banks' holdings of risky assets. Moreover, QE has pushed central banks out of traditional monetary policy — which operates by altering the stock of currency and of bank reserves — and into credit policy, which involves lending to particular borrowers or acquiring private assets with proceeds from the sale of government securities.

That moves central banks into a fiscal policy role for which they are poorly suited, all the more so as they lack the accountability and constraints that fiscal policy normally entails in democracies.

Last but not least, QE has imposed substantial costs on emerging economies, which have been buffeted by short-term capital flows as cashed-up investors in the US and Europe seek higher returns. Those capital flows have placed great pressure on emerging economies' exchange rates; and given that they largely lack currency derivatives markets that could help efficiently hedge currency risk, also on their firms involved in international trade.

Together with the impacts of short-term capital flows on their stock exchanges, the resulting risks have encouraged a broad range of interventions by emerging economies into foreign exchange markets, aggravating distortions in their financial systems. They have also induced them to accumulate foreign exchange reserves, which they have invested in the advanced economies' still growing public debt.

The paradoxical result is that low-income countries are funding debt accumulation in high-income countries. And they now stand to lose should their exchange rates appreciate, as fast productivity growth means they ultimately must, since that would reduce the domestic currency value of the foreign debt they have acquired.

Indeed, assuming the emerging economies' exchange rates eventually appreciate by about 20 per cent in the next decade, the loss (taking current foreign exchange holdings as given) would transfer about $US1.4 trillion from poorer to richer economies.

All this adds up to a policy laden with downsides. Markets are usually good at managing the uncertainties that arise from the behaviour of economic agents, but many of these downsides are due to governments, whose decisions tend to be difficult to predict, large in scale and unresponsive to changing circumstances.

That should induce governments to be cautious, including in the setting of monetary policy; all too often, however, they have failed to heed Friedman's admonition against "assigning to monetary policy a larger role than it can perform, asking it to achieve tasks it cannot achieve, and, as a result, preventing it from making the contribution it is capable of making".

The "unconventional" measures the Fed is bringing to an end may become an object lesson in the costs ignoring that warning can impose.

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