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Markets Insight: QE addition may be hard to kick

By Satyajit Das

Withdrawl from policies could result in massive economic disruption, says Satyajit Das

Financial markets are focusing on the potential exit from the expansionary fiscal and monetary measures, low or zero interest rates and quantitative easing that policy makers have relied on to engineer a recovery.

Central banks believe they will be able to exit when appropriate, reminiscent of Ashly Lorenzana's definition of addiction in her journal *Sex, Drugs & Being an Escort*: "When you can give up something any time, as long as it's next Tuesday." In reality, these policies may be hard, if not impossible, to reverse.

The difficulty of an exit is complicated by the size of the intervention as well as the fact that economic activity and financial markets are heavily reliant on these support measures.

In the US, it now requires a government budget deficit of about $600bn, augmented by injection of about $1tn in liquidity from the Federal Reserve, to create about $300bn of growth. Since 2008, the balance sheets of big central banks have expanded from about $5tn-$6tn to more than $18tn. In many developed countries, central bank assets now constitute between 20 per cent and 30 per cent of gross domestic product.

As the European evidence highlights, withdrawing fiscal stimulus would lead to sharp slowdowns in economic activity. Slower growth would make it difficult to correct budget deficits and control government debt levels, increasing the risk of a crisis or forcing reliance on central bank financing.

Zero interest rate and QE policies have increased financial risk. Low rates allow overextended companies and nations to maintain or increase borrowings rather than reducing debt levels. It becomes difficult for central banks to increase interest rates. Levels of debt encouraged by low rates rapidly become unsustainable at higher rates. Higher rates may trigger increases in bad loans, which would also create problems for banks, creating a financial crisis.

Central banks also cannot sell government bonds and other securities held on their balance sheets. The size of these holdings means disposal would lead to higher rates, resulting in large losses to banks and investors. The reduction in liquidity would exacerbate this by tightening the supply of credit, destabilising a fragile financial system.

In effect, present policies compound existing issues, making the problems ever more intractable. The real question is for what period and to what extent these policies can continue. With fiscal policy constrained by 'bond vigilantes', economies are increasingly reliant on central banks to finance governments, keep rates down and continue QE programmes. But there may be limits to the scope of central bank activism.

The balance sheet expansion required by QE programmes exposes a central bank to the risk of losses on its holdings from defaults or (more realistically) from higher yields, if the economy recovers and rates rise. In theory, there is no limit to the size of the losses a central bank can incur. But there may be practical constraints.

First, potential losses on investments, causing a loss of credibility and operational ability, may limit debt monetisation. Ironically, the biggest risk is if the current policies are successful, causing an increase in inflation and rises in interest rates, triggering large losses on central bank security holdings.

Second, seigniorage revenues (the difference between interest earned on securities acquired in exchange for money created by central banks) constitute another possible limit to debt. A central bank is solvent as long as the discounted present value of seigniorage income is greater than its other liabilities in the long run.

Third, risk of excessive inflation levels constitutes a constraint. Where a bank's charter encompasses maintaining financial and price stability, debt monetisation may be constrained by price pressures exceeding acceptable levels.

Fourth, the ultimate constraint remains preservation of the status of the currency as a medium of exchange or accepted store of value. Central banks presumably would not risk the currency becoming unacceptable for normal commercial transactions.

Central banks have not reached the limits of their capacity to act. While inflation remains low, they retain scope for action. But zero interest rates and QE do not address the real issues and may not be capable of restoring economic health. It may also be impossible to exit current policies without major economic disruption, as the recent market reaction to central bank guidance highlights.

Addicted to monetary morphine, central banks and market participants believe there is no alternative. Policy makers must now rely on the advice of comedian and former drug addict Russell Brand: "The priority of any addict is to anaesthetise the pain of living to ease the passage of day with some purchased relief."

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