7
Quantitative Easing vs Credit Easing
Frans H. Brinkhuis

7.1 Introduction

On 18 March 2009 the Federal Reserve (Fed), the central bank of the United States, announced that it would pump an additional 1.15 trillion dollars into the financial markets. The Fed announced that “in the light of increasing economic slack, the Committee\(^1\) expects that inflation will remain subdued and sees some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer run”\(^2\). To provide greater support to mortgage lending and housing markets, the committee decided to purchase up to $750 billion of agency- and mortgage-backed securities (MBS), bringing its total purchases on these securities up to $1.25 trillion. It would also increase its purchases of agency debt by $100 billion. Moreover, to help improve conditions in private credit markets, the Fed decided to purchase up to $300 billion in longer-term Treasury securities over the next six months.

Initially investors responded with surprise and enthusiasm. The Dow Jones index, which had been down about 50 points just before the announcement, jumped immediately and ended the day at almost 91 points. The 7-year Treasury yield plummeted 54 basis points to 2.08%, 10-year Treasury bonds went down 51 basis points to 2.49%, and the 30-year yield decreased by 28 basis points to 3.52%\(^3\). Daily changes in Treasury bond yields of this magnitude are quite rare. Changes in the 30-year yield were smaller than changes in the shorter segments, because the Fed indicated that it would “concentrate purchases in the 2- to 10-year sectors of the nominal Treasury curve”\(^4\).

But there were also indications that the markets judged that the Fed was taking too much risk in its operations, and setting the stage for
further inflation. Commentators remarked that with this extra 1 trillion dollars, the Fed’s balance sheet would amount to $3,000 billion. A swollen Fed balance sheet runs the risk that the Fed may find it difficult to manage down the money supply when the economy turns, raising the possibility of inflation.\textsuperscript{5} On the same day, 18 March, gold prices rose $26.60 an ounce, hitting $942, a sign of declining confidence in the dollar.\textsuperscript{6} The dollar dropped sharply against the euro. The euro rate increased from $1.2972 just before the Fed’s announcement to $1.3730 one day after the announcement, an increase of 5.8% in two days.

7.1.1 Problem statement

In this paper we want to investigate the consequences of the \textit{quantitative easing} strategy for the American economy, specifically the effect on the yield curve and on possible future inflation. We want to compare the strategy of the Fed with the quantitative easing approach of the Bank of Japan (BOJ), which executed this policy from 2001 to 2006.

7.2 Quantitative easing vs. credit easing

The above-mentioned steps taken by the Fed can be characterized as part of a policy of quantitative easing. This is an extreme form of monetary policy, used to stimulate an economy when interest rates are close to zero. This means that a central bank can no longer stimulate the economy by lowering interest rates. Instead, the central bank is stimulating the economy by way of its balance sheet. In practical terms, the central bank purchases financial assets, such as Treasury bonds, from financial institutions, so that the current-account balances of banks at the central bank are augmented. These excess reserves of banks can be used for extra lending, thereby stimulating the economy. A few months before the Fed took its steps on the path of quantitative easing, the Bank of England applied this policy; the positive experiences of the Bank of England were a source of inspiration for the Fed. However, in the context of this article we will not go into the details of the London approach.

At the beginning of this millennium, quantitative easing was executed by the BOJ. The Japanese quantitative easing policy (QEP) in 2001–2006 was an unprecedented monetary policy worldwide; the only other example is the policy of the US Federal Reserve Board during the Great Depression in the 1930s.\textsuperscript{7} At that time Japan was in the midst of a period of deflation. The BOJ made the commitment to execute this policy until the consumer price index (CPI) started to grow again. We will go deeper into the Japanese situation in section 3.