

Quantitative easing in the us economy

Business



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In response to the worst financial downturn since the Great Depression, the United States Federal Reserve Bank has instituted a policy known as Quantitative Easing (QE). QE in its essence aims to stimulate the economy by means of two distinct mechanisms: The purchase of long-term treasury securities and mortgage backed securities. The presence of this type of policy truly indicates a dire economic situation, as this authority is technically not given to the FED; rather it is preformed under the emergency powers clause of the FED Charter. Thus, Quantitative Easing does not have a large history in the United States.

However, it was deemed critical as a result of the “ Great Recession”. QE1 was announced in the midst of this crisis, in November of 2008. It involved the purchase of a total of \$600B worth of mortgage-backed securities and long-term treasury securities, and ran from December of 2008 until March of 2010. Shortly thereafter, the FED announced the implementation of a second round of quantitative easing, aptly named QE2. It was nearly identical to the previous policy, in that it involved the purchase of \$600B of long-term treasury securities at a rate of \$75B per month. It was in force from late 2010 until June of 2011.

In September of 2012, the FED announced QE3. Instead of specifying an end date, the FED created this as an open-ended policy, with the purchase of \$40B worth of mortgage backed securities per month until the labor market improves “ substantially”. Most recently, the FED voted to approve a supplement to QE3, including the purchase of \$45B of long-term treasury securities. All of these rounds of quantitative easing are intended to help to stimulate the economy, and have had several effects with varying success.

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Because the quantitative easing policies instituted by the FED have been two-fold, the effects on the macro economy are also two-fold. The first mechanism, the purchase of long-term treasury securities, has primarily driven down the yield received on these bonds.

The bond market has always been a safe investment, albeit with lesser yields than other investment markets. Because the FED is buying up a large number of these bonds, the yield that private investors receive is reduced. These investors are then incentivized to “reach for yield”, and invest in another market with a higher yield such as the US equity markets. In this sense, quantitative easing has been successful in stimulating the economy. The Dow Jones Industrial Average recently recouped its losses from its low in March of 2009 and is reaching record highs each day.

However, the entire success of the gains in the stock market cannot be totally attributed to the quantitative easing policies. Even without these policies, the equity markets have become attractive autonomously. Average Price/Earnings ratios have dropped to levels at or below the historic average of fifteen. This should be very attractive for investors, as it means that the stock price is undervalued in relation to the firm's earnings. This, coupled with the doubling of corporate profits over the last four years have helped assist these quantitative easing policies in stimulating the stock market. In addition, the lowering of bond yields has an impact on the global relation of the dollar.

International investors are also incentivized to reach for yield, and will look to other countries with a higher yield to place their investments. The second

mechanism of quantitative easing involves the purchase of mortgage-backed securities from banking institutions. For the large part, the securities that the FED is purchasing from these lenders are considered to be “toxic”, and are unlikely to be repaid. By purchasing these, the FED essentially takes the loss for the bank. The FED will pay cash for these securities, increasing the supply of loanable funds. According to the loanable funds chart, an increase in the supply of loanable funds should lead to a decrease in real interest rates.

These low real interest rates should spur an increase in the amount of investment within the US economy. Finally, because investment is a component of aggregate demand and GDP, an increase in investment should trigger a subsequent increase in aggregate demand and GDP. A larger demand in the economy should encourage employers to begin hiring, thus lowering the unemployment rate. All of this should, in theory, occur within a reasonable timeframe. However, unemployment trends and GDP growth have not indicated any significant improvement.

In this sense, the quantitative easing policies have not been successful, and there are many possible reasons to explain why. While the implementation of quantitative easing was absolutely necessary to avoid further recession, and possibly prevent a recessionary spiral from taking hold, there are several externalities that may have impaired its progress. The largest of these externalities are business and investor expectations. As previously mentioned, unemployment has not improved significantly since quantitative easing has been implemented. This likely harmed the faith that investors and businesses had in these policies, and have discouraged them from new

investment and increased hiring. Additionally, government activity is a large precursor to economic growth.

Since Congress failed to reach a compromise on controlling government spending, the automatic spending cuts, commonly known as sequestration, recently took effect. These automatic cuts targeted many industries essential to long-term growth, such as infrastructure and education. This likely caused increased caution for new investment, as businesses know that long-term growth will be impacted. In addition, economic problems in Europe and China, some of our largest trading partners, have worried investors that problems abroad could easily spill over into the US economy because of global interdependence. Another significant obstacle to the benefits of quantitative easing has been the low velocity of money.

Because the money in the economy is not changing hands as rapidly as it should normally be, an unnecessary time lag has been created with regards to the benefits of quantitative easing. Based on real interest rates near or at zero percent, as well as the federal funds rate near zero percent, it is obvious that quantitative easing has had an effect on the US economy; only its benefits are not yet being felt. While quantitative easing has had the effect of expanding the US equity markets, expanding the monetary base, and lowering real interest rates, not all of the benefits of these policies have been experienced throughout the economy. The equity markets have seen amazing success, yet other aspects of the US economy have not. The US is, in fact, located in a perilous position. Quantitative easing, by its very implementation, creates inflationary pressures.

So far, inflation has remained within the FED's acceptable limit; however how long it will stay this way is yet to be determined. In order to avoid these inflationary pressures, the US economy must grow at a faster rate than the growth rate of the money supply. The fiscal policy decisions that have been made in recent months have hindered the ability to strengthen our growth rate. Many of the cuts have been to multiplier industries, and these decisions may end up causing further damage to our economy as quantitative easing begins to unwind. If quantitative easing is to be successful, it will require the cooperation of experts in both monetary and fiscal policy.

This collaboration will help to ensure that the United States increases and sustains GDP growth and maintains economic stability in the medium to long-term, bringing numerous benefits to investors, consumers, and businesses, both domestic and abroad.