Example of qe3, fiscal cliff and the european debt crisis term paper

Parts of the World, Europe

Third Round of Quantitative Easing (QE3)

QE3 or the third round of quantitative easing is a central bank (i. e., Federal Reserve) open-ended bond-buying policy directed towards lowering the interest rates and mortgage rates to stimulate demand in the economy. The QE3 in the US that started on September of this year involves buying of mortgage-backed securities (MBS) worth $40 billion every month. This is done by injecting a pre-determined quantity of newly created money in the economy through the purchase of debts (bonds) from banks.

The graph shows what’s happening in the bonds market with the QE3 policy of the Central Bank. As the government buys MBS the supply of debt decreases resulting to increasing price of bond. Increasing bond price implies decreasing expected return on bonds and/or interest rate. The decline in the cost of borrowing has the wealth effect to the consumer, hence, encouraging them to spend more. The increase in the spending behavior of consumers sparks increases in commodity prices.

The value of the country’s currency is also affected by the QE3. The injection of newly created money to banks increases the quantity of money in the economy resulting to a drop in the interest rate. In effect, demand for dollars decreases, and hence the depreciation of the currency. Nevertheless, decrease in the value of dollar relative to other currencies makes the exports of the US to become very attractive in the foreign market. The increase in export together with the increase in investment (because of lower cost of borrowing) and consumer spending enhance growth in the gross domestic product (GDP) of the economy.

Moreover, in relation to employment, because of the reduced cost of borrowing, this entices businesses to borrow funds from banks to increase investment spending. The rise in spending of the business sector is viewed to help increase employment (thus, lower unemployment) by creating jobs in the economy.

Also, inflation is more likely because the demand-inducing policy encourages spending in the economy.

The increase in the demand for housing drives up the housing price. Housing sales and buildings also increases as the mortgage rates decline.

Fiscal Cliff

Fiscal cliff refers to the expiration of the combined tax cuts (such as 2001/2003 Bush tax cuts, 2009 stimulus, payroll tax holiday) and government spending cuts on December 31, 2012, and if not remedied, will have the dramatic effect of bringing the economy into a recession. The cliff refers to the immediate disaster that will immediately happen at the beginning of 2013. Upon expiration of the current policy, the combination of spending cuts and higher taxes is believed to reduce the fiscal deficit. However, this will have the effect of reduction in GDP by 4% in 2013 resulting to a negative growth, and hence, recession.

Increases in tax reduce the disposable income of households, and therefore the consumption spending. This results to a drop in the consumption spending in the aggregate level and therefore a drop in aggregate demand also. Reduced government spending further reduces the level of aggregate demand. Decreases in the aggregate demand because of the above-mentioned changes shifts the AD curve to the left, inward. The equilibrium price is now lower as well as aggregate demand. The reduction in aggregate demand also decrease the national output (GDP).

Moreover, the declining price level discourages workers to produce more, and most likely will stop selling because of the declining prices. This decrease in production affects the labor market which further implies and unemployment increases also.

European Debt Crisis

The European debt crisis is the financial crisis that is being faced by the countries in the euro zone area. The crisis entails the struggle of some countries in the euro area to pay or refinance its government debt. In particular, five countries namely Portugal, Greece, Spain, Italy and Ireland were not successful in generating economic growth.

The increasing levels of debt of both the government and private sector around the world along with government debt downgrading in some of the countries in Europe caused fears among the investors of a sovereign debt crisis. What have caused the crisis? The property bubbles in several countries resulted to rising private debts that were transferred as sovereign debt due to bailouts made by banks and the government in response to post bubble slowing economies. Meanwhile, the unsustainable public sector wage and pension commitment led to the increase of sovereign debt in Greece. All in all, the structure of the euro area as a monetary union but with differing tax and public pension rules contributed significantly to the European debt crisis that crippled the ability of the European leaders to respond to the situation. A significant amount of sovereign debt is owned by European banks. In 2010, the leading European countries implemented a series of financial support measures including the EFSF or European Financial Stability, and ESM or European Stability Mechanism in response to rising and intensified concerns about the crisis.

On the part of the European Central Bank, it has implemented monetary policy aimed at lowering the interest rates. Cheap loans were made available to ensure the flow of money among European Banks in the region. Moreover, ECB also provided support to all the euro countries that were under the sovereign state bailout and financial support measures by lowering the OMT or Outright Monetary Transactions.

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