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QE Paradox

It was supposed to be straightforward. In mid-March the Federal Reserve announced it would begin buying US Treasury bonds. This is quantitative easing (QE), no? The Fed is printing money. Other things being equal, as the supply increases, the price will fall.

It may be QE but is not QED, an acronym, which traditionally ends mathematical and philosophical proofs, for a Latin phrase meaning "which is demonstrated". The negative implications of the Fed's QE policy have not been demonstrated. The resilience of currencies whose countries have engaged in QE has been remarkable. It is worthy of examination.

Start at the Beginning

We need to define quantitative easing. It is problematic because there is not a comprehensive definition of the policies associated with it. It broadly refers to an element of monetary policy. It is concerned not with interest rates, or price of money, but rather the quantity of money. In order to combat the financial and economic crisis, central banks around the world are concluding that cutting policy rates has run its course and further cuts could be counterproductive.

Yet policy makers still need to make monetary conditions even more accommodative to resist the deflationary forces that have been unleashed by the deleveraging process and the severe economic downturn. Measures to increase the quantity of money vary from country to country depending on a host of institutional, historical, political and cultural variables. But the point is that the G7 countries, and others such as Switzerland and Sweden, have either adopted quantitative easing tools of one variety or another, or are threatening to do so.

In some ways this leads us to the first observation about the resilience of currencies where quantitative easing is either taking place or is expected to begin shortly: Because QE has been widely adopted, it is not a distinguishing factor among central banks. There is a systemic financial crisis and a synchronized global downturn. Policy makers have fiscal and monetary levers and both are being deployed to meet the profound challenges of the day.

Shrouded by Mystery

There are also many critical unknowns related to quantitative easing, which may contribute to its seemingly muted impact in the foreign exchange market. For example, while the Federal Reserve has been clear on the assets it will purchase, it has been less candid on how it will finance those purchases.

It could but need not, create bank reserves, what is often meant by the Fed printing money. It could but need not, be given the money by the Treasury Department, who would raise it through the sale of bills. This was done last year and could happen again, but may be limited by the Congressionally-approved debt ceiling.

A little noted element of the Treasury/Federal Reserve joint statement last month points the direction of another potential course. Officials indicated they would seek formal authority from Congress for the Federal Reserve to issue its own debt instruments. For example the Federal Reserve could expand the assets on its balance sheet by purchasing them with funds raised by the sale of its own bills.

The Fed can either create reserves, be given money from Treasury, or borrow money by issuing its own IOUs. It is not clear which measures will be used and in what combination. These issues have direct bearing on the potential inflationary impact of quantitative easing.

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ECB
Another reason the quantitative easing of the Federal Reserve has had limited impact on the major currency pair, the euro-dollar exchange rate, may be a function of the uncertainties surrounding the ECB's actions. ECB officials do not call it quantitative easing. They prefer "non-conventional measures" and this may have confused many observers. The fact remains that the ECB's balance sheet has expanded by roughly the same percentage as the Fed's.

Operationally, the ECB has taken several important measures that are tailored for its institutional framework. For every euro that a European company raises by issuing equity or debt, it raises almost two through bank loans. The US is nearly the opposite way around. ECB policies have generally worked through the banks. In addition to slashing interest rates so that the floor, set by the rate the ECB pays on reserves (deposit rate), is now a lowly 25 basis points, the central bank has made unlimited amounts of liquidity available to the banking system for up to six months. It has also adopted very liberal collateral rules.

The ECB has indicated it will unveil additional "non-conventional measures" early next month. It is not clear what the ECB will do. However, officials are moving very gradually, reluctant to deviate from their course, which they seem to see as fairly effective. Officials note that one-year Euribor is below one-year dollar Libor. Bank deposits, they can point out, have fallen from their peak of over 300 billon euros, standing at 23 billion euros this past week. Bundesbank research suggests the transmission mechanism of monetary policy is working, though not perfectly. It found that around three quarters of the interest rate cuts by the ECB have been passed on to the short-term corporate credit market.

The ECB is out of room to reduce the key deposit rate any further. It stands at 25 basis points currently. The refi rate of 1.25% can be cut a bit more, but its significance has diminished. Although there does appear to be a wing of the 22-person governing council that is advocating more aggressive measures, the majority is likely to remain dominated by the incrementalists. An extension of current efforts, such as expanding the tenor of the ECB's unlimited liquidity provision beyond the current term of six months and the loosening collateral requirement a bit more, are the most likely courses of action.

Next Up: Canada and Sweden
The Bank of Canada meets next week on April 21st. Its current target rate stands at 50 basis points. Another 25 basis point cut is unlikely to be very helpful. Instead, the real focus is on the Monetary Policy Report, which will be delivered two days later. Officials have indicated they would outline the framework for a quantitative easing program, but have stopped short of committing themselves to such a course. They seem to believe the threat of quantitative easing can bolster investor confidence in the capabilities of the central bank.

The Bank of Canada can lengthen the duration of some of its existing operations, such as purchase and resale agreements. It can also stop sterilizing or offsetting such operations. It could buy government bonds, like the Fed, BOE and BOJ have done, but that may have the unintended consequences of reducing the liquidity in an already thin market. In some ways, the Bank of Canada faces the same dilemma as the Swiss National Bank, which opted to buy foreign bonds.

Sweden's Riskbank also meets on April 21st. Its current target rate stands at 100 basis points. Most expect a 50 basis point cut, but after officials indicated that the key rate will be 25 basis points at the end of the year, there has been increased speculation that it might just cut 75 basis points in one fell swoop and begin the discussion of quantitative easing as well.

Other Considerations
There are a couple of other considerations that may help explain why QE has not had the kind of impact that many expected. Unlike other asset classes, valuation is difficult to determine in the foreign exchange market, because the range of influential factors is great and the coefficients of those factors also change dramatically. The relative quantities of money supply are one of the factors that may or may not influence currencies for a particular period.
Rather than try to deduce currency movement from a priori assumptions, it might be more instructive to begin inductively with a survey of currency performances. Factors far a field from quantitative easing appear to be better explanatory variables. The relative out-performance of the Australian and New Zealand dollars may have to do

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with their relative growth trajectories and perceived commodity backing, especially if China's stimulus kicks in and its commodity stock piling continues. The relative out-performance of sterling so far this year, making a 1.3% advance against the dollar versus the euro's 6.6% decline against the buck, suggests something besides quantitative easing is the main driver. Perhaps ideas that sterling suffered among the most during the panic of last year's forth quarter, and thus is in best position to do better on the first glimmers of hope that the macro-situation is stabilizing.

Lastly, given the significance of the crisis, isn't there a general consensus among officials that action is needed to prevent a deeper and more sustained contraction and crisis? We want and need officials to respond. The more aggressive one responds, with conventional and unconventional measures, the greater the odds that a recovery takes place sooner rather than later. The driver for the foreign exchange market might not lie with enacting quantitative easing strategies. Rather, the key might be ability to exit them in an orderly and timely fashion that lasts long enough to support the real economy, but not long enough to break the anchor of inflation expectations.

There is a story that is about two boys being chased by a tiger. One boy stops to put on a pair of running shoes. His friend asks, "What are you doing? You aren't going to be able to outrun the tiger just because you have running shoes. His friend explains, "I don't have to out run the tiger, I just have to outrun you." The same can be said of the dollar.

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