Quantitative Easing or Quackish Easing?

Myths Surrounding Monetary Policy Easing

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Protracted Monetary Easing

Central banks have responded to the financial crisis with an easing monetary policy that included unconventional measures. In 2014, the Eurosystem (central banks in the euro area including the European Central Bank) broke through the lower zero bound by introducing a negative interest rate policy. In other parts of Europe, Denmark, Switzerland, Sweden and Norway also have adopted negative interest rates. Japan followed suit in February 2016.

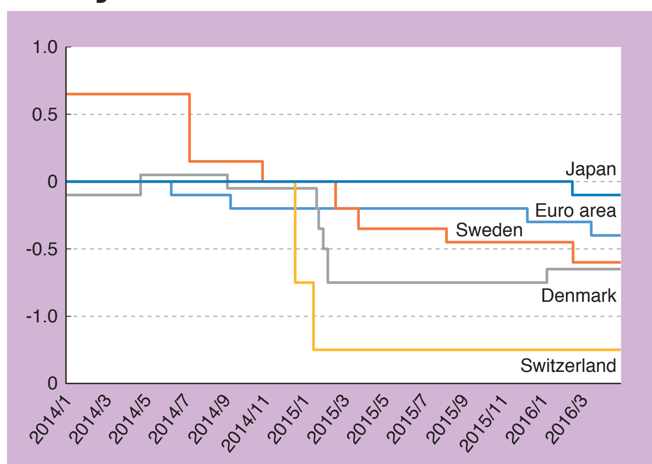
Central banks continued to supply more liquidity in addition to lowering policy interest rates, swelling their balance sheets. The Eurosystem has been purchasing a wide range of securities through its Asset Purchase Programme, while the Bank of Japan (BOJ) has continued to buy up government bonds and is currently engaged in "quantitative and qualitative monetary easing with a negative interest rate" (QQE).

A wide range of measures were introduced, as monetary easing was justified as the injection of liquidity into the financial system against the background of a chaotic financial market. Even after the chaos ceased, the Greek financial crisis, falling commodity prices and continuous disinflation led the authorities deeper into monetary easing instead of towards an exit. The purpose of monetary easing had shifted from saving the financial system to supporting the macro-economy.

Here, we will consider whether such excessive monetary easing is necessary or not, and what its impact is on the economy.

CHART 1

Policy interest rates since 2014



Note: The lowest policy rates for each central bank are adopted.
Source: ECB, Danmarks Nationalbank, Sveriges Riksbank, Swiss National Bank, BOJ

Why Is it Necessary to Provide Liquidity?

Should excessive monetary easing be banned? The answer is no. Excessive monetary easing does become necessary, albeit briefly, when there is a financial crisis. Banks harbor excessive anxiety when a financial crisis occurs. Demand for liquidity is high but banks cannot find counterparties in the money market. Under normal circumstances, funds can be secured by offering higher interest rates, but securing funding under crises becomes difficult as psychological phenomena overcome financial theory. Since banks, even soundly managed, try to get large amounts of liquidity, market liquidity runs dry and the central bank is obliged to compensate for illiquidity.

Walter Bagehot pointed out that the central bank should supply adequate liquidity as it is needed to banks that have failed liquidity management, along with punitive interest rates, as the lender of last resort. However, considering financial market circumstances today, the central bank must supply as much as required to all the banks, and play the role of no longer the lender of last resort for individual banks but the "supplier of last resort" for the market as a whole. It may be desirable for policy interest rates to be lower than pre-crisis levels, though they do not necessarily have to be reduced to zero or negative.

What Is "Quackish" Easing?

The large number of monetary policy instruments introduced have been categorized according to type, but they must be categorized according to their objectives, since purchasing government bonds can be used for both injecting liquidity into the financial system and stimulating the economy. I define excessive monetary easing to guarantee the stability of the financial system as quantitative easing, and excessive monetary easing to support the economy as quackish easing. In quantitative easing, banks should be able to determine for themselves how much liquidity is necessary. Thus, supply should be limitless, while the banks should be allowed to prepay if they decide

that excessive liquidity is no longer necessary, as in the Eurosystem's three-year long-term refinancing operations (LTRO). By contrast, in quackish easing, the central bank determines the amount of liquidity. However, since the central bank cannot know the necessary amount of liquidity in advance, the liquidity may be insufficient or excessive liquidity may persist in the economy.

Central banks claim that there have been two paths for monetary easing in recent years. The first is to encourage investment and support the macro-economy. Prices rise to appropriate levels with the economy on the upswing. The second is to induce exchange rates to fall. If the exchange rate falls, import prices go up, exerting upward pressure on domestic price levels. In both cases, the ultimate objective is to raise the inflation rate currently hovering around zero.

On the first path, central banks have succeeded in lowering the yield curve with monetary easing. When the BOJ announced its negative interest rate policy, long-term interest rates dropped immediately in Japan, and 10-year government bond yields have since remained in negative territory. However, lower yield curves have not led to increased bank lending to businesses. Interest rates are already low enough and liquidity supply is also sufficient, so further monetary easing will not stimulate lending. Lending is greatly affected by the performance outlook of businesses and the financial health of banks. Lending has been decreasing in the euro area as a whole in the 2010s although there are differences between individual member states.

The relationship between monetary easing and low exchange rates is not clear on the second path. Denmark, which participates in the Exchange Rate Mechanism II (ERM II) and pegs its currency to the euro, and Switzerland, which wants to keep its franc from soaring by suppressing inbound capital flows, have succeeded in managing their exchange rates through monetary easing. However, the euro and the yen have not been behaving as their central banks intended. The BOJ's February 2016 introduction of a negative interest rate and April announcement of its intention to maintain the status quo sent the yen soaring on each occasion. Central banks have lost the ability to control exchange rates.

Adverse Effects of Quackish Easing

Here are eight problems with quackish easing.

1. Promoting transfers from households to the government (low interest rate tax)

When interest rates go down, the income of households that hold assets declines, while the government's interest payments also decline. This is an expression of the transfer of wealth from households to the government. Let's call this phenomenon a "low interest rate tax".

The combination of supplying liquidity and adopting negative interest rates raises the low interest rate tax much more. Purchasing government bonds with negative interest rates in the primary and secondary bond markets and holding them until they mature will finalize losses to bond holders. To avoid losses, banks only have to sell the government bonds to the central bank. Negative interest rates can exist only in the bond market when the central bank submits to the negative interest rate in the end. The central bank can make a profit by seiniorage, which is then paid to the government as a tax. Quackish easing reduces the tax paid by the central bank, which then is borne by the private sector in the form of a heavier low interest rate tax.

2. Reducing households' purchasing power

Low interest rates mean less household income. Although the share of household investment in stocks and bonds in Japan is smaller than in other countries, assumed interest rate reductions of life insurance and premium hikes for pensions erode current and future household disposable income. This is particularly damaging to Japan and Europe, since the elderly are more dependent on interest income than the working generation.

3. Loss of fiscal discipline

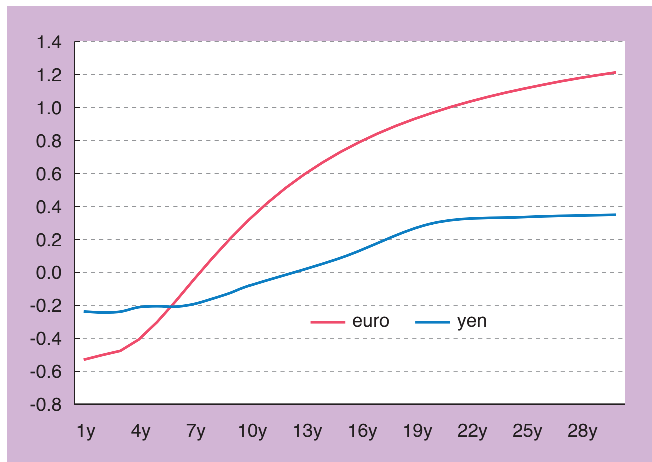
A government finds it easier to issue bonds when interest rates go down. The more governments issue bonds when interest rates go negative in the primary market, the more profits they make, further eroding fiscal discipline. True, when the government issues bonds at negative interest rates, it will end up with a profit if it spends none of the debt at all and instead uses it to redeem bonds. However, when it spends the debt from the bonds, taxpayers wind up with the burden, just as they would with government bonds with positive interest rates. For example, even if the government manages to issue bonds at a negative interest rate of 1%, taxpayers only register a gain of 2%, from 101% to 99% compared to a positive interest rate of 1%.

4. Yield hunting

Low interest rates prevent banks, insurance companies, investment trusts and the like from earning sufficient revenue by investing in bonds, making it necessary for them to seek better yields. Bonds with longer maturity are the first destination for such investment. Money is pouring into bonds with longer maturities in Japan, Switzerland and the euro area, where yields are negative for bonds with maturities of up to 10, 18, and seven years respectively. The demand for long-term government bonds is particularly strong in Japan, flattening their yield curves. The duration of the bonds represents the downside risk of bond prices from rising interest rates, meaning that investment in bonds with longer maturities increases the risk from price fluctuation.

Bonds with lower ratings are the second investment destination. Junk bond yields have fallen to levels that cannot be explained by financial theory. These bonds have extremely high credit risks in addition to price downside risks. Yield hunting is increasing low-risk, high-return investments.

CHART 2
Yield curves



Note: Yield curves as of April 28, 2016
Source: Ministry of Finance Japan, ECB

5. Rising house prices

House prices have been going up for several years in Denmark and Sweden, for example. House prices have also been rising in London, Amsterdam and other major European cities; likewise in Japan, mainly in Tokyo and other urban areas. Banks have been inclined to increase housing loans, which offer secure revenue as well as low credit risk with the houses themselves as collateral. But the rush to lend increases demand for housing loans, resulting in rising house prices, which impact the economy negatively, as many countries including Japan have already experienced.

6. Sapping corporate energy

Businesses borrow money to make investments, with which they gain revenue, which they use to repay the loans. Revenue must be greater than the financing costs, and research and development and innovations are essential to that end. Super-low interest rates make businesses lose the incentive to invest in research and development and innovation and prefer existing low-risk operations that promise a certain level of revenue.

Excessive liquidity sustains businesses that should be exiting the market, which instead remain as zombie companies. Capital and labor remain in the hands of incompetent managers, reducing the productivity of the economy as a whole and sapping energy from society.

7. Onset of deflationary mindset

Holding cash means losing the interest that could be earned from bank deposits. This opportunity cost is high when the interest rate is high, while it becomes extremely low in times of hyper-low interest rates. People will prefer cash over deposits when deposit rates go negative. This makes the value of cash go up, which in turn means deflation.

Switzerland is already issuing more 1000-franc bank notes. The Japanese preference for cash has not changed, as cash has been on the rise in Japan since 2014, and sales of safes have gone up since the introduction of negative interest rates. The Eurosystem announced that it would stop issuing 500-euro notes at the end of 2018, but that has not been sufficient to reduce the preference for cash. Although 500-euro notes will no longer be issued, they will maintain their role as legal tender, so increasingly more will be issued through 2018, and few will be taken out of circulation after that. Preference for cash reduces the multiplier and the effectiveness of monetary policy.

8. Leading away from the exit

Quantitative easing is a measure for maintaining the stability of the financial system, and can be implemented for a predetermined, finite period, such as six months or a year. The exit can actually be reached even earlier if banks are allowed to prepay. However, the objective of quackish easing is economic recovery, which means that the central bank cannot proceed to the exit until the economy recovers. Since quackish easing has the effect of lowering the economic growth rate, the implementation of quackish easing of itself pushes the exit away.

Economic indexes do not move consistently; some go through cycles of improvement and deterioration. Temporary deterioration of economic indexes produces expectations of further quackish easing, enmeshing the central bank in a web of its own weaving.

Quackish easing saps energy from households and businesses, while financial institutions assume excessive risks and the government abandons fiscal discipline. The economy becomes more vulnerable, and the impact of the next crisis grows.

The Japanese Economy & Quackish Easing

Let's look at the situation in Japan. The Japanese government has long been encouraging households to invest in the stock market, but bank deposits comprise 52% of personal financial assets in Japan. Japan suffers from over-banking and competition in retail banking is extremely harsh. There are no account maintenance fees, weekday ATM charges, or such things as fees for casual consultations regarding loans and asset management. Remittance fees and currency exchange commissions are also extremely low. Many Japanese have several accounts for receiving wages, paying public utilities, paying credit cards, and for savings. Each account has low balances, which raises management costs for the banks.

As for lending, consumer loans and student loans are performing relatively well but are small in volume, so the bulk of the retail business consists of housing loans. Since Japanese banks do not issue covered bonds, housing loans are financed by money collected as deposits. Some 97% of the loans are not securitized, which means that the banks are exposed to the risk.

Quackish easing has continued for a long time in Japan, with the

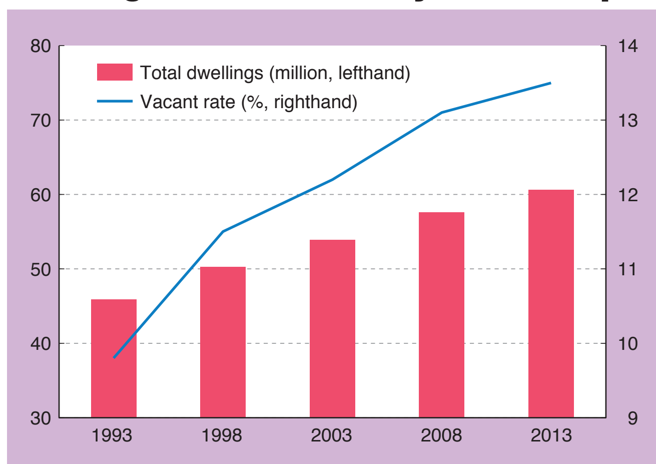
interest rate for ordinary deposits at an extreme low of 0.001%, pushing households into a situation where they are not earning interest income. Some households are engaging in leveraged FX trading (foreign exchange futures transactions), as "Mrs. Watanabe" exerts a significant influence on FX trading. Mrs. Watanabe's impact should become smaller in an economy that offers sufficient interest income. Quackish easing leads households to turn to foreign exchange, foreign bonds, and other riskier financial instruments instead of the domestic stock market.

Housing loans have been strong due to the low interest rates under quackish easing. Housing loan refinancing has been declining for the last five years, but still accounts for 20% of the loans, making it a negative factor in the interest revenue of the banks as a whole. Many of the new loans are being taken out by lower-income households that would not have been capable of owning homes. According to a Japan Housing Finance Agency survey, 50.5% and 46.0% of the banks surveyed aimed their housing loans at households with an annual income of about 4 million and 6 million yen respectively — households with low capability to repay. Some 54.7% and 37.6% of new loans have variable interest rates and fixed rates for 10 years or less respectively, resulting in an increase in "potential subprime loans" that are likely to be in arrears if interest rates rise. Increasing new high-risk loans and low-revenue refinancing loans lead banks to become more vulnerable.

House prices are rising in the Tokyo area, just like in major European cities, but there are many vacant homes in urban areas in Japan. According to the Housing and Land Survey at Statistics Japan (Statistics Bureau, Ministry of Internal Affairs and Communications), vacant homes are on the rise, with 8.20 million or 13.5% of all homes vacant in 2013. This is because leaving homes vacant is the most advantageous option under the Japanese tax system. But the Japanese government has begun reforming the system to utilize vacant homes, raising the possibility of a large number of homes being supplied going forward. Since families have fewer children and few immigrants are being accepted in Japan, there is a possibility that house prices may stop rising and begin to decline. There is a possibility that the risks carried by the banks become actualized, leading to a financial crisis.

CHART 3

Housing stock & vacancy rate in Japan



Source: Statistics Japan, Housing and Land Survey 2013

How Monetary Policy Should Be

Quackish easing cannot control the economy or exchange rates, and has many shortcomings that render the economy more vulnerable. Thus, monetary policy should be used only to contribute to financial stability, not to control the macro-economy. Quantitative easing becomes necessary temporarily in response to financial crises, but one-year or other time limits should be imposed on its implementation. The BOJ and the Eurosystem should move promptly towards the exit.

Inflation targeting is the backdrop for quackish easing. As the fragmentation of production progresses beyond national borders in the 21st century, lower production costs have led to worldwide disinflation. Moreover, commodity prices falling in recent years have been reducing the inflation rate. Since deflation does not have monetary causes, monetary policy should not be taken to deal with it, and will be ineffective in any case.

The element of surprise has gained importance in monetary policy in recent years. It appears in the beginning that the market can be controlled through surprises, but their effectiveness diminishes over time. The only way to maintain their effectiveness is to expand the volume of financial easing and the scope of the instruments. When the market learns that the central bank is surprise-oriented, it will escalate its demands. But surprises cannot be continued forever, and the time will come when the central bank can no longer respond to the demands of the market. Although surprises are a means of controlling market expectations, they will end up in losing credibility with the market through such a process.

Controlling expectations is an important element of enhancing the efficacy of monetary policy, but a central bank with low credibility will be unable to control expectations, with the consequence that it will find the achievement of suppressing inflation and other objectives of monetary policy difficult. Dialogue with the market means explaining the purpose of monetary policy to the market in detail to secure its understanding, not yielding unilaterally to the demands of the market.

What should be the objective of monetary policy? Not to chase an inflation rate or other such numbers, nor to please the market, but to enable the public to live their lives in security. It is time to rethink the purpose of the existence of central banks. JS

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