Quantitative Easing and Federal Tapering Explained

Under our Background Digging Operation™ on the most highlighted economy terms in recent times, we have so far covered the following topics : (1) Sub-prime crisis, Fiscal Cliff and Fiscal Drag. (2) US debt ceiling crisis and US Federal Government Shutdown. Another important topic worth discussion and understanding is Quantitative Easing and Federal Tapering. While Fiscal Cliff and US debt ceiling are fiscal issues related will government bills in US congress, Quantitative easing is a monetary policy related with the central bank, and in this case, the Federal Reserve of United States of America. Let's straight away dive into the topics of Quantitative Easing and Federal Tapering.

Difference between Conventional Monetary Policies and Quantitative Easing

Monetary Policies are policies taken by the central bank – RBI in case of India and Federal Reserve in case of United States of America. What are standard or conventional monetary policies? Hope you remember about conventional monetary policies. In case of RBI – remember REPO, Reverse REPO, CRR, SLR, Bank Rate, Base Rate etc. Normally the central bank follows an easy money policy (low interest rates) when they need to promote growth and a tight money policy (high interest rates) when they concentrate on controlling inflation. You may also take a close look at the Open Market Operations (OMO), a conventional monetary policy action performed by Reserve Bank of India (RBI).

What happens during OMO? The Reserve Bank of India either sell or purchase **Government Securities** to/from the public. The purpose of OMO is to control liquidity or to raise cash from public. But you may please note that during OMO, RBI deals with Government securities and not private bonds. Having understood the basics of conventional monetary policies, now let's look at Quantitative Easing – a recent policy used by US Federal Reserve.

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Quantitative Easing : Asset Purchase

Quantitative Easing is mainly an asset purchase or asset swap policy. The purpose is to increase money supply to the banks. A central bank implements quantitative easing by buying specified amounts of **financial assets from commercial banks and other private institutions**, thus increasing the monetary base and lowering the yield on those financial assets. This is distinguished from the more usual policy of buying or selling **short term government bonds** in order to keep interbank interest rates at a specified target value.

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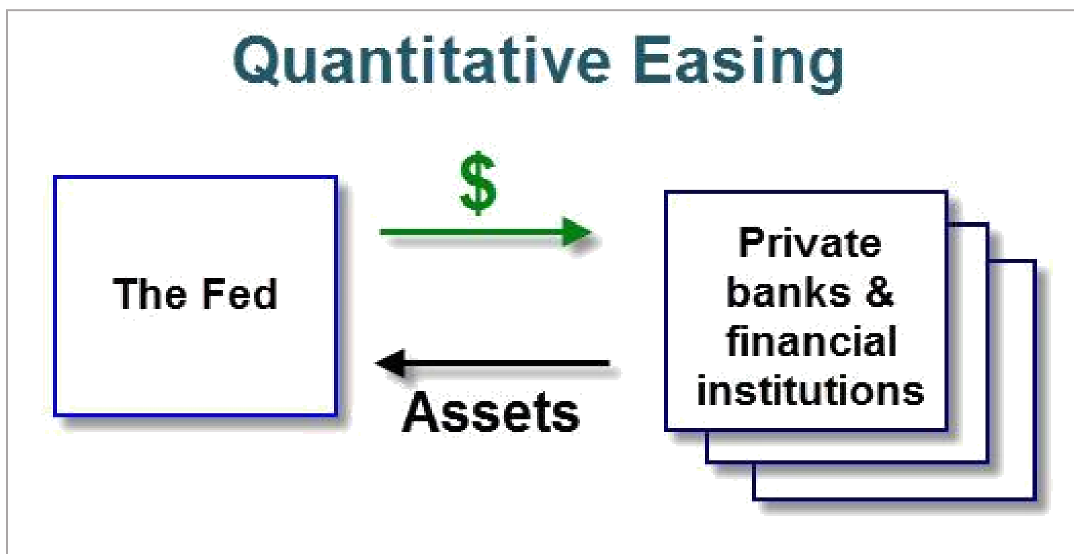

The best definition I read about Quantitative easing (QE) is the one from Wikipedia itself : QE is an unconventional monetary policy used by central banks to stimulate the economy when standard monetary policy has become ineffective. A central bank implements quantitative easing by buying specified amounts of **financial assets from commercial banks and other private institutions**, thus increasing the monetary base, so that the banks have now more money to lend.

Also read: Lateral Entry into Civil Services - Should the Government Allow It?

You may please note that all commercial banks work on the basis of lending. It's the lending which runs and economy too. What if banks do not have money to lend?

Cases when lending is affected : Need for Quantitative Easing

1. When interest rates have been lowered to nearly zero (because of either deflation or extremely low money demand).
2. When a large number of non-performing or defaulted loans prevent further lending (money supply growth) by member banks.
3. When the main systemic risk is a recession or depression.

Quantitative Easing is Not Printing Currency!

Quantitative easing has been nicknamed "printing money" by some members of the media. But this idea is actually wrong. Printing new currency is one of the options under deficit financing, (also known as monetizing the government debt). But don't confuse it with Quantitative Easing.

Another term associated with QE is creating new money. Though the creation of money is a better wording for the process, that too does not convey the true picture of the story. Though the central bank purchase assets from commercial banks, it normally does not involve printing new currencies. The 'money creation' is done by means of asset swap.

What happens during Quantitative Easing?

In layman's terms QE corresponds to more liquid cash with commercial banks instead of bonds. The Central Banks allows the asset swap under QE, so that the commercial banks will have more cash instead of bonds. There is no difference on the net asset-liability position; ie the net-asset-liability position remains the same. (There will be addition in assets and liabilities column of the central bank; so the total-asset-liability value may increase; but the net value will remain the same). Also there is no printing of new money. If you need an example to see how Quantitative Easing works, then read the CNBC article on QE.

Problems of Quantitative Easing

1. If the money supply increases too quickly, quantitative easing can lead to higher rates of inflation.
2. Banks may decide to keep funds generated by quantitative easing in reserve rather than lending those funds to individuals and businesses (failing the purpose of QE).
3. Difficult to gauge how much QE is required.
4. Potential to destroy the confidence in an economy.
5. Central bank can lose money.
6. May not work if not implemented aggresevily enough.

Also read: ISRO's World Record PSLV C37 Launch: Top 10 Facts You Should Know

US Quantitative Easing (QE1, QE1 and QE3)

Quantitative easing was first used by the Bank of Japan (BOJ) to fight domestic deflation in the early 2000s. Since the advent of the global financial crisis of 2007–08, similar policies have been used by the United States, the United Kingdom, and the Eurozone during the financial crisis of 2007–2012. Quantitative easing was used by these countries because their risk-free short-term nominal interest rates were either at or close to zero.

US has done Quantitative Easing measures three times – in 2008, 2010 and 2012 – and they are known as QE1, QE2 and QE3 respectively. US Fed Reserve started buying Treasury notes and Mortgage Backed Securities and this increased the monetary base of US banks. Understand that this measure of buying Treasury notes corresponds to a position of more liabilities in the asset-liability portfolio of the Central Bank. Though not a sustainable measure, QE1, QE2 and QE3 has helped United States to slowly recover from recession and other economic problems.

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Federal Tapering

Tapering refers to a gradual reduction in the monthly purchase of assets by the Federal Reserve. Keep in mind that tapering means the Fed will still be purchasing assets, just not as many. So Federal Tapering is the process of slowing down the rate at which Quantitative Easing is done.
$85 billion in assets were being added to the Fed's balance sheet each month—$45 billion in Treasuries and $40 billion in mortgage-backed securities (MBS). The first step in the Fed's exit framework was to decrease the level of asset purchases each month, or taper them. After the tapering phase concludes, the Fed's next step would be to reinvest maturing securities in like securities, keeping the size of its balance sheet steady for some time. The whole process should be quite gradual: Tapering may last for six to nine months, maintaining a steady balance sheet may persist for another six to nine months, and then the Fed may raise its target federal funds rate sometime in 2015.

Fed's exit strategy: An illustrative timeline

Potential stages of the Fed's exit

Stage	Consensus timetable	Severity
1. Taper QE3	Fourth quarter 2013	Less easing but still accommodative
2. End QE3	Mid-2014	Less accommodative
3. Stop reinvesting maturing assets	Late 2014/early 2015	Tightening as balance sheet declines
4. Raise federal funds rate and IOER	Mid-2015	Tightening
5. Normalize balance sheet	2018 if active selling, 2020+ otherwise	Significant tightening if active selling

Source: Vanguard Investment Strategy Group.

The unconventional monetary policies experienced in the past several years have to be rolled back at some point. As the economy gradually regains the ability to stand on its own —at least in the Fed's view—the Fed will inevitably start the gradual process of removing the quantitative easing measures.

Also read: Union Budget of India 2015-16 Highlights and Analysis

Why many countries including India fear Federal Tapering?

What will happen to the economy after the Federal Reserve begins to slow down its current quantitative easing? Because once federal tapering happpens, banks will have only less free money with them to lend loans. There are chances of loans becoming costlier, inflation to go high. This can affect FDI and FII inflows to India. Hence the fear.

India is among the markets that may be affected, at least in the short-term, as capital flows shift to the US as growth there recovers. Outflows may put more pressure on the slumping rupee. Portfolio flows are a key tool to finance India's current account deficit.

Is India ready now to face Federal Tapering?

Yes. According to Finance Minister and RBI Governor. Tapering will be a gradual process, followed by keeping the balance sheet steady, and then eventually increasing the target rate. Though there are many claims that India is ready to face it, only time can test the strength of Indian Economy.

Quantitative Easing vs Qualitative Easing

If quantitative easing is focused on the amount of assets purchased, qualitative easing is focused on the type of assets bought. Qualitative easing is a shift in the *composition* of the assets of the central bank towards less liquid and riskier assets, holding constant the size of the balance sheet (and the official policy rate and the rest of the list of usual suspects). The less liquid and more risky assets can be private securities as well as sovereign or sovereign-guaranteed instruments. All forms of risk, including credit risk (default risk) are included.

The Fed has engaged in aggressive quantitative and qualitative easing. Federal Reserve's purchase of riskier assets such as mortgage-backed securities was crucial to reviving the stock market in 2009 and spurring economic recovery.

To sum up on qualitative easing, it is a government policy that is designed to mitigate risk through central bank purchases of privately held risky assets and their replacement by government debt, with a return that is guaranteed by the taxpayer. Policies of this kind have recently been carried out by national central banks, backed by implicit guarantees from national treasuries.

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