Quantitative Easing - About Monetary Policy Part I

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Reigniting the economy is one of the main objectives on the western hemisphere at this moment. From the Federal Reserve System to the European Central Bank there is a lot of tension regarding the prospect of economic recovery, curbing inflation, ensuring the financial system's stability and promoting job creation. Thus, inducing economic growth has become the battle hymn of the policy makers.

Our social-economic system depends on the activities and monetary policy established by the Federal Reserve Bank. Our current political-social status as a territory of the United States of America establishes the undeniable reality of this fact. So it is fundamental to affirm that our socio-economic conditions are linked and influenced by the FED's movements. In addition, for ensuring a rigorous discussion of our economic reality we need to mention additional variables such as: industrial sector productivity, consumer confidence, geographical reality, inflation and government spending, among others.

In synthesis, monetary policy is the process, method and/or approach by which a sovereign state (with its sovereign currency) controls its supply of money or the total amount of money available in an economy at a particular point in time. The main objectives of the FED are to maintain low inflation (or prevent deflation) and low unemployment, even though sometimes these two objectives may be in conflict. That means that sometimes to keep unemployment rate low, inflation must be sparked, and sometimes to keep inflation low, unemployment rate has to go up.

In monetary policy development, there are two main sets of principles, methods and tools used for managing the money supply: contractionary and expansionary monetary policy.

CONTRACTIONARY MONETARY POLICY focuses on decreasing the money supply to prevent or curb inflation, in other word access to credit, investments rates and economic expansion is halted. During contractionary measures the FED interest rates are increased, bank’s reserve requirements are increased and open market operations are stopped. Whenever the FED comes to the conclusion that there is a significant risk of high inflation spikes, they will move swiftly to contain it.

Some of the outcomes of contractionary monetary policy include the following:

1. Decrease domestic bonds prices and increases interest rates, thus curbing access to credit.
2. Higher interest rates induce a decrease in levels of capital investment.
3. Demand for foreign bonds decrease, and demand for domestic bonds increase because of better yields linked to a higher interest rate.
4. An increase in exchange rate occurs, because the demand for domestic currency increases and makes domestic products costlier.
5. A higher exchange rate induces the balance of trade to decrease because imports increase and exports decrease.
6. Inflation is reduced because a higher exchange rate means that each currency unit buys more goods and services, thus a money supply shortage ends up strengthening the value of money.

EXPANSIONARY MONETARY POLICY is geared toward creating a positive financial environment for individuals and corporations that enable access to credit-capital and induces job creation. It is composed of a set of fiscal policies that encourage economic growth. Among the main tools used for expansionary policy we can mention lowering the federal discount rate, purchasing securities on the open market and lower reserve requirements.

The results of expansionary monetary policy are not black and white, nor totally effective, the main result is to induce economic growth, and thus some by-products while not desirable are necessary collateral results.

Among the effects of expansionary policy we can mention the following:

1. Increases in domestic bonds prices and reduction in interest rates.
2. Lower interest rates facilitate access to higher levels of capital and higher rates of investments.
3. As domestic bonds prices rise, making them less attractive, the demand for foreign bonds arises.
4. A decrease in exchange rates takes place, because the demand for domestic currency falls and makes domestic products cheaper.
5. A lower exchange rate induces the balance of trade to increase because exports increase and imports decrease.
6. Inflation is triggered because a lower exchange rate means that each currency unit buys fewer goods and services, thus a money supply surplus ends up diluting the value of money.

What happens when every tool in the book has been used and interest rates are zero or close to zero, the main banks that compose the financial system are on the verge of bankruptcy and the economy does not expand?

This was the case during the peak of the financial crisis on 2008, Henry Paulson and Ben Bernanke tackled the harsh reality that challenged all traditional models for expansionary monetary policy intervention and posed policy makers on the path of depression.

Hence, among the radical methods the FED used, quantitative easing became the weapon of last resort during those turbulent times.

Quantitative easing (QE) is the final resort tool used by central banks to increase the supply of money when the bank interest rate, the discount rate and/or interbank interest rate is zero or close to zero. “Quantitative” refers to the fact that a specific quantity of money is created, “easing” refers to reducing the pressure on banks. It is important to stress that quantitative easing is not equal to printing money, because money in the quantitative easing method is electronically created, no money is printed.

During the next couple of weeks we will discuss the process for using quantitative easing (QEase or Die!), QE overall effectiveness and its risks (Flipping the Coin) and the prospects for the financial system’s future (Too Small to Fail).

God bless you all!

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