

# Quantitative Easing - Flipping the Coin Part III

**Dr. Manuel E. Maldonado Cotto**

When the uncertainty on the banking industry was at its peak on September 2008, the Federal Reserve System pumped billions of dollars to stabilize the principal banks in the US economy. The total amount disbursed to stabilize banks was one-hundred and twenty-five (125) billion dollars.

This pre-emptive move to market's distrust on the banking system was geared in restoring confidence on the soundness of banks and also aimed toward unfreezing the systemic credit crunch. This means that at the time there were empirical concerns over the capacity of the economy to activate commercial and individual transactions on all major industrial sectors in the economy.

During the course of defining the next steps for adequately leveraging the financial system, the Federal Reserve System had to discuss and implement very unorthodox methods for responding effectively to the crisis. Because there was no previous methodological or comparable policy for rescuing the financial system, some of the proposed solutions were considered the equal to FLIPPING THE COIN!

FLIPPING THE COIN IMPLIES THAT SOME KIND OF GAMBIT HAD TO BE TAKEN IN THE DECISION MAKING PROCESS TO IMPLEMENT UNCONVENTIONAL MONETARY POLICY.

In the classic coin toss probability exercise, when asked the question, what is the probability of a coin toss coming up heads? Most people answer without hesitation that the probability is of 50%,  $1/2$ , or 0.5. The main reason for getting this answer lies in the underlying assumption that the coin is fair, or heads and tails are equally likely to come up when the coin is tossed.

Obviously, quantitative easing came to be a response to a time of financial turmoil that had no precedent in history, thus deploying it as a tool for managing uncertainty was a very drastic move indeed. Moreover, its consequences could not be foreseen at the time because the scale, in which it had to be used for re-leveraging the financial system in the US, had never been seen.

In a broad sense, quantitative easing is used by central banks to increase the supply of money in an economy when the bank interest rate, discount rate and/or interbank interest rate are either at, or close to, zero. "Quantitative" refers to the fact that a specific quantity of money is being created; "easing" refers to reducing the pressure on banks as to ensure adequate leveraging of the financial system.

The steps for using quantitative easing are the following:

1. THE FEDERAL RESERVE SYSTEM SETS THE INTEREST RATE AT ZERO OR CLOSE TO ZERO – Ordinarily, the central bank uses its control of interest rates, or sometimes reserve requirements, to indirectly influence the supply of money. Among other things, this is done to ensure that inflation is kept in check, that inter-banking lending keeps moving and the access to credit is stimulated, hence, the probability for nurturing an economic upturn is enabled. This intention in monetary policy must be coupled with the perception of stability in financial markets by consumers and investors, if there is a credibility crunch (no trust in the system) then the effectiveness of near zero interest rates is reduced dramatically and or neutralized altogether by the negative perception that things do not seem stable and economic prospects are not good.
2. THE FEDERAL RESERVE SYSTEM CREATES ELECTRONIC MONEY – by crediting its own account with money it has created ex nihilo ("out of nothing"), the Federal Reserve System added a huge amount of money to the system. The main idea for using

the electronic money is to actively participate in Open Market Operations. It is important to clarify that this is not considered the same as printing money; this usually implies that the newly minted money is used to directly finance government deficits or pay off government debt; it is also known as "monetizing the government debt".

3. THE FEDERAL RESERVE SYSTEM THEN BUYS FINANCIAL ASSETS
  - The newly created money is then used for buying government bonds and other investment products (particularly high risk and toxic) from financial firms such as banks, insurance companies and pension funds. In late November 2008, the Fed started buying \$600 billion in Mortgage-backed securities (MBS). By March 2009, it held \$1.75 trillion of bank debt, MBS, and Treasury notes, and reached a peak of \$2.1 trillion in June 2010. Holdings were projected to fall to \$1.7 trillion by 2012. However, in August 2010 the Fed decided to renew quantitative easing because the economy wasn't growing as was expected by policy makers. The new objective was established to keep holdings at the \$2.054 trillion level. To maintain that level, the Fed bought \$30 billion in 2-10 year Treasury notes a month. In November 2010, the Fed announced it would increase quantitative easing, buying \$600 billion of Treasury securities by the end of the second quarter of 2011, this is widely known as QE2.

Under QE, a central bank buys from an institution, the institution's bank account is credited directly and their bank gains reserves. The increase in deposits from the quantitative easing process causes an excess in reserves and private banks can then, if they wish, create even more new money out of "thin air" by increasing debt (lending) through a process known as deposit multiplication and thus increase the country's money supply and activating lending.

The concept "quantitative easing" has been attributed to the economist Dr Richard Werner, Professor of International Banking at the School of Management, University of Southampton (UK). At the time working as chief economist of Jardine Fleming Securities (Asia) Ltd in Tokyo, and noted for his 1991 warning of the coming collapse of the Japanese banking system and economy; he coined the expression in an article published on September 2, 1995 in the Nihon Keizai Shinbun (Nikkei Group).

QE is seen as a risky strategy that could trigger higher inflation than desired or even hyperinflation if it is improperly used and too much money is created. There is the assumption that there is less risk of such an outcome when a central bank employs quantitative easing strictly to ease credit markets (by buying commercial paper), whereas hyperinflation is more likely to be triggered when money is created for the purpose of buying up government debts.

QE in the United States has been used for buying both, investment products and government debt.

The results of using QE are still being discussed and debated, but according to the IMF, the quantitative easing policies undertaken by the central banks of the major developed countries since the beginning of the late-2000s financial crisis, have contributed to the reduction in systemic risks following the bankruptcy of Lehman Brothers. It also states that the policies also contributed to the recent improvements in market confidence, and the bottoming out of the recession in the world's leading economies.

In synthesis, determining that the gamble on using QE was effective remains to be seen. Although, there are positive signals on the soundness of financial markets, the sustainability of an economic upturn is at this moment a big longshot. In our final article we will be discussing the real prospects on the financial system's future.

God bless you all!

**Dr. Manuel E. Maldonado Cotto**

**President & CEO**

**Intelligence Forecasting, Corp.**

**Contact at: [mmaldonado@intelligenceforecasting.com](mailto:mmaldonado@intelligenceforecasting.com)**

**Mobile: 787.536.4072**