A discussion on QE costs and constraints

In an excerpt from Goldman Sachs Research’s "Top of Mind" report, Editor Allison Nathan discusses the constraints, costs, and benefits of unconventional monetary easing in the Euro area and Japan with co-heads of Global Markets Research Francesco Garzarelli and Charlie Himmelberg.

Allison Nathan: The constraints and costs of unconventional monetary policy have been at the center of market discussion this year, with asset scarcity a key focus. Has this focus on scarcity been appropriate?

Francesco Garzarelli: Absolutely. But let’s be clear: We are not running out of bonds. If you look at the volume of bonds available for sale plus the volumes being issued against the size of central bank purchase targets, the balance remains largely favorable. The problem is that in longer-dated maturities, there are fewer securities outstanding and the holders of these securities don’t want to sell them due to regulations and risk-management practices. Evidence of this is the fact that since the inception of QE in Japan and Europe, the percentage of government securities held by insurance companies and pension funds hasn’t changed. And that’s where the scarcity issue shows up: As central banks seek to buy longer-dated assets from investors that don’t want to sell, the price of these assets rises. Further, by specifying a designated quantity of asset purchases in advance, central banks invite speculative activity that exacerbates the price action. It has been quite profitable to buy bonds and then hold onto them until the central bank is willing to pay up.

Charlie Himmelberg: What Francesco just described doesn’t worry me per se; after all, distorting relative asset prices is the name of the game in monetary policy. What’s unconventional about the post-crisis period is the extent to which central banks have been willing to push these distortions further out along the yield curve and influence the prices of longer-maturity bonds. Ultimately, monetary policy should be judged not by its effects on yields, but by the extent to which it creates incentives for credit intermediation to fund real activity. Flattening the yield curve through QE may have a counter-productive effect on these incentives because it reduces the attractiveness of borrowing short-term to lend long-term. To the extent that QE undermines the profitability of credit creation and risk intermediation by the financial system, it is obviously self-defeating.

This implies an important distinction between monetary policy instruments that operate at the back end of the yield curve versus the front end. The back end of the curve is the more natural habitat for traditionally risk-averse investors such as insurance companies and pension funds. As Francesco pointed out, these institutions are choosing to stay in safe, long-duration assets, at least in Europe and Japan. Pushing them to take more risk, as QE aims to do, may not be wise. Ideally, policy would create incentives for entrepreneurs, hedge funds, private equity funds, venture capitalists—the pools of capital that are better-equipped to take the kinds of risks that help drive innovation and economic growth. Such risk takers rely more on bank funding, and fund closer to the front end of the yield curve. Even in a sophisticated capital market like in the US, banks remain the financial “nerve center” of this risk-taking universe. This is why I suspect it is better to subsidize risk intermediation via instruments like forward guidance than it is to simply sit on the price of duration risk.

I’d also note that small and medium-sized businesses in the US are 100% reliant on bank funding. One of the striking artifacts of the current economic recovery has been the collapse of dynamism of these firms, which employ tens of millions of Americans. I think some of the frustration among the middle class, which is especially evident in this US election cycle, may trace back to pressures on the US banking sector. In contrast to large corporations for which credit has been cheap and readily available, I suspect it’s gotten harder for small entrepreneurs to access credit.

Allison Nathan: To what extent are these counterproductive effects playing out in practice?

Francesco Garzarelli: There is growing evidence that QE has become self-defeating in some respects. Although the European and Japanese central banks have pumped massive amounts of money into the economy, that money is stagnating on private sector balance sheets; the share of cash and overnight deposits on corporate and households balance sheets has just gone up, while bank lending has remained subdued. If the yield curve is too flat, it damages the stock prices of financial institutions and, unsurprisingly, leads them to behave more conservatively. Similarly, to the extent that QE intends to induce investors to shift into riskier assets, it is questionable how much more benefit can be extracted when yield curves are very flat, equity prices are generally very high and credit spreads are very low. The fact that financial conditions in Europe and Japan have tightened suggests that the benefits of these programs may now be smaller than their costs.

Allison Nathan: Have distortions on the long end just been counterproductive or actually potentially harmful?

Charlie Himmelberg: I think it can be dangerous to distort the incentives for risk-taking on the long end of the curve. Subsidizing traditionally risk-averse investors to move out of their safe, long-duration assets and into riskier assets runs the risk of creating a mismatch of investor skill and capital. We experienced the dangers of this firsthand in the run-up to the global financial crisis. Even though US yields in 2006-2007 were at levels that seem downright generous today, at the time, they prompted duration buyers to search for yield in the credit market, and particularly via structured credit. Of course, we all know how that story ended. Today, these funds face similar pressures, which ought to be a concern if history is any guide. That said, the institutional discipline on risk-taking has been much higher in the post-crisis period. Some of the recent...
pushback on QQE in Japan, for example, has come from institutional investors arguing that a reallocation into riskier assets isn’t prudent or often even feasible given regulatory constraints. And I think that policymakers and market observers are increasingly cognizant of the constraints and dangers of unconventional policies as we gain more experience with them, which is allowing us to fine-tune our judgement on their appropriate use.

**Allison Nathan: So is there still a case for QE?**

**Francesco Garzarelli:** Yes. The importance of QE in opening up space for fiscal stimulus should not be underestimated. In Europe, the ECB’s asset purchases have considerably lowered the interest bills for highly indebted countries and enabled new issuance at longer maturities, allowing more fiscal spending—hopefully on productive investments. Given that the ECB will be reinvesting the proceeds on its sovereign debt holdings as they mature, a large share of public debt will not need to be rolled over for the foreseeable future.

We have seen the benefits of this fiscal channel in places like Italy, where the interest bill has fallen substantially, the debt structure has lengthened, and the primary deficit has increased—all of which have supported growth. On the flip side, in places like Germany, where there is a smaller supply of bonds and a larger number of long-duration investors, asset purchases have been detrimental for the economy. But that can be fixed by buying fewer German bonds and more Italian ones. That would face political objections, but is a function of the Euro area’s institutional setup, not of QE per se.

**Allison Nathan: Beyond the backdoor to fiscal stimulus, is there a better approach to boosting credit creation?**

**Charlie Himmelberg:** As I mentioned, in my opinion, forward guidance is far superior to QE if the goal is to stimulate real activity via credit creation. By reassuring the financial sector that short-term rates will stay pegged over a finite amount of time, central banks effectively reduce the risk that rising funding costs will squeeze lending margins. The term funding facilities offered by the BOE and ECB are a close cousin to this. Instead of pledging to keep short-term market rates at a low level, you simply supply term loans at very low rates, which is basically the same thing. Note that all of this would be a lot easier if the banking system, especially in Europe, had more equity or risk-absorbing capital—a key input to credit creation. If the capital buffers in the European banking system were much larger, that would have likely created more of a comfort zone for the ECB to pursue term lending.

**Allison Nathan: Is BOJ’s move to yield targeting a step in the right direction as far as mitigating the costs of QE?**

**Francesco Garzarelli:** Definitely. I think the fixation with targeting asset quantities on the premise that those asset purchases would weaken the yen and ease financial conditions has proven wrong. In my view, shifting to a target zone for real yields may not by itself reflate the Japanese economy—which is indeed a tall order—but it should increase the transmission of monetary policy, for three reasons. First, it should prevent speculative investors from front-running central bank purchases. This should reduce the risk of extreme price aberrations at the long end of the yield curve. Second, it should make way for more powerful fiscal stimulus. Before, if the government had increased its bond issuance to finance fiscal stimulus, chances are that the price of those bonds would have declined and the sovereign risk premium would have risen, which would have been particularly problematic given Japan’s high debt levels. But now 10-year JGB yields should hold at 0% regardless of how many bonds the Ministry of Finance decides to sell. And third, the peg on 10-year yields should keep any upward pressure on US yields from migrating to the Japanese yield curve and tightening Japanese financial conditions. On net, a Fed rate hike should therefore result in greater interest rate divergence between the US and Japan than before, depreciate the yen to a greater extent, and generate a bigger net easing in Japanese financial conditions.

**Charlie Himmelberg:** I agree. I would just add that the BOJ’s new policy also removes the pointless burden that quantity targeting places on long-duration investors. Continuing to buy massive quantities of bonds from investors who are loathe to sell, even when yields are below zero, offers no benefit. Under the new regime, the BOJ will presumably stop buying JGBs long before it gets to that silly point.

**Allison Nathan: Does managing the yield curve to such a degree make you uncomfortable?**

**Francesco Garzarelli:** It might look more radical, but the reality is that overnight rates are routinely fixed and through that there is already some attempt to manage the price of 10-year yields. At the end of the day, the goal is to shift relative prices to induce the right incentives to lend and invest. If policymakers find that they are able to generate a more coherent set of relative prices by committing to keep the 10-year rate fixed, I think it’s not a bad idea. It does raise a question of how to exit this policy, which becomes akin to the challenge of exiting a currency peg. There is likely to be substantial volatility when that time comes, but hopefully it is the right time, marked by higher inflation and enough pressure from investors to sell bonds that it makes sense to relax the price target.

**Charlie Himmelberg:** I agree. Longer-dated yield targeting is just an extension of the principle behind overnight-rate targeting, and don’t see anything particularly concerning about it. But I think it is important not to lose sight of an even bigger picture here. Rates are not low because central banks have put them there. They are low because the demand for capital in developed economies is behaving as if the future is much bleaker than the present. This is generating more savings than the demand for investment can absorb. And by the way, the pressures on bank credit that we discussed contribute further to this inability to absorb savings. To address this imbalance, global real rates need to be negative—and for that to happen, inflation rates must become more positive, which is why making progress towards inflation targets remains critical. It may well be the case that inflation expectations need to be even higher than current targets suggest; I wouldn’t be surprised if the concept of shifting inflation targets to, say, 4%, gains more traction. The main point is that central bank rates and targets are mostly a symptom of the real economy, not the main driver of it. And innovation in central bank and other policies will likely continue to be required to address this reality.