No. 2 | JANUARY 2019

ECONOMICSFORALL

SG Economics and Sector Research

The quantitative easing retreat

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The world has entered a new era, with the central bank liquidity tap – on full since the 2008 crisis – now being gradually turned off. While the Fed continues with quantitative tightening (QT), that is, the shrinking of its balance sheet, the ECB ended its quantitative easing (QE) programme on 31 December 2018. Monetary tightening could have disruptive effects.

The quantitative easing (QE) programmes implemented by the world's major central banks in response to the financial crisis **are continuing to be unwound.**

After reducing the pace of its asset purchases, **the European Central Bank (ECB) ended its expanded asset purchase programme (APP) on 31 December 2018**. From 1 January 2019, the ECB will aim to maintain its balance sheet at around EUR 4.7 trillion (equivalent to 40% of eurozone GDP), purchasing just enough assets to replace maturing securities.

As such, the ECB is following the path embarked on by the US Federal Reserve (Fed) in 2014. After reducing its asset purchases, from October 2014 the Fed stabilised the size of its balance sheet at USD 4.5 trillion (25% of US GDP). **Since October 2017, the Fed has been engaged in quantitative tightening (QT)**, by reducing the vast stock of securities it acquired to support the US economy, but without saying how big it wants its balance sheet to be at the end of the process. For now, QT is not on the ECB's agenda.

QT is the opposite of QE.

With QE – an unconventional monetary policy – central banks create money for large-scale purchases of unconventional financial assets, mainly long-term government bonds or private sector assets such as corporate bonds, mortgage-backed securities (MBS), or even equities. QE is intended to stimulate the economy and avoid deflation by lowering medium- and long-term interest rates, boosting asset prices and encouraging banks to lend more.

It is generally thought that this huge monetary stimulus played a key role in the initial and most acute phase of the financial crisis by fending off unfettered financial instability and preventing a deep recession from becoming a second "great depression". Today, **the spectre of deflation has been staved off, and growth and employment conditions have improved**. Consequently, many voices are now calling for the normalisation of monetary policy.

Above all, **a long-term, ultra-expansionist monetary policy may have a number of undesirable impacts**, most importantly:

- The creation of asset price bubbles
- Disproportionate risk-taking
- Excessive debt accumulation
- Distortion effects on investment decisions

- Inflationary drift.

With QT, central banks reduce liquidity in the financial system by selling the assets they have purchased, or in the Fed's case, by not spending the proceeds from maturing bonds on buying new bonds, thereby passively reducing the size of the balance sheet as securities reach maturity.

What impact is this expected to have on financial markets? It is difficult to answer this question given the entirely unprecedented nature of QT. There is no guarantee that the effects of QT will be symmetrical on the way down with those of QE seen in recent years: indeed, investors' degree of risk aversion could be very different.

With all things being equal, **QT** will bring down bond prices, and thus increase yields and **push up interest rates** – at the risk of harming growth and increasing the burden of debt in government budgets. Furthermore, the market reactions could cause **spikes in volatility**, thereby posing a risk to financial stability.

In 2013, the Fed's mere announcement of a slowdown in its monthly asset purchases caused a global panic and a surge in bond yields – an episode known as the "taper tantrum". Since then, predictability and progressivity have been central banks' keywords, in order to ensure the smooth functioning of the markets.

Until this summer, the financial markets were relatively unaffected by the Fed's QT and the prospects of the end of the ECB's QE. However, pressures have mounted since then, particularly with the stock market correction that started in October, **against a backdrop of concerns over global growth, US-China trade tensions and major political uncertainty**.

With less liquidity around, the situation could become very delicate for indebted borrowers. **The leveraged debt market (including high yield bonds)**, which tremendously benefited from QE and investors' search for yield in the ultra-low interest rate environment, now **appears vulnerable**. An increase in the default rate for the most heavily indebted companies could exert strong pressure on a market with already stretched liquidity, which could have wider repercussions for the financial markets.

Given the starting point – an economic slowdown, very high financial asset valuations in developed countries and unprecedented global levels of debt – the uncharted territory of central bank balance sheet normalisation will be tricky to navigate.

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