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Quantitative easing: A move to spur lending

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What is 'quantitative easing'?

THE term 'quantitative easing' came into being during Japan's 'lost decades'.

TD In the 1980s, prices of Japanese shares and real estate surged five times. To correct the bubble, the Bank of Japan (BOJ) sharply tightened monetary policy and raised the target for the official discount rate. The target discount rate reached a peak of 6 per cent in 1990.

Between the 1980s and 1990s, the growth rate of the Japanese economy moderated from an average of 4 per cent to an average of 2 per cent. The lower growth was due to the maturing of the economy, the bursting of the bubble and the appreciation of the yen.

The Japanese government and central bank worked valiantly to stimulate the economy. The government increased expenditure and the BOJ eased monetary policy. The BOJ cut its discount rate in stages to 0.5 per cent by 1995, and further lowered it to 0.1 per cent in 2001 to 2005.

But despite these efforts, economic growth continued to be anaemic, and Japan's growth rate fell even further to an average of 1 per cent in the 2000s. Japan's experience in the 1990s and 2000s has come to be known as its 'lost decades'.

Historically, like many other central banks, the BOJ had gauged its monetary policy by a benchmark interest rate. In Japan's case, the benchmark is the 'discount rate'. However, with the discount rate cut to 0.5 per cent, it was obviously impractical for the BOJ to gauge further relaxations of monetary policy by the discount rate. How much further could it cut the discount rate?

Accordingly, the BOJ turned to an alternative performance indicator - the size of the monetary base. It is this exercise that became known as 'quantitative easing'.

In earlier times, the central bank would buy government securities from commercial banks, bidding up their prices, and so reducing their yields and interest rates. The objective was to increase the liquidity of commercial banks and hence induce them to increase lending to households and businesses.

Likewise, in quantitative easing, the BOJ would buy government securities from commercial banks to increase their liquidity, and induce them to increase lending. The only difference was the gauge by which the central bank measured its performance: targeting the monetary base rather than the discount rate.

In the aftermath of the 2008 to 2009 sub-prime crisis, United States interest rates were driven down to extremely low levels. At present, the US Federal Reserve's target for its benchmark federal funds rate is 0 per cent to 0.25 per cent.

Just like the BOJ in the 1990s and 2000s, the US Federal Reserve cannot gauge further relaxation of monetary policy by interest rates. So it, too, measures its performance by the increase in the quantity of the monetary base. Hence, 'quantitative easing'.

Whether monetary policy (as measured by interest rates or the increase in monetary base) actually works depends on commercial banks. The banks receive funds from the central bank and make loans to the real economy - households and businesses.

In the Japanese experience, the banks were weighed down by huge amounts of bad loans, and so they were averse to increasing their lending for fear of attracting more bad debt. Moreover, in a deflationary environment, households and businesses were averse to borrowing. Why borrow now to buy a house or factory if the price will be lower next year?

The US Federal Reserve confronts similar issues today. Through quantitative easing, it can increase the liquidity available to commercial banks. However, will the banks cooperate and increase their lending?

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