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Quantitative easing and buying toxic debt – will it work?

Key points

- The move to 'quantitative easing' and US efforts to remove toxic debt from banks add to confidence of a global economic recovery from later this year and through 2010 and hence are positive moves for shares.
- Past banking crises tell us bad debts must be removed from banks' balance sheets to get a decent recovery. The US bank plan is not risk free, but US authorities seem to be pulling out all the stops to make it work.

Introduction

As the global financial crisis and associated recession have gone from bad to worse, the worldwide policy response has become more extreme. This has been highlighted with several central banks embarking on 'quantitative easing' and the US authorities at last moving to remove bad or 'toxic' debt from US banks. These moves beg a number of questions: What is quantitative easing? Will it work? What about inflation? Why is it so important to remove bad debt from banks' balance sheets? Will the US Government's latest bank plan work? Will Australia need to follow?

What is quantitative easing?

Quantitative easing involves a central bank targeting the level of money and credit and private sector interest rates rather than the key policy interest rate. It effectively involves printing money and injecting this directly into the economy by buying public and private sector debt.

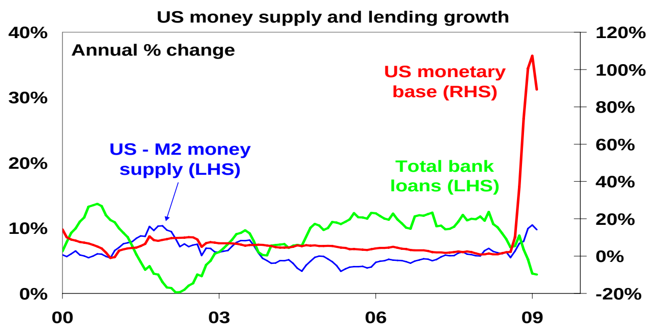
Why use quantitative easing?

Normally a central bank buys and sells government bonds to maintain a target level for its key interest rate. Over time the amount of cash in the economy normally grows in line with nominal GDP. And as the cash circulates it supports measures of broader money supply and credit even though these are multiples of actual cash in the system. However, the 1930s depression tells us that the combination of falling consumer prices and prices for assets such as shares & property along with high debt levels can create a downwards spiral where the supply of and demand for credit falls regardless of the level of interest rates. This is called a 'liquidity trap'. The only way for a central bank to fight it is to print money and pump it into the economy.

What is the current situation?

Because of the severity of the global financial crisis official interest rates have already fallen to effectively zero in several countries – eg, in the US, UK, Japan and Switzerland - without much sign of any economic impact. This is due to a combination of factors including banks being unable to pass on the lower rates due to problems with bad debts, the lack of funds flowing into credit markets keeping the cost of funds relatively high, the use of fixed rate mortgages in the US which are more dependent on bond yields and a lack of demand for credit on the part of borrowers. For example, while the Fed Funds rate fell from 5.25% to 0.25% standard mortgage rates in the US were stuck around 6% (despite near zero inflation).

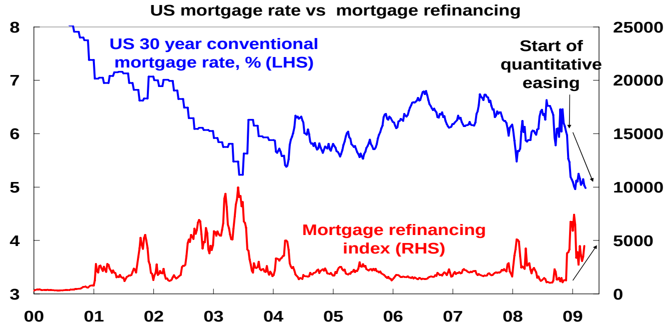
So as a result, several central banks have moved to directly focus on private sector borrowing rates and on the quantity of money and credit in the system. For example, prior to Lehman Brothers' collapse last September the Fed was pumping cash into its banking system but financing this by the sale of Government bonds. But since last September the cash the Fed has been pumping in has not been offset by bond sales. And this year the Fed began directly buying mortgage related debt (to help get the mortgage securities market moving again and reduce mortgage rates) and has recently started to buy Government bonds as well (to get bond yields down and hence also influence private sector borrowing rates). So the Fed has been undertaking quantitative easing since late last year but has recently started to step it up. The Bank of England, Bank of Japan and the Swiss National Bank are also now doing the same. As a result, the US monetary base has exploded as bank reserves and cash in the system have shot up. See the next chart.



Source: Thomson Financial, AMP Capital Investors

Will quantitative easing work?

Since the aim of quantitative easing is to lower private sector borrowing rates one measure of its success is if these fall. Since the Fed announced that it would start to buy mortgage related debt late last year and then last week increased the amount it plans to buy along with buying government bonds, US mortgage rates have fallen. This has led to an increase in Americans refinancing their fixed rate mortgages to lower variable rates which in the past has been a pre-condition for economic recovery.



Source: Thomson Financial, AMP Capital Investors

More broadly though we need to see an acceleration in broader money supply and credit growth. In this regard the evidence is mixed so far. See chart on previous page.

What about the $US?

An obvious concern is that by increasing the supply of US dollars, the value of the $US will fall. Certainly it has fallen sharply in the last week or so. But it's hard to see the $US falling too far. Other countries are also undertaking quantitative easing and it's only a matter of time before the European Central Bank is forced to do the same – their banks have potentially more debt problems than US banks made worse by the problems in eastern Europe and the European economy is in worse shape than the US economy. As a result, it's hard to see the $US falling too far or the euro rising too far.

What is the risk of inflation from quantitative easing?

Some worry quantitative easing will create inflation. However, right now the main risk is deflation as the recession is resulting in idle factories and rising unemployment queues putting downwards pressure on prices. Only when the increase in bank reserves and cash feeds through to a broader increase in credit *and* economic activity returns to more normal levels will inflation be a serious risk. But that is still probably two years away. Once we get there though the inflationary impact will depend on how quickly central banks soak up the extra money.

What about Japan's experience?

Despite undertaking quantitative easing from 2001 to 2006, the Japanese economy never got onto a firmer footing and deflation remained an issue. There were several reasons: Japanese policy makers were very slow to react by only introducing quantitative easing 11 years after Japanese shares peaked by which time deflation had set in, they were half hearted in its implementation, and more broadly Japan was hampered by the failure to deal with bad debts in its banks which led to so called 'zombie banks' who were unwilling to increase lending. Japan's experience with quantitative easing is not a mark against its usefulness. But it does highlight that it's not inflationary if recovery fails to take place, that it must be introduced with conviction and it's also necessary to remove bad debts from the banks.

America's bad debt removal plan

Which brings us the US Government's plan to remove 'legacy assets' (or toxic debt) from both the banks and the securities market. The experience of past banking crises in Japan, Sweden and elsewhere have highlighted that while monetary and fiscal stimulus are necessary, they are not sufficient to generate a decent economic recovery unless something is done to remove bad debts from banks' balance sheets, in order that they can make new loans. Japan failed to do this and paid the price, but Sweden did in the early 1990s and recovered relatively quickly. US authorities clearly recognise this and despite a few false starts seem to have come up with a comprehensive plan. The plan announced this week involves matching equity capital from private investors with funding from the US Treasury and debt capital (at up to 6 times the equity contribution) which will be insured against losses by the Federal Deposit Insurance Corporation (FDIC) to buy banks' bad debts. It also involves the Government matching private sector funds which may also borrow from the Fed to buy older mortgage related securities that are no longer AAA rated and other securities.

Will the US bank rescue plan work?

Naturally this raises several issues: banks may not want to part with their problem loans given that it may mean further asset write downs; private investors may be wary of participating; and the $US0.5-1 trillion of bad debt purchases under the plan may not be enough with estimates of the toxic debt on bank's balance sheets ranging up to $US2 trillion. Worries along these lines may cause several bouts of doubt about the plan. But the plan has several things on its side. Firstly, banks may be encouraged to sell their bad debts as a pre-condition to getting more capital from the US Government and it may enable them to use existing capital more effectively. Secondly, the attraction for private investors is that they are buying into distressed assets using very attractive Government financing provisions with limited downside but the potential for huge gains if default rates are not at the depression levels being priced in by markets. Treasury Secretary Geithner has said that private investors will not face the stringent restrictions on executive pay being imposed on companies getting bailout funds. Some fund managers have already expressed interest in participating. Finally, the $1 trillion amount of bad debts to be purchased under the plan is a big chunk of the total.

What about Australia?

At this stage the Reserve Bank of Australia has no need to engage in quantitative easing as the banking system is operating pretty well, mortgage rates (down from 9.6% to 5.9% have fallen roughly in line with the cash rate (down from 7.25% to 3.25%) and the cash rate still has a way to go to zero. And there is no need for a plan to buy bad debts because they are a fraction of US levels. And of course to the extent that the US is successful it will take pressure of the RBA. There is a risk that Australia may have to do the same, but the global and hence Australian economies would have to get a lot worse than expected.

Concluding comments

Shares have had a very strong rally from their lows just a few weeks ago with US equities now up 19% and Australian shares up 14%. The global economic outlook remains very uncertain and so there is no guarantee we have seen the bottom. However, recent developments including better Chinese economic data, signs business and consumer confidence globally may be stabilising and more aggressive policy action including the ramping up of quantitative easing and plans to remove bad debts from US banks add to confidence that we may have.

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