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PRESS RELEASE

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HERMES' NEIL WILLIAMS: HAS QE WORKED?

The past six years of quantitative easing (QE) has been only partly successful. It can probably take the credit for unclogging financial markets, providing liquidity, keeping bond yields down, and loosening the monetary reins when rates were already on the floor.

In his November Ahead of the Curve, Neil Williams, Group Chief Economist at Hermes Investment Management reviews its impact, and considers whether it's now 'dead' or 'just resting'.

Dead or just resting?

It may have been running for almost six years, but why has QE taken so long to work?

First, the responsiveness of GDP to money growth has been far less than the one-to-one hoped for by central banks, as consumers and producers scared of unemployment and deflation became interest-rate insensitive, thus falling into a 'liquidity trap'. No matter how much QE is run, its reflationary impact also depends on how quickly the liquidity is pushed around the system.

No good throwing money out of a helicopter…

Economics students will remember Fisher's 'quantity of money', where 'MV=PT'. The impact of a money stimulus (M) on GDP (PT) will be quantified by the speed (V) at which agents push money round the economy. In reflation terms, it's no good throwing money out of a helicopter if no-one spends it! In practice, the velocity of money circulation, in the US and UK, has understandably been slow to recover.

Second, the fact that GDP and money growth were lacking till about 2012 suggests the inflation QE spawned came more by inflating asset prices, than the direct, consumer route hoped for in 2009. The cost-inflation that QE contributed to acted more like a tax. Cash stayed cheap, but with confidence fragile and banks repairing their balance sheets, the irony is that QE undermined a major justification for using it: to boost disposable incomes.

There have been additional obstacles: the unwillingness of institutions to sell back their bonds when riskier assets are unattractive; regulatory pressure for them to hold onto bonds; and the reluctance anyway of banks to raise lending.

Third, QE may have 'got into the cracks', but offers little directly to push wage growth - the missing 'jigsaw piece' of this recovery. US real GDP may be up 9% from its pre-crisis peak, but with CPI up 16% and wages up 16%, there has been no real-terms kick to consumers via wage income. Worse still, the UK's RPI is up 27% over the period, but average wages up just 13%.

Consumers will have benefitted of course from higher asset income, though if aiding disproportionately higher-earners, QE will be accused of helping those that needed it 'least'.

And, even as the US Fed and BoE start switching it off, other major central banks are accelerating QE (BoJ) or about to start it up (ECB). Japan's higher CPI needs to be matched by wages. If it isn't, while taxes go up, Prime Minister Shinzo Abe's progress will be another false dawn. The ECB is about to 'dip in its toe' with private asset purchases. But, the amounts look small (circa 2% of all euro-zone issuance). More potent will be the 'bazooka' of unlimited sovereign QE (government bonds accounting for half of all issuance). This comes in 2015, when bond yields are rising.

Hardest hit from QE's end could be the emerging markets (EMs). But, despite higher volatility, this doesn't 'smell' like the start of a 'blanket crisis'. Few EMs now have rigid currency pegs to defend, meaning weak currencies can be a pressure-release without eroding scarce reserves. Many EMs have used previous crises to get their houses in order, with external debt ratios lower. And where local debt ratios are up because of fiscal profligacy or political risk, their central banks can print money. So, systemic risk comparable to Russia 1998 looks less likely.

So, QE is probably far from dead. Even if it's run its course in the fast-growing US and UK, it is accelerating in Japan (even after 16 years), and should play an increasing role in others (euro-zone, China?). And (risk case), should switching it off now throw sand in the wheels of the US recovery, QE even there may be no more than 'resting'.

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Notes to Editors:

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