

# The implications of non-conventional monetary easing and fiscal deficits for interest rates

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# This is not just a crisis in global financial markets and economies

- This is a crisis in economics and finance
  - Macro modeling over the past decade has focused on interest rates,
  - With no role for quantities, and
  - Financial economists have not taken to heart absence-of-arbitrage arguments
- Any evaluation of Quantitative Easing (QE) is *deus ex machina* from the perspective of models
  - Role for event studies, for good or ill
- Difficult to embed financial strains

# Evaluate the IMF's *ongoing* work of QE and fiscal deficits

- **①** In terms of the channels of QE
  - Including why they might be hard to measure
- **②** The incidence of the cost of a financial crisis
- **③** The short- and long-term effects of fiscal deficits

# 1 QE, QED

- We are amidst efforts to rebrand QE, but it helps to go back to basics
- Why the rebranding?
  - The Fed started QE in October 2008, before embracing it for macroeconomic reasons
  - No one wants to be compared to the Japanese (even though they may fairly be in some respects)

**QE holds that the *size* and *composition* of a central bank's balance sheet influences financial markets and the economy over and beyond the level of the policy rate**

- Policy does not necessarily run out of ammunition at the zero bound
- QE is not just about the level of reserves
- QE can be undertaken at a nonzero policy interest rate (which is relevant for the unwinding of policy stimulus)

# QE potentially works through both sides of a central bank's balance sheet

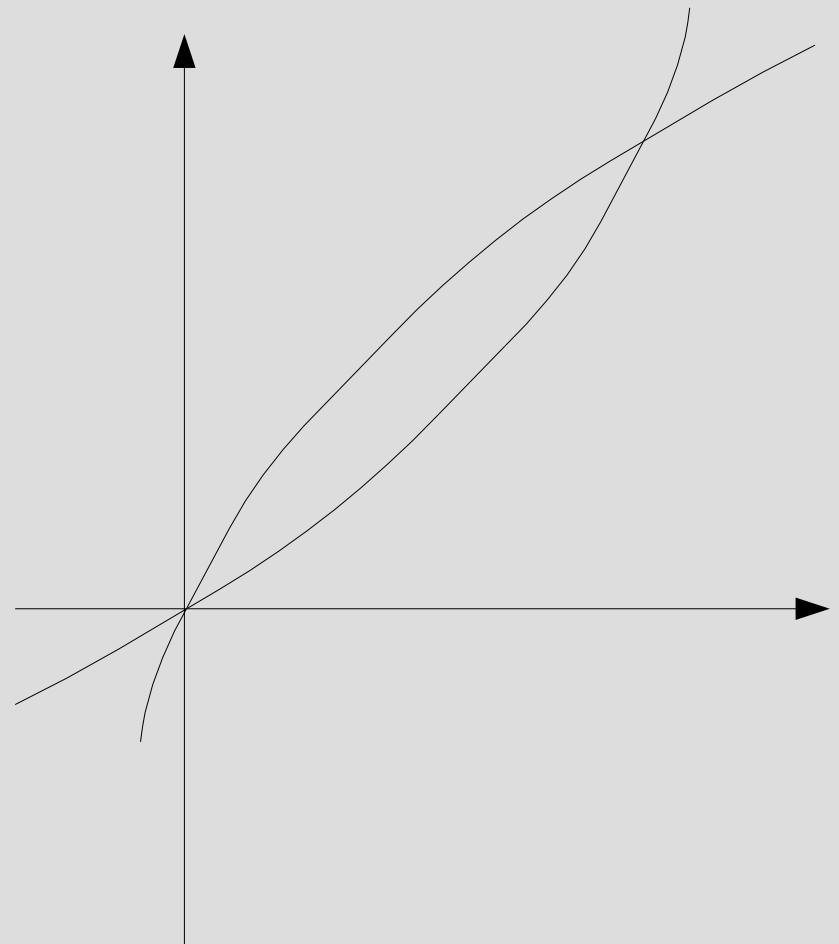
- Large provision of reserves
  - Induce banks to make use of idle balances (*the money multiplier*)
  - Convince market participants that the policy interest rate will be low for a long time (*the policy duration effect*)
- The accumulation of assets
  - Influence spreads in markets (*asset substitution*)
  - Generate additional income for the central bank so as to encourage government action (*creating fiscal space*)

# Assessments of QE

- Are limited in modern models to the *policy duration effect*
  - If interest rates are expected to stay pinned at zero for longer
  - How does that play through the yield curve (in nominal and real terms)
  - And influence the economy?
- Working outside a model, researchers can rely on event studies (Table 1 in the IMF presentation)
- Event studies beg the questions
  - How much was expected?
  - What happened outside the window?

## • ② The incidence of the cost of a financial crisis

- A crisis leads the management of a large complex financial institution to
  - View with disfavor the size and risk of their balance sheet
  - View counterparties from this same perspective (potentially leading to high and low trade outcomes-->)





# An increased cost of balance-sheet size (either implicit or explicit) in a crisis

- Discourages arbitrage across markets
  - Hence money market risk spreads are a fever chart of the absence of arbitrage
- Leads banks to pass along the higher cost to the customers over which they have some market power

# Incidence depends on what is different about banks (R&R, '99)

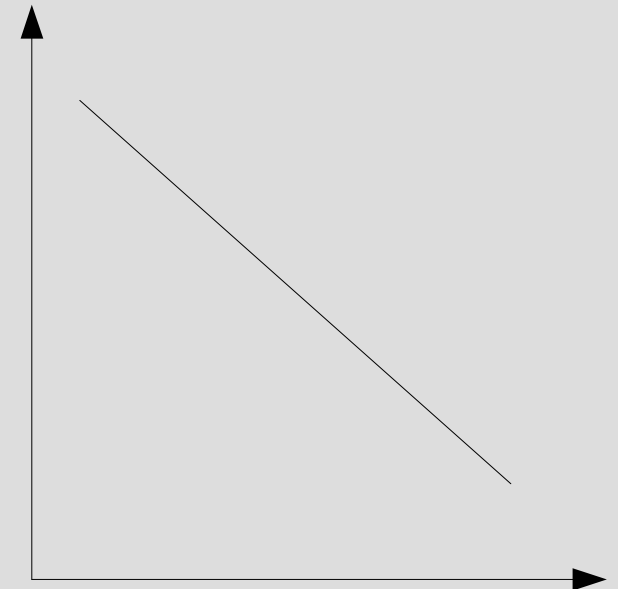
- If banks have market power over deposits
- Then deposit rates can be lowered (relatively) in a crisis
- And the shock is essentially monetary (with no real effects)
- If banks have market power over loans
- Then loan rates can be increased (relatively) in a crisis
- And the shock has real consequences

# Incidence also determines the appropriate central bank response

- If banks have market power over deposits
- The central bank can issue more of its own liabilities (currency and reserves) to accommodate the public
- If banks have market power over loans
- The central bank can purchase assets to influence those rate spreads

# • ③ The short- and long-term effects of fiscal deficits

- The best intuition for the long-run anchor to interest rates comes from Elmendorf and Mankiw (1998)
  - Capital has a diminishing marginal product
  - Government demands limits the private capital stock according to
    - The public choice between consumption and investment
    - Availability of external funding
  - The consequences for the real rate follow from technology



# In the short run,

- Which is the interesting horizon in our current unruly world
- How does above-average fiscal impetus interact with below-average policy rates?
- In particular, how much fiscal space does monetary policy create by pinning itself to the zero bound?
  - How do fiscal sustainability exercises depend on the “monetary policy duration effect”?

# This leads to a few general questions

- How do we reconcile the notion of “fiscal space” with Ricardian equivalence
  - Going back to Metzler/Mundell/Obstfeld
- In the absence of arbitrage, what is the incidence of a higher cost of capital?
  - Do bank profits provide another route for monetary policy to influence the economy?
- Do quantities matter?

