QE. That ain't working. That's the way you do it. Money For Nothing …

QE in the US seems to have worked whereas elsewhere it has either failed to take hold or has not been started. Yet even the US, QE has had less than stellar results requiring three rounds, with a twist and the last one was unlimited as well. Why is QE not very effective? To understand why, we need to clear what QE is. In the US context, it is specifically the purchase of US treasuries and agency mortgaged backed securities.

QE appears to be useful in two ways. One, it makes cost of debt lower for sovereign issuers and by association, private issuers, thus boosting investment. Lower interest rates it is hoped also drives consumer credit and consumption. Government debt issuance has indeed accelerated and so has private debt issuance, yet proceeds have not been recycled as much as hoped. Investment has been muted, and consumption has also been slow to respond. Two, to the extent that it monetizes debt, it allows governments to finance expenditure through borrowing. From 2008 to the present, the US, UK, Germany and France expanded government expenditure even if at a decreasing rate. Notably, Italy and Spain shrank government expenditure under austerity programs. The main impact of QE appears to be in funding expansionary fiscal policy. Where countries have practiced fiscal rectitude the economic results have disappointed. Where QE is not used to finance fiscal expansion, that is where government expenditure is not expanded or maintained, the impact on output is probably negligible. The US of QE therefore appears to be solely in keeping borrowing costs down as the government borrows and spends.

A number of factors have blunted the intended impact of QE. Proceeds of asset sales (purchases by the central bank) have been one time and not recirculated, thus the velocity of money has fallen to fully compensate for the injection. The marginal propensity to consume has been low and thus the multiplier low. Weak consumer and business confidence have led households and firms to hoard capital and not consume or invest. Buying of seasoned debt issues do not encourage new lending only provide relief to stressed balance sheets. Private commercial banks having repaired their balance sheets have been slow to releverage. Buying of new debt, particularly loan securitizations on a blind pool to be announced basis would have worked much better in encouraging new loans. QE together with austerity or neutral to contractionary fiscal management is self defeating. While government balance sheets may improve the impact on consumption and output is neutralized. Austerity neutralizes QE. When we turn our eye to Europe, ECB QE will be relevant only if Europe abandons austerity and balanced budgets.

For QE to be effective, central banks cannot purchase legacy debt or bonds in issue; central banks have to underwrite new issue. The use of proceeds for such a targeted QE has to be pre-specified to directly boost output and consumption. Accepting as collateral for cheap repo blind pool, conforming, new issue, is a valid way of operating QE.

We have seen how long it has taken US QE to be effective and we have seen how blunt a tool it has been. As the ECB and BoJ and potentially the PBOC embark or continue their QE efforts, we can now build expectations about the efficacy of policy based on the above observations, namely that underwriting of new issue is fast acting and purchase of legacy assets is slow acting and ineffective. There are trading implications for this. Investment strategies are not one dimensional. Time is as important as potential returns. If policy is expected to be slow, derivative or option strategies such as calendar spreads can be used to maximize efficacy.

Put simply, if QE doesn’t involve buying new issue securities but seasoned issues, the impact will be small and late. The trade is to bet that the policy will work using long dated calls financed by selling short dated calls. If QE involves buying new issue blind pools, buy outright underlyings, futures, or short dated calls.

If governments are really serious about reviving moribund economies they might want to try more controversial (fruitcake) remedies such as:

Credit all retail bank accounts with money. Get the money down to the people who need it most. This can be quite inflationary.

Distribute to the public amortizing cash vouchers which decay when not used. This is deliberately inflationary.

All of the above will rubbish the balance sheet but desperate times call for desperate measures and you don’t want to waste desperation in half measures.