

Quantitative Easing and Taper in the Context of Debt Monetization.

If we stop thinking about QE as an expansionary policy but rather as a treasury refinancing operation and debt monetization, the behavior of the Fed becomes clearer. For one, the Fed surely understands that without reducing the banking system's reserve requirements, the money multiplier and the velocity of money cannot accelerate and thus asset purchases have very little impact on real or nominal output. Indeed by increasing capital requirements, the Fed is effectively neutralizing any expansionary effects of QE. A side effect of refinancing the treasury is an expanded balance sheet which risks runaway inflation should the velocity of money pick up. Any sign of improved fiscal position must encourage a corresponding reduction in asset purchases.

The impact on pricing of the term structure due to the Fed going forward should be regarded as at best neutral.