

Where, When and How Does Quantitative Easing End?

What's all this talk of QE3? The private commercial banks have been big buyers of US treasuries to the extent that they are operating QE3 on behalf of the Fed. Buying has accelerated from 63 billion usd in 2011 to 136 billion usd YTD 2012. The Fed is already the largest lender to the US treasury, ahead of the PBOC.

The BoE and BoJ are explicitly monetizing sovereign debt hand over fist. The only mega scale central bank to not engage in direct debt monetization is the only central bank without a country, the ECB. Constitutional issues impede the ECB from direct debt monetization, however, Mario Draghi has already found proxies in the private commercial banks using the LRT0. The current negotiations will likely lead to capitulation and a direct flow of capital from the ECB to sovereigns.

So every single central bank will be in easing mode with most of them monetizing local domestic debt.

The question of local or external funding of sovereign debt is only relevant at the micro level. At the global level, all debt is internally funded. Economists who point out that Japan need not worry since its debt is internally funded should not worry any further.

One question that arises is whether with excess liquidity at an extreme, inflation might become a problem. Debt monetization increases the money in circulation per unit output potentially leading to inflation. Depending on sentiment and confidence, inflation can occur even before the economy achieves full potential.