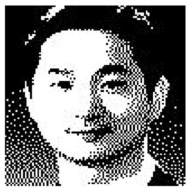
Viewpoint

What has the QE programme achieved in the past five years?

26 May 2014 by Kyle Shin



After more than five years of highly accommodative monetary policy, we keep asking ourselves when the next interest rate cycle will start and how long will it last? To address this question, we need look into several key macro angles, namely GDP recovery, consumption, liquidity conditions and inflation.

US real GDP sputtering
The intended consequence of the quantitative easing (QE) is to revitalize real GDP growth back to its normal potential following the collapse of global financial markets in 2008. During the turmoil, US real GDP year-on-year contracted by over 4% on a quarterly basis. The magnitude of real GDP downfall from a historical perspective was only surpassed by the 1929 financial collapse which, of course, was the start of the Great Depression.

Since 1948, real GDP recessions had never contracted more than 3% year-on-year, which is clear evidence that the “Great Recession” of 2008 was far worse than just another cyclical business recession. The growth rates in real GDP after 2008 barely hovered around 2%, a subpar recovery rate far below the average 4% recorded during previous recessions. Moreover, history shows that deep economic collapses are usually followed by stronger-than-average recoveries due to the release of massive pent up demand.

However, the rebound in real GDP growth rate after 2008 has been muted. More alarming, the real GDP recovery remains sluggish even after the massive QE and stimulus packages were put in place. Hence, we believe the recovery is still weak in historical standards and economic growth has not yet reached its full potential.

Consumption spending at the lowest rate
So has the unprecedented QE programme failed to spur a robust economic recovery? Let us first take a closer look into one of the most significant drivers of the US economy, making up about two-thirds of the country’s GDP – consumer spending.

Unlike highly cyclical business spending, personal spending tends to be less volatile. A key measure of consumer spending, the personal consumption expenditure (PCE) index, recorded year-on-year growth of only 1%-2%, among the lowest since 1960. High unemployment and wealth destruction hit the US economy extra hard in 2008, and the situation has still not fully turned around. None of the key consumer indicators, such as real disposable personal income growth, median household income and average hourly earnings, indicate that consumers are better off than pre-2008, nor do they have newly-created wealth to spend. In fact, the median household income is still 10% below its 1999 peak and the lowest recorded since 1995. Average hourly earnings growth is below 2%, the lowest reading since 1965.

More importantly, the year-on-year nominal PCE, for the first time since 1948, dipped below 0% in 2008, showing the severity of damage that was inflicted on American consumers during the global financial crisis. History shows that the year-on-year changes in nominal PCE have rarely fallen below 3% through numerous business cycles over the past 70 years. However, during the global financial crisis of 2008, not only did the nominal PCE drop below 3% at the trough, it also fell back to 3% after the initial rebound during the lengthy recovery phase, a historical red zone. We believe that consumers have not benefitted from the massive QE programme, nor fully recovered from the deep recession.

A flood of liquidity but no inflation

While the current state of the economy lacks the growth momentum to justify a swift tightening cycle soon; we also need to look at the other side of the coin: inflation. Is there any forthcoming sign that inflation has reared its ugly head because of the flood of liquidity that the Fed has released upon us?

We do not see any sign of imminent inflation. The recorded CPI numbers during QE since 2008 have ranged between 1%-2%, far below historical averages of 3%-4% and, in fact, among the lowest CPI readings recorded since 1954. The market seems to share a similar view as well, with the future CPI implied in US TIPS yield forecasting a growth of only 1.5%-2%.

2008 was a year of financial crisis induced by a credit bubble. The financial crisis, due to the different nature of their root causes and recovery dynamics, is an entirely different story from more common business recessions. For the economy to recover from the massive burden of leveraged debt accumulated during the past decades, a painfully long deleveraging process is needed to work out these excesses, and deflationary pressure usually prevails over inflationary pressure.

Let us take Japan as an example: despite its own massive QE programme after the bubble burst in 1989, Japan is still mired in a deflationary economy. Although the Fed has injected massive amounts of base money into the economy through the QE programme, it does not necessarily translate into great amounts of money being circulated and spent. This is evident when we look into the money multiplier indicator, which is the ratio of M2 over base money. In order for the base money sitting in the banking system to go through the multiplication process and turn into M2 in the economy, it has to go through the mechanism of the banking and credit system for it to circulate through the economy. Unfortunately, this transmission mechanism has not been effective since 2008. In the past 100 years, the Money Multiplier first peaked in 1930 at 10.6; it then dropped to a low of 4.5 in 1940 after the Great Depression and steadily rose to an all-time high of 12.5 in 1985 before settling down to a steady 8 in the 1990s and 2000s. After 2008, the indicator collapsed to an all-time low of 3.1 in 2013.

The current all-time low reading shows that the Fed is faced with a daunting task to jump start the economy with QE. Money creation is only one part of the puzzle, while encouraging people and businesses to spend is another. When there is not a lot of real demand for spending, inflation is naturally muted despite the excess liquidity.

What has the QE programme achieved in past five years?

The programme did manage to push stock markets up in three major waves which almost coincided with the three periods of implementation of QE1, QE2 and QE3.

With an inflated financial market on one hand and a sputtering economy on the other, the Fed will have to ponder the question of whether a pre-mature withdrawal of QE liquidity will damage the already choppy stock market and upset the fragile economic recovery? Such scenarios would almost certain to stall all the hard efforts to rescue the economy after 2008.

After evaluating all of the above macro-trends, we still believe that the Fed has more to worry about regarding the lack of economic growth rather than for excess liquidity and runaway inflation. The tightening cycle will eventually be upon us, but it is not likely to be in the near term and the magnitude will be mild.

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