Credit and Quantitative Easing under Scrutiny

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Among the various policy measures orchestrated by both governments and central banks to cope with the ongoing global economic crisis, credit- and quantitative- easing schemes stand out as the most debated policies among economists as well as the most difficult ones in terms of the general public's understanding.

Both credit and quantitative easing share the same objective of facilitating and boosting credit expansion to stimulate the economy. While credit easing aims at cleansing bank balance sheets and providing loans and loan guarantees to jump-start the credit markets, quantitative easing focuses on increasing bank reserves and hence money supply to enhance credit extension.

To date, the most innovative way of dealing with the faltering banking sector has been the credit-easing approach by the US Federal Reserve Bank and by some other major central banks. To encourage bank lending and revive the securitisation markets, these central banks purchase mortgage and asset-backed securities or provide loans to buyers of those securities. This crucially implies that credit risks are transferred from bank portfolios and the financial markets to the central banks' balance sheets.

While this approach has been generally applauded by the markets, the results in terms of credit expansion and improvement in credit spreads have still been quite limited.

The most recent add highly controversial credit-easing approach is the Public-Private Investment Programme (PPIP) initiated by the US government. This scheme aims to provide pricing for toxic assets and loans as well as remove some of them from bank balance sheets. Its essence relates to the reliance on private co-investors to discover prices and the government to guarantee debt and provide the majority of the financing.

The US authorities believe this approach is more advantageous than nationalising banks, mainly because it lessens the need to recapitalise troubled banks with public money. It also requires private co-investors to share a certain level of possible losses. Some critics, most notably Paul Krugmen, have argued against the PPIP on the ground that, with the enormous size of toxic assets and loans in the US financial system, nationalisation cannot be avoided.

Nevertheless, its proponents contend that it is still too early to observe the PPIP effects.

In the meantime, several major central banks have adopted quantitative easing despite the unclear effectiveness of this measure in Japan in 2001 and 2006. The main reason seems to be the need to bring down interest rates, as increasing government bond issuances to finance rising government spending have pushed up interest rates especially at the long-end of the maturities. In spite of the pronounced effects at the time this measure was announced, a sustained decline of those interest rates has yet to be observed.

The extent to which those measures will really help enhance credits in the system going forward remains to be seen. However, the vital steps ahead will be on adjusting the programmes to address the core and evolving problems, and finding ways to communicate effectively about these unconventional mission.

(Views expressed are the author's own.)

Source: The Nation