Duvvuri Subbarao: Quantitative easing – unconventional policy response to the financial crisis

Remarks by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, while welcoming Mr Ben Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, at the Reserve Bank of India, Mumbai, 10 October 2012.

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I am delighted to welcome Chairman Ben Bernanke to the Reserve Bank and to this meeting with the Top Management Group of RBI.

It would be presumptuous on my part to introduce a legendary personality like Ben Bernanke, especially to a gathering of central bank staff. I will do so nevertheless, if only to pay homage to a tradition.

Crisis – an intellectual challenge

As we all know, the crisis was an intellectual challenge as it called into question many of our beliefs and theories, and reopened issues that we thought had been settled. Clearly, it demanded a policy response that went beyond conventional economics. As central bankers started battling the crisis, ferociously easing monetary policy, leading the intellectual charge from the front was Chairman Bernanke.

Unconventional policies

Through his resort to unconventional policies, Ben Bernanke demonstrated the enormous range, depth and power of the central bank policy arsenal. In doing so, he drew not only from his impressive scholarship of the Great Depression, but also from the lessons of several post-war crises, including the long slow down in Japan. This is a rare instance of academic economics being tested in real time.

As an academic and as a policy maker, Chairman Bernanke was ahead of others in recognizing the limits of conventional monetary policy. As someone quipped, he believed strongly that it is better to succeed through unconventional policies than to fail through conventional policies! In a scenario where the policy interest rate was already at the zero lower bound, he had advocated a money-financed tax cut, essentially equivalent to a “helicopter drop” of money (earning him the sobriquet “Helicopter Ben”). Unlike a bond-financed tax-cut, which leads to tax increases down the line, a tax cut financed by money creation should, in theory, not emasculate fiscal expansion through the Ricardian Equivalence.

Quantitative Easing (QE)

The Federal Reserve under Bernanke was not, of course, the first central bank to deploy quantitative easing (QE). The Bank of Japan (BoJ) is considered to be the pioneer in this regard. However, where Chairman Bernanke stood out was that he used QE far more aggressively than the BoJ ever did, introducing innovations as he went along. QE became “credit easing” when private assets were bought to stabilize financial markets, followed by another unconventional move – “operation twist” – to intervene directly at the long end of the yield curve with offsetting interventions at the short-end. The latest version of QE, as we all know, is an open ended commitment to purchase mortgage backed securities at the rate of $40 billion per month for as long as the “labour market does not improve substantially”.

QE, in all its variations, was able to halt the downward deflationary spiral by making up for the declining velocity of money caused by deleveraging. It kept sovereign borrowing rates

low in the face of a market revolt. It helped clean up the balance sheets of stressed financial institutions through cheap funding.

The recovery from the Great Recession was relatively quick; at least that was how it seemed through the "green shoots" of 2010. Now, of course, we are no longer so sure. The limitations of macroeconomic techniques honed through deconstructing the Great Depression, the inflationary seventies and the Great Moderation are there for all to see. Quite understandably, therefore, QE has its critics. It may be relevant to recall some of the criticism.

Criticism of QE

The main criticism has been that QE is being continued beyond its usefulness. What the US economy requires now is a fiscal stimulus, and further QE is no substitute for a fiscal stimulus. It would only stoke inflationary pressures down the line.

A second criticism, in fact a corollary to the first one, has been the argument that stretching monetary policy to unconventional levels has obliterated the firewall between fiscal and monetary policies, with monetary policy increasingly becoming an extension of fiscal policy, thereby renewing concerns about the fiscal dominance of monetary policy.

Third, whereas fiscal stimulus leads to higher taxes down the line, the combination of zero-bound interest rates and QE is an immediate tax on savers, who in effect finance the stimulus. This tax on savings should induce people to consume and invest more, and save less. But with impaired balance sheets, they are possibly saving even more. Given this outcome, some have questioned the circumstances under which and the extent to which QE can trigger a virtuous cycle of demand for and supply of credit to the real economy.

Fourth, there has been criticism from some emerging markets alleging that the excess liquidity unleashed by QE is fuelling volatile capital flows, asset bubbles and inflation and also spiking up commodity prices.

Finally, the Fed is being challenged on the risks in the process of unwinding QE, in particular of how this could be managed consistent with price stability and financial stability.

Chairman Bernanke has responded to the above criticism on several occasions from various platforms. He has also found an innovative answer for each new problem thrown at him so far. This is all the more remarkable given that there is no recent real life experience to draw from.

Central banks and the new trilemma

As a central bank, we empathize with the Fed's concerns. The crisis has pushed central bank policy making into uncharted territory. We will not know for many years whether the policy mix we have followed to manage the crisis is right. Even so, in real time, all of us have to struggle with the challenge of managing the new trilemma – of balancing fiscal sustainability, price stability and financial stability.

Communication policies

Chairman Bernanke's unconventional policies have extended beyond the content of policy to its communication. Hard as it might be to imagine from today's perspective, prior to 1994, the Federal Reserve was not actually announcing the target Fed Funds Rate; the market was expected to infer the rate from the timing, sequencing and magnitude of its open market operations. In sharp contrast, today the Fed not only explicitly announces the rate but also gives a clear indication of the future policy trajectory. Like Chairman Bernanke has carried his policies to an unconventional level, he has carried their communication also to an

unconventional level by shaping and managing expectations through post-policy press conferences and town hall meetings.

Bernanke's legacy

All in all, because of what he did, what he said, and above all because he stuck to his convictions honed through deep scholarship, Chairman Bernanke will have a profound and lasting influence on the theory and practice of central banking. In the world of policy, he might be remembered for fashioning the monetary policy of the 21st century. In the world of academia, he will probably earn the ultimate honour an academic craves if his real world practice of economics becomes the stuff of text books.

Once again, I have great pleasure in welcoming Chairman Bernanke to the Reserve Bank. Ben, we are truly delighted to have you with us and look forward to hearing you.