The Dangers of Endless Quantitative Easing

By Raghuram Rajan

CHICAGO – Inflation readings in the United States have shot up in recent months. Labor markets are extremely tight. In one recent survey, 46% of small-business owners said they could not find workers to fill open jobs, and a net 39% reported having increased their employees’ compensation. Yet, at the time of this writing, the yield on ten-year Treasury bonds is 1.28%, well below the ten-year break-even inflation rate of 2.4%. At the same time, stock markets are flirting with all-time highs.

Something in all this does not add up. Perhaps the bond markets believe the US Federal Reserve when it suggests that current inflationary pressures are transitory and that the Fed can hold policy interest rates down for an extended period. If so, growth – bolstered by pent-up savings and the additional government spending currently being negotiated in Congress – should be reasonable, and inflation should remain around the Fed’s target. The break-even inflation rate also seems to be pointing to this scenario.

But that doesn’t explain why the ten-year Treasury rate is so low, suggesting negative real rates over the next decade. What if it is right? Perhaps the spread of the COVID-19 Delta variant will prompt fresh lockdowns in developed countries and damage emerging markets even more. Perhaps more nasty variants will emerge. And perhaps the negotiations in Congress will break down, with even the bipartisan infrastructure bill failing to pass. In this scenario, however, it would be hard to justify the stock-market buoyancy and break-even inflation rate.
One common factor driving up both stock and bond prices (thus lowering bond yields) could be asset managers’ search for yield, owing to the conditions created by extremely accommodative monetary policies. This would explain why the prices of stocks (including “meme stocks”), bonds, cryptocurrencies, and housing are all a little frothy at the same time.

To those who care about sound asset prices, the Fed Chair Jerome Powell’s announcement this week that the economy had made progress toward the point where the Fed might end its $120 billion monthly bond-buying program was good news. Phasing out quantitative easing (QE) is the first step toward monetary-policy normalization, which itself is necessary to alleviate the pressure on asset managers to produce impossible returns in a low-yield environment.

The beginning of the end of QE would not please everyone, though. Some economists see a significant downside to withdrawing monetary accommodation before it is clear that inflation has taken off. Gone is the old received wisdom that if you are staring inflation in the eyeballs, it is already too late to beat it down without a costly fight. Two decades of persistently low inflation have convinced many central bankers that they can wait.

And yet, even if monetary policymakers are not overly concerned about high asset prices or inflation, they should be worried about another risk that prolonged QE intensifies: the government’s fiscal exposure to future interest-rate hikes.

While government debt has soared, government interest payments remain low, and have even shrunk as a share of GDP in some countries over the last two decades. As such, many economists are not worried that government debt in advanced economies is approaching its post-
World War II high. But what if interest rates start moving up as inflation takes hold? If government debt is around 125% of GDP, every percentage-point increase in interest rates translates into a 1.25 percentage-point increase in the annual fiscal deficit as a share of GDP. That is nothing to shrug at. With interest rates normally rising by a few percentage points over the course of a business cycle, government debt can quickly become stressful.

To this, thoughtful economists might respond, “Wait a minute! Not all the debt has to be rolled over quickly. Just look at the United Kingdom, where the average term to maturity is about 15 years.” True, if debt maturities were evenly spread out, only around one-fifteenth of the UK debt would have to be refinanced each year, giving the authorities plenty of time to react to rising interest rates.

But that is no reason for complacency. The average maturity for government debt is much lower in other countries, not least the US, where it is only 5.8 years. Moreover, what matters is not the average debt maturity (which can be skewed by a few long-dated bonds), but rather the amount of debt that will mature quickly and must be rolled over at a higher rate. Median debt maturity (the length of time by which half the existing debt will mature) is therefore a better measure of exposure to interest-rate-rollover risk.

More to the point, one also must account for a major source of effective maturity shortening: QE. When the central bank hoovers up five-year government debt from the market in its monthly bond-buying program, it finances those purchases by borrowing overnight reserves from commercial banks on which it pays interest (also termed “interest on excess reserves”). From the perspective of the consolidated balance sheet of the government and the central bank (which, remember, is a wholly owned subsidiary of the government in many countries), the government has essentially swapped five-year debt for overnight debt.
QE thus drives a continuous shortening of effective government debt maturity and a corresponding increase in (consolidated) government and central-bank exposure to rising interest rates.

Does this matter? Consider the 15-year average maturity of UK government debt. The median maturity is shorter, at 11 years, and falls to just four years when one accounts for the QE-driven shortening. A one-percentage-point increase in interest rates would therefore boost the UK government’s debt interest payments by about 0.8% of GDP – which, the UK Office of Budget Responsibility notes, is about two-thirds of the medium-term fiscal tightening proposed over the same period. And, of course, rates could increase much more than one percentage point.

As for the US, not only is the outstanding government debt much shorter in maturity than that of the UK, the Fed already owns one-quarter of it. Clearly, prolonging QE is not without risks.