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The Potential Impacts of Quantitative Easing on the U.S Financial Markets

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Abstract: Recently quantitative easing is widely used by many countries in order to deal with negative impacts that Covid-19 brings to global economy. The article gives a general analysis of how quantitative easing will affect U.S financial markets by analyzing financial and currency factors.

1. Introduction

As Covid-19 pandemic spread widely across the world, the global economy has been in a recession. To deal with the economic depression, many governments are adopting monetary policies, such as quantitative easing. The purpose of this paper is to explore the potential impacts quantitative easing have on the U.S financial markets.

Quantitative Easing (QE) is a form of unconventional monetary policy. The Federal Reserve can implement QE by purchasing longer-term securities (such as treasury bonds) from the open market, in order to increase the money supply and encourage financial institutions to make more loans. Monetary authorities usually resort to such extreme measures only when conventional tools, such as interest rates, are no longer effective. The goal of QE is to keep the interest rate low for a long time. Therefore, the national bonds involved in the QE policy are huge in amount and long in duration. The Federal Reserve releases large amounts of money into the market through QE and provides banking system with more liquidity.

2. Positive effects

2.1 Interest rates and unemployment

First introduced in Japan in 2001, used to deal with the aftermath of the financial crisis of 2008—2009 and the recent coronavirus crisis, QE has gradually become the mainstream of monetary policy in many countries, because it usually plays a prominent role and brings several positive effects.

The first positive effect is lowering interest rates and recovering the domestic economic growth. When the Federal Reserve injects a huge amount of money supply into the market through QE, financial institutions would be eager to lend their excess money. When the supply of loans increases, the interest rates of borrowing loans will be pushed down in order to attract borrowers.

The low interest rate will lead to a rise in stock price. Since the outbreak of Covid-19 in United States, the stock market has fallen into a depression. BBC News reported on 17 March 2020, “In New

York, steep falls as markets opened with the Dow losing nearly 3,000 points or 12.9%, it's the worst percentage drop since 1987." [1] Nevertheless, after implement of QE policy, the low interest rate would motivate companies to invest and produce by borrowing money. Stock investors anticipate the increased company sales and revenue, and then buy the stocks. Also, individuals would be more likely to consume or invest rather than save money in the bank, because the interest rate of saving money may be even lower than the inflation rate. One of most common investing way of individuals is buying stocks. Therefore, the stock price will increase as the demand increases. Besides, the growth in both investment and consumption would definitely spur the domestic economic growth.

The domestic economic growth will lead to a decline in unemployment. Since Covid-19 pandemic spread widely in U.S, there has been a remarkable influence on unemployment. According to CRS Reports, the unemployment rate peaked at an unprecedented level, not seen since data collection started in 1948, in April 2020 (14.8%) before declining to a still-elevated level in December (6.7%). [2] A policy of QE would have a contribution to alleviate the problem of increased unemployment, because more job opportunities will be created when companies and individuals are more active in financial markets. One good example is Japan. (Tyler Gallagher, 2019) Since Japan formally introduced QE as part of Prime Minister Shinzo Abe's economic-reform in 2012, it has helped create approximately 2.5 million jobs. [3]

2.2 Foreign investment and exports

The second positive effect of QE on the U.S financial markets is attracting foreign investment and increasing exports. The growth of money supply always guide to a lower exchange rate of U.S. dollar. This makes the U.S stocks more attractive to foreign investors and also makes exports cheaper. In March 2020, the Federal Reserve lowered the target range of the federal funds rate to between 0% and 0.25% and announced the start of the $700 billion QM policy. This was the Fed's most aggressive market intervention to date since the COVID-19 outbreak began in the US. However, it did have a noticeable impact on Foreign Direct Investment (FDI) in U.S. According to the CEIC database, there was a rapid increase in the FDI of U.S, from $20.533 billion in July 2020 to $41.044 billion in September 2020.

2.3 Seigniorage and fiscal deficit

Thirdly, QE would raise a lot of seigniorage to the U.S and provide important support for increased fiscal spending in the U.S. According to the Bretton Woods Agreement, gold was the basis for the U.S. dollar and other currencies were pegged to the U.S. dollar's value. Since then, the U.S dollar has become the most important international currency, and the U.S government has also enjoyed substantial international seigniorage income. Therefore, the Fed's implementation of QE through the increase of monetary base is essentially a global seigniorage. Besides, QE helps maintain fiscal deficit in U.S. For instance, in the four rounds of 2008-2012 QE in U.S, except for the purchase of mortgage-backed securities in the third round, the other three rounds of QE implemented by the Federal Reserve were all purchases of national bonds, which provided support for the U.S government's policy of maintaining fiscal deficit and expanding fiscal expenditure.

3. Negative effects

However, as everything has two sides, QE policy is also not perfect and has some potential negative impacts on U.S financial markets.

3.1 Inflation

To begin with, a considerable amount of money injected into the markets will inevitably lead to a certain degree of inflation. Although one of economic targets of the Federal Reserve is to keep inflation rate at an optimal range, the policy of QE usually leads to an opposite side. Since this policy creates money and uses it as reserves to further enlarge loans, it is inflationary in nature. For example, The Bank of Japan expanded scale of QE four times between September and December 2012, increasing the supply of Japanese yen in the foreign exchange market. This policy led to a depreciation of the yen and made Japanese exports competitive. According to the IMF data, the cumulative inflation rate in the United States between 1996 and 2016 was as high as 46%. However, given the status of U.S dollar as an international currency, it never depreciates too much. The dollar share of global reserves is around 60%, so the new USD or equivalents that QE created will be divided into small parts and transfer to the rest of world. In recent years, U.S inflation rate has been kept within 2%.

3.2 Asset bubble

In addition, the policy of QE leads to an asset bubble forming in the market. An asset bubble is the part of an asset price that cannot be explained by fundamental factors such as cash flow, discount rate, etc. It is usually caused by low-interest rates and demand-pull inflation, which will definitely come with QE. People with higher wages and companies with higher profits will always invest their excess money into asset markets. In this case, the demand for assets rises so the prices of assets traded in them will rise. However, if the market becomes to rely on monetary stimulus that QE provides excessively, it may lead to a sudden collapse in market prices of assets when the policy stops, because the rate of return will be no longer so considerable as before, so people will begin to withdraw money from the market.

4. Conclusions and Discussion

To conclude, the Federal Reserve's QE policy to the financial markets is not a fine-tuning, but a dose of drastic medicine, because it usually provides immediate results. That is, QE helps stimulate the U.S domestic economy, attract foreign investment and provide support for the U.S government to expand fiscal expenditure. However, QE can have side effects on U.S financial markets if the Federal Reserve does not control it well, it may lead to inflation and asset bubble. Nevertheless, the dollar's international status has made implement of QE in United States relatively less risky. Therefore, QE would have more positive impacts to the U.S financial market compared with other countries if the Federal Reserve monitors and controls it well.

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