The great unwind

What is quantitative easing?

The U.S. Federal Reserve last week announced that starting in October, it would begin to gradually roll back its nine-year programme of quantitative easing (QE). Under the programme, the central bank has been buying bonds and other debt instruments like mortgage-backed securities from the open market since 2008. As the Fed creates fresh dollars to buy these securities, it helps to pump in more dollars into the U.S. economy. QE has been carried out in the hope that increased money supply would help stimulate the economy. The Fed's balance sheet currently stands at $4.5 trillion. Other central banks like the European Central Bank too have adopted similar bond-purchase programmes to boost their respective economies.

Why is it being rolled back now?

The U.S. central bank resorted to QE in the immediate aftermath of the 2007-08 financial crisis in order to boost a falling economy. It had no other choice but to inject money through QE as short-term interest rates, traditionally influenced by the Fed to control money supply, were already close to zero. Now the Fed has grown more confident about recovery in the U.S. economy, which, in the quarter ending June, grew at its fastest pace since 2015. Inflation has shown some signs of strength. As modern central banks are in the business of keeping inflation and growth at manageable levels, it is no surprise that the Fed has now decided to pull the plug on QE.

How will it affect the world economy?

Lower demand from the Federal Reserve should cause interest rates on U.S. bonds to rise from their current, historically low levels. This is likely to make these bonds more attractive to investors, as they can now be purchased at lower prices in order to earn higher yields. In fact, the yield on U.S. Treasurys has already jumped up in expectation of lower demand. Investors are likely to sell their other investments offering lower returns to invest in U.S. bonds, which could cause some turbulence in financial markets. The Indian stock market, for instance, has witnessed a steady outflow of foreign capital as foreign institutional investors have sold out their holdings to invest elsewhere. The rupee too has shown weakness as investors pull money out of India. This is likely to continue until the risk-adjusted returns on various investments equalise. But more importantly, the distortions that QE has caused in financial markets and the wider economy are likely to be exposed as the Fed winds up its balance sheet. This will likely keep policymakers on their feet in the coming months.

The new U.S. Fed Chairman is unlikely to opt for policies that might upset the President's plan

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