Voltaire and Modern Finance

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"Doctors are men who prescribe medicines of which they know little, to cure diseases of which they know less, in human beings of whom they know nothing."

François Marie Arouet, better known as Voltaire, is the author of this famous quotation. Three hundred years ago, medicine was not what it is today, and it was reasonable to think that way. Nowadays, no one would dare dispute the benefits of modern medicine.

Modern finance, which for the past three years has been navigating in unchartered waters, could be compared to medicine in the Age of Enlightenment. In fact, since the crisis of 2008, governments and central banks have deployed unconventional quantitative easing measures, commonly called QE, to stimulate the economy. The first round of easing occurred in March 2009 and the second, in September 2011. What are the characteristics, risks and benefits of these unorthodox measures? What would be the impact of a third round of easing? Opinions are divided. Some claim it is necessary, while others question its effectiveness. I will try to explain the uncertain environment in which central banks and governments must now operate.

In the past, the conventional measure most often used to stimulate the economy was simply to lower interest rates. Now that rates are around zero, central banks must resort to other measures, including quantitative easing, the most popular stimulus measure in the past three years. What it amounts to is creating money to buy assets. Here are three examples of asset purchase programs, or QE:

- ***Credit Easing*** – This program involves buying mortgage-backed securities. It supports the economy by increasing liquidity and lowering interest rates.
- ***Operation Twist*** – The U.S. Federal Reserve (Fed) recently resorted to this measure to sell (or issue) short-term Treasury bonds and buy long-term Treasuries. The goal is to lower long-term rates and facilitate access to long-term credit.
- ***QE Proper*** – This measure was used by the Federal Reserve in March 2009 for a total investment of US$1.725 trillion, and again in September 2011 for a more modest investment of US$600 billion. By buying assets like U.S. Treasury bonds, the proceeds from the sale can then be redeployed by investors to buy other, riskier assets. The program has the effect of lowering interest rates, which encourages borrowing and investment and, ultimately, stimulates consumption. A country's currency can also be devalued, which boosts exports.

Benefits

According to the available data, the implementation of such easing programs in Japan, England and the United States has had a positive effect on the markets. Although the current data is still summary in nature, these programs also seem to have had an impact on gross domestic product (GDP), employment, inflation and productivity. The second round of QE (US$600 billion) has resulted in a decline in corporate bond yields. In short, the positive effects are very tangible.

Risks

The lack of historical data prevents us from fully assessing the risks of these programs. Here are three risks that seem to be of concern to its opponents:

- The incredible growth of bank reserves has driven the overnight rate down to zero, causing the overnight market to atrophy. This market is essential to the smooth functioning of the economy.
- The massive buying of government debt could cause a distortion of the bond market by artificially inflating bond prices. The bond market would then be vulnerable to a sudden drop in prices, which would result in an increase in rates, with all of its consequences.
- These programs cause long-term rates to fall. The concern here is that the decline in sovereign interest rates–particularly in Europe–would allow countries to avoid taking responsibility for their debt problem.

Impact of a third round of QE

In light of the current economic situation, the Federal Reserve has instigated a further round of QE. The Fed's stated strategy is to buy mortgage-backed securities on the market with the ultimate goal of lowering mortgage rates. The Fed is betting that this strategy will lift the markets and create a wealth effect which, in turn, will have an impact on consumption and investment. Opponents of a new round of QE argue that it will put further downward pressure on bond yields.

Although the monetary authorities now seem to be venturing into uncharted waters–like medicine in the time of Voltaire–, it is wise to think that they will do everything in their power to remedy the situation and to create a better world for us in the years to come–just as medicine over the past three centuries has helped to improve our quality of life.

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