



For such a widely used tool, it is surprising how hard it is to make QE work in theory.⁶ The trouble is that any such framework must take its longer-term impact into account. Fortunately, central banks not much keener than stage magicians to let you in on the inner workings of their latest creations. As a result, it is fairly easy to figure out what is known – and, more worryingly, what even central banks do not know.

We know from empirical studies in the United States, the United Kingdom, and, in recent years, the Eurozone and Japan, that QE “works” in the short term in terms of moving markets, and perhaps, even increasing lending. We have some ideas on why this might be so. It remains unclear, however, how QE will impact inflation, economic activity and asset prices across the economic cycle.

From a theoretical perspective, we know that households and firms will try to anticipate future central-bank actions – which risks offsetting much of what the central bank is doing through the channels described above in the here and now. To take the example of the wealth effect, let’s say that the Fed buys 30-year bonds today, drives down nominal market rates and thereby increases the nominal value of the longer maturity bonds I hold in my portfolio. On paper, this makes me wealthier. If I am rational, though, I will know that returns on any additional bond investments I make to save for my retirement will be lower. Moreover, if and when QE does its job in restoring full employment, interest rates will increase, so I will face losses in the future.

My real wealth, over my remaining life-time, has not really gone up, and there is little reason why I should boost my consumption. Instead, I might even decide to save more!

⁶ As a useful starting point for figuring when central-bank open-market operations do and do not impact the private sector, see Wallace, N. (1981). A Modigliani-Miller theorem for open-market operations. *American Economic Review*, 71(3):267-74.

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