Ben Bernanke: A Quantitative Easing Trilogy

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Abstract

The modern theory on money demand incorporates the evolution of financial markets behavior, and then of households' allocation and preferences in different fashions; innovation in money demand can be considered as an increasing number of liquid assets between which to choose, considering money as a store of value and as a mean of payment; innovation modifies the utility of money holdings, through wealth and substitution effects. Liquidity has to be weighted with risk aversion and profitability to incorporate portfolio innovation properly (Oldani 2005).

The name "new monetary aggregates" is attached to the Divisia monetary aggregates and the CE indices. The aim is to introduce the theoretical framework that the micro foundations approach to construct the new monetary aggregates and introduce financial innovations. Empirical results showed that Currency Equivalent Index and Monetary Service Index are performing better than Simple Sum Monetary Aggregate.

The widespread innovations in the financial markets have brought important changes in the way monetary policy is conducted, communicated and transmitted to the economy. The transmission mechanism is changing. The expression "QE2" became a nickname in 2010, usually used to refer to a second round of quantitative easing by central banks. In retrospect, the round of quantitative easing preceding QE2 may be called "QE1". Similarly, "QE3" refers to proposals for an additional round of quantitative easing following QE2.

The US Federal Reserve held between $700 billion and $800 billion of Treasury notes on its balance sheet before the recession. In late November 2008, the Fed started buying $600 billion in Mortgage-backed securities (MBS). By March 2009, it held $1.75 trillion of bank debt, MBS, and Treasury notes, and reached a peak of $2.1 trillion in June 2010.

The main purpose of the article is to test the empirical validity of enriching money demand function with derivatives using the new monetary aggregates and test whether QE is an effective method to recover and QE3 is necessary as well by using time series models. In this context aftermath of Global Financial Crisis 2008 sparked off by subprime mortgage crisis, the effects of derivatives on financial markets and transmission mechanisms of economics should be revisited and questioned.