



Quantitative Easing: What Is It? Will It Work

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Fed officials have indicated that they will likely buy significant amounts of fixed income securities to increase their balance sheet, a process called Quantitative Easing (QE). The purpose is to spur nominal growth and, in the process, reduce the unemployment rate. The mechanism for doing this is to drive up the price of fixed income securities and, by implication, other asset prices. In turn the lower rates and higher wealth created by the process will create demand and, hence, jobs. Finally, the expectation that the process will work will build business and investor confidence, speeding up the process. Those skeptical of QE either say it won't work or they cite unintended consequences such as a weaker dollar and the potential for unacceptable future inflation.

Note that, even if it works, QE is designed to boost nominal growth and does not distinguish whether that growth is achieved by higher inflation or a real increase in economic activity. The Fed itself has emphasized that it is willing to accept a somewhat higher level of inflation in order to achieve the result. At the current level of unused resources, Chairman Bernanke expects much of the growth in GDP will be real, although some might be inflation. I agree.

Why do the lower rates and increases in asset prices result in demand creation and how much will be needed? When rates go lower households will borrow more and, if demand increases, businesses will also borrow more in order to expand. As asset prices increases, holders of those assets feel wealthier and will spend a portion out of the increased wealth. Indeed, as former Fed Chairman Greenspan pointed out in the mid-2000's, one of the reasons the savings rate was so low is that the rise in housing prices made households feel richer and they spent a small portion of that wealth in addition to the normal spending out of income. At the time many observers suggested that the Fed should hike rates to slow the price increases. Now, the appropriate policy is to boost asset prices to make up for sluggish demand due to weak household income gains.

No-one knows how much QE will be needed to get the desired result. I suspect that on November 3rd, the Fed will announce it is prepared to buy about \$100 billion a month for, say, 6 months and more if needed after that. Most observers, including myself, feel the Fed should announce its intentions in advance. This would increase confidence and remove uncertainty. Recently, economic data suggests that the economy will not slip back into recession, but that will not stop the Fed from buying as much as is needed to get the economy growing faster and on a sustained basis.

Finally, although some observers fear that QE will result in an inflationary spiral, this outcome is not inevitable. In a modern global open economy, demand is determined by credit expansion not money expansion. When the economy was closed and before the development of modern credit and

instruments and derivatives, velocity of money was relatively stable and money supply was fairly well correlated with credit creation. In today's economy, the Fed monetary response has to anticipate, as best it can, how money leveraging (credit velocity) will change and then respond accordingly. If deleveraging continues and the Fed does not increase its balance sheet, there is a danger of credit implosion and deflation.

Once credit velocity reverses and begins to expand, the Fed can sell assets, letting the credit expansion drive the economy. Because the data is imprecise and collected with a lag, it is probable that, for a period, inflation will go above the desired level as it did in 2007 and 2008 even as the economy was already slipping into recession. However, there is no danger that the Fed, with its tools and research, will simply allow inflation to spiral up for an extended period. That would only occur if political pressures on the Fed from Congress or the administration pushed the Fed to depreciate the Federal debt. I admit this is a risk, but it is different from thinking that the Fed lacks the policy tools or knowledge to control the situation.

Quantitative Easing and the Dollar

The most important and immediate unintended consequence of QE is a weaker dollar. Some say the Fed has introduced the prospect of QE in order to depreciate the dollar. I disagree. The Fed was clearly aware of the potential for their recent communiqué to weaken the dollar and was willing to accept the consequence of their action. Moreover, to the extent that a weaker dollar makes the U.S. more competitive it is consistent with boosting growth as long as it does not cause a pullout of foreign investment in the U.S. or does not cause a trade war. It also increases the earnings translation of U.S. companies who have overseas operations and, thus, facilitates asset appreciation by supporting stock and corporate bond prices.

There is no question but that the timing of the QE announcement was fortuitous for the administration as it pressures other countries to cooperate in the joint effort to get countries with trade surpluses to increase domestic demand and also their purchase of U.S. goods. But if dollar depreciation is the longer-term goal it would undermine foreign investment in the U.S. and could prompt a trade war. The Fed knows this and also knows that an ever-weakening dollar makes the U.S. less wealthy as a nation and undermine the U.S. role in the world

While QE has a negative near-term impact on the dollar it will be a positive over the intermediate to longer term. Consider the alternative. If, in the absence of QE, the U.S. goes back into recession, then the U.S. ability to service its foreign debt would be impaired. The result would likely be a chaotic collapse of the dollar. **By stimulating asset prices and U.S. growth with QE, the Fed accepts a near-term weakening in exchange for the dollar-strengthening that a more robust U.S. economy will produce.**

The dollar and the G20 meeting

G20 Central Bankers are currently meeting in Korea, and G20 finance ministers (Treasury Secretaries) will meet on November 11-13. At present there appears to be disarray and dissention between some

members as to the appropriate policies regarding currencies. In particular, many members of the G20, including the U.S., think the Chinese currency (yuan or renminbi) is undervalued and should rise more aggressively. Others contend that the U.S. is intentionally depreciating the dollar. Still others, South Korea and Japan, have taken measures to try to hold their currencies down or have intervened.

In my opinion, much of the discussion is intended to “jockey for position” at the upcoming finance ministers meeting. Some of it, e.g., as is the case for the U.S., is to placate domestic voters. But in the end, I think the G20, realizing the consequences of inaction, will come to enough of an agreement on how to allocate responsibilities for growth to avoid a trade war and competitive currency devaluations. If my assumption is correct, the dollar should rally into and following the November 11-13 meeting. If I am wrong, I think the U.S. will have a crisis in which equity prices move down sharply and quickly. In this case and, despite prospects for QE, foreign and domestic investors alike will begin to pull back on U.S. investments for fear of a dollar collapse.

A Final Note

All of the above is predicated on the assumption that, following the U.S. election, Congress will extend the bulk of the Bush tax cuts. The recent rise in the U.S. equity market is predicated on the impact of QE that I have outlined above. It is crucial that the positive impact not be countered by a broad-based tax hike at this time. Thus, either the failure of Congress to act on taxes or failure to gain a consensus at the G20 meeting could result in a sharp fall in equity prices.

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