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The Nudge that Roared

By Bob Veres, Inside Information

What does the end of the Fed's QE2 initiative mean for the markets and the economy?

President Obama's speech on Afghanistan collected most of the headlines, but Fed Chairman Ben Bernanke's press conference the same evening was, for some economists, more interesting. Among other things, Bernanke made it clear that the Fed was ending, on schedule, a widely-publicized initiative known as QE2, more formally referred to as the second round of quantitative easing by the U.S. Central Bank.

Some of you may have read dire headlines telling us that without QE2--or a new QE3--the economic recovery will stop in its tracks and the stock market will go into a tailspin. Elsewhere, you may have heard grumbling that QE2 has set the stage for bouts of future inflation.

People should feel free to panic if they want to, but let's take a moment to understand what they're panicking about. To do that, put yourself in the shoes of the Chairman of the Federal Reserve Board back in November. You settle into a comfortable chair behind a very large desk, look at a bunch of economic reports and realize that the economy is still, two years after 2008, growing very sluggishly. You notice, not for the first time, that unemployment is way too high. So you reach for your normal stimulus tool--the Fed Funds Rate; the rate at which your Federal Reserve system is willing to make short-term loans to the banking system. If you lower these rates, then banks can offer lower interest rates to their corporate customers and still make a profit, and those corporations will have cheap money to go out and build factories, hire new workers and report higher profits to people who might want to buy their stock.

Better yet, when money markets and bonds are paying next to nothing, it

tends to drive money off the sidelines into what are known as "risk assets"--higher-yielding corporate bonds and stocks, causing the market to go up and making it easier for companies to raise capital.

So, as Fed Chairman, you reach for your handy Fed funds rate instrument, and you realize that the Fed Funds Rate is already down in the 0% to 0.25% range. At 0%, your central bank is essentially giving away money. Any further lowering, and the Fed is paying banks to borrow from it.

Your normal method of stimulating the economy has gone about as far as it will go.

At the same time, you notice--as an analysis from the Sratfor Global Intelligence service made clear back in November--that some of America's global competitors are openly manipulating their currencies to gain an unfair advantage in the export markets. The report notes that Japan hoped to pull out of its post-recession malaise by intervening in the global currency trade, actively driving down the value of the yen. Brazil and South Korea were following a similar tactic. Germany, another major export economy, was benefiting from the weak euro--the result of the European debt crisis.

As all of these currencies weakened against the dollar, the manufactured products of Japan, Germany, Brazil, Korea and others were priced ever-more attractively to American consumers. The more they sell, the more money is diverted from the U.S. economy into theirs--or, in economic terms, the wider our current account deficit becomes.

So here you are, sitting in the Fed Chairman's office, looking around for a way to do two things at once: stimulate the U.S. economy by applying some new tool that hasn't been used before, and at the same time fire a warning shot across the bow of those exporting nations who are busily trying to pull themselves into recovery on the back of the U.S. economy.

Your solution--the Fed's QE2 initiative--is simply an announced commitment, by the U.S. Federal Reserve, to purchase $600 billion worth of U.S. Treasury securities over the eight months from last November through the end of June 2011.

Treasuries are sold at auction; that is, everybody who wants to lend the government money submits a bid for how much interest they are willing to accept. Theoretically, the more bidders, the lower the rates, so QE2's first impact is to push down the rate at which the government borrows money, which has the nice side effect of reducing the government's debt burden.

How much? If you have a little free time, you can go to a web site called Treasury Direct, and look at the amounts of bills and bonds that our government puts up at auction. (The weekly press releases can be found here: *http://www.treasurydirect.gov/instit/annceresult/press/press.htm*) You'll find that the government borrows about $28 billion a week in 4-week

T-bills, another $27 billion a week in 90-day T-Bills, $24 billion a week in six-month bonds, $24 billion a month in one-year Treasuries, and--well, by now you probably realize that $600 billion spread out over eight months is not likely to tip the overall supply/demand numbers dramatically. Consider it a nudge in the right direction.

But QE2, plus the threat of additional future intervention in Treasury rates, had a remarkable effect on those exporting nations. Within days of the original QE2 announcement, the Wall Street Journal was quoting finance ministers and economists from Brazil, France, Korea and Germany, all criticizing the purchase and calling for an immediate cease fire in the currency wars. Meanwhile, as Treasury rates drop a little, and speculators worry that they could drop a lot, the dollar begins falling against foreign currencies, putting a little wind at the backs of U.S. exporters, and in the face of foreign imports.

That's one reason why QE2 is considered a stimulus measure. Another has to do with liquidity in the U.S. economy. Whenever the Fed purchases anything, it is effectively creating new money--and, at the same time, replacing buyers of Treasuries, who will have to put their investment capital into something else (like stocks or steel mills).

Once again, however, we are talking more about a nudge than a hard shove. It is helpful to remember that the U.S. GDP--the value of all goods and services produced in a year--is currently running at about $14.3 trillion a year. A $600 billion infusion would probably be enough to stimulate your own personal lifestyle, but to the American economy, it represents at most a visible, highly-publicized drop in a large bucket.

Nor is QE2 likely to spur new rounds of inflation--at least, not by itself. As Stratfor pointed out last November, creating $600 billion in eight months is not dramatically different from the Fed's normal actions in managing the money supply. With $8 trillion in circulation (this is the M2 money supply figure, which does not include certificates of deposit or institutional money market fund balances), QE2 didn't suddenly make dollars dramatically more plentiful.

So what will be the effect on the economy now that QE2 is over? Separate analyses by BlackRock Investment Management and ForEx.com suggest about what you would expect: that Treasury rates might (or might not) bump up a little, with a consequent bump in bond rates generally--which would be good news for people who have been trying to live on the (almost nonexistent) interest provided by today's fixed-income investments. The long, slow decline in the value of the dollar may reach a logical bottoming, and any upward pressure that QE2 might have been putting on the inflation rate will be gone.

But it's helpful to remember that even though the Fed won't be a net buyer of Treasury debt, it will still have a lot of options related to QE2. In his press

conference, Chairman Bernanke pointedly did not outline any plans to sell off the government bonds that the Fed has already purchased. When the Treasuries "mature"--when the bond terms are up--then the Fed will have the flexibility to make a long, gradual series of decisions based on what it sees in the economy.

If the economic recovery continues, those assets might be allowed to quietly slip off of the Fed's balance sheet gradually over time. If not, the money collected could be reinvested in Treasuries without any expansion of the Fed's current balance sheet--helping to keep Treasury rates low and continuing the effect of the stimulus for as long as you (the new Fed chairman) think it's needed.

The bottom line here is that QE2's effect may have been more powerful psychologically (see the inflation worries, the white flag flown by exporting nations and now fear that the recovery is doomed if the Fed stops purchasing Treasury debt) than its actual effect on the economic landscape. If you're the Fed chairman, right now you're probably surprised that your newest policy tool stirred up so much excitement--or worked so well. And you're probably also surprised that whoever writes those headlines would think that such a small, albeit creative, nudge could be the main reason the U.S. economy is climbing out of the hole of the Great Recession.

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