

QE3? You Make the Call

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2011 Outlook

GDP GROWTH:
2.5%

UNEMPLOYMENT:
9.0%

INFLATION:
1.75%

FED FUNDS RATE:
0.35%

The financial and economic effects of the second round of Quantitative Easing (QE2) are coming to an end. Officially, QE2 will be over by the end of June. With the current lowering of economic growth momentum and the increase in economic uncertainty, most market pundits are asking if there is going to be a QE3 – another round of economic easing by the Fed. There are as many economic reasons for, as there are against, the Fed launching another round of easing at this time. We are not sure as to which direction the Fed will eventually go (or not go). So...you make the call!

Details of Fiscal and Monetary Stimulus

Two types of “stimulus” programs have been utilized by Washington since the financial and economic meltdown in 2008 – fiscal policy adjustments and monetary policy adjustments. Fiscal policy adjustments are controlled by politicians and involve tax policies and spending policies. Monetary policy adjustments are broadly controlled by the Federal Reserve and include interest rate adjustments, the issuance/monetization of debt creation, bank reserve policies and the like. Since the federal government is running fiscal budget deficits in excess of \$1 trillion annually, the idea of “stimulus” spending programs has been pretty much taken off the decision table. Over the last year, with budget deficits as “high as an elephant’s eye,” monetary stimulus programs have played a more significant part in the stimulus discussion than taxation decreases and massive spending programs.

As such, the Federal Reserve has been the only active game in town as far as stimulus packages are concerned. QE2 has been initiated and conducted by the Fed in an attempt to revive one side of their “dual mandate.” The Fed’s dual mandate, which was given by Congress to the Fed in 1977, is to combat both inflation and unemployment.

Unlike the central bankers in Europe which have one mandate – price stability – our Fed has two charges by Congress. The first is to maintain a “stable” pricing environment, and the second is to keep the economy in a fully-employed status. These two mandates, according to the “Fisher Rule,” are mutually exclusive. Inflation tends to move to the upside during a time of strong economic growth as does employment gains. During a weak economic environment, both inflation and employment gains tend to fall. Consequently, the Fed’s “dual mandate” charge is akin to a balancing act.

Last summer, Ben Bernanke and the Fed decided that we had too little inflation and too much unemployment. Consequently, they decided to “stimulate” the economy by purchasing \$600 billion in Treasuries, which in effect injected \$600 billion into the banking system (as they purchased Treasury notes from the banking system, they injected cash into the banks). The idea was the banks would lend the capital to borrowers, thus increasing economic activity, employment and perhaps, over a period of time, inflationary pressures.

QE2 – Was it Successful?

The jury is still out on the final judgment regarding the verdict of success/failure for QE2. However, if the purpose behind QE2 was to increase economic growth and lower unemployment, consider the following points regarding economic activity before QE2 and currently:

- Real Gross Domestic Product (GDP) grew by 3.7 percent during the first quarter of 2010. GDP grew by 1.8 percent during the first quarter of 2011.
- The ISM Manufacturing Index, which measures the health of the manufacturing sector of our economy, was at 57.8 for the three months prior to QE2 and is now at 53.5 at the end of QE2.
- The ISM Non-Manufacturing Index was at 54.6 prior to QE2 and is now at 52.8.
- The Case-Shiller Housing Index, which measures housing values, was at 156.2 prior to QE2 and is now at 151.7.

Consequently, it is fair to say that GDP, manufacturing, non-manufacturing and housing values have all been under pressure during the QE2 process. Stimulative? Perhaps not. Then again...

- The unemployment rate was at 9.8 percent a year ago. Now, the rate is at 9.1 percent.
- Headline Consumer Price Index (CPI) inflation was at 0.3 percent for the three months prior to QE2 and is now at an annual rate of 6.2 percent over the last three months.
- Core CPI inflation had increased by 0.5 percent on an annualized rate for the three months prior to QE2 and is now growing at an annualized rate of 2.1 percent.
- Asset price inflation has increased as the stock market (as measured by the S&P 500) is up 8.6 percent in value and commodity prices (as measured by the CRB Index) are up 15.2 percent in value.

Therefore, if the goal was to lower unemployment at the expense of increasing inflation, QE2 could be measured as a success. Incidentally, if we look at the Fed purchases and the building up of leverage on the Fed's balance sheet, QE2 cost \$600 billion. Over QE2's period of time, the labor force increased by 1,028,000 jobs (data according to the Bureau of Labor Statistics). Given these two facts, one could say that one job was created for every \$583,657 the Fed purchased in Treasury notes. Given this data, the Fed would need to purchase \$1.9 trillion in treasuries to move unemployment down to 6.5 percent. This analysis is, of course, folly. But who knows what is lurking in the minds of some folks in Washington? By the way, the Fed has also purchased (in addition to the \$600 billion in Treasuries during QE2) \$1.25 trillion in mortgages during actions prior to QE2.

Final Word

So, the Fed has levered the Federal Reserve balance sheet by \$1.85 trillion. According to our facetious analysis above, the Fed needs to lever the balance sheet by \$1.9 trillion to “solve” the unemployment problem. This may indeed catch the eye of some of our leaders in Washington who are currently worried about being re-elected.

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