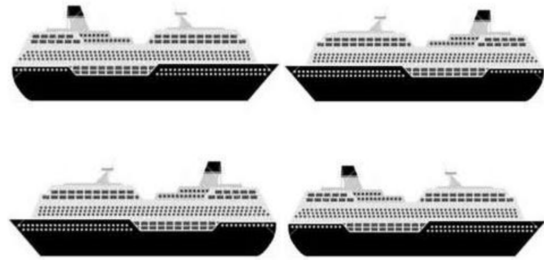
QE 1, 2, 3, 4
…… AND COUNTING!
A fleet of luxury ocean liners? ……. No Way! It's just the Feds printing money to encourage inflation and ……!



Stephen L. Bakke April 12, 2013

I may need HELP!

One of my majors in college was economics, but if I ever knew and understood the term "quantitative easing," I can't remember! I guess this concept came much later. Nevertheless, "quantitative easing" is upon us with a vengeance! I decided to learn what this is all about, so now you get to as well. In my attempt to understand this subject, and to simplify it enough so that I could explain it, I have had to balance a lot of confusing and seemingly contradictory explanations. Nevertheless, I believe I have found a reasonable and useful explanation for laymen like me. Still, this report may be a "work in progress" as I learn more.

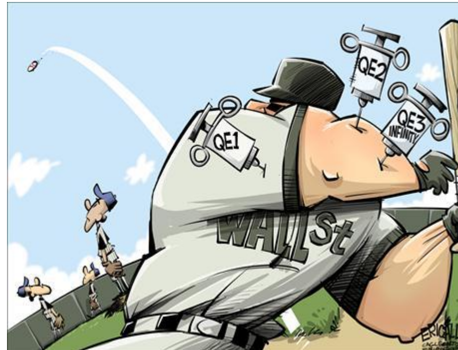
First, what is quantitative easing? It sounds so friendly and harmless!

We've been hearing a lot about "quantitative easing" lately in news and economic reports. "Quantitative easing" (QE for short) is when the U.S. buys government and other securities or financial assets. For example, the central bank may buy financial assets from commercial banks and other private institutions. Assets purchased can include U.S. Treasury debt and mortgage backed securities.

QE is one Federal Reserve (the Fed) procedure intended to increase the money supply by flooding the nation's financial institutions with capital and thereby increasing liquidity. Its stated purpose seems to be to encourage lending which would energize the struggling economy. Also, by buying up mortgages, the government intends to lower mortgage rates, thereby helping in the real estate recovery. In effect this is relieving the housing market lenders of a preplanned amount of mortgage risk, thereby supposedly a "stimulus" in its affect. But overall uncertainty in the financial institutions seems to have mitigated much of the incentive to make new mortgage loans.

I understand that QE is most often used when interest rates have already been lowered to near zero without achieving the intended improvements. **In other words, its usage is an admission of previous policy failure (in my opinion)!** And think about it – QE inflates the money supply but doesn't do anything to increase the available goods or services, so "voila," inflation will be the expected result. **Permit me to be cynical and suggest the Administration WANTS inflation so that the national debt can be repaid more easily and quickly, using cheaper dollars.**

The money supply is increased (money is "printed") by QE because in essence funds are created out of "thin air." The method used by the Fed to buy the financial assets isn't by borrowing necessary funds, nor are the funds obtained from tax revenues. In fact, the Fed doesn't pay the security dealer banks or commercial banks with currency or other claims to existing funds. It merely credits those banks reserve accounts held at the Fed – and magically, all that new liquidity is created, and it can be used for making loans. The funds actually come out of nowhere – a "virtual" printing of money!



*[**For simplicity here,** I'm not going to complicate the discussion with the subject of "Federal Reserve Notes" and how those can fit into the process in some situations in which the commercial bank doesn't want their reserve accounts credited. I won't complicate the discussion by dealing with the subtle distinction between true QE and a similar monetary policy in which the Fed buys government bonds to control interest rates. Also I am staying away from a discussion of purchasing government debt to directly finance government deficits, or pay off government debt – sometimes referred to as "monetizing" the debt. I think the distinctions between these things are often blurred and their impact can be similar.* ***And, I'm retired, so I don't need to include them if I don't want to!****]*

Some unintended and intended consequences!

Let's assume the QE does result in inflation and a cheapening of the dollar.

This is actually a camouflaged way to "tax poor people" ……

People have their money taken from them, not by direct taxation but by having the value of that money reduced. This burden falls on the backs of the poorest because the more affluent have alternatives for escaping by making investments which hedge against inflation (e.g. gold, and even stocks in some ways – discussed later). **Assume the poor person's $100 cheapens to $90 due to manufactured inflation. At the same time that there is misfortune for the poor guy, there is a new advantage to the federal government.**

The new, cheaper, inflated $10 that disappeared from the poor guy is now only worth $9 in historical terms, yet they are used to repay the full original $10 amount of debt. How is that different than taxing the poor people? Absent inflation, if taxes were assessed for $10, that leaves $90 for the poor guy under both scenarios and $10 is spent by government to retire debt. **It's the very same economic reality, folks!**

How are seniors affected? ……

Many seniors rely on interest for the bulk of their income. QE has the effect of lowering interest rates overall. **Hence, seniors usually loose income as a result of QE.** Stocks and commodities usually benefit, in the short run, from QE.

Call me cynical, if you wish! ……

As I was working on this, I started to think about the recent double-speak by the administration regarding their claims that they have and will continue to reduce the deficit and debt. In an earlier report I discussed the "funny money" and misleading disclosures that result from using baseline budgeting. But that's only part of it! I believe that the administration went searching for a "plausible" explanation for how in the world they could claim reductions while the totals continue

to rise. They came up with the method of measuring everything in relation to GDP – i.e. they represent that the deficit and debt is reduced, even when it goes up in real dollars, but reduces as a percentage of **projected** GDP. **Therefore, previously incurred obligations are compared to an intentionally inflated projection of GDP – that inflation being fueled by the episodes of QE.**

But what happened to the huge adjustments in the economy?

Where did inflation disappear to? ……

I asked myself that question and found what I think is the answer. There hasn't been much inflation at all! While the multiple QEs did occur, over a period of about 4 years, inflation has been modest because **the banking system has just sat on its enhanced reserves rather than aggressively lending. That is what happens when there is uncertainty over everything** from international economic problems to future tax legislation, and the implication of the oppressive level of debt we have accumulated.

Why hasn't the dollar weakened as much as one might have expected? ……

Very simple! **The dollar's image hasn't been tarnished as much as expected because the rest of the industrialized world, especially Europe, continues to be in such bad shape.** And, some other countries have had policies in place that weakened their currencies as well.

Call me cynical once again, if you wish! ……

I believe one motive (conscious or unconscious) for the repeated episodes of QE is that inflation hasn't been significantly affected, nor has the dollar weakened as intended. They are telling themselves: **"let's keep doing this until we get it right!"**

The stock market seems to be a totally different animal!

Economists seem to be all over the map!

Opinions vary significantly as to whether QE had any effect on the stock market. To me, the nature and extent of this major effort by the Fed must have had a significant impact on the market. It's reasonable to expect an inflationary impact from the QE efforts. And it's reasonable to assume that at least some of the stock market "run up" has been due to the **expected** inflationary impact of the Fed's policies. Just like gold and commodities go up with a weakened dollar and inflation, so might the stock market as long as the economies around the world continue to have their own problems. Foreign money being invested here, as a last/best resort, has also buoyed the economy.

In closing, let me give you some idea of the magnitude of increase in the Fed's involvement in our economy in recent years. The Fed's balance sheet was approximate $500 billion the last time the S&P was at current levels – that was just a few years ago. Their current balance sheet shows about $3.1 trillion and it is growing at almost $100 billion each month.

> ***The Fed's footprint across this nation is becoming almost frightening, and even depressing. And the Fed operates with no oversight! Be very, very careful!*** – Stefano Bachovich, obscure but very wise political pundit, and an enthusiastic and prolific purveyor of opinions on just about everything – SB's major "go to guy."