Liquidty Traps
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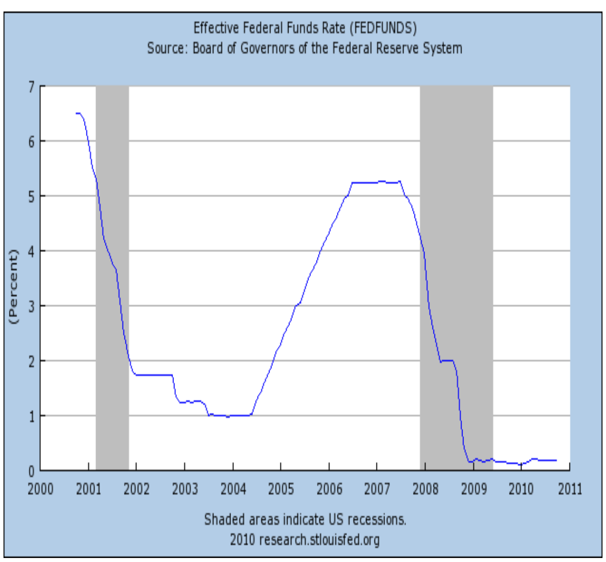
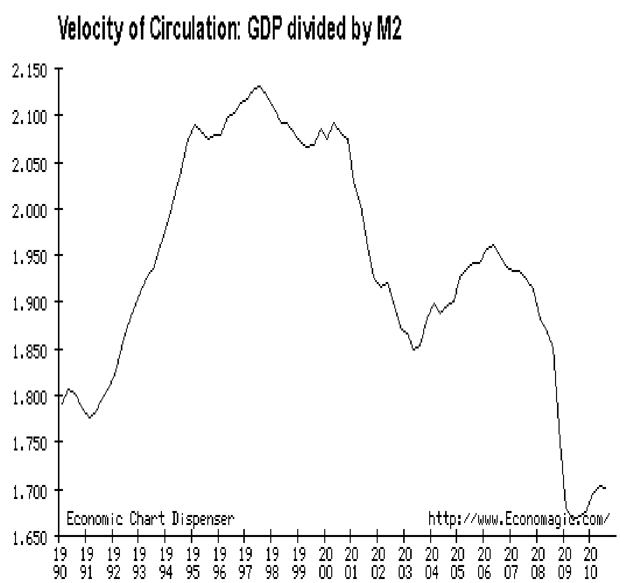
The topic today: QE2. As many of you know, last week the [Fed announced plans to buy US Treasuries in the order of $600B over a 6-8 month window](). And whilst it was expected, there has been a healthy dose of debate over the program's effectiveness and long run implications. Personally I am very worried about QE2. I am mostly troubled by the Fed's inability to stimulate demand. I hear the term "liquidity traps" mentioned more and more these days. It's essentially what happened to Japan in the early 90's and it's a central banker's worst nightmare. It means that the central bank has lost control of it monetary policy: no matter how low interest rates go or how much liquidity is pumped into the system, it fails to stimulate demand for loans and commerce. This is true because the Fed can not directly affect employment or growth levels simply by lowering rates or making cash available to the economy. There has to be an underlying need or demand from the market. Without the demand to capitalize on these favorable investment conditions, the Fed becomes powerless in their abilities to change the projectory and momentum of the economy. The Fed starts 'pushing on a string'.

Since the end of 2008, the Fed has dropped rates to near zero percent. As the recession deepened and capital markets seized up, the Fed turned to outright quantitative easing and pumped additional currency into the system. All told over $1.7T. This first injection of capital was meant to stabilize the banking system and compensate for the fact that the velocity of money had fallen off a cliff. A number of central banks employed similar strategies and I think there is general consensus that these actions pulled us back from the brink.





Source: FRED, St Louis Federal Reserve

The Fed's ultimate goal in QE2, however, has nothing to do with financial markets. They are looking to create jobs and stimulate demand. The problem here is that monetary policy is simply not as effective at stimulating the economy as fiscal policy and can only affect the level of activity through second order effects. This is why the equity markets are raging. Cheap short-term financing is acting as the 'tide that lifts all boats'.

This is not to say, however, that the Fed's thesis is completely devoid of a set of sound economic principles. In supporting (and increasing) asset prices the Fed can stimulate the economy through something called the "wealth effect". Simply put if asset prices (such as stocks and bonds) increase in your investment portfolio by +15%, then you have effectively become 15% wealthier and hopefully will spend 15% more. In addition to raising asset prices, the Fed is also looking to raise inflation expectations. The Fed hopes that if you feel your dollar will be worth less tomorrow then you would prefer to spend today.

This 2nd round of QE has the potential to be very damaging in the long run, yet Bernanke & Co. are of the opinion that it's better to stamp out inflation in the future then deal with deflation in the present. Let me walk you through their rational. With the Fed's additional liquidity, the dollar weakens and people start to hoard hard assets such as real estate, gold, silver and energy commodities such as oil. Now you have hard assets appreciating in value. Many of these hard assets, especially oil, is used in the production of goods. (This problem is further exacerbated in developing markets because they are less efficient with their resources so they end up using more oil per unit of finished good. This means the effect is amplified and compounded). Eventually the higher prices in the raw inputs will make their way into the prices of our finished goods that we import back home. We've essentially exported inflation and imported it right back.

Another detrimental effect to consider: if commodity prices were to rise, so would fuel costs. As people spend more on food/energy they have less disposable income (aka discretionary spending), and since consumer spending accounts for nearly 70% of GDP, messing with the wallets of the consumer is serious business. But alas these things take some time to trickle through the economy. For now the Fed is happy lifting asset prices and inflating their way out of this problem.