



May 17, 2010

What is Quantitative Easing, Why Should I Care, and Can I Get Some?

Quantitative Easing

As the Euro continues to melt like a piece of baklava left too long in the sun, once again the weekend papers are full of references to 'quantitative easing.' Just what does this oblique phrase mean, and why should anyone care?

Central banks typically reduce the price of money (the short term interest rate) to stimulate demand. As we write this, the yield on the 1 Year U.S. Treasury Bill is 3/10's of 1 percent. Were your credit as worthy as that of the United States, it would cost you about a penny, over the next year, to borrow \$3.00 today for your local latte.

Despite such low rates, the rates facing other borrowers (those offering Greek bonds and certain US mortgage-backed securities spring to mind) can still be relatively high. If a central bank is interested in reducing the cost of money for those borrowers, and rates cannot go below zero, is there anything left to do? There is. 'Quantitative easing.'

How It Works

Step 1 – The Federal Reserve creates new dollars. Sometimes incorrectly referred to as 'printing money,' what actually happens is that the Federal Reserve credits its own account by tapping a few computer keys and hitting 'Enter' to increase the dollar balance in its own account by X. X usually being a very big number.

Step 2 – With these new dollars, the Fed then buys selected assets. It may purchase sub-prime mortgage securities from an anxious bank, or US Treasuries in the open market. In each case, the desired effect is to support the asset, lowering the cost of borrowing.

Step 3 – The seller delivers the security to the Fed, who credits the seller's account with the bank's new dollars, fresh from the Fed's hard drive.

Step 4 – The anxious bank, having off-loaded their problem asset to the account of the Federal Reserve, is now free to put those dollars to work in the economy, boosting demand. At least, that's the theory.

Will it work? Here we answer with an unequivocal... maybe. The Japanese central bank from 2001 to 2006 vigorously hit 'enter' to create additional Yen, but the response from the real economy was tepid at best. In the US, recent experience seems to indicate that the economy is recovering.



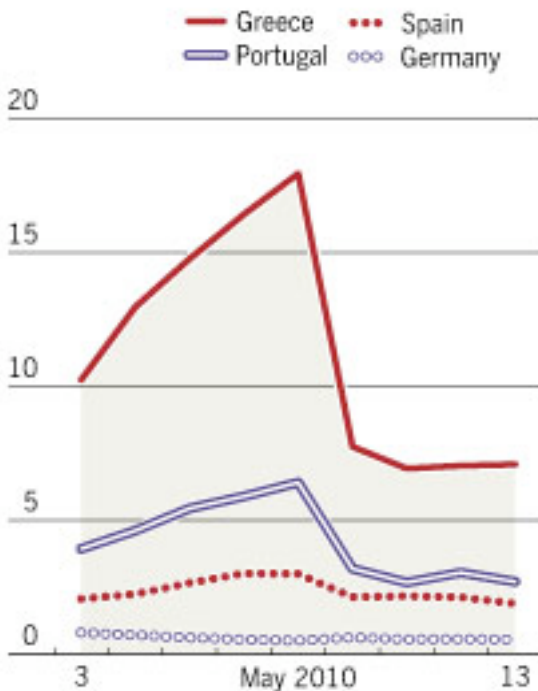
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Why You Might Care

The Federal Reserve (and now potentially the European Central Bank) is attempting to provide additional fuel to the economy through quantitative easing. With this much monetary gasoline sloshing around the system, the fear is that any spark of demand that is not quickly countered by monetary tightening could ignite inflation and higher interest rates. While eventually likely, this outcome is by no means certain. Bear in mind that at the end of 2006 10 Yr Government rates in Japan were about 1.5%. And today? 1.25%.

ECB purchases lower bond yields

Sovereign bond yields (2-year, %)



In Europe, the central bank has purchased Greek debt, bringing yields on the 2-year note from an eye-watering 18% to around 7% in less than a week. That's the good news. The bad news is that the markets now fear that the Euro will bear the strain of relatively uninhibited quantitative easing to finance the purchase of this debt.

Can I get some?

Sadly, no. At least not directly. Although if you are in the fortunate position of being a bank the benefit has been direct and tangible. Existing homeowners currently re-financing their houses have benefited indirectly. Unlike the infamous 'dropping money from helicopters' procedure, quantitative easing attempts to target specific assets. So, no need to strain your ears listening for the sound of rotor blades. Yet.

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€20bn

ECB has bought an estimated €20bn, which traders say is mostly in Portuguese, Spanish and Greek debt between 1 and 3 years

Source: Financial Times