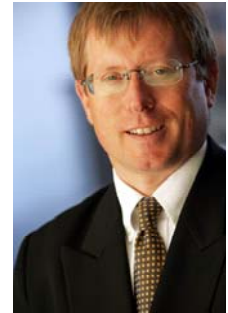


## Unintended Consequences

It is now nearly two months since the Chairman of the US Federal Reserve Board (FRB) began to suggest that he was considering re-introducing a Quantitative Easing Policy (QEII). Unlike its predecessor, which relied on the Federal Reserve purchasing troubled mortgage securities from banks and other financial institutions, QEII is expected to revolve around the Federal Reserve purchasing considerable quantities of Treasury bonds, notionally in the 5-30 year duration bracket. We strongly suspect – and indeed have been led to believe by our sources – that the Federal Reserve does not view its QEII as being an optimal one.

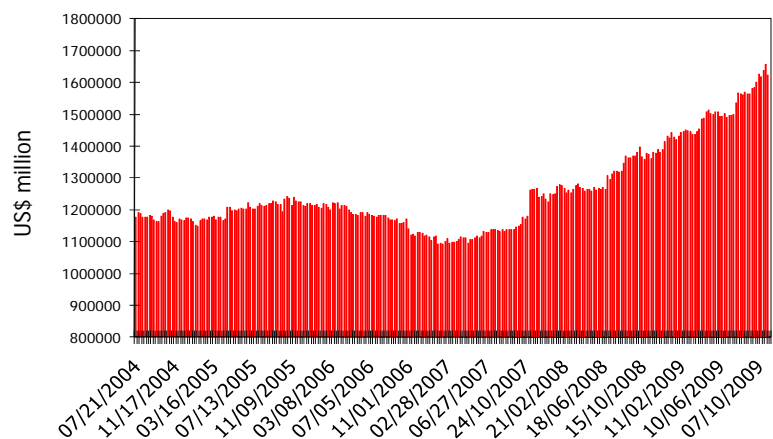


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Instead, we gather that the FRB's hierarchy would much rather purchase more private sector debt instruments or even equities since it reasons that by acquiring these assets directly, it could both reduce 'real' people's borrowing costs and potentially provide the owners of assets with a worthwhile holding gain, two events that might be expected to lead people to save less and therefore spend more within the economy. However, we further understand that the Fed's legal advisors have decided that such a strategy would be in breach of the FRB Act and therefore the Fed is constrained with regard to its actions such that it can therefore only buy more Treasuries at this juncture.

Certainly, it is clear that the intermediate aim of the Federal Reserve in returning to quantitative easing is simply to get people to save less of their current incomes despite the weak state of their balance sheets and existing negative equity positions in their homes and there are many – both inside and outside the FRB – that regard this strategy as rather foolhardy given that for the last 20 years economists have regularly complained that people have not been saving enough! However, it is clear that near term politics and we suspect FRB Chairman Bernanke's dread of a deflationary shock emerging have combined to lead the Federal Reserve to the point at which it is now deliberately aiming to encourage people to save less, almost regardless of the consequences that this may have for their long run financial positions; we can only assume that Bernanke is merely practicing Keynes' observation that "in the long run we are all dead (anyway)".

USA: Banks' Treasury Securities Holdings



Returning to the actual mechanics of the expected QEII, we find that the Fed intends to purchase sufficient Treasuries in order to push the yield on these bonds down to what might be considered a punitive yield at which ordinary savers and investors begin to quit the T-bond markets. At this point, Bernanke and his colleagues presumably hope that these funds will flow into domestic equities (thereby exerting a

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positive wealth effect on consumers); or into domestic private sector debt instruments (thereby improving conditions for would-be borrowers in these markets); or the funds will flow out of the dollar altogether with the result that the US currency falls and the US export sector gains a useful advantage relative to its peers.

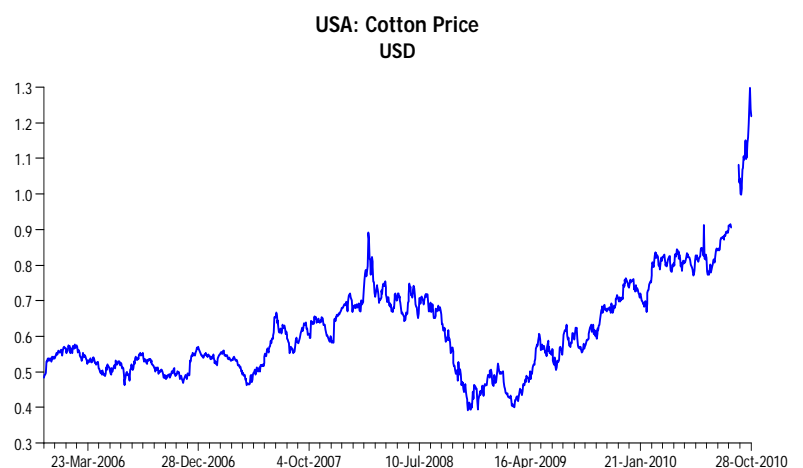
Of course, many of these things have already happened. Virtually as soon as Bernanke began to articulate his plans for QEII, it became clear that many financial institutions were beginning to attempt to 'front run' the Federal Reserve and in particular we note that the US commercial banks have already been buying Treasury bonds aggressively. Moreover, in so doing we find that they have helped to push yields down and thereby implicitly provided the necessary liquidity that was needed in order to raise other asset prices and even to weaken the external value of the dollar. By purchasing around \$60 billion of Treasury bonds since the beginning of September, it seems that the US commercial banks have already done much of the Fed's work for it and hence we can say that, in an effective sense, QEII is already upon us.

What concerns us at this point (aside from our earlier reservations about reducing the savings rate once again) is that QEII may have a number of unintended consequences, particularly given that this US-led QEII appears rather unilateral as opposed to the 2009 multi-lateral version.

Firstly, the resulting weakness in the US dollar implies that effective monetary policy settings for the US's trading partners in Asia, Australasia and most of all Europe have tightened appreciably. In Europe, we suspect that the appreciation of the Euro has increased the pressure on the embattled – and already uncompetitive – periphery of the currency union and this has led to a resumption of stresses and strains within the European economy. If the weaker dollar causes these economies to slow (or worse), then the result is unlikely to be positive for global growth trends and, although some may think that the European Central Bank should merely match the Fed with its own new version of QEII, few within the ECB seem to share this view at this time.

In Asia, meanwhile, the weakness of the dollar and the related strength of the speculative capital flows that these countries are attracting has led many governments to consider the greater use of capital controls so that they can better insulate themselves from what they increasingly see as the West's exportation of 'funny money'. Certainly, there are few in authority in Asia or elsewhere in the developing world that are not acutely aware of just how destabilising and unhelpful the large capital inflows of the early 1990s were to Asia and the way in which these flows ultimately contributed to the devastating Asian Crisis. Therefore, these countries are actively considering the greater use of capital controls and if these are introduced, they could thwart some of the Federal Reserve's reflation plans and reduce longer term global capital market efficiency.

However, perhaps the greatest unintended consequence that we fear already appears to be forming. Clearly, the Federal Reserve hoped that by pushing Treasury yields down it would force a tidal wave of liquidity into asset classes and it has been unfortunate that it has not only been corporate equities and bond markets that have been affected by these flows, so too have the commodity markets. Since the Fed's first QEII announcements were made, oil prices have increased by nearly 7%, meat prices by 10%, grain prices by 15-20%, soya prices by somewhat more and cotton prices by an amazing 40% in USD terms.



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For the holders of these commodities and in particular those that have been speculating in them, these price rises are of course part of the Federal Reserve's desired wealth boosting effect but, for the vast majority of the world's population – including in the USA – the increase in commodity prices represents a substantial increase in one's cost of living or subsistence. In essence, rising commodity prices act in much the same way as a tax on consumers and hence this effect of the de facto QEII has been detrimental to the very people that the policy is designed to encourage.

In many ways, this does not matter for financial markets in the near term. The Federal Reserve and we suspect the Bank of England are indeed succeeding in forcing down bond yields and there has clearly been a flow of funds into both alternative asset classes and out of the US dollar that has rewarded those that were positioned correctly. Moreover, there have also been some signs of life from the US consumer sector over recent weeks following the policy change and therefore we can easily imagine that the QEII rally will continue a reasonable while longer – perhaps even until year end or beyond.

However, in the final reckoning, the decision to attempt to reduce the US savings rate further from an already too low position and the by-product of raising living costs for many of the world's poorest households in pursuit of a little more short term growth may look rather less defensible, or even wise. In this regard, we find it notable that the former arch-proponents of the QEII-style approach, the Bank of Japan, has been prepared to risk a stronger Yen rather than see itself embark on QEII and we know that this is because they fear the long term consequences of using such monetary regimes. For now, we would enjoy the QEII-inspired rally but we doubt that it will deliver a sustainable solution to the world's ills – when QEII are removed once again in late 2011 or even 2012, we may find ourselves back where we were a few months ago with sluggish economies and deflation fears.

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