

More monetary easing on the way in the US and EU – will it work?

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Oliver's Insights



Key points

- > The US Federal Reserve looks to be on the verge of more monetary easing and the European Central Bank has indicated it's working on plans to buy bonds to reduce yields in troubled countries in concert with the European bailout fund.
- > While such measures are not without risk and Europe invariably has implementation problems, on balance they should help sustain the global economic recovery.
- > Action will ultimately be positive for growth assets such as shares, commodities, corporate debt and the \$A.

Introduction

On one level, the outlook for investment markets right now is simple. If you believe the global economy will spiral down into another recession, then shares and growth assets are likely to struggle. Alternatively, if you believe that global policy makers will be successful in keeping the global economic recovery going, then a sharp rebound is likely at some point.

The US Federal Reserve (the Fed) has now clearly indicated that it will ease further unless the US economy improves. Our assessment is that the Fed will announce another round of quantitative easing in September. Likewise in Europe, there is increasing evidence the recession is deepening as excessive bond yields in Spain and Italy serve to hamper monetary policy and threaten the euro, which seems to have galvanised the European Central Bank (ECB) towards more aggressive action. But will it work?

Can easy money keep the US and EU afloat?

For the past five years, the US and Europe have been going through a process of deleveraging as the private sector and governments more recently, have sought to reduce debt. This has meant the economic recovery since the global financial crisis (GFC) has been fragile and constrained. Our assessment remains that while monetary policy cannot prevent the adjustment, it can ease the pain and prevent economies from spiralling into a 1930s-style depression.

Monetary policy can be a bit arcane at the best of times, but in recent times it has become even more complicated as interest rates have fallen to zero in the US and Europe, forcing central banks to resort to non-conventional measures to support their economies. However, central banks still have a range of tools at their disposal including:

- > 'Jawboning', i.e. telling investors they have got it wrong and if they don't reverse course the central bank will act;
- > Communicating how long they will keep interest rates low in order to keep long term borrowing costs low;
- > Cutting interest rates to zero or below for bank deposits at the central bank to encourage banks to lend;
- > Adopting some sort of 'funding for lending' scheme like the Bank of England has recently done;
- > Rearranging their balance sheet – e.g. selling short term bonds and buying long term bonds as the Fed has been doing with "Operation Twist" since September last year in order to reduce

long term interest rates, or the ECB's selling of short term bonds and buying Italian and Spanish bonds to reduce bond yields in such countries; and

- > Quantitative easing, which involves using printed money to buy government and private sector securities or to lend to banks to pump cash into the economy – action the Fed is likely about to undertake unless the economy improves soon.

Of these, the latter is the most powerful. But it, along with balance sheet adjustments, is also subject to the most criticism. The main criticisms of such proactive action are:

- > It will create hyperinflation;
- > It is just delaying an inevitable adjustment;
- > That it takes pressure off governments to reduce borrowing;
- > That it will distort financial markets and hence investment decisions; or
- > It's an action that is hard for the central bank to exit.

A final objection is that it hasn't worked so far.

However, the more extreme fears have been wrong. There is no sign of the hyperinflation many said would follow quantitative easing in 2009. US inflation is now just 1.7%. Similarly, inflation is not a problem in the UK or Japan where quantitative easing has been deployed. What those worried about inflation seem to have missed is that quantitative easing has boosted cash and bank reserve deposits (i.e. narrow money) but in an economy with lots of spare capacity this needs to be lent out and spent for inflationary pressures to build and this hasn't happened, at least not in a big way. And when it does, the Fed can withdraw the stimulus.

The argument that monetary easing is just delaying an inevitable adjustment or allowing governments to avoid fiscal tightening is frequently heard in Europe from self flagellating disciples of Austrian economics, but is also getting airplay from US tea party Republicans. It's usually argued that free market forces should be able to run their course until any excess is unwound. The problem with this argument is that it ignores the role of free market forces in causing the problem in the first place. Additionally, if free market forces are able to run their course, numerous innocent bystanders will be adversely affected, as was the case in the 1930s depression or amongst the 52.7% of unemployed Spanish youth. So there is a case for monetary policy to smooth any adjustment in fiscal policy and iron out extreme mispricing in European bond markets caused by market panic.

Finally, there is no doubt that large scale Fed buying of US Treasuries is creating distortions in financial markets and it does create uncertainty around how the stimulus will be withdrawn. But the question then becomes whether these costs are justified by the benefits of quantitative easing.

On this front, the reality is that were it not for the Fed's quantitative easing, the US economy would arguably have been far worse. Since the GFC, the US has been battling private sector de-leveraging as households and businesses have sought to reduce their debt ratios following a sharp loss of wealth, and more recently, fiscal drag of around 1%p.a. as the budget deficit is reduced. Quantitative easing has provided an offset to these forces, enabling the US economy to at least grow.

In fact, the US is a bit like a patient in a coma with the Fed acting as the drip by keeping the economy alive until it has healed enough to exit the coma. The Fed's liquidity can't heal the economy but it can support it until it is healthy.

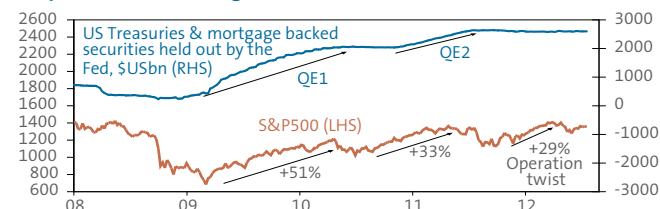
So would another round of QE help the US?

It's almost inevitable that another round of US quantitative easing (QE3) will have less of an impact than QE1 and QE2. Bond yields and mortgage rates are much lower than in 2009 and 2010, share markets are not as cheap and there is no longer likely to be as big an announcement affect. However, there is still likely to be a positive impact:

- > The gap between mortgage rates and bond yields is wider than normal, suggesting that they have scope to fall if the Fed starts buying mortgage backed securities;
- > A further expansion of bank excess reserves will help continue a gradual increase in bank lending;
- > By buying up low risk assets like Government bonds or mortgage backed securities, the Fed will entice investors to take on more risk in their portfolios such as by buying corporate debt or shares;
- > An increase in the supply of US dollars will likely take some of the upwards pressure off the \$US, which helps US companies that compete internationally.

So our assessment is that another round of quantitative easing will at least help ensure US growth continues to average around 2%. The next chart shows the value of The Fed's holdings of Treasuries and mortgage backed securities against the US share market. Both QE1 and QE2 were associated with gains in shares and there is no reason not to expect a positive impact with QE3, albeit smaller.

US quantitative easing and US shares



Source: Bloomberg, AMP Capital

To the extent that QE3 will increase the supply of US dollars, it is also likely to provide a boost for the \$A.

The ECB and the euro

ECB President Mario Draghi has indicated that bond yields in Spain and Italy are too high and that the ECB is working on plans to buy bonds in such countries providing they apply to the European Financial Stability Facility (EFSF) for assistance and sign a Memorandum of Understanding (MoU) committing them to economic reforms. Such action will effectively involve the EFSF buying bonds in the primary market (i.e. at auctions) and the ECB buying bonds in the secondary market until yields fall to more sustainable levels. Markets were disappointed that the ECB is not acting immediately. However, it would be wrong to underestimate the ECB's commitment to preserving the euro, with Draghi saying "it's pointless to bet against the euro...because it will stay and it's going to be irreversible". There are a number of points to note. First, Mario Draghi has a track record of delivering despite initial scepticism as was seen last year with the provision of cheap funding

for banks. Second, the proposed approach has two key benefits. By acting with the EFSF, the ECB can allay fears that it is providing "money for nothing" as it will be conditional on MoUs being signed; and the ECB can effectively boost the EFSF's firepower as its resources are unlimited. Third, Draghi has made two very positive comments in saying that investor concerns about the ECB ranking senior to private investors will be addressed and that any bond buying may not be sterilised, thereby opening the door to quantitative easing. Next, while Germany's Bundesbank is opposed to any ECB bond buying, this is unlikely to be a problem as the majority vote rules at the ECB. Finally, there's an element of win-win here – either Spanish and Italian bond yields settle down or if they don't, the governments will apply for assistance and bond buying by the EFSF and ECB will force yields down. So it may all take a bit longer than would be ideal but its heading in the right direction.

ECB and EFSF bond buying won't end the recession in the Eurozone. But it should help put an end to the panic in various bond markets, thus allowing the benefit of low interest rates to flow through and prevent the recession from turning into a deep recession as was seen in 2008-09.

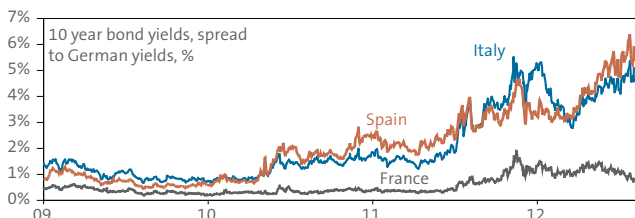
Deepening European recession



Source: Bloomberg, AMP Capital

The key indicators to watch are Spanish and Italian bond yields. If they stay up or move higher it's inevitable they will sign up with the EFSF which will swing the ECB into action to push yields back down. The plan stands a good chance of success if it is implemented aggressively.

Spanish and Italian bond yields are unsustainable



Source: Bloomberg, AMP Capital

Concluding comments

While the Fed can't solve all of America's problems and the ECB can't prevent recession in Europe, additional action by both central banks will add confidence to the global recovery continuing. This will be positive for growth assets including shares, commodity prices, corporate debt and the \$A.

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