The Current Recession and QE3. Why QE Faces Severe Diminishing Marginal Returns

Some Thoughts about Quantitative Easing

The crisis of 2008 was precipitated by the realization that debt levels in the economy had become acutely excessive. In a short space of time, investors lost faith in banks and one another, suspecting that their respective counterparties had excessive exposure to the debt that had been created. The sudden desire to avoid this debt and to avoid those alleged to be holding this debt led to flight to safety and in particular, a malfunctioning LIBOR market.

Under normal circumstances, government should never have stepped in. The scale of the debt problem, however, held governments to ransom over bailout funding. What ensued was a wholesale transfer of debt from private balance sheets to government balance sheets.

The financing of these assets, or debt, by governments through the issue of government bonds is the equivalent of a transformation of one form of debt (secured in most cases, by the way) to another (quite clearly unsecured.) The private sector has been understandably wary, even leery, of government debt, as evidenced by the CDS spreads on Greek, Irish, Portuguese, Spanish, Italian, Belgian debt. Countries with a sovereign currency have the luxury (quite frankly cold comfort) of being able to monetize their debt by using their left hand (central bank) to purchase what their right hand (treasury) is issuing.

Part of the emergency bailout procedures taken in the dying days of 2008 included extension of credit beyond mere transfers of debt. In the midst of violent volatility, it never occurred to investors that trying to expand credit is hardly a solution for a problem defined by excessive levels of credit. The appropriate analogy is ‘trying to put out a fire with gasoline.’

Our experiences with the Greenspan Put are instructive. It was Greenspan’s untested thesis that bubbles were best left to inflate to failure rather than be deflated prior to bursting. When such bubble had burst, the Fed would supply liquidity and cut interest rates in a policy that hardly promoted symmetry of returns to excessive versus responsible behavior. The phenomenon of interest, however, was the efficacy of interest rate policy. Experience has found that the initial rate cut has significant impact at least on risky asset markets, the second less so, and the third and subsequent rate cuts tend to be less and less effective. Interest rate policy it would seem is subject to rapidly diminishing marginal returns.

Since 2009 the Fed has bought ABS and it has bought US treasuries. The impact of the first round of debt purchase had a strong positive effect on risky asset markets and helped to pull the economy out of recession, at least on traditional measures of output growth. If one subtracts debt from GDP, it is questionable if the Fed’s action was very effective. Upon cessation of the first debt monetization risky assets fell back into volatile sideways trading only to be buoyed by a second effort of debt monetization this time targeted at US treasuries. It is no coincidence that the recent volatility in markets has coincided with a cessation of so-called QE2.

That the market envisages or anticipates a QE3 should be a sign that the economy and its capital markets are vulnerable and incapable of resuming pre crisis trend growth in the absence of bailouts. This alone should blunt the impact of a QE3. Rational or rationalized expectations would imply almost no impact coming from a QE3. Whatever asset price inflation another round of quantitative easing might inspire, a concomitant debasement of the underlying accounting currency would take away in real terms. The operation of QE creates a hierarchy which puts real assets such as gold first and low to zero yielding assets such as cash last. The exception to this hierarchy is the instrument by which the QE is being implemented.

Expectations for the Future:

– A continued (not a double dip) recession in US and Europe

– Emerging markets such as China slowing down as infrastructure build slows

– A more correlated global cycle biased towards weakness

– More debt transfer and transformation

– Debt deleveraging and pay down

– Trade protectionism

Caveat:

In times of great economic stress, observers can only base their analyses on a stable geopolitical environment. Social and political stability can be at risk when economic stress reaches beyond certain levels. The efforts to resuscitate economies with unconventional policies such as debt monetization carry side effects which are not always predictable or desirable. One of the side effects of debt monetization is fiat currency debasement. It expresses most evidently in hard assets, in real assets, in agricultural products and food. Food price inflation amid shrinking real output and persistent unemployment can precipitate social and political change, sometimes violently. The complexity of capital and derivative markets and the global financial system also provide ammunition for politically motivated debate. The scale of the debt problems and the grubby deals that incumbent governments have had to enter into to deal with them introduce considerable political risk. A shrinking economic pie just makes all parties less patient and more intolerant.