The Federal Open Market Committee (FOMC) announced, on November 3rd, its intentions to repurchase some $600 billion worth of Treasury securities over the forthcoming eight months. This 2nd round of “quantitative easing,” referred to in the popular media as “QE2,” is viewed as a means of addressing continued anemic economic growth in the wake of the so-called subprime mortgage crisis.

This action invokes many questions. Will this policy be effective in promoting economic growth? Is $600 billion sufficient to do the job or will the Fed follow QE2 with QE3? What does this mean for interest rates? Is this policy inflationary? How will this impact the value of the U.S. dollar and foreign trade flows? How will this affect the commodity markets?

Anemic Economic Growth – As a backdrop to the Fed’s policy action, consider recent domestic economic performance. The recovery from the financial crisis, commencing in the 2nd half of 2009 has decelerated in 2010. GDP rebounded from the 1st quarter 2009 low of -6.4% to a healthy +5.7% during the 4th quarter 2009. But the preliminary read for 3rd quarter 2010 GDP has slipped back to +2.0%.

While unemployment has backed off from the 26-year high of 10.1% recorded in October 2009, it remains alarmingly high at 9.6% and has risen slightly over the past several months.

These conditions have prompted some observers to speculate regarding the prospects of a “double-dip” recession. Certainly, there are many economic headwinds including continued weak income growth; the precipitous drop in money velocity; large “overhangs” in terms of underutilized industrial capacity and unsold housing inventories; fiscal distress at the state and local government level; continued soft credit market conditions; and, the conclusion of federal stimulus programs, e.g., the $8,000 first-time home buyers’ tax credit.

Recent performance of the CPI lends credence to these fears. Inflation rebounded from the -2.0% year-on-year of the CPI reported in June 2009. But both overall and core (ex-food and energy) CPIs have slipped to near +1.0% on an annual basis.

Other observers link the decline in aggregate domestic demand with the possible onset of a “deflationary spiral” or “debt deflation” where reduced demand leads to reduced prices, reduced production, which leads to still further reduced demand, prices and production.

Fed Mandate – The Fed’s mandate is simultaneously to pursue “maximum sustainable employment” along with “price stability.” These objectives are, of course, inherently contradictory. Easy monetary policies generally result in enhanced economic activity and employment – but this comes at the risk of heating up inflation. Tight monetary policies tend to weaken the economy resulting in reduced employment – but with the benefit of reducing inflationary price pressures.
Current unemployment at 9.6% is well above levels considered consistent with "maximum sustainable employment," which might loosely be defined as falling in the range of 5-½% to 6%. Current inflation at +1.0% on an annual basis is below a level consistent with the Fed’s mandated objective of "price stability," which might loosely be defined as falling in the range of 1-¾% to 2%. These circumstances would seem to prescribe further easing on the part of the Fed.

**Monetary Policy Tools** - The target Fed Funds rate has historically been the major policy tool of the FOMC. In response to the subprime mortgage crisis, the Fed aggressively eased by pushing the target Fed Funds rate from 5-¼% in September 2007 down to 0-0.25% by December 2008. Target Fed Funds remain at 0-0.25% and all indications from Fed Chairman Ben Bernanke suggest that the rate will remain at that level at least into late 2011 and possibly beyond.

With the target rate effectively at zero, the FOMC appeared to retain no further ability to ease or impact monetary policy and economic conditions. But while the short end of the yield curve generally is administered by Fed policy, the long end of the yield curve where Treasury notes and bonds reside, is generally market driven and keyed to inflationary expectations.

**Enter Quantitative Easing** - The Fed was not deterred in its interest to invigorate the economy. While flexibility further to reduce short-term rates is constrained, the Fed may engage in open market operations including the purchase of long-term securities, presumably funded with expansion in money supplies. Thus, between December 2008 and March 2010, the Fed purchased some $1.7 trillion worth of U.S. Treasury, Agency, and mortgage backed securities (MBS) as the 1st round of quantitative easing.

Arguably, the Fed staunched further economic deterioration with that first round of quantitative easing. This injection of liquidity resulted in reduced private credit rates and higher asset prices in all economic sectors. Observers estimate that the Fed effectively reduced Treasury rates by at least 0.5%. Of course, this had the further effect of inflating the Fed’s balance sheet and money supply.

**QE2** - In light of anemic economic conditions, the FOMC stepped up again on November 3rd with an announcement that it would repurchase another $600 billion of Treasuries over the next eight months. Note that the Fed is further pursuing a program to reinvestment principal payments from agency and MBS holdings of $250 to $300 billion in coming months as well. This would place Fed purchases in the range of $850 to $900 billion by mid-year 2011.

Observers suggest that such easing may boost GDP growth by perhaps 0.5% in 2011. But is this enough? Some economists had been forecasting that unemployment could rise to 10% with inflation falling to 0.5% by the 3rd quarter of 2011. Thus, it is quite possible that QE2 might be followed by a third round of quantitative easing during the 2nd half of 2011. While the value of any "QE3" is indeterminate, some analysts speculate that some $1 to $2 trillion might be committed to such a program in order to expect any significant impact.
Debt Destruction and M2 Velocity – The creation or destruction of debt is frequently linked with levels of economic activity. While issuance of Treasury debt doubled from 2008 into 2009, the aggregate level of domestic debt has languished.

After many years of consummate spending, consumers and businesses now seem intent on lightening debt loads and pursuing a financial surplus. This is reflected in Commerce Department reports suggesting that the Household Debt Service Ratio (DSR) fell to 12.1% while the Financial Obligations Ratio (FOR) fell to 15.5% by the 2nd quarter 2010.1

This trend is further reflected in declining M2 Velocity, defined as the current GDP Index divided by M2 Money Supply Index. M2 Velocity currently is at its lowest point since 1990. Consider that as the U.S. savings rate increases, money sits idle at banks; it is not lent out or reinvested back into the economy. At current market rates, those additional deposits are earning near-zero interest. Every dollar entering this cycle is therefore unproductive and has the impact of contributing to further declines in GDP.

In order to maintain economic stability, any private sector surplus need be offset by a public or foreign sector deficit (where total income is less than total spending). If balance is not maintained and if all sectors run at a fiscal surplus, economic output will tend to decline. If all sectors run a fiscal deficit, the economy will tend to overheat.

The federal government is constrained in the amount of deficit spending it can incur. As a general rule, we believe that the public and, ultimately, their representatives in the legislature, are uncomfortable with the prospect of deficit spending approaching 7% of GDP. Thus, the aggressiveness of “debt destruction” on the part of the private sector bodes for slowing aggregate demand to the extent it may be unlikely that the federal government can muster the political will to run deficits up to 7% or beyond.

Debt Deflation – Current conditions inspire a review of the theory of “debt deflation” as formulated by noted economist Irving Fisher during the throes of the Great Depression.2

Fisher suggested that economic declines may be traced to a decline in the aggregate level of debt (“debt deflation”). Where “over-indebtedness” exists, this may lead to large-scale liquidation, triggered by economic shocks. This may lead to the following chain of circumstances.

- Liquidation of debt leads to distressed sales, then
- A contraction of deposit currency, as loans are paid off, and to slowing velocity of money circulation, then
- Declining prices, then
- Still greater declines in the net worth of businesses, precipitating bankruptcies then

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1 The Debt Service Ratio (DSR) represents the ratio of household debt payments relative to disposable personal income where debt consists of payments on outstanding mortgage and consumer debt. The Financial Obligations Ratio (FOR) adds auto lease payments, rental payments on tenant occupied property, homeowner’s insurance and property taxes to the DSR.

• Declining profits, then
• A reduction in output, trade and employment of labor, then
• Pessimism and loss of confidence, then
• Hoarding and more slowing of velocity, then
• Interest rate disturbances including declining nominal rates and advancing real or commodity rates of interest.

Fisher’s solution to debt inflation was “reflation” as a means of breaking the “vicious spiral.” The alternative would be “needless and cruel bankruptcy, unemployment and starvation.”

Current Fed Chairman Ben Bernanke criticized Fisher in 1995, suggesting that his “idea was less influential ... because of the counterargument that debt deflation represented no more than a redistribution from one group (debtors) to another (creditors).” Others, in turn, criticize Bernanke’s interpretation of Fisher as minimizing the central role that debt destruction may play in the deflationary cycle. In any event, current circumstances and Bernanke’s QE2 program suggest that Fisher’s work may take on a new life.

Clearly, additional money supplies can devalue the U.S. dollar in international exchanges. While that may boost U.S. exports, it further implies the risk of rising energy and food prices, where prices have been pressured higher in recent years by burgeoning demand from “emerging market” nations including China and India.

Note that the value of gold as a universal “store of value” has advanced to new all-time levels above $1,400 per ounce, at least in part as a reaction to QE2.

**Risks of QE2** – The Fed’s initiative has been roundly criticized as weakening the U.S. dollar (USD) and possibly leading to untoward inflationary pressures. U.S. international trading partners have not received QE2 warmly.

The strongest criticism has come from German Finance Minister Wolfgang Schauble, suggesting, at the G-20 meeting in Seoul on November 8th, “with all due respect, U.S. policy is clueless ... It’s not that the Americans haven’t pumped enough liquidity into the market. Now to say let’s pump more into the market is not going to solve their problems.” Others have suggested that U.S. policy is hypocritical insofar as the administration has criticized the People’s Republic of China (PRC) for pegging the Chinese Renminbi at artificially low levels while effectively devaluing the dollar by printing new money supplies. This policy has been reflected to a certain extent in rising foreign currencies vs. USD.

**Conclusion** – So what does QE2 mean with respect to economic conditions? Some have suggested that the program is like “pushing on a rope” in the sense that the injection of additional liquidity absent productive applications of that liquidity is futile. Others believe that QE2 will have an impact but that the scale of the program may need to be expanded in order to exert a near-term and readily observable impact.

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In any case, current levels of economic uncertainty, which the FOMC is attempting to address with the QE2 program, generally provide an impetus for use of financial and commodity derivatives, such as those offered by CME Group, to manage risk in uncertain times. CME Group’s diversified array of derivatives products serve the vital economic functions of price discovery; and, as vehicles to manage risks on the part of commercial market participants. For more information, please contact …

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