What is Quantitative Easing?

Foundational Principles

To understand Quantitative Easing (QE), it is helpful to go over a few basic economic concepts. First, there are two forces constantly at work that permeate all aspects of the economy and stock market. This includes:

1. Supply is how much of something there is. This could be a product or a service. It can also mean the amount, or how many shares, of a stock are available.

2. Demand is how much of something is wanted. If many people want a product or service, the price will go up. If there is not much desire for a product or service, the price will go down. The same principle applies to stocks. In the stock market, if there are more buyers than sellers, prices will go up. If there are more sellers than buyers, prices will go down.

Supply and Demand work together and coexist. Very simply, if there is a set amount of something (Supply) and if it is wanted or not, this creates various demand levels.

If Supply and Demand are equal, prices stay the same.

If there is more Supply than Demand, prices go down.

If there is more Demand than Supply, prices go up.

The above concept can be applied to anything and is not only applicable to products and services. For example, various financial instruments are subject to the forces of Supply and Demand. However, for the sake of this discussion, currency (money) and the stock market will be used as examples to understand the concepts.

Other definitions to understand include:

- Monetary Policy is set by a central bank. In the US, this is the Federal Reserve (The FED). Their job is to “promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates." This is done in many ways, but the two main monetary policy methods are setting interest rate targets and expanding or contracting the Money Supply.

- Fiscal Policy is set by the federal government. Obviously, in the US, this is the US Government, specifically Congress. Tax and spending policies are implemented, modified, and repealed as seen fit.

What is Quantitative Easing (QE)?

QE is a form of unconventional and non-traditional monetary policy. QE is only used when the situation dictates the need. However, since 2008, QE is becoming more and more "normal." At one time, QE was seen as radical, intrusive, and beyond the scope of what the American Republic should endure, since QE involves an increase in governmental control. Today, it is seen as a necessary "go-to" tool that can be quickly enacted. The alternatives to QE depend on capitalistic tendencies of the economic ebbs and flows that are worked out through the system itself.

QE promotes the concept of a "short-term gain" while potentially leading to "long-term pain." On the other hand, capitalism promotes a "short-term pain and long-term gain" approach.

Another cliché, "Pay me now or pay me later," is also true. Somewhere down the line, the unavoidable payments will be due. The balance between enduring pain in the short-term (now) versus more significant pain in the long-term (later) is a source of great debate.

Many schools of economic thought promote various theories. Economics is a discipline mainly of ideas. Actual implementation can only be enacted in real-time under natural conditions. Unintended consequences, either positive or negative, are impossible to foresee with certainty.

The QE Process

1. Money Creation

Quantitative Easing (QE) begins when a central bank, such as the Federal Reserve (the FED), digitally creates money, which is used to buy long-term securities such as bonds and mortgage-backed securities from the open market.

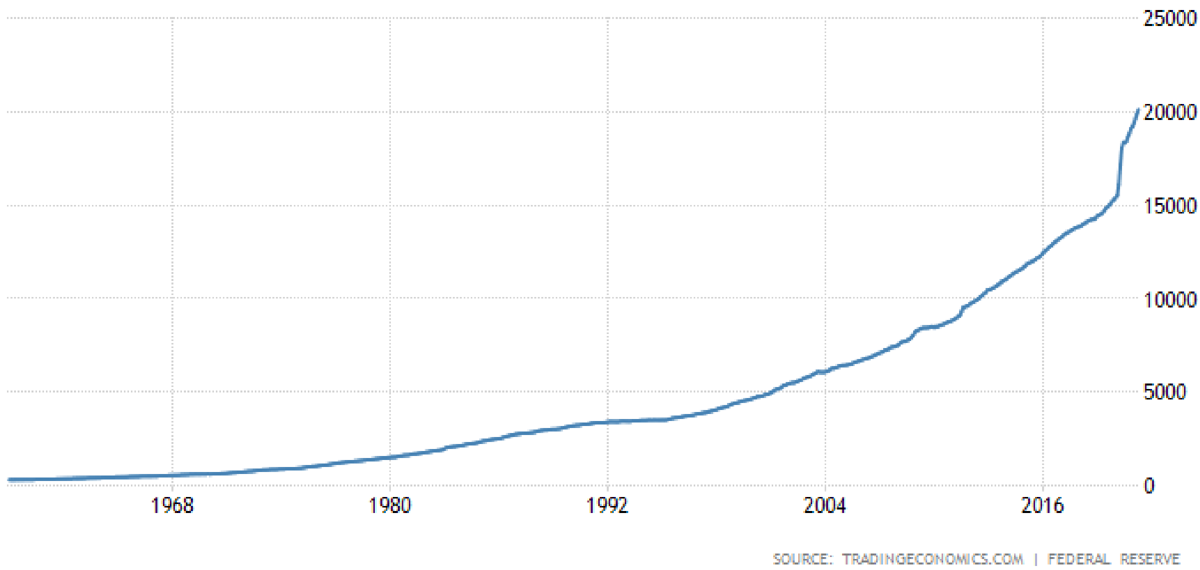
The US Dollar is a fiat currency which means that it is not backed by anything. Until 1971-1973, the US Dollar was backed by gold. Once the US abandoned the gold standard, the US Dollar became a fiat currency and has remained such ever since. Fiat currencies are backed by the "goodness" of a government rather than by a physical commodity such as gold or silver.

Naysayers see fiat currencies as very dangerous, irresponsible, and reckless. Claims are made that fiat currencies will eventually lead to ruin in the US. Despite that, most global governments have adopted fiat currencies.

2. Money Supply

The Money Supply is the total amount of money in circulation or existence for a country. During times of economic crises, the Money Supply is increased in order to encourage lending, investing, and spending.

When new money is created, this adds additional cash and liquidity to the amount already in existence. The hope is that the new money will quickly help improve the economy.



The desired outcome is to combine the additional new money with low interest rates to promote spending and growth. Until 2008, the process of raising and lowering interest rates to control or stimulate economic growth has been seen as effective. However, in 2008, it was decided that lowering interest rates to stimulate economic growth was not enough and that the FED needed to do more. Therefore, Quantitative Easing (QE) was implemented. From 2015-2019, the US economy was growing, so it was decided to stop implementing QE in 2014 and start to raise interest rates in 2015. As a result, the FED began to taper, or decrease, the level of intervention.

Everything changed in 2020 with the COVID-19 Pandemic as the US economy, and world economies were basically shut down. Therefore, it was deemed necessary to lower interest rates to zero AND implement QE to handle the crisis.

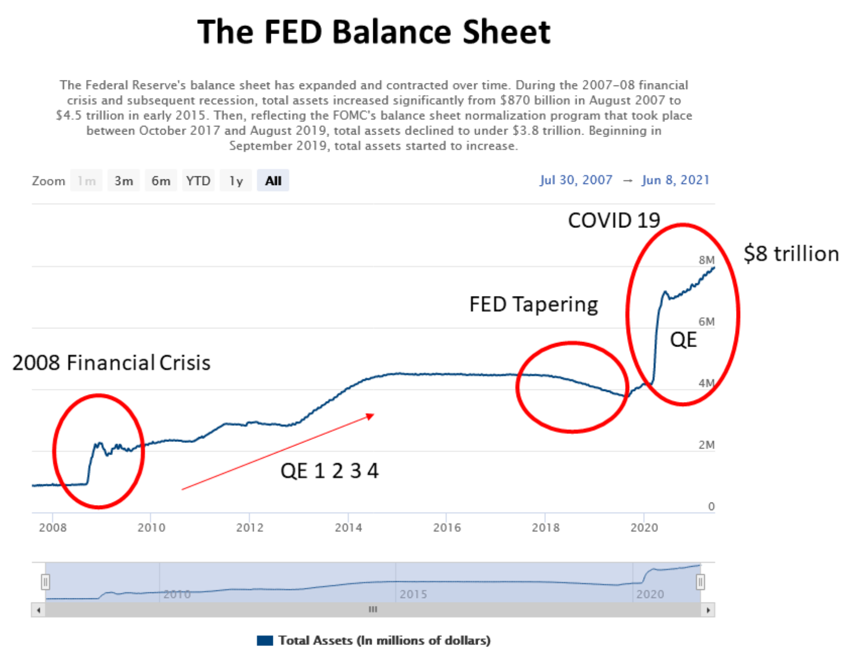
Some see QE as a necessary and wise action with few viable alternatives. Others feel the economy should be free to work this out by itself. They feel QE is government intervention that is too extreme and will lead to much future pain.

3. Bonds Purchases

The Fed introduces the newly created money into the economy by purchasing government bonds. Bonds are loans that pay an interest rate. Since money is borrowed, bonds are debt instruments. Literally, when buying bonds, the US government is using its own funds to purchase its own debt, which is something an individual or corporation could not do without going to prison. However, the US Government has the power to do this.

When bonds are purchased in large quantities, prices go up, which pushes interest rates down. Lower interest rates often help to stimulate economic growth since money is cheaper to borrow and more readily available. For a deeper explanation of how interest rates impact stock prices, please click here.

The FEDs Balance Sheet



As the FED buys bonds, the balance sheet is expanded. Conversely, when the FED sells bonds, the balance sheet is contracted. The Fed Balance Sheet is updated regularly and should be watched.

Information concerning the FED's balance sheet can be found on Google by entering: "Federal Reserve Balance Sheet."

Link
https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm

Corporate Bond Purchases

Additionally, in response to the Pandemic, the FED also began purchasing corporate bonds. For many, this may seem logical and necessary. This can help private companies weather the storm of the economic crisis much easier. Others see this as very dangerous since the mixing of private corporations with public policy is one of the tenants of fascism.

Fascism?

Fascism is a word that is thrown around a lot these days, yet few have any idea what it truly means. To try and provide an applicable concept of what fascism is like in today's world, it is necessary to use the proper context since fascism can be implemented differently.

Fascism is when a government, typically ruled by a dictator but could also be a group of powerful people, controls the rights of governmental institutions as well as private industries and individual citizens. Commonly, freedoms such as free speech are often limited or eliminated, and there is an overt concern over racism and racist tendencies.

Fascism also has a closely related philosophy called Democratic Socialism. Most know this as Nazism led by Hitler in Germany in the 1930s which led to the start of World War II in 1939. Mussolini's and Hitler's Fascism and Democratic Socialism may have varied slightly in Italy and Germany during the 1920s and 1930s, but many believe this is precisely what is currently happening in the US.

Many welcome such changes, as long as unemployment benefits continue, stimulus checks are received, and distraction-laden news permeates the news cycles with irrelevant stories. But, as long as most individuals have “theirs,” it is felt that the move toward a totalitarian system can continue. How this scenario is played out will have a significant impact on the economy and stock prices.

The FEDs Responsibilities

The FED was created in 1913 to do three main things:

1. Achieve maximum employment
2. Promote price stability
3. Encourage moderate long-term interest rates

Usually, the FED helps control monetary policy by setting a target rate for short-term interest rates. Since the 1980s and ’90s, this has typically been effective.

Where Has Quantitative Easing Been Used?

The US is not the first country to implement Quantitative Easing (QE). QE has been enacted many times throughout history. Unfortunately, QE ultimately has a perfect losing record in which things do not end well. The hope is that “this time it will be different.”

Japan:

In recent times, Japan was the first to implement QE in response to the 1997 Asian Financial Crisis. Government programs similar to what would eventually be called QE started in the late 1980s. The Bank of Japan set low interest rates and applied easy monetary policy, but little consistent economic growth was seen. In 2008, Japan went down with the rest of the world during the Financial Crisis. Unfortunately, all government intervention attempts have provided little, if any, of the anticipated assistance to the present day.

US:

As referred to earlier, QE was implemented in the US from 2008-2014 in response to the housing meltdown and recession. In 2020-2021, QE is currently being implemented in response to the COVID-19 Pandemic.

Switzerland:

The financial crisis in 2008 hit countries such as Switzerland very hard. QE was enacted for many of the same reasons QE was used in other countries.

UK:

In 2016, the UK experienced Brexit as UK voters decided to leave the European Union (EU). As a result, QE was enacted, but the severity of the situation was not as bad as anticipated.

Hyperinflation

One of the biggest fears caused by QE is inflation. Inflation is when more dollars are chasing too few goods or services. Inflation is a more normal offshoot of a growing economy and is typically seen as healthy. However, if inflation increases too much, this can lead to hyperinflation. Unfortunately, history has numerous sad examples of when this occurred.

<u>Zimbabwe</u>

In the early 2000s, Zimbabwe experienced hyperinflation. The government incurred excessive debt with low economic growth as well as political corruption. Currency valuation declined, causing inflation to soar.

Germany

Germany was blamed for causing World War I, as stated in the Treaty of Versailles in 1919. It is still thrown around today whether or not this is true. The actual causes of World War I are still discussed and debated. Regardless, in the 1920s, Germany was required to pay reparations to countries including France, England, and the US, which hurt the confidence and pride of most Germans. Additionally, the economy in Germany in the 1920s was in terrible shape with massive unemployment and very high inflation, or hyperinflation. It is somewhat debatable, but the horrible conditions helped pave the way for Hitler's rise, who ultimately came to power in 1933. Basically, he said that German greatness would be restored if he was Germany’s leader. Coupled with the impact of the Great Depression of the 1930s, World War II would start in 1939.

Covid-19

In response to the COVID-19 Pandemic, on March 15, 2020, the FED announced a QE plan of over $700 billion. However, when things looked to be improving, the FED started to reduce its balance sheet in April 2020.

Things looked bad again. On June 10, 2020, The FED committed to buying at least $80 billion a month in Treasuries and $40 billion in mortgage-backed securities indefinitely. Combined, the FED is currently purchasing $120 billion each month.

On March 11, 2021, another $1.9 trillion stimulus package was passed, which may include more QE.

Drawbacks of QE

As powerful as some government entities may be, a central bank cannot force banks to increase lending or force borrowers to obtain loans and/or invest. At least not yet.

Currency Crisis:

Historically, QE has led to currency crises, yet has not been witnessed in the US so far. A domestic currency may become devalued with low to non-existent interest rates and an increase in the Money Supply. In the US, the more US Dollars there are in existence, the "less precious" they become. More US Dollars are needed now to equal what was needed in the past. This makes the value of each US Dollar "worth-less."

Below is a current chart of the US Dollar Index.

Benefits of a Weaker Currency

A devalued currency can help domestic manufacturers because exported goods are cheaper. For example, products produced in the US are more desirable than those in other countries since they are cheaper. This helps the US Economy because there is a greater demand for US products and services.

Imports are more expensive when a domestic currency is devalued. For example, in the US, more US Dollars are needed to purchase foreign goods and services, making them more expensive and less attractive.

Inflation, Hyperinflation, and Stagflation

When there are too many US Dollars, this decreases the value of each US Dollar. Therefore, to make up for the shortfall, more US Dollars are needed, which can lead to inflation, hyperinflation, or stagflation.

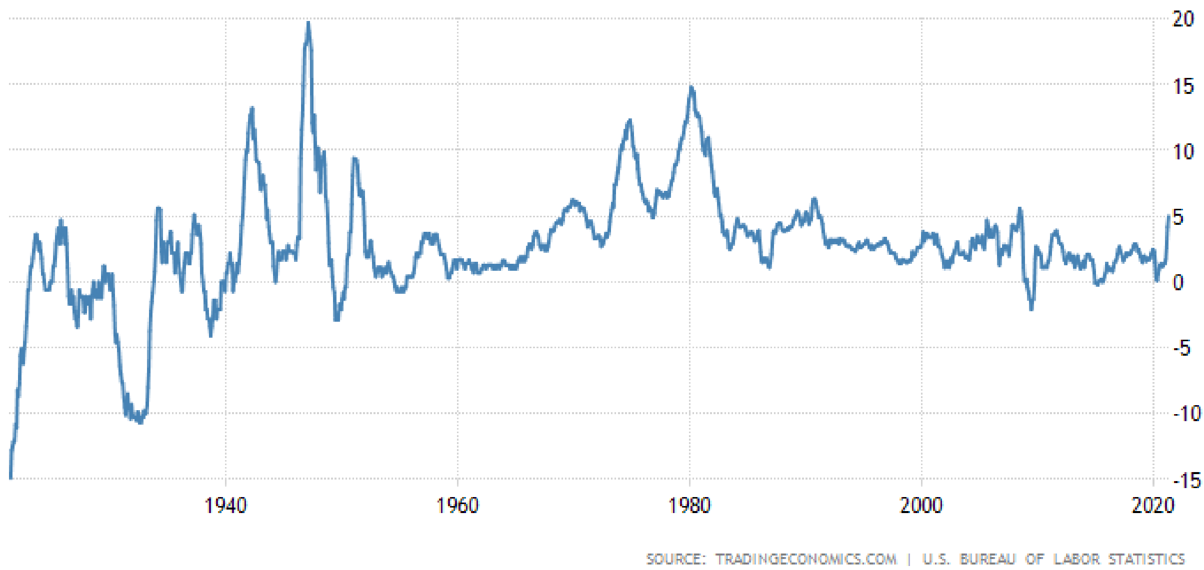
Inflation is always an economic concern and can impact all citizens. However, inflation is seen as healthy and necessary as long as it remains under control.

Hyperinflation is out of control inflation. This can be very bad, as witnessed in Zimbabwe and Germany.

Stagflation is another concern and occurs when there is high inflation but little to no economic growth. This was experienced in the US during the 1970s.

There was a genuine concern that inflation, in its various forms, would appear after the 2008 Financial Crisis. However, since 2008, these concerns have not been substantial.

The chart below shows the current official inflation rate.



Another factor is the stimulus checks issued by the US Government that give money directly to people. This is often referred to as "helicopter drops” as more and more money is pumped out, hoping to stimulate economic growth and satisfy citizens, at least temporarily.

Many see the precedents set by the response to the 2008 Financial Crisis and re-enaction of similar reactions to the COVID-19 Pandemic as a cause of future inflation. However, this has yet to be seen and is debated daily as this scenario is played out.

Conclusion

QE has been implemented numerous times in the US and is currently being implemented to combat the economic fallout caused by the COVID-19 Pandemic. The risk of inflation or stagflation is present as the US Dollar loses value but has not been a concern to date. Investors should have a plan in place in case actions are needed. It is necessary to watch what is happening as the story unfolds. There are numerous examples of QE implementation, but the success rate is zero. Will the US suffer the same fate? Only time will tell.