

Friday, March 20, 2009

[Some of my views on the Fed move to buy treasuries.](#)

The Fed announced this week that it will spend \$300 billion buying US treasuries, presumably to bring down interest rates and to increase market liquidity (weren't treasuries already liquid?). In the same week we have seen a drop in the Dollar and a significant rise in the oil price, the gold price and other commodity prices. OPEC probably can't believe their luck, having only just announced that they would not be cutting production quotas further in light of the severity of the economic downturn.

Whilst it is early days, the rise in commodity prices raises some significant questions about the targeting and validity of the Fed policy. As well as bringing down interest rates the buying of treasuries is also another way of putting money back into the financial system, with the aim of feeding through to the wider economy and keeping inflation alive (specifically to avoid deflation).

Real world inflation is generally driven by two factors (ignoring specific supply bottlenecks) that cause prices to rise: wage growth and credit expansion. The 10 year US treasury yield is currently 2.6% which would suggest that it is not high interest rates that are stopping credit expansion. Extra liquidity in the system could help but what is really needed would be widespread take up of new credit by companies and consumers (not just a rolling over of existing debt, which wouldn't be expansion). I would argue that most companies and consumers are still in deleveraging mode and will be for some time. I think credit expansion on a meaningful scale is unlikely to happen yet, maybe not for a long time.

Will the new Fed spending encourage wage growth? Not unless companies start experiencing increased demand (which won't happen without greater disposable income for consumers, which itself would be a result of higher wages or lower outgoings). Wage demands that are satisfied by employers, are driven by rising prices in an economy but only where they arise from increased demand for goods and services. In the current environment workers will want higher wages because the cost of basic materials such as food and energy are rising but will employers be inclined to give them without a commensurate rise in demand for the goods they produce? Long gone are the days when an employer such as Henry Ford believed that paying higher wages to his employees would enable more of them to buy his cars.

So what if the Fed's policy actually turns out to be damaging to the economy? In the period of a few short days the net result of the Fed's treasury-buying policy is that it has pushed up oil, metal and various other food and energy commodities. The costs of production just got higher. So far, investor demand for inflation-hedging commodities has been sufficient to move their prices in anticipation of the higher inflation rates that could follow. However, if the net result of the Fed's policy is to push up commodity prices initially, but it doesn't feed into wages or credit expansion for the reasons mentioned above, then it is likely to put a brake on any hint of economic recovery that might have been occurring.

We are in unprecedented times and it is entirely feasible, in my humble opinion (!), that the Fed may be on the wrong path and it may actually prolong the pain of a recession. Higher prices are only desirable in the current situation if they lead to wage growth and reasonable credit expansion but if they only succeed in pushing up producer input prices before economic

demand recovers then they are unlikely to get a warm welcome from either consumers or companies.