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Tapering the printing press

Snapshot

A funny thing happened while everyone was winding down for the Christmas break. The US Federal Reserve began winding back the biggest economic stimulus program in history. This news may have failed to excite Australians in barbecue mode, but the effects were soon felt from Boston to Buenos Aires and Brisbane.

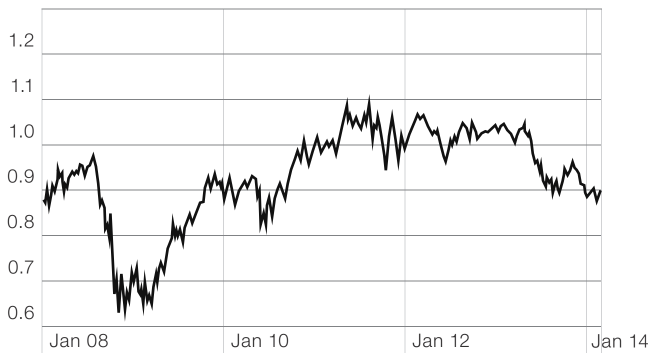
Federal Reserve chairman, Ben Bernanke announced in December the US$85 billion a month stimulus program known as quantitative easing would be wound back – or tapered - by US$10 billion a month. If all goes to plan it may be shelved completely by the end of 2014. Ben Bernanke has since been replaced by Janet Yellen who helped develop the strategy and is unlikely to change course.

What is quantitative easing?

Quantitative easing refers to the US central bank's policy of printing money* to buy government bonds and mortgage-backed securities. The aim was to pump money into the moribund economy and stimulate growth in the wake of the global financial crisis (GFC). The effect was to keep interest rates low while depressing the US dollar to make US exports more attractive.

The first round of quantitative easing began in December 2008 and finished in June 2010. A second round (QEII) followed from November 2010 to June 2011 while the third and final round began in September 2012. As the graph below clearly shows, each injection of stimulus inflated the Australian dollar against the greenback.

Australian dollar



Source: www.tradingeconomics.com | OTC Interbank

Normally central banks use interest rates as their primary tool to manipulate the economy. Cutting rates tends to promote economic growth by encouraging households and businesses to borrow; lifting rates subdues an over-heated economy.

If rates are cut too aggressively there is a risk that prices of goods and services will rise sharply, causing a spike in inflation. But after the GFC, Americans were so focused on reducing debt they could not be tempted to borrow, even when rates were cut to zero.

Hyperinflation in Germany

Critics of a stimulus strategy based on money printing argue that it results in inflation or, in extreme cases, hyperinflation.

The best-known example of hyperinflation occurred in Germany between the wars. The German government printed money and issued government bonds to pay for World War I. When it lost the war it was ordered to pay crippling war reparations, so it printed more money. Industrial and farm production collapsed, leading to a shortage of goods. And because there was so much cash in circulation and so few goods, prices spiralled out of control.

In December 1922 one US dollar was worth 2,000 marks; by August 1923 it stood at more than one million marks. Not surprisingly, many Germans preferred to be paid in bread and sausages.

After the taper

Although the worst fears about quantitative easing were unfounded, it is difficult to say what would have happened if it had not been introduced. What is not in doubt is the Federal Reserve would not be tapering if it did not believe the US economy was on the mend.

Ironically, the removal of monetary stimulus in the US should stimulate growth elsewhere, including Australia, although not without some hiccups along the way. When the taper was announced, investors fled emerging nations for the perceived safety of the United States. South Africa, Turkey, Brazil and India were forced to raise interest rates to support their currencies while Argentina devalued its peso.

The news is more positive for Australia. As US interest rates and the dollar gradually rise to more normal levels, the Aussie dollar should continue to fall. This will make our exports more competitive and strengthen the non-mining sectors of our economy.

If you would like to discuss any of these issues in the light of your investments, please give us a call.

* ie injecting a specific quantity of funds into the financial system each month

Phillip Thompson of Rise Financial
25 Michell Street
Monash, ACT 2904

P 02 6292 0015
F 02 6292 0071
E phil@risefinancial.com.au
W www.risefinancial.com.au