



L. R. Levin Consulting, L.L.C.

Newsletter

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Is Fed Chair Bernanke's Defense Of Quantitative Easing Believable?

After Fed Chair Bernanke first made his suggestion in a speech at the annual Jackson Hole, Wyoming, Federal Reserve conference, we explained why quantitative easing and the other 3 possible Fed intervention policies were bad ideas. ([Click Here To See, For Example, Our October 2010 Newsletter](#)) Since then the Fed has announced that it intends to buy at least \$600,000,000,000 in U.S. Treasury Bonds.

The Fed's quantitative easing approach has come under increasing attack both domestically and around the world. In a speech in Frankfurt, Germany, Bernanke defended his aggressive pumping of the U.S. dollar into the economy by attacking China and other emerging market countries

for keeping their currencies cheap and starting what amounts to a trade war.

Is the Fed Chair's defense of his policy of creating dollars out of thin air believable? As one reads his attempt to justify his actions based on China's behavior, we are reminded of the old story about the minister giving a eulogy for a man that just died. As the minister spoke about the bible's teachings on the meaning of death, he asked those gathered to speak up and recount the deceased's good deeds and attributes.

The silence was deafening. Finally the minister in desperation, never before having had this happen to him at a funeral service, pleaded "has no one a nice thing to say about the deceased?" Whereupon, a man in the back of the room blurted out, "at least he was better than that murdering scoundrel, his brother."

The Fed Chair appears to confuse China's role in what may only be described as a major international monetary attack on the U.S. with

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whether quantitative easing is good sound economics on the Fed's part. The two are quite different questions.

There is no question that China has been attacking the U.S. economically, including trying to undervalue the Yuan and replace the U.S. dollar as the medium of international trade. Just recently China has added Turkey to the growing list of countries (including Russia & Brazil) that will no longer use the U.S. dollar in their trading of goods and services with China. Rather these countries will trade in Yuan.

Moreover, the Yuan remains extremely low in relation to the U.S. dollar, helping China gain a trading advantage against the U.S. and Europe. But quantitative easing has hurt rather than helped this situation. Bernanke's pointing to China's poor behavior seems an odd way to defend his policies.

It would make no sense to acquit one of two joint defendants in a gruesome murder, because the other participant's behavior was even more outrageous. Apparently, Bernanke is pleading guilty to artificially cheapening the value of the U.S. dollar, because China is undervaluing the Yu-

an. Sadly, this only demonstrates that at this point in the economic cycle the Fed's policy will be harmful to U.S. long term interests.

If combating China's aggressive undervaluing of the Yuan was Bernanke's purpose, the recent G 20 meeting certainly demonstrated the failure of quantitative easing. By adopting a policy of quantitative easing when it did, the Fed insured that at the G 20 conference, the world financial leaders would not focus on the very real problem that China represents, but on us. This alone represents a very major failure of Fed policy.

The world leaders at the recent G 20 conference attacked the quantitative easing policy as a threat to a stable world economy. For international finance to work, a stable reliable medium of exchange is critical. The U.S. dollar has served that function since the end of World War II.

The world leaders clearly recognized that the Fed's policy had totally lost sight of the importance of a stable U.S. dollar and a rational domestic economic policy as an anchor for the economic world order. None of our leaders were prepared to deal

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with the reality of drifting U.S. economic policy.

As we have discussed before, the current quantitative easing is causing a misallocation of U.S. investment dollars. By reducing the value of the dollar, it causes U.S. and foreign capital to be invested in countries like China, where there is a better return on investment than in the U.S..

For example, take the impact of investing in a U.S. company or a Chinese company. If you invest in a U.S. company and get a 3% return for every dollar invested you get 3 cents. If you invested in a Chinese company and the U.S. dollar falls 30% compared to Chinese currency and you get the same 3% return on the dollar invested, you not only get 3 cents increase in value, but the added value of more dollars when you bring that investment home. In this example, the 3% return would be worth 4 cents, a penny more, in U.S. dollars than the return on your domestic investment. Foreign leaders were quite aware that this could easily cause asset bubbles abroad leading to further international economic dislocations.

With near uniform reaction, economists including our strategic

partner, the Institute For Trend Research (“ITR”) have predicted that quantitative easing “will not have much of an impact on boosting economic growth.” Moreover, the decrease in the value of the dollar caused by quantitative easing will drive up raw material costs for the U.S. Take, for example, the price of oil. When the value of the dollar falls, the cost per barrel of oil goes up.

Chemicals from oil drive manufacturing and the U.S. economy. If the cost of oil (and other raw materials) goes up it has a highly inflationary impact on the U.S. economy and creates a squeeze on business margins.

These types of raw material cost increases take purchasing power (liquidity) out of the economy. At this stage of the cycle, that retards employment and putting the 26 million unemployed back to work. As ITR put it in its recent economic report, “this suggests a coming squeeze on profits for businesses that aren’t prepared through either increasing efficiencies, the ability to push through finished goods price increases, or lowering indirect costs as we head through 2011.”

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In fact, the Fed's policy hasn't even reduced long term treasury rates, one of its key purposes. Currently, given the near universal adverse reaction to the Fed's policy, long term treasury rates have actually increased.

What should the Fed be doing? Historically, the Fed would be pursuing a very different course today. The real problem in the U.S. economy is not liquidity, but demand for goods and services. The economy is growing, but very slowly.

The U.S. suffers from a very real decline in manufacturing. We lack the productive capacity to manufacture products that are desired domestically or internationally. Our biggest exports are food products.

We are essentially at full capacity in terms of food exports. For lower dollar value to increase job producing exports, we need to manufacture and offer products that meet national or international demand. The Fed should be focused on how to encourage this both through policy and use of its pulpit.

The idea of increasing any taxes at this point in the economic cycle should be seen as job and demand depressing. Instead, Bernanke should be

arguing for across the board tax cuts to increase every one's purchasing power and promote investment.

Even more importantly he should be arguing for very substantial federal spending cuts to reduce the deficits and competition for capital. The Fed should be pushing to create an environment in which business can grow. This means reduced restrictions, not more regulation.

U.S. dollars need to be spent on promoting goods and services manufactured in the U.S., not China, and the Fed should be promoting this. Federal agencies should not be used to impose restrictions on U.S. industries that Congress has rejected.

The Fed is concerned with deflation. Perhaps working to place a tariff on Chinese goods to equalize the cost to U.S. manufacturing of meeting pollution and other similar federally imposed costs would level the playing field and begin to restore efficient U.S. manufacturing.

While this would possibly increase the cost of some goods to U.S. consumers, this may be the type of inflation (non-deflation) the Fed should advocate. The primary mission of the Fed should be to stabilize

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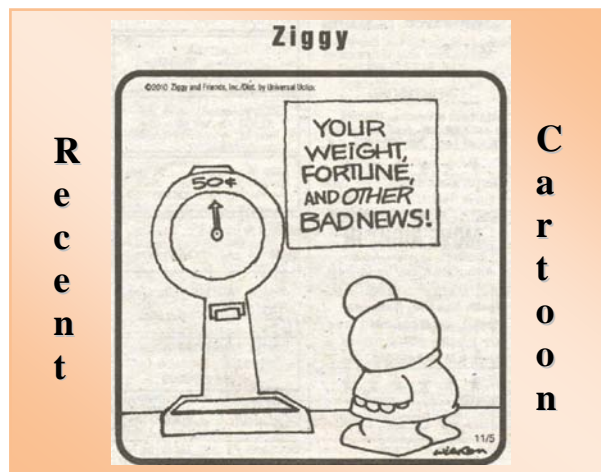
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the U.S. economy so that free markets can work. The controversy over its current approach appears to be centered on its failure to stay focused and a concern that it is becoming politicized.

The current use of quantitative easing does not appear to be focused on stability and a return to economic growth. It is too far removed from reality based economics. The current Fed policies run the risk of creating new and more harmful economic dislocations.

The Fed has artificially kept interest rates too low for too long. It has not realistically taken into account the money in the system which, because of the Fed's depressive policies, when coupled with excessive deficits and increasing taxes, is not being used to invest effectively in the economy.

If the Fed continues down its current road it will materially increase the chance of another Great Depression. Perhaps sooner rather than later. For a discussion on what government actions could cause another depression, [Click Here To See the article, "Are We Headed Toward Another Great Depression?" in our July 2010 Newsletter](#)



Our Eight Leading Indicators Show Moderate Growth Continuing.

What do our **8 Key Drivers To Track The Economy** tell us?

Petroleum Prices

They have been rising over the past month and we expect them to continue to rise over the next 6 to 12 months. This will continue to put upward pressure on inflation over the next 12 months and reduce liquidity in the economy. They could be headed toward \$100 per barrel!

Natural Gas Prices

Prices have risen for the past two months with continuing upward pressure. Like petroleum, this could

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add inflationary pressure and reduced liquidity as 2011 progresses.

Exports

The global economy, including Europe, has continued improving. Europe has become increasingly dependent on exports. The decline in the dollar should have a positive effect on U.S. exports in the coming months, improving the U.S. manufacturing picture. A real negative is the increasing hostility of Europe, China, India, Brazil, Asia, and Russia to the U. S.'s quantitative easing.

China has successfully focused the world on forcing the U.S. to change its currency policy or face others undercutting the dollar. This could hurt U. S. manufacturing.

Retail Sales

Absent autos, retail sales have been improving slightly and are projected to end 2010 2.8% above last year. Retailers expect a better holiday season, and this is helping manufacturing. E commerce is up 11.2%. The data indicates 2011 will see continued improvement but at a slower rate than 2010.

Strength of the Dollar

The dollar has weakened materially over the past two months. This

has helped exports and manufacturing. It is beginning to hurt profit margins as raw material costs rise.

M2 Money Supply

The Fed has been increasing the M2 money supply. This should boost exports and have a positive effect on the economy going into early 2011.

Industrial Production

The economic data shows continuing growth heading toward a 4.7% increase over 2009, even though production slowed in September.

This indicates that industrial production and retail sales should continue a moderate rise over the next 6 months, although we expect the rate to slow during the first 6 months of 2011.

Raw Material Prices

Both consumer and wholesale prices are beginning to increase. The producer price index is 4% above a year ago and accelerating. The second half of 2011 may see inflation begin to take a toll. The economy is increasingly subject to which direction the government takes. If taxes and costs rise materially next year, it will have a substantial negative effect on the economy. More than ever we are stressing our action step planning.

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