**QUANTITATIVE EASING — ROUND TWO**

With short term interest rates set at zero, if the U.S. Federal Reserve (the Fed) wants to stimulate its weak economy it has to take extraordinary measures. Extraordinary measures in extraordinary times generally take the form of quantitative easing, which means the Fed buying up government bonds.

“At CIBC Global Asset Management, we expect the Fed might start quantitative easing as early as November,” says Vincent Lépine, Vice-President, Global Economic Strategy, Global Asset Allocation & Currency Management. “We still expect short term interest rates in the U.S. to remain in the 0% to 0.25% range well into 2011 but the idea behind quantitative easing is to push long-term rates lower and make borrowing even easier. The introduction of another round of quantitative easing also indirectly aims at weakening the U.S. dollar, providing support to U.S exporters.”

Quantitative easing, or asset purchasing, is also sometimes referred to as “printing money”. The central bank increases the supply of money which it then uses to buy government bonds and other assets from financial institutions. Those financial institutions then use the excess capital to increase lending. The risk is that instead of increasing their lending the banks pocket the cash to increase their own capital reserves, which is what happened with the first round of quantitative easing launched by the Fed in early 2009.

Even though the Fed only hinted that it might be doing this – not that it is doing this – financial markets reacted as if the money to buy the bonds had already been printed. Even though quantitative easing is a U.S. initiative, the Canadian capital markets responded to the Fed’s move as well.

“The move was initially positive for the bond market, says Jeffrey Waldman, First Vice-President of Global Fixed Income at CIBC Global Asset Management. “In the near term it may be even more so for riskier assets like corporate bonds and stocks as investors perceive that the Fed is providing a floor for the pricing of these assets.”

Many fear that printing money to buy the bonds will eventually create too much inflation. However, as long as all of this excess liquidity isn’t finding its way to the real economy, deflation will remain a greater threat than inflation. In its statement, the Fed acknowledged that the inflation rate is “somewhat below” acceptable levels and that quantitative easing would help return inflation to an acceptable level. Nudging down long-term interest rates boosts spending on interest rate-sensitive items like housing.

“Canada shouldn’t count on quantitative easing at home,” says Vincent Lépine. “The Bank of Canada has been raising interest rates and still has room to reverse course before it has to consider extraordinary measures. But easing in the U.S. would contribute to a strengthening of the Canadian dollar. The resulting deflation would mean that Bank of Canada Governor Mark Carney would be patient before raising rates again.”

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