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QE 3 and Toxic Assets: The Fed's "Monetary Ammunition"

By Bob Chapman

Theme: Global Economy
Global Research, September 11, 2011
11 September 2011

Many people believe the Jackson Hole was a non-event, a failure and it was. QE 3 was not announced, as we predicted. We believe that was being saved for mid-September when the $300 billion rollover in Treasury securities is completed. Mr. Bernanke has failed in a number of respects, the most glaring being zero interest rates for 2-years and no housing recovery.

Even purchasing $1.3 trillion in toxic mortgages has only helped the banks. We still do not know what the Fed paid and what these bonds are worth. No matter what happens the Fed has to again purchase about $900 billion more Treasuries this new upcoming fiscal year. There is no way to avoid that and if they have to buy Agencies and more toxic bonds the figures will be higher. Auction failures cannot be tolerated. This will, of course, increase inflation in 2013 and 2014. Sales to consumers and profits will fall as a result.

Not so fast, the Fed still has more monetary ammunition most people haven't thought about and it lying on its books. It is the funds that belong to member banks, some $2 trillion that banks have been refusing to put to work. We mentioned the beginning of the movement of these funds from the Fed to the banks just recently. Will this persist? We do not know, but we think it will.

It is a natural answer to the funding problem, they perhaps had been deliberately held in abeyance. We believe this could in part solve the liquidity problem over the next year or more. The Fed has sent the word out to the banks. It is time to employ our secret weapon. As a result in July and August we saw what is tantamount to monetary stimulus, and do not forget this is monetization, money that has not as yet flowed into the system. That means its usage will be inflationary.

Heretofore, these funds were deliberately withheld from the system to be used at the perfect time. There were plenty of borrowers, but the banks did not lend, because they were told to wait for the right moment. The unleashing of these funds leveraged into the fractional banking system will cause damage and inflation, but they will provide temporary assistance to a failing economy. The Fed also needed some relief as their balance sheet grew close to 25%. The combination of Fed spending for treasuries, bank lending and perhaps some government spending, should reinvigorate the economy temporarily over the next year. Unemployment should decline slightly and consumption and personal debt should grow. We think Mr. Bernanke's plan will fall far short, because like in the 1930s too much structural damage has taken place. Demand for goods and services will grow, but not as much as anticipated and as long as desired. This unfortunately leads to disruption within the system for no other reason than the previous systemic damage visited upon the economy.

We are about to see a respite but not a permanent solution. America is headed for 2nd or 3rd world status and the Fed is trying to get us there as soon as possible.

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