

SIMSETT Volume 1

The Quantitative Easing program of US

It seems the whole “bailout bubble” started off with the net infusion of almost \$5 trillion of money in the economy by the Federal Reserve has finally helped the US to come out of the recessionary phase



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Introduction

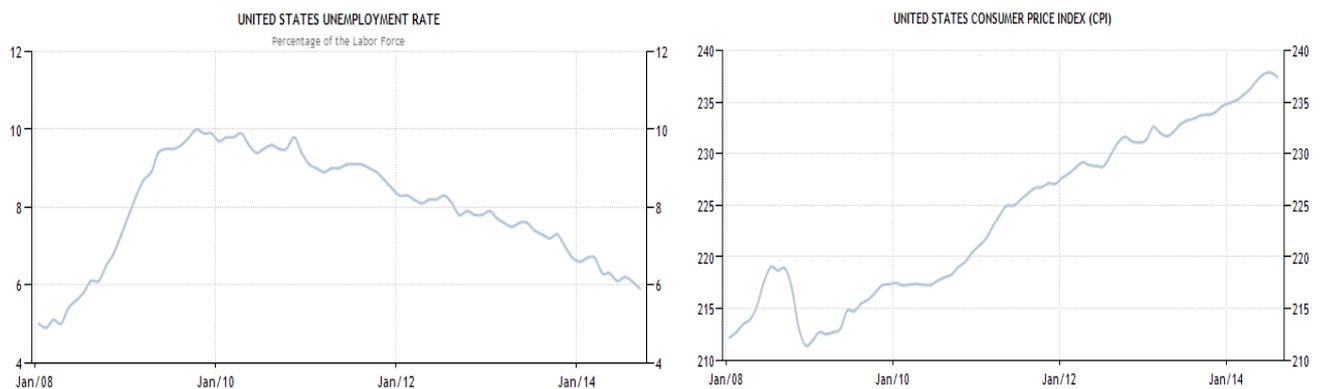
In the mid June of this year the newspapers were flooded with the headline – “*If All Goes Well, Fed to End Quantitative Easing by October*”. This followed a lot of discussions amongst various economists across the world on how this decision will impact the global economy, besides sending the equity markets for a roller-coaster ride. Some say that the ending of the easing promises market uncertainty especially because of the ongoing economic slowdown in the other side of the globe i.e. China, Japan and Euro zone. This article explains the concept of Quantitative Easing- the most powerful monetary tool which was adopted by the US government to fight with the aftermath of the US Great Recession 2008.

Quantitative Easing in layman’s term is the unconventional supply of money in the economy by the Central Bank by buying assets from the commercial banks thus giving money in the hands of the people. Whenever an economy goes through a phase of liquidity crunch or money shortage, the first impact is seen on the consumption rate of goods. Since the availability of money in the economy is low therefore, the purchasing power of the people decreases which hits the inflation rate of the country. Most of the economies have a target inflation rate which needs to be maintained and if the rate falls below the target, the economy can fall into a deflationary trap like Japan.

US’ Quantitative-Easing Program

After the US sub-prime crisis, the economy slowed down, sales plunged and a recession started setting in. Then the US treasury came up with what it is known as the “bailout bubble”. An infusion of \$700 billion was done by the US government - the biggest bailout in the history of the US government known as TARP (Troubled Assets Relief Program) - to shore up the common man’s confidence and capital by buying out the toxic assets of the financial institutions. The housing bubble burst was followed by a series of important events. Fannie Mae and Freddie Mac, the government sponsored enterprises (GSEs), established to buy up the mortgage backed securities were taken over by the Fed. Lehman Brothers, the fourth largest investment bank of US went bankrupt. Merrill Lynch was on the verge of bankruptcy and underwent an acquisition by Bank of America for \$50billion. Bear Sterns was bailed out by the Maiden Lane Transactions created by the Federal Reserve of New York and was acquired by JP Morgan Chase at a rate of mere \$2 per share.

The official first cycle of easing started off right after the collapse of Lehman Brothers; the biggest repercussion of the US housing bubble of 2007-2008 .The dual agenda - of maintaining the dollar’s value (i.e. managing inflation) and managing the rate of unemployment – led to the Fed’s consecutive 3 cycles of the QE program. With the initial pumping of \$1.7 trillion of QE1 (first cycle of QE) in the economy the process was followed by an infusion of another \$600 billion during QE2 and eventually the third cycle of QE, QE3. QE 3 was initiated with the amount of \$40 billion per month but then the value jumped to \$85 billion. Later in 2013, Ben Bernanke announced a \$ 10 billion tapering of the value. Then finally in July 2014 the package was tapered by \$10 billion per month leading to the declaration of ending the program by the end of October this year.



Source: www.tradingeconomies.com

The ending of QE indicates the improvement of the economic situation of the country. The economic factors show improvement like low unemployment rate, a stable home currency (USD), high mortgage value of the houses, stable inflation, increase in the

GDP figures and purchasing ability of the country. It seems the “bailout bubble” started off by the Federal Reserve has helped the US to come out of the recessionary phase after infusing almost \$5 trillion of money in the economy

Impact on India

Increase in the Interest Cost: The end of stimulus is going to impact the yield of the international bond market. In near future, there is a possibility that the Fed will increase the interest rates. For companies which have gone for acquisitions using the route of debt will be in a problem since the interest cost will rise.

Depreciation of the Home Currency: Many FIIs have been investing in the emerging markets including India because of the high interest rates. The high returns of the US bonds will attract back these FIIs to the USA and this might act as one of the reasons for rupee depreciation.

Setback in FII flows: As the yield of the treasury bills will increase, the spread between the US T bills and Indian G-Secs will narrow down making the debt investments in India a less attractive option for the FIIs.

In spite of apparent adverse effects the ending of the QE is going to have on the Indian markets, there’s a brighter side to the story too. There is a very high possibility that the QE will not have any major long term impact on the Indian economy if India is able to fix the economic situation in the right way. If India is able to work out with the various reforms that have been lagging all these years like the GST bill, Land acquisition bill, infrastructural projects and labour reforms then the effect of this event will be temporary.

A State of Freefall: Examining the Factors behind Falling Global Crude Oil Prices

Having already declined by almost 20% since July, 2014; a latest Goldman Sachs report predicts Brent Crude Oil to fall to USD 70/barrel by 2015. What precisely could be causing this massive and continual freefall in prices?



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Global crude oil prices have continued to remain in a state of freefall month after month, this year. Presently pegged at USD 85/barrel, prices have fallen by 4.4% in October, 2014 alone. In fact, this trend first began in July, 2014 and prices have declined by almost 20% since. a latest Goldman Sachs report predicts Brent Crude Oil to fall to USD 70/barrel by 2015. This appears to be a cyclical downturn spearheaded by both demand and supply side factors. Having hovered over USD 100/barrel since 2011 on the back of escalating demand from emerging economies such as China and India, the current sharp and continuing fall in crude oil prices is meritorious of closer examination.

Supply Side Dynamics

In the current scenario, the USA continues to ramp up shale oil production in the states of Texas and North Dakota at an exponentially increasing rate. Slated to enhance total crude oil production to a three decade high, the country's crude oil stockpiles have increased by almost 2 million barrels by the first week of October, 2014. In fact, according to a report released by the USA-based Energy Information Administration on October 7; oil production in the USA has increased to 8.4 million barrels a day as compared to 7.4 million barrels a day, this time last year. That translates into greater

supply in the international market. Furthermore, crude oil production by the OPEC member states has also increased to a two year high. For starters, Libya which was combating the undesirable socio-economic ramifications of Civil War, has drastically increased production to over 800,000 barrels a day in a concerted effort to kickstart its flagging economy. Geopolitical turmoil in the regions of Iraq and Syria; courtesy the ISIS; has also not hampered production to a large extent. Even extremists realize the criticality of oil to their operations. Additionally, Russia has also significantly increased its oil production to record levels after the disintegration of the USSR in 1991. Thus, a significant collective increase in supply of crude oil in the international market would require a concurrent increase in demand. Has that been the case?

Demand Side Dynamics

Unfortunately, that has not been the case. With the growth prospects of the global economy downgraded to 3.8% for next year by the IMF, from a forecasted 5% in July, 2014; the demand dynamics have not been favourable. According to the International Energy Administration, the demand projections for the remainder of 2014 stand at 200,000 barrels per day; significantly down from the initially consumers such as China coupled with fragility in the Eurozone has further diminished demand. If the strongest European economy in Germany suffers an industrial output drop by 4.4% in August-September, 2014; it certainly does not bode well. This has only reinforced concerns over falling oil prices. With the rest of the global economy struggling to achieve any notable growth, there has been a major fall in demand for crude oil. Furthermore, many developed economies, such as Japan, are making a transition towards the more widespread adoption of natural gas and alternative fuel sources in an attempt to pursue a more sustainable path towards development. This further diminishes crude oil demand.

Consequently, there is a major mismatch in supply and demand in the present scenario. Excess capacity and production coupled with dwindling demand have resulted in driving down crude oil prices.

I shall examine the impact of falling crude oil prices on the OPEC member states and the Indian economy in my next article.

BRICs Bank – Plain Tokenism or a strong Alternative to World Bank?

As per the World Bank's own survey there is approximately 1 trillion USD infrastructure investment gap in developing countries and the present multilateral development banks can fill only about 40% of it



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Peace, Tranquility, World Class Infrastructure, Conducive Investment Climate, Jobs and Fair Tax Regimes are all engines of growth, with approximately forty percent of the world population and one fifth of the entire land mass BRICS nations are treasure trove of natural and human resource. However due to lack of infrastructure because of non-availability of funds the vast potential of the above resource remains un-harnessed, in order to rectify the same the idea of BRICS bank was mooted during BRICS summit and agreements signed for establishment of the same.

BRICS Bank would be a multilateral financial institution which would cater to the needs of BRICS nations i.e. Brazil, Russia, India, China and South Africa as also other less developed African and Asian countries. The proposed structure of BRICS Bank has two institutions, New Development Bank and Contingent Reserve Arrangement.

New Development Bank (NDB) will provide financial aid and loans for sustainable development and infrastructure projects with an initial capital outlay of 50 billion USD to be gradually increased to 100 billion USD. Each member nation would contribute 10 billion USD towards initial capital which cannot be increased without the consent of all the other members. Unlike the World Bank which assigns votes based on capital share, in New Development Bank each member nation will be assigned one vote and no country will have veto power. The membership would be open to other countries as well but the share of BRICS nations in the capital cannot fall below 55%. Bank to be headquartered at Shanghai would commence operations in 2016.

Contingent Reserve Arrangement (CRA) framework on the other hand will provide financial assistance to countries facing short term balance of payment problems and will also protect member nation's currencies from global liquidity pressures. It would have a capital outlay of 100 billion USD, with China's share being 41 billion, India, Russia and Brazil would contribute 18 billion each and South Africa would give 5 billion. The CRA would also start operations from 2016.

The need for the establishment of BRICS Bank arose because aid or loan from the Bretton Wood institutions i.e. The World Bank or IMF comes attached with several strings catering to the interests of the contributors. Further both these institutions provide voting rights based on contribution made by each country, since the USA and the European nations are the major contributors to both the institutions, hence grant of aid or loan is contingent upon the recipient nation's willingness to do their bidding. Lowering of Trade Tariff Barrier, Reduction in Negative List of Commodities for Imports, Captive contracts for development projects, full convertibility of currency on current account and introduction of the LPG policies, are but a few examples of the strings designed to favor companies in donor countries. An example of the dictatorial ways of IMF was evident from what it did during the Asian financial crisis. IMF gave a series of "Structural adjustment Packages" (SAP), but these SAPs were given subject to certain conditions such as reduce government spending and deficits, allow insolvent banks to fail and aggressively raise interest rates, these conditions however, proved to be counterproductive and instead of getting the affected economies out of the crisis, it further intensified the crisis.

Precedence Group of nations with common interests have established such institutions in the past. The "*Corporación Andina de Fomento*" (CAF) also known as the "*Development Bank of Latin America*" is another such multilateral development bank which has been fairly successful in catering to the needs of the Andean nations. In fact it funds more infrastructure projects in Latin America than World Bank and Inter-American Development Bank combined and the focus of CAF has also been on transportation, telecommunications, power generation, water and sanitation, signifying that these are some of the major areas in which funding is required.

Advantages of establishing BRICS Bank are:-

- (a) There is a huge demand for infrastructure projects in BRICS countries and severe dearth of funds to finance them.
- (b) As per the World Bank's own survey there is approximately 1 trillion USD infrastructure investment gap in developing countries and the present multilateral

development banks can fill only about 40% of it, a BRICS Bank can partially bridge this gap.

(c) Aid or loan form BRICS Bank would be available without any strings attached as every contributor nation has only one vote.

(d) Aid or loan would be available for projects of recipient nation's choice and not thrust upon them as per whims and fancies of contributor countries.

Drawbacks on the other hand are:-

(a) Initial capital outlay of 50 billion USD is grossly small when compared with the World Bank or the Asian Development Bank which have capital of 232 billion USD and 165 billion USD respectively even when it reaches its maximum capital of 100 billion USD, it would still be accounting for approximately 45% of the World Bank's capital. This casts a serious question mark on how much can the bank actually lend and how effective it would be in financing the infrastructure needs of the less developed countries.

(b) Another potential drawback is the non-availability of credible official currency of the Bank, currencies of member nations are not international benchmarks of stability.

(c) *Hegemony of China in policy making process, being the single largest contributor to the CRA. There is a substantial chance that China may try to use its financial might and dominate the policy making process of NDB as well.*

(d) *Non-convergence of perception and priorities with respect to whom, when and where to lend can be a serious drawback, hence differences must be ironed out and goals quantified.*

Holistically, the establishment of the BRICs Bank would certainly be a step in the right direction, it would ensure that countries in need get loans at favorable conditions, it will ensure a just and dignified treatment being given to countries that are facing economic problems and are in need of financial support and it will also try to put an end to the dictatorial ways of the Bretton Wood institutions.

Hence establishment of BRICS Bank is neither Tokenism nor an alternative to the World Bank but a small and firm beginning to serve the economic interests of the BRICS nations.