



# Macro Comment

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## Monetizing the debt

*Many investors are worried about inflation again because the Federal Reserve announced that it will pump more money into the economy. Several markets are already moving in response to the Fed's new policy. Concerns about inflation are likely to persist until the Fed signals that it is ready to stop this second round of quantitative easing.*

This report will address five questions.

- 1. What is the Fed doing?**
- 2. What are the risks?**
- 3. What is happening in the markets?**
- 4. What are other countries saying?**
- 5. What do we think?**

### What is the Fed doing?

The Fed announced on November 3 that it would initiate a new round of Treasury Security purchases totaling \$600 billion through the end of the second quarter 2011. This is smaller than the \$1.8 trillion of securities purchased in the first round of quantitative easing started during the financial crisis in November 2008. This money is not borrowed from the Treasury or taxpayers. It is newly created by the Federal Reserve which has the ability to create money out of thin air. This is why many investors are worried that the Fed might be monetizing the debt.

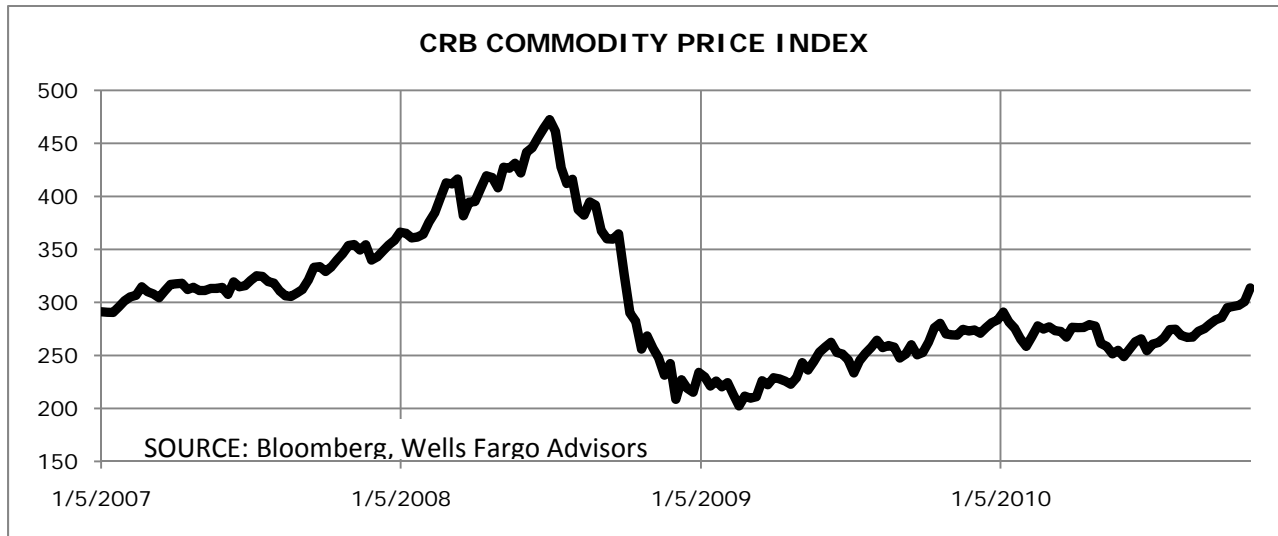
### What are the risks?

Monetizing the debt occurs when the government or an organization sponsored by the government buys excessive amounts of government debt with newly printed money or newly created money. Unfortunately, it is not always easy to know how much is too much. Limited government debt purchases by a central bank are not a problem. In fact, the Fed historically buys government bonds and tries to add just enough liquidity to the economy each year to keep the economy growing. Monetizing the debt is adding more money than

the economy needs, causing inflation. The important question is how much liquidity does the economy need? If the public wants to hold more money than normal, then the Fed can pump extra money into the economy and it would not lead to inflation. Inflation is only likely to be a problem if the Fed increases the supply of money faster than the demand for money is growing. During the recent financial crisis, the public wanted to hold more money as a precaution. Therefore, when the Fed pumped extra money in 2008 and 2009, it was not inflationary. However, investors are worried that the Fed may be going too far this time.

### What is happening in the markets?

Recent market action suggests that investors believe the Fed is monetizing the debt. Consequently, the dollar has declined while gold and silver prices have jumped sharply. Moreover, since the Fed began talking about doing more quantitative easing back in July and August, many commodity markets, including food and energy markets, have rallied. As a result, the Commodity Research Bureau (CRB) commodity price index has increased to a new high for this year. In the credit markets, the fear of inflation has pushed the demand for Treasury inflation protected securities upward, causing yields to turn negative. In addition, the extra liquidity provided by the Fed is finding its way overseas, driving emerging stock markets upward. Some of the extra liquidity is also boosting domestic equities. Finally, inflation expectations, as measured by the yield difference between regular Treasury securities yields and inflation-protected Treasury securities yields, have increased.



### What are other countries saying?

Several other governments are concerned that the Fed is overdoing it with its latest round of quantitative easing. After all, as the dollar declines, foreign currencies increase in value, hurting foreign economic prospects because a stronger currency will make their exports more expensive. Major exporters including Brazil, China, Russia and Germany have criticized the Fed for its policy to boost U.S. economic growth at the expense of potentially slower growth in foreign economies. These countries appear to be worried that the United States is deliberately devaluing its currency, threatening the status of the dollar as the premier reserve currency of the world.

### What do we think?

We do not think that the Fed is monetizing the debt, and do not expect inflation to increase significantly. We believe the Fed is following a difficult course of trying to bring down unemployment by boosting domestic spending without creating a lot of inflation in the process. The window of opportunity to do this is very limited to periods like today when there is a lot of

slack in the economy and very few shortages of resources. However, the Fed has to be careful and not overstay its welcome. The recent increase in commodity prices shows that the new round of quantitative easing is probably going to boost inflation slightly. However, if commodity prices continue to increase and move substantially higher, policymakers may need to back off and curtail the quantitative easing policy. If Federal Reserve policymakers ignore the markets and keep pumping money into the economy when it is no longer needed, then they would be monetizing the debt and the risk of inflation would increase considerably. We are not at that point yet. The Fed can still hold back when economic conditions improve. In the meantime, the fear of inflation is being fueled by skepticism that the Fed will not know when to "say when." Consequently, the dollar may continue to weaken and commodity prices may rise further until the Fed signals that it has done enough. We believe the Fed will pull back, if the economy accelerates and inflation expectations jump too far.

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