

Policymakers Strike Back



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HIGHLIGHTS

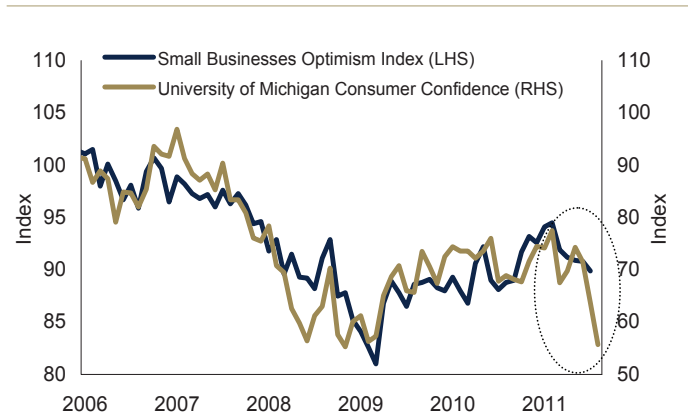
- › A crisis of confidence is compromising the economic recovery.
- › Some argue there is nothing policymakers can do about this, given already low interest rates and heavy debt loads.
- › We disagree: many creative policy options remain.
- › This hardly assures a robust economic recovery, but it does tilt the balance towards a return to growth.

Repeated fumbles by American and European politicians over the summer have parched market risk appetite and drained households and businesses of precious confidence (Exhibit 1). In turn, the global economy is swooning ominously (Exhibit 2), transforming what began as little more than a transient oil- and Japan-induced blip into something far more serious. This is worrisome.

We put the risk of recession between 25% and 50% for the U.S., and even higher for Europe. Already, many jurisdictions are flirting with economic decline. Japan has suffered through three consecutive negative quarters. Canada was dinged by a drop in second-quarter GDP. France was flat, while Germany barely eked out a gain. The U.S. and U.K. have so far done somewhat better, and yet on an absolute basis they barely crawl forward. Given the foreboding of leading indicators, it is hardly inconceivable that some of these countries might be stung by a negative print in the third quarter, thrusting them onto the cusp of a technical recession, or even into one outright.

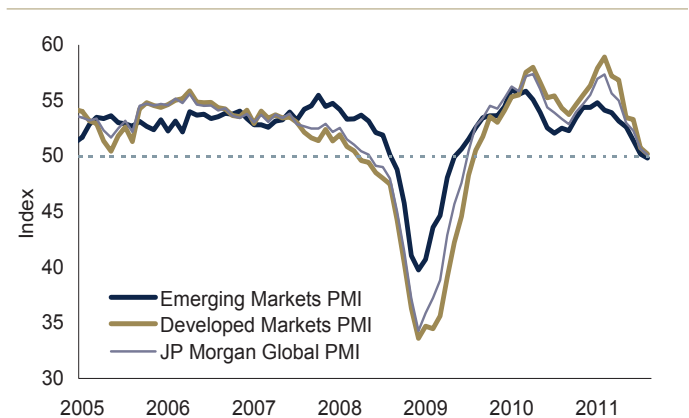
In our view, this obsession with the risk of recession obscures a more important point. Whether economies shrink slightly or grow slightly in the coming quarters – the two most likely scenarios – the main issue is that the economic trajectory is clearly diminished, and insufficient to return metrics like the unemployment rate to their rightful levels.

Exhibit 1: U.S. Confidence is Problematic



Source: Haver Analytics, RBC GAM

Exhibit 2: Economic Indices Have Come Down to Earth



PMI refers to Purchasing Managers Indices, proxies for economic activity
Source: Haver Analytics, RBC GAM



This is unacceptable. Fortunately, policymakers concur. They have already begun striking back against perceived weakness in an effort to jolt the economy back to life (Exhibit 3). It seems the legendary “Greenspan put”¹ never really went away. The U.S. Federal Reserve has rolled out a new stimulus measure, with more possibly to come, and the European Central Bank (ECB) has grudgingly begun acquiring Italian and Spanish bonds. The International Monetary Fund (IMF) is musing about a program of forced recapitalization of European banks. Germany and France talk of tighter fiscal integration. The White House is set to propose fiscal stimulus targeted at hiring and housing. Brazil has shocked everyone by cutting rates. China seems to be letting its currency rise more quickly.

Naysayers

Some say there is little hope – that the economy needs a recession to be purged of its imbalances; that activist policy will just create more problems; that policy to date has accomplished little; and that policymakers lack the necessary tools. We respectfully disagree on all counts.

A Necessary Decline?

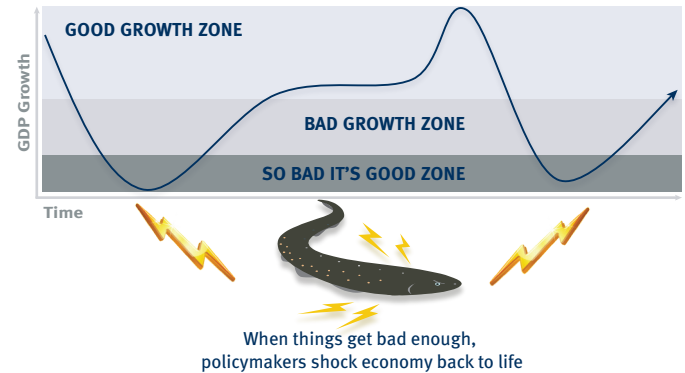
It is popular (and dare we say rather fatalistic) to claim that the economy requires the purging of a proper recession before it can sustainably mount a recovery. In turn, countervailing policy action could just be delaying the inevitable.

It is true there were notable excesses going into the credit crunch. In the U.S., home prices were too high, banks were too leveraged and households too indebted. But, strikingly, most of these imbalances have now been worked off. American home prices are back in line with fundamentals. The global banking sector has increased its capital base enormously. Households are still too indebted, but are well on their way to correcting the problem via a higher personal savings rate. In short, there is little remaining that a recession would ameliorate.

Poisoned Chalice?

It is also true that the policy mistakes of the past have contributed to the woes of the present. Recent dithering over debt ceilings and European bailouts were a central contributor to the economy’s current troubles. Interest rates were held too low for too long through the belly of the 2000s, inducing an unhealthy thirst for yield

Exhibit 3: Policymakers to Shock Economy Back to Life



Source: RBC GAM

that encouraged excessive risk-taking. Policymakers were driven by the best of intentions to increase the homeownership rate, and in so doing inflated home prices and diminished the quality of the mortgage stock. A laissez-faire attitude to banking regulation proved ill-advised. Government budgets were mired in a perpetual twilight of deficits despite healthy economic conditions, squandering the opportunity to build up a buffer.

And yet all of that is the exception to the rule. Policymakers succeeded in taming inflation and presided over an exceptional period of robust and stable economic growth lasting almost three decades. Certainly, the law of unintended consequences tells us that returning to the well for more stimulus will bring with it repercussions later on, some of them undesirable, some of them unexpected. But the situation is arguably dire enough to accept these risks.

Feeble Policy?

Some argue that the stimulus measures implemented so far have been ineffective. After all, the economy remains downtrodden. However, this neglects the counterfactuals. The economy would have been in far worse condition absent these actions.

Without question, the liquidity lines and bank bailouts undertaken during the darkest hours of the credit crunch prevented a total meltdown of the world’s financial system. The North American auto bailout avoided devastating and unnecessary job losses there. Although monetary policy lacks its usual bite due to limited loan uptake, existing borrowers are at least saving money, and low rates can have a psychological effect in propping up inflation expectations.

Assorted rounds of quantitative easing (QE) have alternately lowered interest rates, improved confidence, prompted market gains and/or rescued inflation expectations. The efficacy of fiscal stimulus is always contentious as the benefits of additional spending must be contrasted against the burden of additional debt. While this gamble has been a losing proposition for the likes of Greece, Ireland and Portugal, it has arguably been a winning one for much of the world. Some calculate the economic decline would have been twice as deep without policy recourse.²

Out of Ammo?

Perhaps the most common argument against more stimulus is that policymakers are simply out of ammunition. After all, interest rates are already near zero and fiscal policy is bumping up against towering debt levels and stern ratings agencies. However, this reveals a lack of imagination. There are still a few conventional policy options on the menu, and, more importantly, an enormous variety of “off menu” options. We lay them out here.

Monetary Policy

Monetary policy is the traditional lever for regulating the business cycle. Compared to fiscal policy, it is nimbler, lacks political shackles, is less conventionally costly and has a clearer economic effect. Alas, interest rates are near zero in much of the world, severely limiting the conventional solution of more rate cuts. And yet central banks are not entirely out of bullets.

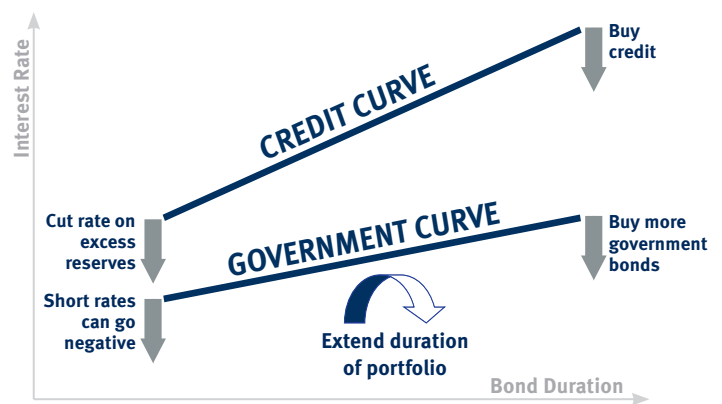
Conventional Stimulus

Contrary to popular belief, even conventional monetary policy isn't completely tapped out (Exhibit 4). First, monetary stimulus is a function of the level of rates, not the pace of change. Thus, that policy rates have stopped declining only means that monetary stimulus has ceased to grow. At such low rates, it is still quite effective (Exhibit 5).

Second, monetary policy traditionally operates with a lag. The full benefit of easier policy takes as long as 18 months to fully trickle through the economy.³ So while the second round of U.S. quantitative easing was completed in June, the economic benefits continue to mount through 2012.

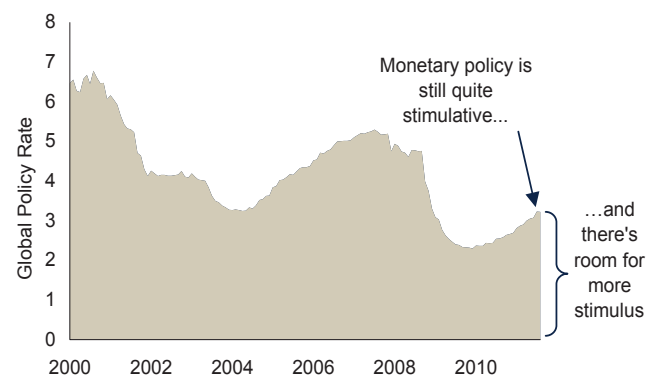
Third, central banks can still cut rates further despite their flirtation with the zero bound. Singapore, Sweden and Switzerland have managed to smash through

Exhibit 4: Sampling of Monetary Policy Options



Source: RBC GAM

Exhibit 5: Global Monetary Policy



Regions included: U.S., Canada, U.K., Eurozone, Switzerland, Sweden, Norway, Japan, Australia, China, India, South Korea, Russia, Brazil, Mexico. PPP weights by GDP share. Source: Haver Analytics, RBC GAM

that floor into negative territory, without adverse consequences. Even in the U.S., the negative yield on some Treasury bills argues more cutting is possible.

Fourth, there is usually a gap between short-term borrowing rates in the market and the policy rate. This can be manipulated. In the Eurozone, this has afforded an additional 40 basis points of stimulus over the past few months, even as the ECB has officially held steady.

Fifth, some countries that were previously set on hiking now appear content on the sidelines. The list includes the ECB, the Bank of England and possibly the Bank of Canada. This is a form of counterfactual stimulus. And some that were expected to be on hold – like the Central Bank of Brazil – have just surprised the market by cutting

rates, citing a “substantial deterioration” in the global outlook. Globally, policy is becoming more stimulative.

Unconventional Stimulus

Over the past few years, several central banks plunged headlong into unconventional stimulus. This mostly amounted to quantitative easing: expanding the monetary base (“printing money”), followed by deploying that money into asset markets, usually government debt. The U.S. Federal Reserve has been the most enthusiastic customer to date, and so we frame the bulk of the remaining options through its eyes. Based on rumblings at the Bank of England and elsewhere, other countries could also be persuaded to implement some of these steps.

First, the Fed could engage in additional rounds of quantitative easing. There is no technical limit to how much QE can be conducted because the money is conjured into existence by the stroke of a pen. We believe earlier QE rounds elicited constructive outcomes,⁴ and future rounds should also have a positive, albeit diminishing, effect. The justification for another round today is weaker than it was in early 2009 or mid-2010 because inflation expectations are well behaved, though souring economic conditions could well provide sufficient motivation.

Second, the Fed could tweak the composition of the quantitative easing that it has already undertaken. In the spirit of “Operation Twist” from the 1960s, bonds maturing from the Fed’s balance sheet (\$500 billion over the next 15 months) could be redeployed into specially targeted areas of the market. For instance, these could be redirected toward longer-dated bonds, reducing longer-term borrowing costs and encouraging far-sighted spending. Alternately, the maturing money could be put into equities, corporate bonds or any number of other investment vehicles.

Third, the Fed could continue to venture down the path of verbal commitments. Originally, the Fed had promised to leave rates unchanged for “an extended period” of uncertain length. In August, this was made more explicit – no hikes until mid-2013. This was effective in lowering term borrowing costs, and may also be successful in lowering bond market volatility. The Fed could extend this commitment for even longer, or promise to keep its balance sheet enlarged for an explicit period, too.

Fourth, the Fed could impose a ceiling on government bond yields, much like the one in place throughout

most of the 1940s and early 1950s. The 10-year yield could be capped at 2.0%, and any effort by the market to push it higher would be countered by Fed purchases. Fed Chairman Bernanke is on the record discussing this option. A complication is that it is uncertain how much such a policy might cost. It might be free if the Fed’s vow managed to cow the market into submission, or it could require a large amount of buying to sustain.

Fifth, the Fed could cut the rate of interest that it offers on excess reserves. Banks have stored enormous sums in excess reserves at the Fed, in part because they earn a decent return on them. If this rate were cut to zero or even below, it might encourage banks to do something economically productive with the funds.

Sixth, if funding markets continue deteriorating, central banks could expand their liquidity programs in either size or scope. The ECB already offers unlimited liquidity to banks, so size is not the issue there. It might wish to entertain a broader scope, such as extending liquidity to non-financial corporations should their ability to fund themselves become compromised. The Fed has its own set of liquidity programs, and could similarly ramp them up as conditions demand.

Really Unconventional Stimulus

Then there are a handful of extremely unconventional policy options that central banks could pursue. These are all long shots, but in the event of a disaster, they might merit dusting off. If nothing else, they demonstrate the breathtaking range of options available to central banks.

First, central banks could temporarily raise their inflation targets from around 2% to, say, 5%. This would do several things. With inflation suddenly running well below target, it would first and foremost justify another round of monetary stimulus. This would lower real interest rates, help to form self-fulfilling expectations for higher inflation and faster growth, whittle away at underwater home prices and inflate away a sliver of government and household debt.⁵

Second is a quirky scenario that has recently captured market attention. Central bankers might shift their policy goal altogether from maintaining a certain level of inflation to pursuing a particular rate of nominal income or nominal GDP growth. The motivation is simple. If policymakers are viewed as credible, the economy should begin to rebound on its own. And whereas current inflation readings give mixed signals about whether more monetary

stimulus is appropriate, an income/GDP target clearly screams for more stimulus. The stimulus spigot would stay open indefinitely, until the economy was well on its way to healthy growth. In other words, this would be an excuse for unlimited quantitative easing. Certain Fed members appear to be contemplating a tamer version of this involving a target for the unemployment rate.

Third, instead of printing money and using it to buy financial assets, central banks might pump money directly into the economy. This is the “helicopter drop” of money proposed by Milton Friedman, and famously cited by Fed Chairman Bernanke in his early years as a central banker. This would be a purely inflationary gambit, plumping household balance sheets in addition to expanding the monetary base.⁶ Attractively, this would bypass the banking sector, which has for the most part sat idly on the money that has been printed to date.

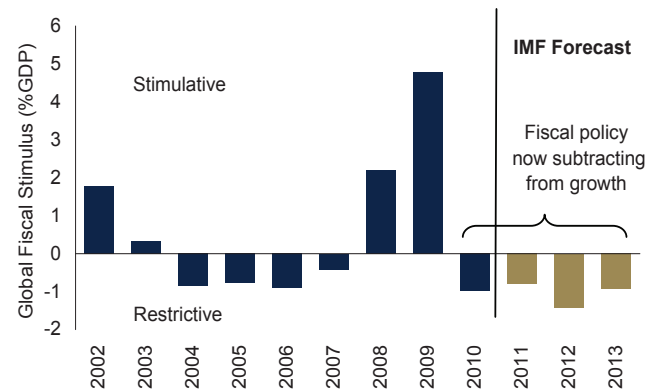
Fiscal Policy

Under normal circumstances, active counter-cyclical fiscal policy is rarely advisable. It is usually best to let monetary stimulus do the heavy lifting. Relative to monetary policy, the fiscal variety is less nimble, hindered by politics, more costly and of less certain macroeconomic effect. Even during the recession phase of a normal economic cycle, it is usually preferable to leave the work to automatic stabilizers such as government revenues that naturally decline as profits and incomes dip, and government spending that naturally grows as demand for social services rises.

However, this is no ordinary business cycle. Everything is topsy-turvy, and from the beginning the economic downside risks have been sufficiently grim to warrant more activist policy. This explains why during the worst of the credit crunch, international institutions such as the IMF implored countries to deliver more fiscal stimulus. And they did (Exhibit 6).

What’s more, despite the conventional wisdom, there may still be scope for a bit more fiscal stimulus, even in countries like the U.S. The reason for this is simple: the S&P sovereign debt downgrade appears to have been mostly toothless. Borrowing costs have gone down, not up, and no great dislocation has occurred elsewhere in the credit market. For that matter, more fiscal stimulus may even be possible – without irking the ratings agencies – so long as it is paired with responsible longer-term austerity (Exhibit 7).

Exhibit 6: Global Fiscal Stimulus



Regions included: U.S., Canada, U.K., Eurozone, Switzerland, Sweden, Norway, Japan, Australia, China, India, South Korea, Russia, Brazil, Mexico. PPP-based GDP weights.
Source: Haver Analytics, RBC GAM

Exhibit 7: The Fiscal Policy Balancing Act



Source: RBC GAM

In particular, the key is to shift from the brute force fiscal tactics employed so far, toward more targeted spending on recalcitrant problems that are short-circuiting the economic recovery, like the U.S. job and housing markets.

U.S. Employment

The U.S. job market remains profoundly broken, as illustrated by the broadest definition of the unemployment rate, which at 16% is double the historical norm (Exhibit 8). This is a perplexing thing. America lost a disproportionate number of jobs during the economic decline, and yet hiring has been underwhelming on the way back up. It has been the worst of both worlds for a variable that is a crucial source of kindling for a sustainable economic recovery, and that more accurately captures the financial well-being of Americans than anything else.

By and large, American businesses are again thriving, with healthy balance sheets, handsome profit margins, good export prospects, low borrowing costs and cheap labour. The capacity to hire exists; it is the will that is lacking. Fiscal policy could well be the catalyst to change that.

Promisingly, the White House has just selected Alan Krueger, a labour market specialist, as chief economic advisor. President Obama seems set to propose several measures to address the employment problem, valued at as much as \$200 billion to \$300 billion. These may include an extension of the payroll tax holiday for workers.

There are many further ways to boost U.S. employment prospects. The company-paid portion of payroll taxes could be temporarily snipped; the government could initially subsidize or top up the wages of people re-entering the workforce from government assistance; the government could temporarily hire the unemployed for public works projects; or it could address housing market problems that are preventing people from moving to where the jobs are. As a longer-term fix, the retirement age could be raised, killing two birds with one stone by linking job growth with a solvent Social Security program.

The job creation flame flickers. It must not be snuffed out by inaction.

U.S. Housing

U.S. home prices have fallen by an enormous 32%, and affordability has improved tremendously. Mortgage rates are already very low, thanks to a combination of Fed stimulus and poor economic prospects. The bulk of the sub-prime market has mercifully vanished. However, the market remains profoundly dysfunctional. A combination of cautious behaviour by home buyers, stingy lending and underwater mortgages have prevented the market from properly recovering and consumers from spending normally. Residential construction is running at just half its normal rate (Exhibit 9), and the economic recovery is accordingly having trouble achieving lift-off.

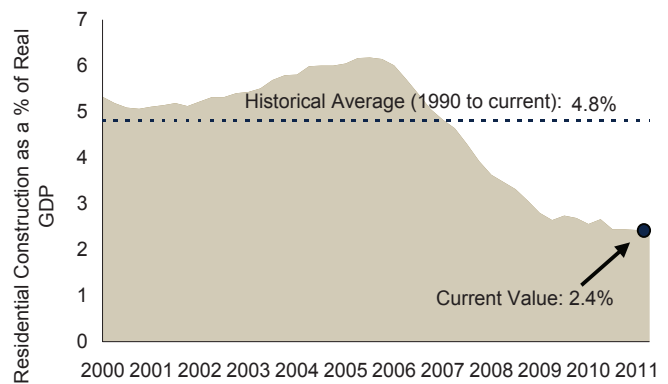
The bulk of the ways to fix the housing market revolve around the government's two housing agencies – Fannie Mae and Freddie Mac – which collectively back 7 in 10 new home loans and own or guarantee over half of the U.S. mortgage market. Unfortunately, Fannie and Freddie have mandates to maximize profits while shedding 10% of the firms' assets per year. This is not helping the housing market.

Exhibit 8: U.S. Job Market Could Use Help



Source: Haver Analytics, RBC GAM

Exhibit 9: U.S. Residential Construction Needs Reviving



Source: Haver Analytics, RBC GAM

Accordingly, the first and perhaps best way to fix the housing market would be to change the mandates of these organizations so that they stop shrinking and shift their focus to alleviating problems in the housing market. This would increase the availability of mortgages to homebuyers, and help to restart the housing market. Unfortunately, this will require an act of Congress to achieve.

Over a quarter of U.S. mortgage holders owe more than the value of their home. For the most part, beleaguered members of this group can neither sell their homes nor refinance them at lower rates.

To assist those wishing to sell, there may be value in expanding the use of "short sales." In a short sale, a lender accepts whatever value a home fetches in a sale, and forgives the remainder of the original loan. This avoids the fees and hassle associated with foreclosure, has less

of a damaging effect on the credit rating of the borrower and avoids the stigma and complications associated with selling a foreclosed home. In turn, the lender saves money and the borrower can re-enter the housing market more quickly. The government could support this program by incenting banks to be more receptive to it and be alerting homeowners to its existence.

Equally, those with negative equity struggle to refinance their mortgages at lower rates, as refinancing technically constitutes a new loan. This prevents many mortgage holders from enjoying the benefit of the Fed's ultra-low interest rate policy. Allowing them to refinance would be worth a few thousand dollars per year per household, a dividend they would reap year upon year for decades. This would not only help to stabilize the housing market, but boost household spending, too.

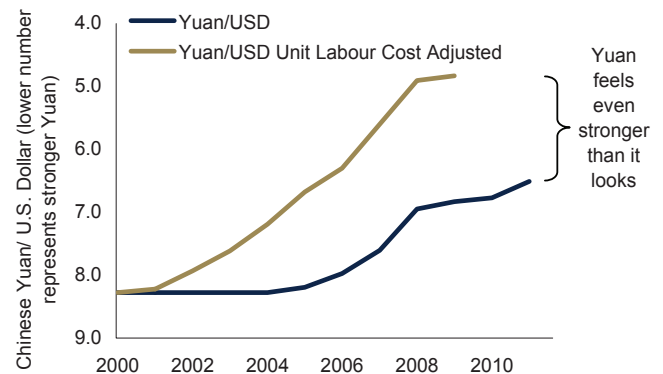
As an extreme option, the government could issue an edict to instantly lower the mortgage rate for all clients of Fannie Mae and Freddie Mac. This would save mortgage holders around \$400 billion, an enormous sum. However, the devil is in the details. The holders of the underlying agency mortgage-backed securities (MBS) dislike this proposal, as they would be on the other side of the \$400 billion. This would be a hit suffered disproportionately by the banking sector, which has just gone through a traumatic rebuilding process after earlier losses to their loan portfolios. What's more, the full \$5.4 trillion of agency MBS outstanding would then have to be reissued into the market, and it is easy to imagine that investors might be reluctant to reload.⁷ Short of having the government make up the difference for investors – an idea perhaps worth entertaining, but a costly proposition – it will be difficult to enact a comprehensive policy of this sort.

A quick list of additional options would include converting Fannie and Freddie's pools of foreclosed homes into rentals, solving the problem of vacant homes and rising rental costs in one fell swoop. Another smaller option would be to reduce the fees that the agencies charge to insure renegotiated mortgages. A highly unconventional option would be to tear down a large swath of the vacant housing stock, eliminating the inventory overhang.⁸ Finally, a more conventional – though costly – strategy would be to offer some sort of rebate or tax credit to home buyers.

European Banks

For European banks, there are a few interesting fixes as well. Most obviously, the European Financial Stability Facility could be upsized, to ensure that enough funds exist to bail

Exhibit 10: Subtle Currency Shift Underway



Source: Haver Analytics, RBC GAM

out the imperilled sovereign states and Europe's banking sector. Alternately, and the subject of recent musings from the IMF, a program akin to the U.S. TARP could be created to directly recapitalize all European banks now – and avoid banking problems later if a European state does default.

Currency Policy

The foreign exchange market is usually viewed as a zero-sum game, and thus incapable of boosting global economic prospects. For every winner there is an equal and opposite loser. However, this is false for two reasons.

First, economically weak countries tend to have depreciating currencies, which stimulate their growth. Granted, this is just an economic transfer from strong countries to weak countries. But the strong countries can compensate for their loss by easing their monetary or fiscal policy. In contrast, weak countries often have less capacity to do this. Thus, the global economy moves more quickly.

Second, the global economy can also run more quickly if international current account balances are remedied. It is just as inefficient to lend too much as it is to borrow too much. Most developed nations are net borrowers, while most developing nations are net savers. Unmooring emerging market currencies that are strategically pegged too cheaply would do much to resolve this imbalance. China has begun to remedy this (Exhibit 10) with an eye toward discouraging another round of quantitative easing in the U.S. (which might increase commodity costs for China) and decreasing its reliance on rising interest rates as a means to tackle inflation.

Regulatory Reform

Various regulatory changes could also invigorate economic growth. There is too much uncertainty about future regulations, and this is often cited as a reason why businesses hoard cash instead of deploying it fruitfully.⁹ Greater clarity is paramount. Another uncontroversial option would be to reduce red tape. The White House recently announced a plan to eliminate unnecessary business regulations, and this is expected to save \$10 billion over five years. Another much-discussed possibility is for the U.S. government to offer a tax amnesty to American corporations, encouraging them to repatriate their hundreds of billions of dollars in accumulated foreign earnings, with the hope that this would create jobs (by some estimates, millions of them) or expand domestic investment.

Europe's collective debt-to-GDP ratio is no higher than the U.S., and yet it is Europe's bond market that is under attack. This is due to a lack of political coordination. Fortunately, France and Germany are beginning to talk about what amounts to a tighter fiscal union among Eurozone countries, including the possibility of creating a common tax base. The precise nature of this union remains vague. Any steps towards tighter fiscal collaboration must be viewed as a positive, as the lack thereof constitutes a serious flaw in the European monetary union. As an example, rolling up existing national deposit insurance agencies into a pan-European deposit insurance fund would be a way to assure depositors of the safety of their money, and get past the credibility issues of some of the weaker countries.

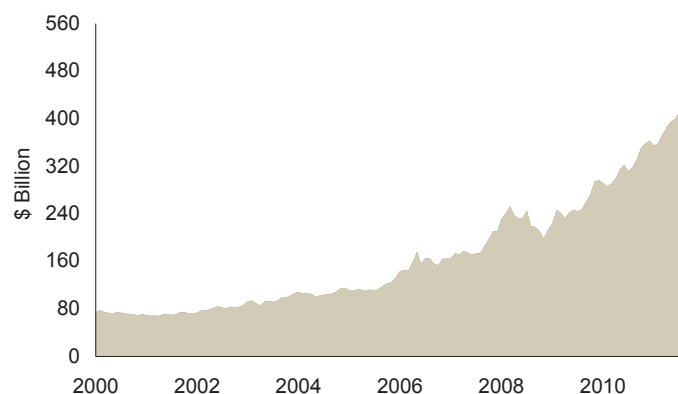
Unorthodox Policy

Lastly, there are a handful of truly unusual policy options that don't fit into any of the other categories.

First, lower commodity prices stimulate the global economy, especially beleaguered commodity importers like the U.S. and Europe. One tactic was already employed over the summer when the International Energy Agency released 60 million barrels of crude oil from the petroleum reserves of its member states. This lowered oil prices, and could be done again.

Continuing in that theme, OPEC could respond to the global economy's sputters by increasing production to moderately reduce oil prices, rather than take its chances

Exhibit 11: U.S. Gold Reserves Valued At An All-Time High



Gold reserves based on current market prices
Source: Haver Analytics, RBC GAM

with a full-blown recession that could have a much more damaging and permanent effect on oil. The prospect of a resumption of Libyan production is helpful.

Second, governments could sell some of their gold. The U.S. has almost \$500 billion worth at current market prices (Exhibit 11). This is clearly not enough to wipe clean a \$14 trillion debt load, but it could be a useful source of funding for some targeted fiscal stimulus. The timing is attractive given the elevated price of the shiny metal.¹⁰ Clearly, the price of gold would fall if such a large allotment were put on the market all at once. A wiser course of action might be to negotiate the sale to another foreign government, perhaps China or India.

Turning back to Europe's predicament, it is useful to recognize that even if European nations prove incapable of saving their weaker brethren, the capacity for action does not end with them. The rest of the world might be inclined to step in, given the alternative of a paralyzing global contagion. In particular, the IMF could create an enormous special-lending facility that the world's healthy countries and surplus nations might contribute to. The very existence of this facility would decrease the likelihood of speculative attacks on countries without true solvency problems (like Italy, Spain, France and Belgium); the lenders would get to keep their money in their own reserves until it was needed; and even if the recipient country defaulted, the IMF's senior lending status would ensure first dibs on the spoils. Much as the U.S. lent extensively to Europe during World War I, signalling a shift in economic power towards America, this scenario could constitute an opportunity

for various emerging market and current account surplus countries to demonstrate their newfound clout.

Conclusion

It is imperative that policymakers now strike back against economic weakness, and heartening that they have so many remaining options. Admittedly, not all of the ideas are wise. Many are untested and a few might constitute nothing more than pyrrhic victories. But there is a core of sound if unconventional policies that policymakers should contemplate if the economy is to regain the necessary confidence and support to resume its advance. Surely at least a few will get a tryout.

We cannot know precisely what policies will be implemented, as this will depend on the frailty of the economy and on complex (and dare we say dysfunctional) political dynamics in several countries. The most likely prospect is for additional monetary stimulus in the form

of pauses from central banks that were previously hiking, cuts from central banks that were previously pausing, and another round of quantitative easing in the U.S., the U.K. and Japan. The countries that can afford to generate additional targeted fiscal stimulus – and the U.S. remains one of these – probably should. In America, employment and housing are the obvious lodestones. Emerging market currencies are likely to continue their cautious appreciation, helping to restore global balance. There is obvious scope for regulatory reform and better clarity.

It is hard to fathom the available policy actions immediately transforming the global economy back to a verdant landscape. There is a limit to what policymakers can do at the best of times, and some of the traditional options are simply unavailable. But creative and pragmatic use of the remaining policy toolkit should at least prevent further economic defoliation, and hopefully sow the seeds of a gradual recovery.

Notes:

¹ This refers to the fact that policymakers usually react with stimulus to counteract negative economic or market events. This cuts off the majority of the downside risks to the economy, much as a put option does in the financial market.

² “How the Great Recession Was Brought to an End” by Alan Blinder and Mark Zandi.

³ This depends greatly on the country, as those with traditions of long-term borrowing feel the effect less quickly. The U.S. is a fascinating extreme, as the popular 30-year mortgage means that many borrowers do not feel rising rates for decades – if at all. And yet the ability to renegotiate their mortgage means they enjoy the benefit of lower interest rates immediately.

⁴ The first round of QE sharply lowered borrowing costs, boosted inflation expectations, unfroze financial markets and bolstered economic confidence. The second round of QE revived risk assets and reversed inflation expectations.

⁵ There are reasons this technique is not lightly undertaken. Inflation was the scourge of the 1970s, and central bankers have subsequently dedicated considerable efforts to eradicating it. Higher inflation punishes savers/lenders and rewards profligate borrowers. Such a step would hurt central bankers’ credibility, and might unmoor long-term inflation expectations. It is also economically inefficient over the long run.

⁶ How would the Fed distribute this money? There are myriad ways. If it really wanted to be sure that the money was spent and not saved (though saving would help rebuild household balance sheets), the Fed could create and distribute a generic gift card, good for use at any U.S. store, that becomes valueless at the end of a limited period of time. This would guarantee additional spending and inflation, and might create the momentum necessary to drive the economy forward. Or the Fed could go in a completely different direction and begin accumulating housing stock, putting money into the hands of banks and homeowners while fixing the housing overhang. Essentially, the entire realm of fiscal policy opens up.

⁷ In fact, Deutsche Bank estimates that MBS buyers would have to be induced into the market via higher yields, resulting in around a 60 basis point increase in mortgage rates – defeating much of the purpose of the operation. Moreover, the government has already had a program of this sort on the books for the past two years, and for various reasons fewer than 60,000 households have managed to access the program out of a potential pool of 5 million.

⁸ This has been implemented on a small scale in some economically devastated towns, but is unlikely to become national policy.

⁹ In the U.S., greater clarity on such matters as Basel III, Dodd-Frank, and a host of others might by itself improve the economic outlook. Dallas Fed President Fisher is just the latest in a long line of pundits to make this point.

¹⁰ Although gold still holds a special place in the hearts of many investors, the gold standard is no more. Gold is just another asset.



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