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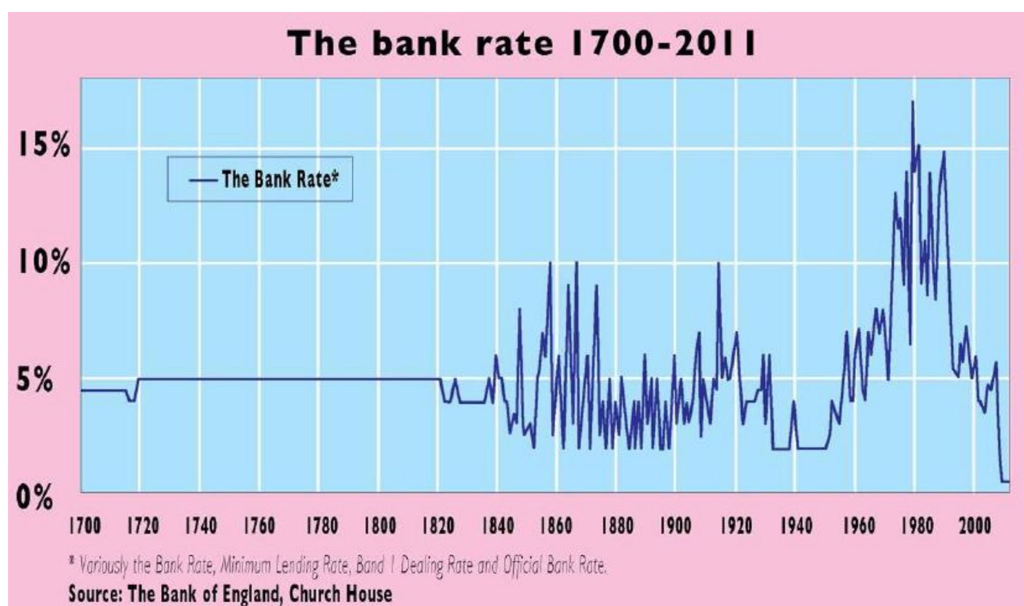
May you live in uncomfortable times

"We have undoubtedly expanded the credit structure, spending today and postponing the accounting until tomorrow. We have been guilty of the sin of inflation. And there will be no condoning the sin nor reduction of the penalty because the inflation is of credit rather than a monetary one..

"..the area covered by credit sales enlarges and the volume of credit expansion increases. As in monetary inflation the immediate results seem favourable. Credit expansion results in business activity, in full employment, in optimistic outlook and in a flood of congratulatory literature proclaiming us wiser than our predecessors. But the evidence is consistent and cumulative. The past decade has witnessed a great volume of credit inflation. Our period of prosperity in part was based on nothing more substantial than debt expansion."

- Charles E. Persons, excerpt from 'Credit Expansion, 1920 to 1929, and its lessons';
  Hat-tip to Eric Janszen at iTulip.com.

The chart frenzy continues. Friday 17th's inaugural MoneyWeek investment seminar provided no shortage of memorable charts, but Merryn's chart of the history of the UK base rate is a particularly remarkable one:



Notwithstanding any missing data issues for the period 1720-1820, we appear to be at a rather extraordinary stage in UK monetary history. The chart should speak for itself, but at the risk of putting words into its mouth, how about: "look at the most desperate monetary policy levels in the history of our country's monetary policy, ***because that's where you are***".

Of course UK policy interest rates – and those of the US, euro zone and Japan – are not at abnormally historically low levels for the benefit of savers, even though a structural inability to save as opposed to consume is arguably a pertinent factor in the current post-bubble environment. They are at abnormally low levels solely for the benefit of crippled banks, in order that they might attempt to restore their balance sheets and reflate profits through borrowing essentially free and lending at quite a bit more than zero (where they choose to lend at all). The example of Japan, of course, which has been flirting with deflation these past two decades, is not entirely encouraging. In any event, when policy rates reach the zero bound, they cannot of course decline further, which leaves quantitative easing as the last resort of the desperate central banker.

Paul Kasriel points out that the current chairman of the US Federal Reserve, Ben Bernanke, wrote an essay for the Peterson Institute for International Economics in 2000 entitled 'Japanese Monetary Policy: a case of self-induced paralysis ?' In the essay, Bernanke argues that the only thing preventing the Bank of Japan from righting its own top-heavy economic ship is intellectual paralysis on the part of the Bank of Japan and / or the Japanese government. We would refer new readers to the letter to the FT which we republished last week:

"..The US Federal Reserve's obsession with Japan is pretty disastrous. First, Alan Greenspan opened the taps wide for too long, fearing Japanese-style deflation.. Now, fearing the lost decade plus, the Fed is probably going to keep easing until some different but unpleasant outcome is the result. Stagflation perhaps, or hyperinflation ?

"This is so ironic, because for so long people have sneered at the Japanese for their inability to steer their economy to recovery. Perhaps because they have sneered so much, it is no longer possible to admit that after a huge housing bubble bursts, there is nothing to do except suffer many years of economic indignity."

As Kasriel suggests,

"..the now 2011 Federal Reserve chairman Bernanke seems to have contracted a case of the same monetary policy paralysis he diagnosed Bank of Japan officials of being afflicted with in the 1990s. At least, this would be the logical conclusion to the FOMC's decision today to terminate its policy of quantitative easing."

In his second post-FOMC press conference, Bernanke admitted that the US economic recovery was weaker than expected and that beyond temporary factors such as supply chain disruptions triggered by the Japanese earthquake and high energy prices [a temporary factor ? Discuss] he was at a loss as to what was causing the soft patch. In short, Bernanke admitted that he had no idea why the US recovery was so fragile.

While scanning the FT archive for a specific satirical letter on the topic of quantitative easing, this author found another on the same topic which highlighted one of the unintended consequences of QE, from a Mr Donald Amstad in Singapore (published in October last year):

"..It is hypocritical for the US to criticise China's intervention in currency markets, because that is exactly what the US is doing with quantitative easing. Printing money is de facto currency manipulation because it weakens the currency.

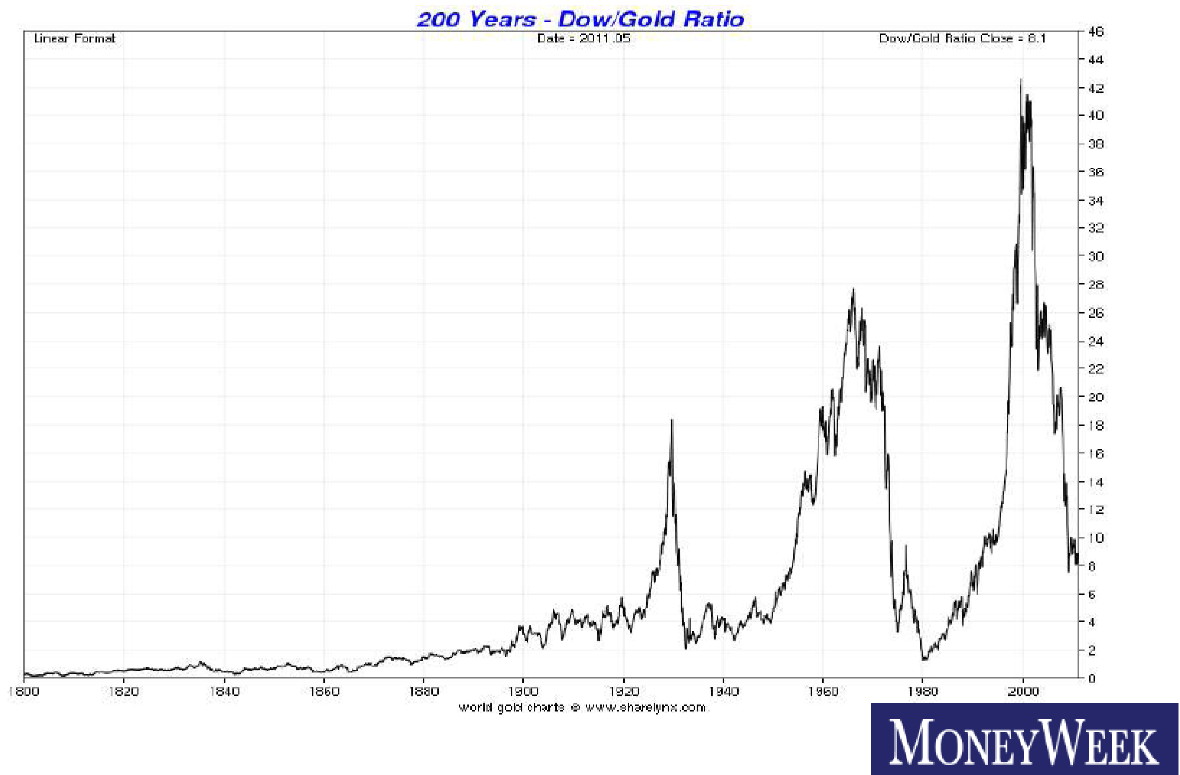
"As regards the US' more general history of intervening in markets, its track record is second to none. Think of 1987 and the Greenspan, now Bernanke, "put" and the new peaks scaled in the last three years. The US cannot have it both ways.

"It is wrong for the US to print money because.. money is flooding out in search of safe havens. Today, that means the currency, stock and bond markets of the solvent and growing developing world and commodities.

"It is damaging because the US is now causing economic and financial havoc in economies where hundreds of people are on the march out of poverty."

The chart with which we opened, that of the UK bank rate between 1700 and 2011, is frightening for a number of reasons. One, because it smacks of desperation on the part of the monetary authorities. Two, because it is forcibly impoverishing a cohort of investors who can either sit on the sidelines quietly watching their savings evaporate in real terms courtesy of state-sanctioned inflationism, or who feel obligated to put their capital to work in risk asset markets for which their capital may never have been originally intended. Now that is moral hazard on the part of our monetary authorities ! Three, because artificially suppressing the cost of capital – assuming that individuals or corporations can admittedly borrow at anything close to those headline rates, if at all – sends out hugely destructive and plainly incorrect price signals to businesspeople and entrepreneurs. This runs the real risk of provoking a huge wave of malinvestments – investments undertaken solely because the market's price mechanism has been wilfully distorted, investments that would never be undertaken if market interest rates were at a more meaningful "high" level in real terms. The financial crisis was provoked in large part because monetary policy rates were kept artificially low. Do we really think it can be resolved by allowing history to repeat itself ? Four, because maintaining base interest rates at zero – and manipulating the price of government bonds higher with some vague sense of creating higher confidence in the process – makes it impossible to fairly and objectively value all risk assets, and not just debt. There is not one single market investment in existence the value of which has not been affected in some way by quantitative easing. Central banks might argue that that was precisely the point of the exercise. But playing a game against a dealer who arbitrarily makes and rewrites all the rules is not a game that many investors would voluntarily play.

For those investors who refuse to sit idly in cash pending the return of economic and regulatory sanity – it could be a long wait – the 'go-to' asset, we have long suggested, in such an extraordinary and extraordinarily challenging and manipulated asset environment, is gold. It is one investment – a currency, if you will – that is stateless and beyond the power of any single government or agency to print into creation on a whim. Gold is the anti-dollar, the anti-pound, the anti-euro. The antidote, perhaps, to an intensifying money sickness running rampant throughout the financial markets, urged on by bureaucrats who have no holistic sense of the damage they are wreaking on the free market infrastructure. But one niggling question on the part of many paper-bug sceptics of the merit of the monetary metals has always been: fair enough, but if I do buy, when to sell ? Fellow MoneyWeek contributor Dominic Frisby addressed this question during his own presentation at the seminar. We single out one of his ratios as a personal favourite: the ratio of the Dow Jones Industrial Average to gold (see below):



After the 1929 Crash – seeded, as our earlier correspondent Charles Persons noted, through an unsustainable prior expansion in credit – the US stock market bottomed at a ratio of Dow/gold of around 2 times – you could "buy" one Dow with just 2 ounces of gold. After the last major gold bull market of the inflationary 1970s, the US stock market bottomed at a ratio of Dow/gold of less than 2 times. 2 times is one ratio that Dominic is targeting as a profit-taking exit point for this gold run. Since this rolling financial crisis could conceivably end with a wholesale restructuring of the global monetary system, we may have to wait a little while for it to come about. But since this exit point is expressed as a ratio, it could come about either from a **significant** further appreciation in the price of gold in isolation, or from a significant further **deterioration** in the price of, say, US equities, or from a combination of both trends. This last outcome seems to us the most likely.

And finally.. we are well aware that to be so consistently "fashionably declinist" in our commentary can be wearing on the soul. So we conclude this week with a photograph of an orangutan baby.

Source: Arthur Xanthopoulos / Barcroft.

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