Myrmikan Update

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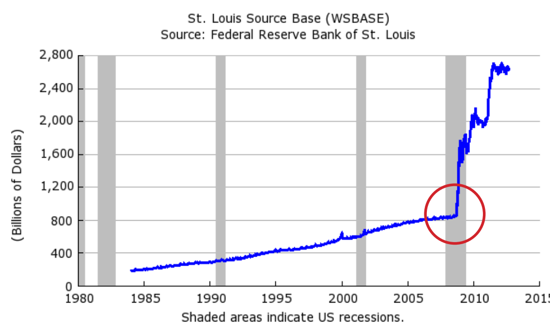
Stumbling Toward the Tipping Point

Federal Reserve Chairman Ben Bernanke gave a speech on December 1, 2008 explaining the dynamics of the then-unknown mechanism called Quantitative Easing. Bernanke felt compelled to preempt the charge that the Fed's policy would cause inflation:

> Expanding the provision of liquidity leads also to further expansion of the balance sheet of the Federal Reserve. To avoid inflation in the long run and to allow short-term interest rates ultimately to return to normal levels, the Fed's balance sheet will eventually have to be brought back to a more sustainable level. The FOMC will ensure that that is done in a timely way. However, that is an issue for the future; for now, the goal of policy must be to support financial markets and the economy.



Numerous Austrian economists opined at the time that the Fed would never shrink its balance sheet. In fact, the then-fringe claim was that once having started to print money to support the economy the Fed would need to continue printing, and at an accelerating pace.

QE1, QE1+, QE2, Twist 1 & 2, and now QE3 (or QE6 to keep strict count) have proved the Austrian view correct. In fact, deep study of Austrian economics is not required to understand the treadmill on which the Fed now finds itself. A passing acquaintance of any number of the many hyperinflations in world history reveals the pattern that money printing demands accelerated money printing. For, if ever the printing stops, the economy suffers and financial markets founder. As such, money printing normally continues, increasingly erratic, until inflation reaches such extremes that the economy and monetary system collapse.

Financial markets, and the Obama Administration, have been waiting impatiently for an acceleration of the Fed's programs. The first round was $600 billion, with a top-up of an additional $300 billion to maintain the size of the Fed's balance sheet as existing debt matured, at a rate of $30 billion per month. The second round was $600 billion implemented at $75 billion per month. The Operation Twists sold liquid[1] bonds to buy illiquid bonds at a rate of $45 billion per month for an announced total of $667 billion.

It should not surprise that the economy began to weaken as the pace of printing slackened. To boost the economy and help re-elect the incumbent, a Fed tradition since its founding, a larger program was needed. But, it would have been politically awkward for the Fed to

1 Using here the term "liquid" in the proper, though not colloquial, meaning of near-to-maturity. Long term debt that is easily sold may be "shiftable" to someone else, but it is not liquid, a distinction explored by Melchior Payli in his essay *Liquidity*, available at http://www.cmre.org/publications/melchior-palyi-liquidity/

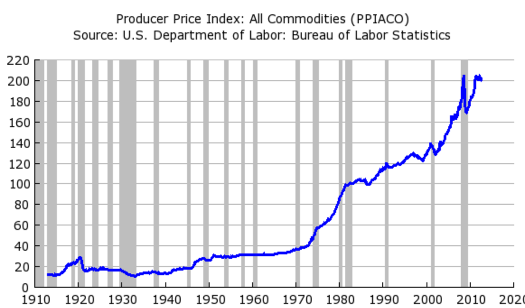
announce a large program so close to the election, so instead it took the advice of Goldman Sachs published in June:

> However, it is also possible that the program would be specified as a "flow" of purchases of perhaps $50bn-$75bn per month. Although there has been little talk about the latter option, it enables the committee to respond more flexibly to changing economic conditions and may be optically more attractive if the committee is worried about a political backlash domestically or abroad against further balance sheet expansion.

In fact, the QE3 announced on September 13 will be $40 billion per month of "open-ended" asset purchases in addition to the $45 billion per month in Twist purchases giving a total of $85 billion per month. To manage optics, no total figure was supplied, but instead the Fed threatened:

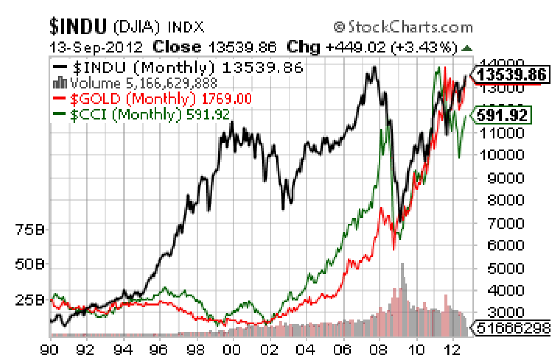
> If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability.

It is impossible to overstate the importance of the above paragraph. Just as the Fed could never again substantially shrink its balance sheet after 2008, it now will never be able to stop the flow of printing without destroying the economy.



The morning QE3 was launched, the Department of Labor announced that initial unemployment claims had risen to 382 thousand, 15 thousand more than the previous week, while the Bureau of Labor Statistics reported that the Producer Price Index rose 1.7% in August. According to conventional theory, inflation and unemployment should not rise together. Unemployment signals there is slack in the economy, and therefore producers should have no pricing power.

The latest PPI figures demonstrate that this theory is incorrect. The Fed can print dollars, but it cannot print commodities. The new dollars drive cost structures higher, raising prices even while falling demand lowers throughput, hollowing out the economy. Looking at the graph above, it is not hard to predict where this line will go with the new open-ended money printing.



In fact, while unemployment and various industrial and trade statistics pushed the Fed into action, *the new QE is taking place with the stock market, gold, and commodities near all time highs*. Inflation will soon reach levels where it is not possible to camouflage with the statistical tricks embedded in the CPI.

And, yet, the printing will continue because it must. The Fed's statement included this line: "the Committee expects that a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens." The economy cannot strengthen without putting substantial upwards pressure on prices. Asked during his press conference if the Fed would reverse course were inflation to go above the 2% annual target, Bernanke responded:

> If inflation goes above the target level . . . we would take a balanced approach. We would bring inflation back to the target over time, and we would do it in a way that takes into account the deviations of both of our objectives from their targets.

In Fedspeak, Bernanke is signalling that the official inflation rate will go well beyond 2%. This means real inflation is set to soar. And, yet, the printing will continue.

Running out of Treasuries to buy, it is no surprise that the Fed is turning again to Mortgage Backed Securities. But this market is also limited. According to a report issued by Bank of America, by 2014 the Fed's balance sheet will be greater than $5 trillion, or 30% of projected US GDP, and will comprise of 33% of the entire mortgage market and 65% of Treasuries with a maturity greater than 5 years.

Though the Fed will be forced to print at an ever faster pace, the path to hyperinflation will not be a smooth one. No doubt, the Fed will attempt to slow the printing at various times causing the economy to slow and asset prices to tumble. When the Fed has saturated the mortgage and Treasury markets and it is time to switch to equities (in the manner of the Bank of Japan), money printing will pause as resistance reorganizes. But, the resulting pain will be such that the population will demand ever stronger measures.

Anyone who doubts this progression should read Andrew White's *Inflation in France* about the hyperinflation during the French Revolution in the 1790s, written in 1912 and available free online. Some choice excerpts include:

> The first result of this issue [of paper money] was apparently all that the most sanguine could desire: the treasury was at once greatly relieved; a portion of the public debt was paid; creditors were encouraged; credit revived; ordinary expenses were met . . . But soon there came another result: times grew less easy. . . . The old remedy immediately and naturally recurred to the minds of men. Throughout the country began a cry for another issue of paper; thoughtful men then began to recall what their fathers had told them about the seductive path of paper-money issues in John Law's time . . . The opponents of paper had prophesied that, once on the downward path of inflation, the nation could not be restrained and that more issues would follow.

White records that after a few rounds of money printing:

> France was now fully committed to a policy of inflation; and, if there had been any question of this before, all doubts were removed now by various acts very significant as showing the exceeding difficulty of stopping a nation once in the full tide of a depreciating currency. The National Assembly had from the first shown an amazing liberality to all sorts of enterprises, wise or foolish, which were urged "for the good of the people. . . ." Yet each of these issues [of paper money], great or small, was but as a drop of cold water to a parched throat. Although there was already a rise in prices which showed that the amount needed for circulation had been exceeded, the cry for "more circulating medium" was continued. The pressure for new issues became stronger and stronger. The Parisian populace and the Jacobin Club were especially loud in their demands for them; and, a few months later, on June 19, 1791, with few speeches, in a silence very ominous, a new issue was

> made of six hundred millions more;—less than nine months after the former great issue, with its solemn pledges to keep down the amount in circulation. With the exception of a few thoughtful men, the whole nation again sang paeans.

This is where the United States currently finds itself: a profligate state, rising prices demonstrating no lack of money, and a financial population crying out loudly for ever more free money. No longer will be there be romantic declarations of large sums of new dollars as a final solution to the crisis. QE is now a process that will expand quietly, masking great consequences with small figures.

Only the useful idiot professors and financial commentators will cheer. Those who gain will be, according to White: "the class of debauched speculators, the most injurious class that a nation can harbor,—more injurious, indeed, than professional criminals whom the law recognizes and can throttle." The few who are thoughtful will quicken their acquisition of gold as the only safe haven from the currency and asset bubbles. The ebbing purchasing power of savings and financial assets will force ever more to become thoughtful. As Ludwig von Mises described it:

> Finally, the public becomes aware of what is happening. People realize that there will be no end to the issue of more and more money substitutes—that prices will consequently rise at an accelerated pace. They comprehend that under such a state of affairs it is detrimental to keep cash. In order to prevent being victimized by the progressing drop in money's purchasing power, they rush to buy commodities, no matter what their prices may be and whether or not they need them. They prefer everything else to money. They arrange what in 1923 in Germany, when the Reich set the classical example for the policy of endless credit expansion, was called *die Flucht in die Sachwerte*, the flight into real values. The whole currency system breaks down. Its unit's purchasing power dwindles to zero. People resort to barter or to the use of another type of foreign or domestic money. The crisis emerges.

Gold's correction is over. It will not take long for gold to make new highs as institutions and individuals, foreign and domestic, scramble for safety chasing prices higher. As events force the institutions to raise their long term gold price forecasts, currently focused in the $1100 to $1300 area, their models will reveal gold miners to be vastly undervalued. Declining profit opportunities elsewhere will compel entry into the sector, too small to accept even a small portion of global capital without dramatic increases in prices. As the Fed prints and prices rise, the tipping point described by Mises above will draw near.

Although the last several months were emotionally traumatic for those in the gold trade, retrospect will recall only the delight of being able to buy solid assets at such ridiculously low prices. Though the mining shares have bounced from the bottom, senior gold stocks remain at depressed levels while junior gold stocks still trade at distressed levels. These valuations cannot last. The first target is the previous cycle's highs – for many issues multiples above current levels – followed by a speculative wave higher.

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