
Can We Survive Four More Years?

By Martin Hutchinson *Thu, Jan 24, 2013*

This always-bearish guest columnist expects that it will eventually be morning again in America, but not without an intervening period of financial chaos and catastrophe.

President Obama's intransigence on economic matters is increasingly clear, so compromise seems unlikely and a succession of tax increases and wasteful spending programs seems inevitable. Meanwhile Ben Bernanke's Fed enables this dangerous course by massive "quantitative easing."

Assuming Bernanke is succeeded by a like-minded colleague (more on that below), we will thus suffer this economically poisonous combination of policies until January 2017. The U.S. economy is unlikely to make it that far in anything like its present shape.

Neither Obama's nor Bernanke's damaging policies would be possible without the cooperation of the other. If the Fed were maintaining short-term rates at above the rate of inflation, without buying large quantities of Treasuries, the Treasury would have great difficulty financing endless \$1 trillion deficits without pushing up long-term interest rates to intolerable levels and loading future years with huge debt interest payments.

Without Obama and his deficits Bernanke would have great difficulty purchasing \$1 trillion of long-term Treasuries and Agency securities annually, since new Treasury bonds would only be issued to replace retiring bonds. The distortions he created by doing so would disrupt the bond market, feeding rapidly into a level of consumer price inflation that he would have a statutory duty to address.

Both Obama and Bernanke appear determined to continue pursuing their ruinous policies. Obama has announced he will not permit spending cuts in connection with a debt ceiling hike, while Bernanke on January 14 said the "worst thing the Fed could do" would be to raise rates "prematurely."

Had we gone over the "fiscal cliff" as this column advocated, more than three quarters of the federal deficit would have been eliminated, and further deficits could have been prevented by the Republican House of Representatives. However the GOP House leadership wimped out, and as a result we are left in a position where taxes on the rich have already been raised substantially, but the deficit has been left almost unaffected - indeed it has been increased in the first year by the disgraceful \$60 billion of tax breaks granted to politically favored corporations and scam artists.

Obama is with us until January 2017, but Bernanke has indicated he may retire next January when his term of office is up. In general Bernanke's is the scalp lovers of sound policy should seek. Obama's damage has already been done, and while he may prevent any near-term attempt to address the deficit, Republican control of the House means he cannot increase spending more than marginally. Every extra month of Bernankeism, on the other hand, distorts the economy further.

It was not difficult to determine before his appointment that Bernanke would be a disaster as Fed chairman; this column said so in a piece published a week before he was appointed, remarking that

“Bernanke’s approach to monetary policy, in which all economic problems can be solved by creating money, is that of the 1919-23 Weimar Republic, which achieved in September and October 1923 inflation rates of 2,500% per month.”

This column can claim only partial credit for prescience; in the event we got the policy, but did not suffer the predicted inflation, being rewarded by an exceptionally deep and prolonged recession instead. Such are the vagaries of economic prognostication!

Next time around, there are few candidates who might move to a tighter policy, although former Fed vice chairman Roger Ferguson, currently CEO of the pension fund TIAA-CREF, is eminently qualified and as a registered Democrat is at least a plausible appointment for President Obama. More likely however is the current Fed vice chairman Janet Yellen, whose published views suggest that she would favor even more easing. However as a known liberal Democrat without Bernanke’s long service she might find it more difficult to attract a majority on the Federal Open Market Committee than has Bernanke. A Yellen Fed would thus probably be a modest improvement over the current one.

One disquieting suggestion I have seen recently is that New York Mayor Mike Bloomberg might want the job; his combination of primitive Keynesianism and proven tendency to meddle obtrusively in everybody’s lives would be truly frightening in a job with such power.

Thus it is highly unlikely that Bernanke’s successor will be much of an improvement. Hence we are for the next four years likely to be subject to ultra-loose monetary policy and trillion-dollar budget deficits.

One area where my crystal ball is now unclear is whether this will cause an outburst of inflation. By monetarist theory it should; M2 money supply has risen at an annual rate of 9.9% in the last 6 months while the St Louis Fed’s MZM, the nearest proxy we have to M3, has risen at 10.6% in the same period. With output rising at only 2%, that should produce inflation of around 8%.

Milton Friedman said “Inflation is always and everywhere a monetary phenomenon,” so where the hell is it? Leads and lags are all very well, but even taking into account a flat stretch between mid-2009 and mid-2010 M2 has been growing at an annual rate of 7.2% since the end of 2007, far in excess of the feeble 2.3% growth in nominal GDP. Monetary “velocity,” that elusive concept, has dropped like a rock (mathematically it had to, given the data), but its ability to do so without any reasonable explanation in itself makes monetary theory look increasingly chimerical.

More likely than a sudden resurgence of Weimar-like inflation is a market crash. Global sub-zero real interest rates have boosted corporate profits to record levels (in terms of US GDP) as well as the value of bonds, commodities and other assets. The Dow Jones index remains about 6,000 points higher, in terms of U.S. GDP, than when Greenspan began easing monetary policy in February 1995. Gold is at double its 1980 high. U.S. house prices have bottomed out and are rapidly reflating. Global foreign exchange reserves have been increasing at 16% annually since the Asian crash of late 1997.

For the current market to be sustainable for another four years the value of capital assets would have to have moved to a permanently higher level in terms of the value of everything else. Capital assets have

become the destination for the world's excess money supply, but it doesn't seem likely that even Ben Bernanke and his colleagues can sustain this disequilibrium forever. Most likely, like tech stock prices in 1997-2000 and house prices in 2004-06, the overvaluation will persist long enough for a substantial body of dozy opinion to decide it's permanent and put all their money on it continuing, doubtless leveraging up to the eyeballs to do so.

Once the silly money has piled in, as with housing in 2007 and tech stocks in 2000, valuations will start to slip. Most likely this will be seen first in the Treasury bond market, where even Bernanke's trillions will prove insufficient to keep the 10-year yield below 2% forever. That will cause a price collapse similar to that of 2007, where previously unassailable financial institutions will be found to have eroded their capital base by overinvestment in T-bonds. Since the Treasury bond market is so huge this in turn will cause a sell-off in the world's equity markets, with corporate earnings being eroded by the rise in interest rates.

Another example of such a slow-motion collapse is Japan after 1990, where eventually a high percentage of Japan's most admired corporations were found to have speculated excessively in short-term "tokkin" funds. In that case, the major banks propped up the loser corporations, wrecking the banking system, filling the country with zombie corporations and causing a 20-year period of economic sluggishness.

In the early years of that period, Japan's policy responses remained fairly orthodox, but since Ben Bernanke's visit to the country in 1998, dispensing truly awful advice, it has been plagued by misguided Keynesian "stimulus" and money-printing by the central bank, prolonging the downturn more or less ad infinitum. On the Japan analogy, if U.S. policy remains as bad as Japan's has been, we are due a downturn lasting until 2035 or so.

If the Obama/Bernanke policies do not cause inflation, but instead produce a collapse of markets and a major recession, we will finally have an answer to the century-old battle between monetarists, Keynesians and the Austrian school of economists.

Keynesian economists will be discredited by the failure of \$1 trillion annually of deficit "stimulus" to stimulate anything beyond an asset bubble, with unemployment remaining stubbornly high.

Monetarists will be discredited by the failure of Bernanke's gigantic monetary stimulus to produce economic recovery, and by the corresponding absence of a serious burst of inflation. The winner in the intellectual battle will be the Austrian school, in its pure Ludwig von Mises form, which will have seen monetary and fiscal expansion produce only a mountain of "malinvestment," the collapse of which will take several years and a major depression to work out.

Of course, that economic victory will be of little consolation to those of us forced to live through the depression, although we can hope that the next such episode in 2070 or so will be solved more effectively, with Keynes and Friedman relegated to the sidelines.

As for the timing, I have said before that I don't think 2013 will be the year in which the bubble bursts - there is as yet insufficient speculative frenzy, although the market temperature is certainly rising. Moreover, it would be a pity to have such a record-breaking blow-off without a serious speculative bubble

in gold similar to that of 1978-80 - which if the \$1500-1900 gold price of the past 15 months is regarded as a base, suggests a gold price peaking certainly above \$3,000, very possibly above \$5,000.

Equally, it would seem impossible for the present bubble to outlast President Obama, and fairly unlikely for it to last into the election year of 2016. The 18-month period between July 2014 and December 2015 would thus be my best guess for the onset of collapse, with a prolonged rolling crisis lasting for the greater part of that period being the most likely outcome. 2016 and 2017 would then be years of grinding depression, benefiting the 2016 electoral prospects of both Republicans and extremist fruitcakes on both ends of the spectrum.

In the very long term, U.S. reserves of cheap energy, the intellectual capital in its research facilities and the political distaste of its people for infinite Washington expansion are pretty good guarantees that we will again see prosperity. But it's not going to happen within the next four years.

Martin Hutchinson's work can usually be found at prudentbear.com.