The Fed and the Debased "Imperial Dollar": Inflation, Stagnation and Higher Interest Rates Ahead

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> "Under a paper money system, a determined government can always generate higher spending and hence positive inflation."Ben Bernanke, future Fed Chairman (in 2002)

> "My thesis here is that cooperation between the monetary and fiscal authorities in Japan could help solve the problems that each policymaker faces on its own. Consider for example a tax cut for households and businesses that is explicitly coupled with incremental BOJ purchases of government debt – so that the tax cut is in effect financed by money creation. Moreover, assume that the Bank of Japan has made a commitment, by announcing a price-level target, to reflate the economy, so that much or all of the increase in the money stock is viewed as permanent."Ben Bernanke, future Fed Chairman (in 2002)

> "The Fed, in effect, is telling the markets not to worry about our fiscal deficits, it will be the buyer of first and perhaps last resort. There is no need – as with Charles Ponzi – to find an increasing amount of future gullibles, they will just write the check themselves. I ask you: Has there ever been a Ponzi scheme so brazen? There has not." Bill Gross, PIMCO's managing director

On Wednesday, November 3rd, the Bernanke Fed announced that it stands ready to resume money printing to stimulate the economy through quantitative money easing, an euphemism for printing more dollars. Indeed, it intends to buy $600-billion of longer-term Treasury securities until the end of the second quarter of 2011, plus some $300 billion of reinvestments, on top of the some $1.75 trillion of various types of securities, many of which were mortgage backed securities, that it has added in 2009 to its balance sheet, currently standing at a total of $2.3 trillion. There could even be additional increases in newly printed money as the Fed intends to *"regularly review and adjust the program as needed to best foster maximum employment and price stability."*

After the election of fiscal conservatives on November 2nd, it seems that printing money is the only instrument left for the Obama administration to stimulate the economy. I fail to see, however, what is "conservative" about that. Actively debasing a currency to stimulate an economy used to be a Third-World economic recipe, —A recipe for disaster. Now, the United States government feels that is the only way to get out of the economic doldrums.

But U.S. economic problems are essentially structural in nature, and are due to a bad housing mortgage policy, a bad industrial policy, a bad financial policy, a bad fiscal policy, a bad foreign investment policy, too much entitlement debt, severe demographic problems related to the aging baby-boomers, and to very costly wars abroad. Relying exclusively on monetary quick fixes to correct them misses the mark and may have serious unintended negative consequences down the road.

In fact, it is likely that in the long run, this extreme monetary policy risks exacerbating rather than correcting the problems. Economic structural problems cannot be corrected with monetary means. They rather require real economic solutions. That means correcting the housing mortgage mess and devising an industrial strategy, a fiscal strategy, and an investment strategy that can put the economy back on its tracks of economic growth.

But, for better or worse, the Federal Reserve Board (Fed) seems to be the only branch of the U.S. government left that can still function properly, i.e. that is not caught in a permanent political gridlock. As a consequence, for the time being at least, bankers are in charge of the U.S. economy. Since they are the ones who created many of the current problems, this is not very reassuring.

Let's remind ourselves that the Fed is a semi-public, semi-private organization that has a long history of creating financial asset price bubbles in the U.S and around the world, essentially because the U.S. dollar is an international key-currency widely used around the world and is an important part of other central banks' official reserves.

Thus, the real danger is that the Fed will again overdo it and create unmanageable financial and monetary bubbles in the coming years. —It did it in the past. It did it in the late 1960's and early '70s, and we witnessed the same scenario unfolding with the Greenspan Fed in the late 1990s, when excessive easy money helped inflate the Internet and tech stock market bubble. We saw this again in the early 2000s, when easy Fed money helped inflate the housing bubble. And now, we're seeing it again with the Bernanke Fed. As a general rule, a central bank should not push the monetary gas pedal to the floor and be obliged to slam on the monetary brakes later, thus placing the real economy on a roller-coaster of booms and busts. That is not the way to run a large economy.

But because of the circumstances, the Fed may be at it again. This time it is busy creating a massive bond bubble, some important currency misalignments and a massive gold and commodity price bubble. We should also not forget that abnormally low interest rates and lower bond yields increase the present value of pension liabilities of most defined benefit pension plans.

Therefore, I would not be surprised to see a pension crisis developing in the coming years under the current Fed monetary policy. Of course, all of these bubbles are interrelated but when they come crashing down, four or five years down the road, maybe sooner, the economy may then be in worse shape than it is today. My most likely scenario is for the Fed to keep the monetary gas pedal way down until the 2012 election, and then slam on the monetary brakes thereafter to salvage what will be left of the imperial dollar.

If so, this could be a partial repeat of Japan's experience in mismanaging its economy in the early 1990's until 2000, a period known as the lost decade.

The current Fed's monetary policy is to flood financial markets with liquidity, i.e. newly created dollars, and, in the process, devalue the U.S. dollar, spur American exports and prevent deflationary expectations from taking hold and from making already high debt loads even heavier. For this, the Fed has been engaged since 2009 in round after round of money creation and interest rate reductions to the point of pushing short-term monetary rates close to zero and keeping short-term real rates negative. But if the economy is in a liquidity trap, as it is fair to assume it is, although a central bank can print all the money it wants, this is unlikely to stimulate the real economy for very long. —This is like pushing on a string. Printing money, if it is an emergency temporary measure, can help mitigate the effect of having too much debt and debt-service costs relative to income, as is the case today with many debtors in a debt liquidation mode. However, if this becomes a feature of monetary policy for too long, it can have disastrous consequences.

In general, it can be said that the Fed can manipulate short term interest rates by artificially increasing demand for short term securities, but inflation expectations are a big component of long term interest rates and are much less influenced by the Fed. Therefore, if the Fed's intention of printing large amounts of new money raises fears of future inflation, long term interest rates may rise rather than fall, and this is bound to hurt long-term productive investments.

Moreover, make no mistake, with globalized financial markets, a large chunk of the newly created dollars is flowing out of the United States and is invested in higher interest rate countries, pushing the dollar further down and these countries' currencies further up. Of course, some of the newly created money will immediately find its way in the stock market, but there is no certainty that this will induce already stretched banks to increase their banking loans to businesses.

Another consequence is this: The current outflow of U.S. dollars helps keep the dollar exchange rate low, but when the Fed is forced to aggressively raise interest rates, as it will inevitably be forced to do later on, the reverse will happen and the U.S. dollar will likely overshoot and then become overvalued. This is the case today with the Japanese yen which became unduly strong when the Japanese carry trade (too much cheap money invested abroad returns home) collapsed.

What counts for most people, however, is that the Fed's zero-interest rate policy has not cured the structural housing mortgage crisis, since home foreclosures are still very high. The Fed now places most of its hopes on a currency devaluation, which is the old trick of the "beggar thy neighbor" policy, i.e. trying to export one country's unemployment to its trading partners by devaluating the currency. This was a form of protectionism much relied upon during the 1929-39 Great Depression. This may work for a while, at least as long as other countries can absorb American exports without launching their own money printing process in order to prevent an appreciation of their currencies.

Indeed, is it likely that countries which see their currencies being revalued by the Fed will remain passive? The Fed is implicitly making the bet that these countries will not retaliate, and that the international dollar-based currency system will remain intact. But for how long? Sooner or later, some central banks around the world will have no choice but to impose capital controls in order to slow down the inflow of unwanted outside money and the onslaught of imported inflation, and prevent their exchanges rates from rising too high too fast. If they do, the entire process of economic globalization may begin to unravel.

Meanwhile, foreign central banks, for example, could accelerate their rush to dump the U.S dollar and to accumulate gold and other more stable currencies such as the euro, the Swiss franc, the British pound, the Canadian dollar and the Australian dollar. China has already begun to do just that. The share of dollar official reserves would then decline from about 60 percent presently to perhaps less than 50 percent. That may signal the beginning of the end for the "imperial dollar" which has dominated the international monetary system since the Bretton Woods conference of 1944.

This is to be followed closely.

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The book "***The Code for Global Ethics, Ten Humanist Principles***", by Dr. Rodrigue Tremblay, prefaced by Dr. Paul Kurtz, has just been released by Prometheus Books.: www.TheCodeForGlobalEthics.com/

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