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One last gasp for Treasurys?

In his valedictory to the nation's economists in Philadelphia last week, Ben Bernanke reiterated his commitment to a price level that never falls but always rises: a rate of 2% a year would be nice, the chairman affirmed. That sentiment, made familiar by years of repetition, scarcely raised an eyebrow, let alone a controversy. It's a deficit we undertake to correct. To put the conclusion ahead of the argument, the Fed will discover—we all will discover—that nothing's so unstable as a stabilized price level.

As we read the new year consensus of investment sentiment, people love stocks, hate bonds and feel sorry for gold. "In the many years I've been surveying experts for their predictions for the coming year," writes *New York Times'* columnist James B. Stewart, "I cannot recall another time when optimism about the stock market, the economy and corporate profits was so widespread. As is pessimism about the bond market."

Perhaps the trader's maxim applies: "If it's obvious, it's obviously wrong." If so, it may behoove us, aged and grizzled bond bears, to imagine a contrary scenario. We ground these imaginings in a longstanding *Grant's* theme, namely, there ought to be deflation.

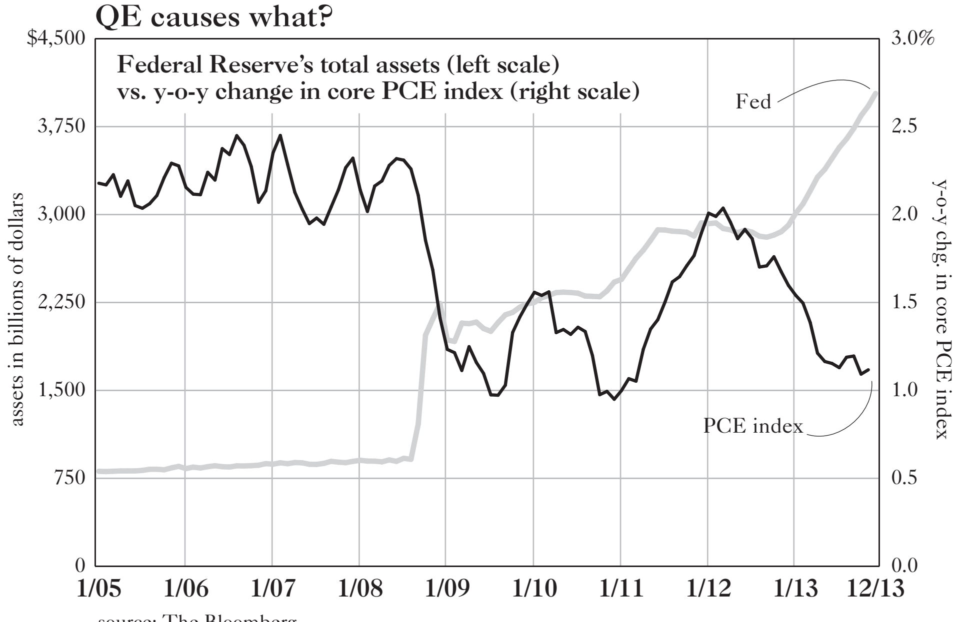
There ought to be inflation, too, this publication has maintained at intervals since the dawn of QE. Let us rather now focus on the march of progress—and on the accretion of debt. As technology advances, prices should fall. As it costs less to make things, so it should cost less to buy them. In the case of TV sets, washing machines, refrigerators, cell phones, etc., prices have been falling for years. Not since 1996 has the durable goods' segment of the personal consumption expenditures price index registered a positive year-over-year change.

Debt, like progress, is a force for deflation. Encumbered firms produce to remain solvent. Heavily encumbered firms overproduce. Overproduction presses down prices. Easy access to debt prolongs the life of marginal firms. They don't go broke but, finding ready access to speculative-grade credit, carry on, thus adding to the physical volume of production and therefore to the overhead weight on prices. Debt is deflationary the more it drives production, or—in the case of governments and individuals—the more it constricts consumption.

Money printing is inflationary. It lifts some prices, but in the current cycle, not all of them. Banks have been impaired. Borrowers have been reluctant. The dollars that the Fed has conjured, most of them, take the shape of unmobilized bank reserves. They are inert.

The central bank is egging on inflation with one hand but suppressing it with the other. It materializes the dollars that drive some prices higher. It fosters the debt formation that presses certain other prices lower. What it refuses to do is let markets clear.

Since December 2007, the Fed, the People's Bank of China, the European Central Bank, the Bank of Japan and the Bank of England have collectively materialized the equivalent of $8.9 trillion. The five central banks have inflated their balance sheets to $15.1 trillion, or to 20.6% of global GDP, from



source: The Bloomberg

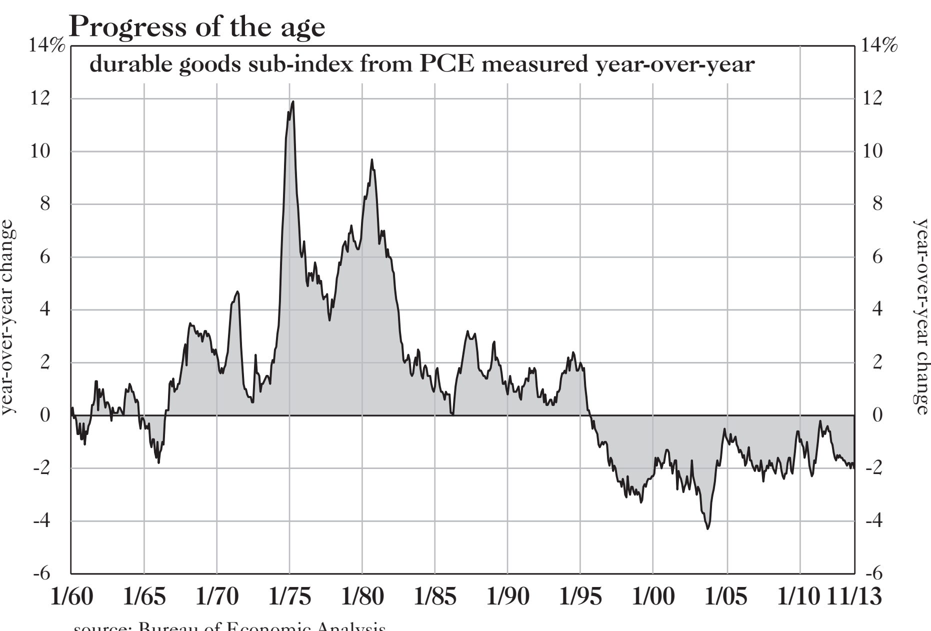
$6.3 trillion, or 11.1% of world GDP in December 2007. Yet measured rates of inflation have dwindled. In neither the euro zone nor the United States will the rise in the chosen price indices in 2013 (stocks, bonds, commercial real estate, etc. not included) hit the central banks' 2% target.

"Anxieties are rising in the euro zone that deflation—the phenomenon of persistently falling prices across the economy that blighted the lives of millions in the 1930s—may be starting to take root again as it did in Japan in the mid-1990s," reported Monday's *Wall Street Journal*. The deflation bulletin shared page A2 with a dark ponderation on the threat of "secular stagnation," another homage to the 1930s.

As for us, we find the 1920s more instructive. Between 1922 and 1927, wholesale commodity prices fell by 0.1 percent a year, while the cost of living rose by 0.7 percent a year. In that time of hurtling technological progress, one might have expected prices to fall, as they persistently fell in the final quarter of the 19th century. The Federal Reserve was happy to take credit for the fact that they didn't. The central bank seemed to germinate enough credit to resist the gravitational pull on prices of falling production costs and rising productivity. "Business and prices have both become more stable," asserted a Herbert Hoover-sponsored volume entitled, "Recent Economic Changes" in 1929. "There is evidence that our economic system is moving in this direction."

"Price stability" was the ideal, agreed Irving Fisher, professor of economics at Yale University, and Benjamin Strong, governor of the Federal Reserve Bank of New York. Fisher, hugely influential, contended that there was no such thing as a "business cycle"; price disturbances were rather to blame for booms and busts. Iron out the price level and you've conquered the "cycle," he—and many luminous others—contended.

There's more than an echo of Fisher in the words and deeds of our 21st-century mandarins. One notable difference is how the moderns define stability. For Fisher, "stable" meant just that, neither inflation nor deflation. For Bernanke and Yellen and the rest, "stable" means no deflation. To prevent what earlier ages took as a sign of progress—bargains are good, the primitives reasoned—the leaders of the Fed, like their forebears of the 1920s, have had to create enough credit to prop up the price level.



"The world is a cornucopia," this publication observed in the issue dated Jan. 14, 2005. "Thanks to the infernal machine of American debt finance, the Internet and the economic emergence of India and China, among other millennial economic forces, goods are superabundant. More and more services, too, are globally traded, therefore cheaper than they would be in the absence of international competition. Yet the measured rate of inflation in the United States is positive, not negative, as it was in so many prior eras of free trade and technological progress."

At the time we wrote, house prices were rising by 13% and the "core" personal consumption expenditures deflator was rising by 1.6% (both measured year-over-year). Household debt was expanding by 9.7%, personal disposable income by 2.1% (also measured year-over-year). The fed funds rate was quoted at 2.29%, up from 1.27% in November 2002, when the then-Governor Bernanke gave his famous speech about the bogeyman from the 1930s. "Deflation: Making Sure 'It' doesn't Happen Here," he entitled this effort.

Exactly how the former Princeton economist intended to lift average prices without distorting certain, very specific prices—house prices, for instance—he didn't say. Nor did he stop to define terms. That job fell to us, as follows: "Inflation is not 'too many dollars chasing too few goods.' Pure and simple, inflation is 'too many dollars.' What the redundant dollars chase is unpredictable. In recent months, they have chased stocks, commodities, euros, junk bonds, emerging-market debt and houses."

As for "deflation," what it isn't, we said, is falling prices. That is a symptom of the thing, not the thing itself. We defined deflation as too few dollars chasing too much debt: "Dollars extinguish debt; too few dollars in relation to the stock of debt is the precondition for what, these days, is euphemistically called a 'credit event.'"

In a debt crisis, people throw assets on the market to raise cash. The weight of this new supply, not offset by new demand, broadly sinks prices. *That*, to us, is deflation. If, on the contrary, prices fall because the world is becoming more efficient, we would call that circumstance "everyday low prices," or "progress." In no public utterance of which we're aware has any senior Fed official addressed this critical distinction. We had our hopes for the chairman's goodbye address, but the old professor let us down.

Whatever the source of deflation, the central banks of the world are pledged to resist it—by the means of creating more debt. They are not fighting fire with fire. They are fighting fire with gasoline.

Bloomberg on Monday was out with the projection that debt as a percentage of the world's 34 largest economies (i.e., members of the OECD) will climb to 72.6% in 2014 from 70.9%

last year, and from 39% in 2007. In addressing the economists in Philadelphia, Bernanke defended the radical policies of the past five years by alluding to the depression that wasn't and the recovery that is. He failed to mention that the means to the end of salvation was the near doubling of the world's debt burden. Nor did he choose to acknowledge the truism that debt and deflation go together like PB and J.

If the Food and Drug Administration were monitoring Bernanke's speeches, as maybe it should, the Federal Reserve's anti-deflation pledge would include some frank talk about side effects. "People who take QE or ZIRP may suffer from giddiness and a loss of financial perspective," the FDA-mandated disclaimer would say. "They may experience nausea, shortness of breath, hair loss, impotence, bankruptcy and heartburn."

The Fed's price stabilization program is no one-off policy. It's the very mission of the modern central bank. Committed to stabilizing some prices, the Fed is reciprocally (though tacitly) dedicated to distorting others. In the 1920s, an economist at the New York Fed devised a price index encompassing real estate prices and security values as well as rents, wages and wholesale prices. The Carl Snyder Index of the General Price Level rose by 2.7% a year between 1922 and 1929. An updated edition would certainly present a very different picture of today's "stability" than the indices that omit asset prices. Inflation is where the central bankers aren't looking for it.

It strikes us as not a little ironic that a central bank under the leadership of a supposed historian of the Great Depression lives in ignorance of the decade preceding the Great Depression. The best of the contemporary postmortems of the years 1929-33 harped on the unintended consequences of artificial price stability.

"Banking and the Business Cycle," produced in 1937 by the trio of C.A. Phillips, T.F. McManus and R.W. Nelson is the gold standard of the genre, to our mind. As the book is long out of print, we'll quote from it; the authors seem almost to be addressing the editor and the readers of *Grant's*. "The principal shortcoming of price level stabilization as a primary goal of monetary policy," Phillips et al. write, "is found in the fact that the 'freezing' of any one set of prices tends to establish resistances to the readjustments that need to be made continually within the price system if that system is to be kept in balance in the face of a highly dynamic economic setting: stabilization of *all* prices is, of course, quite impossible in any nation other than one having a completely 'frozen' economic structure. Nor is an unchanging price level any insurance against depression, as the events of recent monetary history have abundantly proved."

The authors go on to enunciate a law of unintended consequences. They don't use the word "bubble," but you can tell what they're driving at. "As long as economic progress is maintained," they continue, "resulting in increasing productivity and an expanding total output, there will be an ever-present force working for lower prices. Any amount of credit expansion which will offset that force will find outlets unevenly in sundry compartments of the economic structure; the new credit will have an effect upon the market rate of interest, upon the prices of capital goods, upon real estate, upon security prices, upon wages, or upon all of these, as happened during the late boom. A policy which seeks to direct credit influences on *any* single index, whether it be of prices, either wholesale or retail, or production, or incomes, in the interests of stabilization, will result in unexpected and unforeseen repercussions which may be expected to prove disastrous in the long run."

"Disastrous" grabs the reader by the collar; "long run" rather loosens the grip. How to apply the preceding ideas in the here and now?

By resisting deflation, today's central bankers will ultimately create one, we believe. But when? Before or after they instigate an unscripted 3% or 5% inflation rate? We don't know, nor do they.

At last report, November's, the PCE expenditure index registered a year-over-year rise of 0.9%. It's not so far-fetched to imagine monthly readings below the zero marker—there were seven of them in 2009. In five consecutive months between 1961 and 1962, there were year-over-year readings of less than 1%. In 12 consecutive months between 1954 and 1955, there were year-over-year readings in the CPI of less than zero. Nobody seemed to object very much in 1954-55 or in 1961-62. For that matter, the deflation of 2009 could be explained away by the financial crisis (that, actually, was deflation). But now? A more than passing slip into official deflation territory would send the Fed to general quarters. Then what?

Action, of course. The Bank of Yellen is as constitutionally incapable of inaction as were the Banks of Greenspan and Bernanke. The Fed would paw around in its tool kit. It would discover new, seemingly sharper-edged instruments—nominal GDP targeting, perhaps, or some literal application of the Bernanke helicopter-money metaphor.

How would the world interpret an admission of the failure of monetary policy to prevent this imagined lurch to deflation? We suspect it would buy Treasurys. Maybe the government securities market has another big rally in it, and maybe that hypothetical rally will reward this year's contrarians.

Where would all this lead? If we were writing the script, it would lead to a belated but well-reasoned loss of confidence in the institution of modern central banking. It would produce a flight from paper money into tangible things. That is, it would lead to inflation. We expect that it will. And we expect that come that historic moment, people will stop feeling sorry for gold.

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Fiat-fest 2014

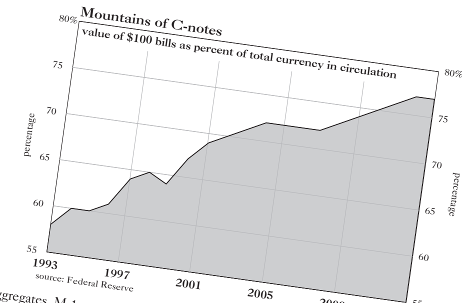
(July 25, 2014) The annual summertime monetary hoedown at Jackson Hole, Wyo., won't be the same this year, Bloomberg reports. The Kansas City Fed, host of the August fiat-fest, is cutting Wall Street dead. Economists from the TBTF banks, longtime schmoozers in Jackson Hole, are this year being invited to stay home.

Maybe that's a good thing—the crony financiers were especially thick on the ground at the 2006 proceedings, where they collectively seemed no more alert to the looming mortgage-cum-credit-crisis than the government employees did. Then, again, the Fed has a job of work on its hands. Its balance sheet is too big and its interest rates are too low. It may need some help in strategizing.

With money-supply growth ticking higher and the rate of producer-price inflation accelerating, "How to exit?" is one question. "Which rates are relevant in this zero-percent world?" is another.

Before QE, the funds rate was the central bank's one and only. "However," colleague Evan Lorenz observes, "with excess reserves measured in the trillions today vs. in the billions pre-crisis, the fed funds market has ceased to function." On to the next rate, then: The new reverse-repurchase rate, perhaps? Maybe or maybe not, the thinking goes, given the not-so-farfetched risk that the mere existence of the RRP facility might invite a bank run (*Grant's*, May 2), or maybe the interest rate on excess reserves, now fixed at 25 basis points? Or a new funds rate that encompasses more than the funds market?

Accompanying the technical debate is the continued growth of the monetary



aggregates. M-1 rose by $282 billion in the 12 months ended July 7, paced by an $87 billion increase in currency and a $196 billion jump in deposits. If $100

"Well I, for one, am going to miss QE."

bills represent 77% of the currency growth (as the Fed reports that they did in 2013), and if $20 bills account for the rest, the green emission would weigh 3.8 million pounds. More significant from a pure monetary perspective is the growth in deposits, which corroborates the surge in business lending—after all, loans create deposits.

Nearly four million pounds of paper money do create a sense of inflationary anticipation. Where's the thing itself? The Cleveland Fed, which calculates the CPI every which way (median, trimmed and otherwise), essentially comes up with 2%. Two percent is supposedly what the Fed is shooting for. Still, the Fed keeps on shooting. And as it fires, asset prices dance. Measured year-over-year, the S&P 500 is up by 17%, the Russell 2000 by 9.8%, the S&P/Case-Shiller Composite-20 Home Price Index by 10.8%.

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