The Economic Rebalancing : A Consequence of Central Bank Excess

(**July 2004**; David Jensen is Principal of JENSEN STRATEGIC - a Vancouver-based business strategy and advisory services company. www.jensenstrategic.com)

For the past decade, the United States has undertaken a monetary policy with an associated impact that, due to the esoteric nature of monetary and banking systems, will not be clear to most business leaders. In fact, much as in the 1970's, the impact of the monetary policy can be seen all around us in rocketing commodities prices (yes supply / demand is a factor, but not the only factor) and the economies of the US and Canada displaying a number of asset bubbles.

The implications for the business leader are important as the economic after-effect of this monetary policy will bring an economic rebalancing directly impacting our economies.

The year was 1995 and the retirement of Lloyd Benson as President Clinton's Secretary of the U.S. Treasury ushered in a new Era which will likely impact the world's economies for years still to come. His replacement was Robert E. Rubin, Wall Street maven and Chairman at the New York investment bank Goldman Sachs and Co., Assistant to President Clinton for Economic Policy from January 1993 until his ascension in January 1995. Known for his smooth manner and dapper dress, his image belied the aggressive action that Rubin and the Chairman of the U.S. Federal Reserve, Alan Greenspan would initiate with the US monetary system.

Under the Federal Reserve Act, the Federal Reserve Banks, as a system of independent non-commercial banks are established primarily to control the money supply within the US in order to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates" in the US. To accomplish this, the Federal Reserve (or the "Fed" as it is known) adds or subtracts money from the U.S. economy through these Federal Reserve Banks. It also sets the interest rates which the US Federal Reserve will provide money to commercial banks who in turn loan money to US industry and consumers. The US Fed Funds Rate is currently at 1.50% (up recently from its historic low of 1%) equaled only during the Great Depression and in the 1950's as America recovered from the War. Chairman Greenspan euphemistically calls this an "accommodative" interest rate. Economists call the 1% rate an "emergency rate".

According to the monetarist theory of economics, a country's economic activity can be controlled by controlling the money supply and setting interest rates in that country. Simply put, add money to the commercial banking system and banks lower their credit requirements and lend money more easily into the economy thereby stimulating consumption and economic activity. Lower interest rates and much the same occurs – lowering interest rates lowers the cost of borrowing and more money can be accessed by industry and consumers thereby increasing economic activity in the economy.

The two primary dangers with monetarist "control" of the economy lie in unintended consequences of the Fed adding too much money to the economy (central bankers are typically loath to add too little money to the economy).

First, adding too much money to the money supply stimulates inflation (rising prices) as increasing consumption stimulated by the increased money in the economy pursues a limited supply of goods. As experienced in the 1970's, once such inflation is started it is very difficult to contain without slowing the economy substantially (and driving up unemployment) through drying up the money supply or raising interest rates thus lowering the availability of money. Inflation is also especially harmful because it consumes the value of cash savings and investments such as government bonds upon which seniors, who hold them for their apparent safety, depend for a fixed income. Rising prices can also lead to hoarding inducing further shortages driving further price increases as well as other economically inefficient activity.

Second, adding too much money (or "liquidity") to the economy also leads to mal-investment – again, simply put, when money is too easy, foolish or inefficient investments are made. When such mal-investment occurs on a widespread basis it is termed a bubble an example of which was the dot-com stock market bubble which occurred in the late 90's and the famous stock market bubble of the 1920's.

There has been a belief that monetarist economic policy which provided superior economic conditions could be effected within limits - a country which issued too much money would experience the pain of inflation and a devaluation of its currency thus being forced to limit the money supply before inflation became too negative an impact on the economy. This has shown itself not to be the case during the last decade in the US.

When a country issues paper or "fiat" money it is not backed by a tangible; only a promise by the issuing country that such a piece of paper holds worth. This creates the temptation for the issuing country to manage its monetary system in order to gain short-term economic advantage.

In the early 90's, the US economy experienced a recession. By the mid 90's, although the economy was showing solid growth, the Dow Jones had increased from 2800 at the beginning of 1990 to 3800 by the beginning of 1994 (non-stellar average gains of 6 % per year). At the end of 1994, the Dow ended where it started, at roughly 3900, and, as a leading economic indicator, pointed to a less than shining economy in 1995. President Bush Sr. had experienced the damage of having an election as the US pulled out of a recession in 1992 and this was not desirable for President Clinton in 1996.

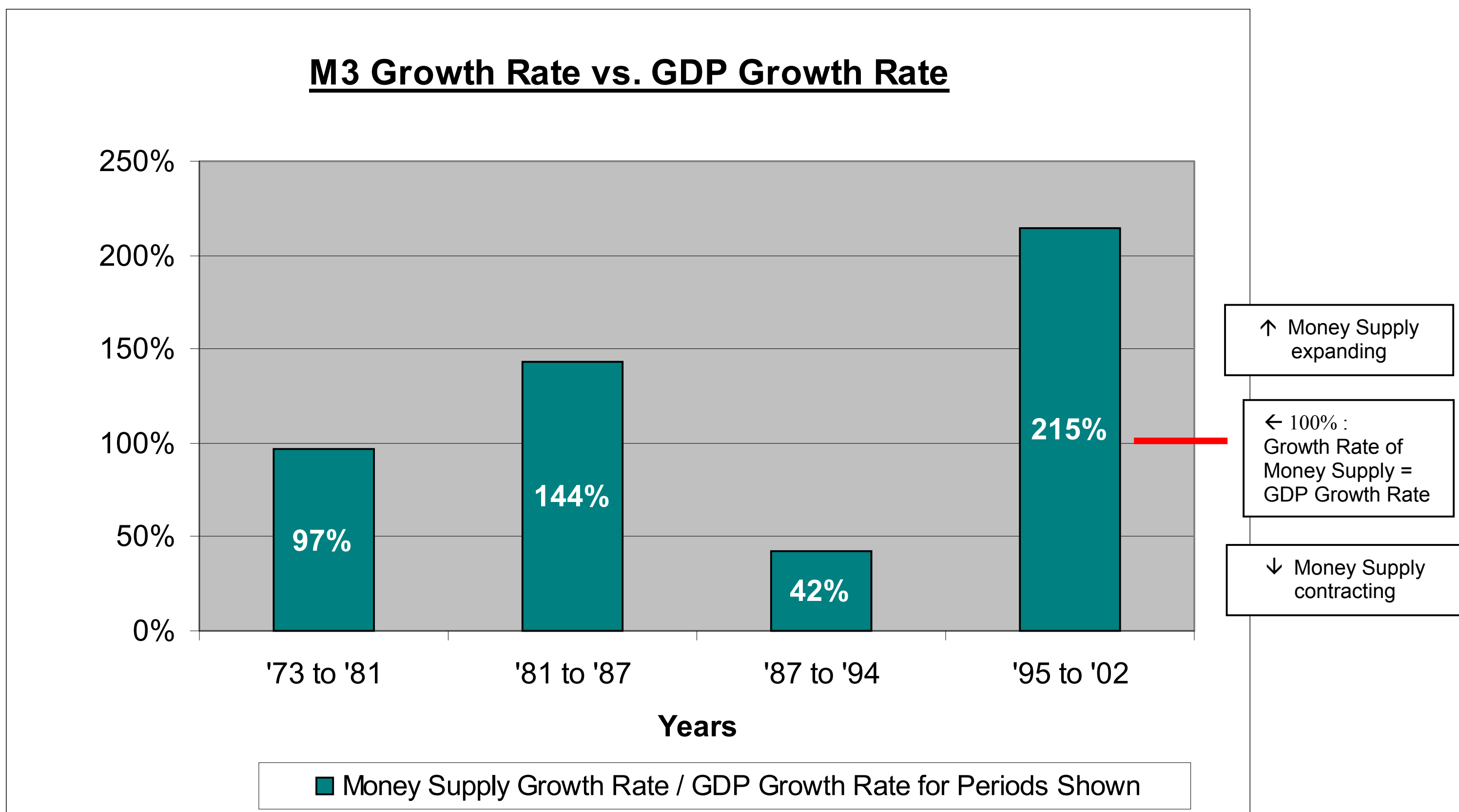
Enter Mssrs. Rubin and Greenspan in January 1995. As noted above, the Fed controls the money supply, so what does Treasury Secretary Rubin and the US Department of the Treasury have to do with US monetary policy?

First, according to the Department of the Treasury, " The Secretary of the Treasury is the principal economic advisor to the President…". Practically speaking, any divergence from current monetary and economic policy would require support from the President's principal advisor. Second, although the Fed maintains control of the money supply, according to the Federal Reserve Act, currency (paper money) cannot be issued or retired without the signature of the Treasury Secretary.

Third, the Treasury Secretary has sole control over the Exchange Stabilization Fund. This fund is the U.S. Government's tool for "exchange market intervention policy" and is utilized as a "stabilization fund" to effect an "orderly system of exchange rates". Accordingly, the Treasury Secretary "may deal in gold, foreign exchange, and other instruments of credit and securities" [1]. Addition of large amounts of money to the money supply would have to be carefully countered by the Treasury Secretary with the ESF and the influence of his office on the world's markets to ensure they did not perceive that the US dollar would be diluted – even if that was to be the case. Executed properly, the world financial markets could for a period be led to believe that little deleterious effect of the injection of money into the US and world economy would be experienced.

From 1987 until 1994, while the economy grew by 57%, the money supply grew less than half as much (23%). This represents a "tightening" of the money supply due to the fact that, as less money is added than the economic growth of the economy, less money is available to change hands for a given amount of economic activity - economic growth and inflation, if it is present, is reduced.

In 1995, the Fed then executed an unprecedented reversal in modern money supply policy. It should be noted that in the past, the Fed had executed a reversal from tightening the money supply to expanding the money supply relative to economic output of the economy (GDP) but expansion of the money supply had never been executed after 8 consecutive years of record tightening as occurred from 1987 until 1995 and such reversal had in the past always occurred during a recession. In 1995, the Fed would depart from its policy of tightening, and now execute an abrupt u-turn by not gradually transitioning from a tightening policy to a neutral money supply policy (where the money supply expands at a rate equal to the long term economic growth of roughly 3.5%) but, instead, the Fed for the next 9 years aggressively expanded M3 (as the Fed calls the broadest measure of the US money supply) by adding money into the US economy at a rate 215% the rate of economic growth[2]. It is unclear what the Fed's exit strategy was when embarking on this policy of massive monetary expansion.



Relative to economic growth, the increase in money from January 1995 through March 2003 represents the greatest money supply increase in modern US history - an increase 71% greater than had been attempted during such a previous short period (1981 to 1987). In total, while the economy grew by 45% during this period, the M3 money supply was increased 96% or $4.2 Trillion (a rate 215% the GDP growth during this period). The money supply continues to grow today at an annual rate of 200% the growth rate of the economy.

The growth of the US money supply occurred in the shadow of the vaunted policy of "Rubinomics" and Rubin's "strong dollar policy" which entailed tight fiscal policy as the reason behind the economic recovery, reduced deficits, and consequently a strong US dollar.

In fact, the "strong dollar" talk took place in the face of an intentional massive printing and dilution of the dollar - started under Rubin and continuing to this day – while Rubin, on the world stage, utilized his office to advocate the strength of the US economy and its currency.

The fallacy of this period was the belief that this massive injection of capital into the US economy could be effected as a policy without negative repercussion. Much as during a sudden rainfall dry land cannot absorb the water which instead runs-off pooling into flashfloods in other areas, the sudden injection of money by the Fed at a rate which the economy cannot productively absorb leads to mal-investment of this "easy" money – otherwise known as speculative "bubbles".

With the whipsawing of the US money supply and massive injection of money into the US money supply starting in 1995, the response by the stock markets was immediate. The DOW which had languished with no gain in 1994 abruptly climbed upward in January 1995. During 1995, the DOW climbed by 41% and for the entire period of Rubin's reign (ending in July 1999), the DOW increased at an average annual rate of 26% closing at an incredible 10,970 compared to the DOW's 3,861 in January 1995 - an incredible feat given the DOW average historical increase of approximately 10% per annum. Similarly, the Nasdaq increased from 752 to an equally amazing 2,706 in July of 1999 – an average increase of 33% per annum. Rubinomics was truly incredible and Greenspan was the "maestro".

In addition to the explosion of the stock markets driven by the easy money policy, the US housing market responded at a similarly incredible rate. Home mortgages in the US increased from $ 3.3 Trillion in 1995 to $7.3 Trillion[3] in 2003 for an increase of 121% - a period where, in comparison, the economy grew 41% and the rate of US home ownership increased by a paltry 4% (from 64% to 68% of the population).

In December 1996, Chairman Greenspan issued his famous phrase warning of "irrational exuberance" in the stock market level. At this point the DOW was at 6,500: up 71 % since the start of his easy money policy 24 months previous. Greenspan stated his concern regarding excessive market valuations spurred by loose monetary policy on the heals of a similar market bubble induced by similar monetary stimulus on the Japanese Nikkei in the late 1980's – even as he and Rubin continued to hyper-stimulate the economy, the stock market, and the housing market with trillions of dollars injected into the money supply. Two years later when the DOW had surpassed 10,000 the Chairman reversed course and was now giving speeches raving about an internet driven "productivity" miracle which was greatly increasing the earnings growth rate of American companies justifying higher stock valuations.

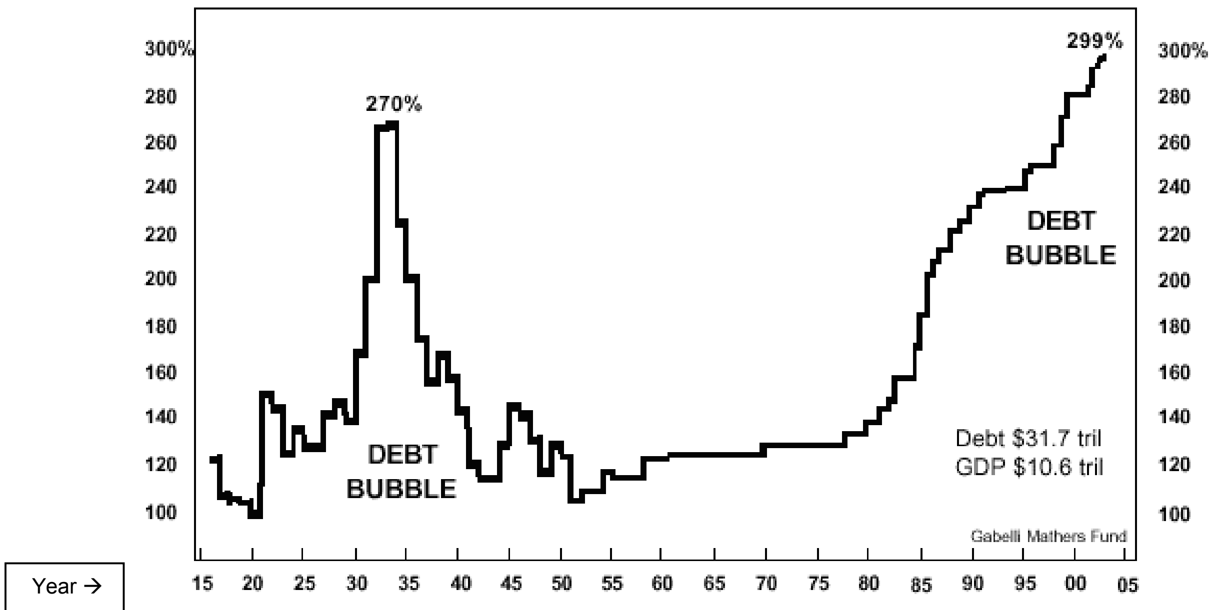
Upon Rubin's retirement in July 1999, Rubin's Deputy Treasury Secretary Larry Summers was confirmed by the Senate to replace Robert Rubin, who returned to Wall Street to serve at Citibank, as Treasury Secretary ensuring continuity of the monetary policy initiated during Rubin's tenure.

As we all know the Markets crashed in March 2000 and Chairman Greenspan was now ready with… … more easy money. He now called it an "accommodative" money supply. Working with Bush Administration Treasury Secretary Paul O'Neill from January 2001 forward, Greenspan started precipitously lowering the interest rate as consumers, who constitute 70% of U.S. economic activity, were indicating that with their equities plunging in value, they had lost the appetite to spend. After previous crashes caused by mania investment in questionable assets, the economy has entered a period of recovery during which inefficient or mal-invested capital is removed from the economy. Similarly, the post dot-com bubble period could have served as a painful but much needed time for financial and industrial restructuring and reallocation of investment capital and economic activity from speculative to productive purposes.

However, a period of economic healing and restructuring was not acceptable. Anyway, monetarist economic theory had an answer: by rapidly starting to lower interest rates from 6.5% to the ultimate 1% Fed level we have today (well below the rate of inflation), the consumer was able to trigger a second great wave of consumption driven by borrowing to further stimulate growth.

With a massive wave of consumer borrowing started, the Chairman began to give speeches about how the Fed "quite rightly" had not addressed the stock market bubble (i.e. slowed the money supply growth which had caused the stock market bubble expansion) but instead addressed the "after effects" of the bubble. In other words, the car crash was not prevented as the Fed instead chose to deploy post-crash airbags. This may have masked the damage to the occupants in the short term but there was still damage; and the structural distortions associated with excess liquidity and excess credit in the economy now continued to mount.

With the Fed rate at 1%, everyone could now afford a house and with the attendant run-up in real estate valuations, home equity cash-out refinancing at record low mortgage rates against the rapidly rising asset value, further consumer purchases now continued the post-bubble economy. And so we now have the economy with an unsurpassed level of indebtedness. Greenspan has responded to concerns regarding the indebtedness with his trademark nonchalance stating that such indebtedness is backed by assets. Guess what? These assets are real estate, bonds, and stocks – all of which are inflated asset classes due to the Fed's loose money policy.



It has been a good run. As noted by Morgan Stanley Chief Economist Stephen Roach[4] (himself a former Fed economist), for the period from 1995 until 2002 U.S. economic growth accounted for 98% of the world's net economic growth. However such periods are clearly unsustainable when they are fueled with printed paper.

Where does this all end? With a tapped-out consumer and Yahoo! shares again trading at P/E multiples of 110 times earnings, the DOW rounding-out and inflation clearly raging in sectors of the economy, the Fed has dropped the famous words "considerable period" for its 1% Fed rate policy. It now states that the Fed rate can be raised "at a pace that is likely to be measured". This is not reassuring. According to Barron's Magazine, in 2003 with stable low interest rates, US bankruptcies already occurred at a rate of 1 in 73 households - an increase of 7.3% from the record level of 2002 - and half of the consumer's $2.5 Trillion in debt accumulated in the past 3 years is held with variable interest rates[5].

The immediate danger lies in inflation or a sudden loss in confidence in the U.S. dollar forcing the Fed to suddenly raise interest rates more than desired causing consumer mortgage / debt default by the variable rate debt holders and a collapse of the stock, bond and derivatives market bubbles caused by the sustained 1% emergency Fed rate policies. Many now in the stock market are retirees driven there by the record low interest rates and negative savings account returns when inflation is accounted for.

The housing market is no better as a safe haven. As noted in a recent Wall Street Journal article[6], housing prices in some US markets would drop 14% with a 2% increase in interest rates. This begs the question of the impact of even higher rates.

As a consequence of Globalization and continuing US trade deficits, foreign holding of US dollar debt is now to the tune of $5 Trillion dollars. On a trade-weighted basis against a basket of currencies, the U.S. dollar has recently fallen 13%[7] and against the Euro alone, 35%. And yet the U.S. dollar must decline further to balance the annual $550+ Billion trade deficit and ensure the current recovery is sustained.

Type of U.S. Security	Foreign Holdings $ Amount (Trillion) November 2003 [8]	Total Foreign $US Holdings
U.S. Equities (stocks)	$ 1.70	$ 1.7
Long Term Debt :		
U.S. Treasury's	1.20	
U.S. Agency Debt	0.60	
U.S. Corporate & Municipal Debt	1.10	2.9
U.S. Currency[9]	0.46	0.5
		TOTAL : $ 5.1 Trillion

Whether foreign holders of US currency and debt "can afford to be patient" as the Fed Chairman is often wont to say, is the great unknown. Will they continue to hold their U.S. dollar investments as they erode or will they start to divest ultimately sending a giant wave of dollars home to the originating country? Whether it will be a gradual or a precipitous decline from holding US debt by foreigners is the great question which is unknown even to Chairman Greenspan. If the Fed now holds-off on further raising the Fed rate, we can count on a continued decline in the value of the dollar given incipient inflation, continued increase in money supply, and the massive trade and budget deficits. Conversely, if the Fed is forced to raise rates more quickly as the bond market detects the current onset of inflation, the unwinding of economic imbalances and the following period of economic restructuring may be of a withering nature unfamiliar to this generation.

It seems that the time of rule of clever, as opposed to wise, is now coming to a close. What now needs to be asked is whether the centralization of monetary control into a few hands of unelected officials acting in a way difficult for a country's citizens to understand is tolerable given the temptation to spur the eternal spring, delay the recession, or to address the "after-effects" rather than the bubbles themselves (i.e. cover their past mistakes) – especially given the fact it is clear that these officials themselves do not, and cannot, fully understand the repercussions of their actions on the complex economic systems which they claim to control.

A fixed monetary policy (such as a Gold Standard backed currency which limits money supply growth to roughly 3%) with all of its limitations and periods where the economy and stock market will grow modestly and not climb to the stratosphere may prove to be much more attractive than the excess and precipitous decline characterizing the current approach of monetarist "control" of our economic system. It will also limit the temptation for management of the money supply for short-term gain and act as a natural limitation on the past patterns of eye-watering deficit spending by governments who fuel these deficits with government bonds knowing that they can later simply trigger inflation by printing masses of money to consume the debt held by bond holders.

Ultimately, the economy will rebalance itself, shed past excess, and structure itself for future growth. The challenge for business leaders now lies in structuring their products and companies for sustained competitiveness in what will become an intensifying competitive environment marked by slower economic growth, currency and interest rate volatility, as well as increasing energy and commodity costs.

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[1] US Department of the Treasury Website, see "Exchange Stabilization Fund".
[2] Source : U. S. Bureau of Economic Analysis (GDP) and the Federal Reserve (M3 Money Supply)
[3] Source : Federal Reserve Document FFA, 1995-2003 – March 4, 2004.
[4] Morgan Stanley "Macro Page"; May 14, 2004 see : *www.morganstanley.com/GEFdata/digests/latest-digest.html*
[5] *J. Alfred Greenspan* ; Barron's Online, May 10, 2004.
[6] *Why Your Home Might Sell for Less*, Wall Street Journal, November 16, 2003.
[7] *IBID note 6.*
[8] Report on Foreign Holdings of U.S. Long-Term Securities: U.S. Federal Reserve, November 2003.
[9] Estimate : 2/3 of $700 Billion in Federal Reserve Notes outstanding. The Fed has numerous studies on this matter all of which differ to some extent. 2/3 is an accepted estimate of the amount of US currency in foreign hands.