

Deceptive Warnings: Nearing Economic Disruption, the Fed Distorts Perception



December 2005 – David Jensen is the Principal of Jensen Strategic (www.jensenstrategic.com) a corporate strategic planning and business advisory services company. The following commentary is not investment advice.

This article follows “**In Denial of Crisis**” published in June 2005.

As Federal Reserve Chairman Alan Greenspan sails toward his port of retirement, he and his associates are now given to issuing warnings, on numerous topics and with increasing frequency.

Most recently, the Fed Chairman has warned of fiscal policy causing a “pernicious drift toward fiscal instability” and of a “protectionist reversal of globalization.”¹ He also warns that he fears “that we may have already committed more physical resources to the baby-boom generation in its retirement years than our economy has the capacity to deliver” so Congress needs to review how best to allocate its limited resources² (this is not news - in 2002, the O’Neill Report identified that, in 2002 dollars, the Government had \$43 trillion in future unfunded liabilities for Social Security, Medicare, and Medicaid.³)

Nominally, Chairman Greenspan is giving warnings. However, the cadence and varied topics of successive warnings by Chairman Greenspan over the past few months have created a cacophony so as to give them little effect – and the warnings are issued on important but secondary issues that mislead the public as they divert citizens’ attention from the root cause and scope of approaching economic correction.

Notable in recent warnings from Greenspan, Federal Reserve Governors, and their allies, is the focus on fiscal matters for which the president and Congress have responsibility, while the nation faces two primary threats that arise directly as a consequence of decades of Federal Reserve monetary policy failure:

- The U.S. and world economy face a potential inflation and interest rate spike with a disrupting effect on financial markets and existent investment bubbles - especially if they were to occur suddenly; and
- The economy is distorted and is declining in sustainable economic terms due to an historically high debt level that has grown strongly during the past 20 years.

The U.S. energy complex has been damaged from Hurricanes Katrina and Rita in a way that may lead a sudden spike in energy costs (esp. natural gas) this winter – with an associated impact on inflation and interest rates. In much the same way as America, in an inflationary environment as a consequence of central bank monetary policy was made vulnerable to the OPEC oil embargo in 1973, the U.S. (and Canada) similarly stand vulnerable today because of similar monetary policy failures.

To be clear: we face the possibility of an epic economic correction.

Neither our elected representatives, nor politicians or government officials, the mainstream financial community, or the media, who all have a duty to inform citizens, have provided fidelity of information to properly inform the public.

In advance of crisis, concerted and direct action is now required by allied governments to begin the arduous task of reforming our monetary and financial system. However, one country must take the first step; others will follow.

“Freedom is the Freedom to say two plus two make four. If that is Granted, all else follows.”

George Orwell

1. The Federal Reserve Continues a History of Inflationary Disruption

The most recent experiment with central banking in the United States began upon the inception of the Federal Reserve Bank (the Fed) in December 1913. This new era was heralded as one of prosperity and economic stability made possible through economic central planning by central banks using interest rates and the money stock (the amount of money) and an expandable “elastic currency” or “fiat currency” to modulate the economy. It is termed “fiat currency” as simply government fiat or law, instead of tangible backing such as gold, gives the paper money status as tender in payment of debt. Instead of prosperous stability, even Fed chairman nominee Ben Bernanke concedes that the Fed’s actions resulted in the 1920’s stock market bubble which crashed in 1929 leading in to the Great Depression of the 1930’s⁴.

Less well known is the Fed’s repeated failure in its task⁵ of also maintaining price stability in the economy. There have been 3 major price inflations during the Fed’s existence, the first starting upon the Federal Reserve being given authority as central bank in early 1914.

The commodities index components and weightings have been changed on numerous occasions, the price inflations can be seen only if we look at an inflation-adjusted fixed basket of commodities over the long run.

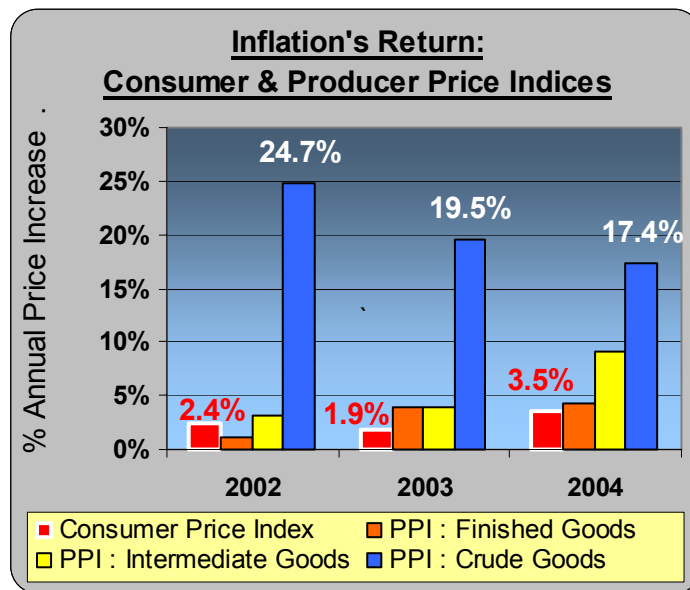


Source: Di Tomasso Group

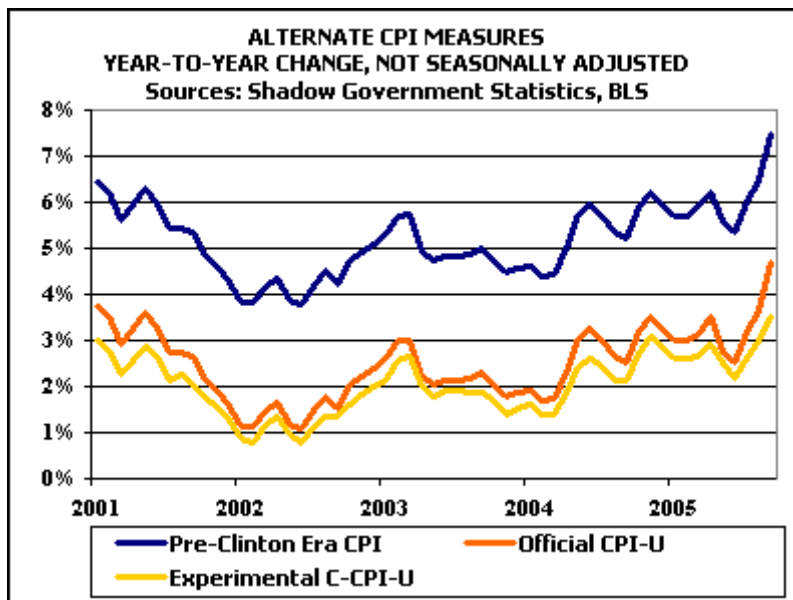
Inflation Adjusted Basket of Commodities in The Current Reuters CRB Index
(17 Equal Weighted Components): Years 1920 -2005

The three price inflation peaks are clearly visible. It is notable that each commodity price peak has been higher than the previous and that we remain near all-time lows for commodity prices despite the 77% run-up in commodity prices of the last 4 years.

In today’s economy, inflation has not been contained strictly to commodity prices. Price inflation in the various phases of production, as measured by the Producer Price Index (PPI), shows inflation pushing through to consumer goods prices in the Consumer Price Index (CPI). Producer prices at the crude goods phase of production have increased a total of more than 75% between 2001 and 2004 and even the mainstream financial media has tentatively started using the “I – word”: inflation.



The CPI looks low and it is low. Making analysis of the CPI and comparison of the current economy versus the inflationary economy of the 1970s more challenging is the fact that, over several years in the early 1990s, the measure of inflation, as published in the CPI from the U.S. Bureau of Labor Statistics (BLS), was changed by the Clinton Administration to reduce measured inflation – in essence, defining-down the CPI's measured and published level.⁶ Similarly, “discouraged” job seekers, who still wish to work but look for employment less frequently, have also been eliminated from the ranks of the unemployed in defining-down the unemployment rate thus allowing the BLS to trumpet remarkably strong unemployment numbers month after month.



Fed chairman Alan Greenspan and his replacement Ben Bernanke continue to make statements that “inflation expectations remain well contained.” Inflation expectations may well indeed be temporarily contained in the minds of the unknowing public yet the long-run driver of inflation (commonly defined as an increase in consumer goods prices) is an increase of the money stock. Temporal effects such as an increase in productivity or increased economic activity may also, for a time, mask the negative impact of long run increases (or inflation) of the stock of money. But inflating the stock of money which pursues a comparatively fixed basket of goods in the economy ultimately leads to price inflation in the price of all goods.

Here is the root of central banks' erroneous portrayal of inflation. Controlling inflation is not a matter of skewing perception or expectations to prevent inflation accelerating activities such as goods hoarding. Nor is it, as

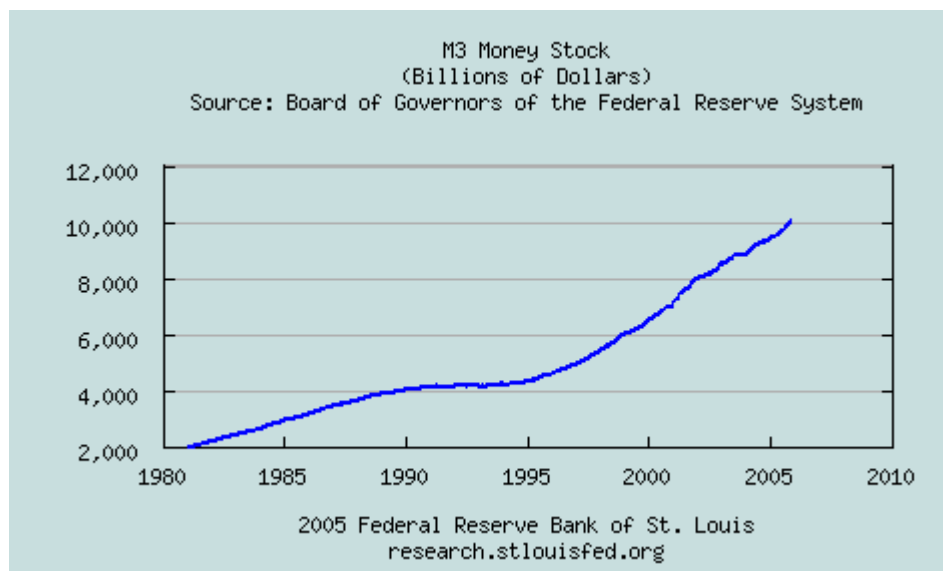
intimated by Greenspan and Bernanke, an ephemeral enigma which curiously pops up in different locales just to be tamped down by prescient Fed Chairmen; inflation can only be minimized when a money stock is not tampered with thus encouraging economic equilibrium – an equilibrium which, at the best of times, cannot be effectively determined by the central planners at the Fed and which has disruptive consequences when it is perturbed with variation of the money stock by central banks.

Price inflation after long-run growth of the money stock, while delayed and initially uneven, is ultimately widespread and lasting. The tremendous inertia of the economy dictates that once inflation of the money stock pushes through price rises to the consumer, price inflation will run until prices have reached a long run equilibrium level (assuming of course that the money stock is not continually bloated).

In the past, the appearance of strong inflation in the consumer price index has been delayed by up to a decade from the initiation of drastic increases of the money supply as occurred in the 1960s and 70s and as we have also recently experienced. The associated, though delightfully intoxicating, temporary economic benefits such as rapidly rising stock, bond, and housing markets, declining unemployment and increased government tax revenues (with associated temporary declines in government budget deficits as occurred in the 1990s) are just that - temporary. This delay does not make the later onset of price inflation any less a direct consequence of previous central bank monetary policy action; nor can delay of consumer perception stop its appearance in the economy.

Because additional money created by central banks enters the economy primarily as loans through the banking system, delaying the perception of inflation by citizens simply allows prolonging low interest rates and further protracting an already extended credit cycle, with increased and destabilizing economic distortions and deepening debt levels, without raising concern among the public. The ultimate result is even greater corrective impact when the correction occurs.

The most recent rapid expansion of the U.S. money stock and the attendant rise in U.S. asset prices, including the dot.com stock market bubble, started in 1995 under Treasury Secretary Robert Rubin's inaptly named "strong dollar policy". The U.S. money stock (most broadly measured by the M3 Money Stock index) has increased by 117% from 1995 through 2004. In comparison, the economic output (GDP) of the economy increased 59% during the same period - half the rate of money stock increase.⁷



On November 10, 2005, the Fed announced that, from March 23, 2006 forward, it would no longer publish M3 monetary data.⁸ No release explaining the move was given by the Fed although it did say through a spokesman that the Fed, with more than 20,000 employees, could look forward to saving \$500,000 per year from the move.⁹ (If this is a marker of the "increased transparency" under the Bernanke Fed, we can look to further obfuscation from the Fed – delivered this time in clear language.)

It appears that the Fed believed that it was free from constraints of moderate money supply stewardship because of a confluence of several factors:

- The importation of cheaply priced Chinese consumer products produced with the benefits of \$0.50 hourly labor rates and lax environmental and labor laws created a wage pressure mechanism to temporarily contain price and wage increases in the U.S. economy;
- A belief that skewing inflationary perception could contain consumer inflation expectations and thus limit activities such as hoarding and forward-buying that spur inflationary pressures if price inflation is detected;
- A reliance, in the late 1990s, on temporary increases in economic productivity to help contain price pressures; and
- Starting in the late 1970s and continuing through the 1990s, liberalization of financial markets (as identified by Peter Warburton in his book *"Debt and Delusion"*¹⁰) allowed the massive pools of capital (money) that were created by central banks (U.S., European, Canadian, etc.) to move into financial instruments such as bonds, stocks, currency markets, and derivatives. This inflated the values of these markets, drew further investment, and hid the monetary inflation of the central banks as consumer goods prices increased relatively slowly in comparison. According to Warburton, the world bond market grew from \$1 trillion in 1970¹¹ to more than \$50 trillion today. World stock market capitalizations now approach \$30 trillion; during the first 6 months of 2005 alone, financial derivatives grew 16% (or at a compounded 35% annual rate) from \$9.45 trillion to \$11 trillion¹² and through financial gearing now exceed \$270 trillion in underlying asset value - more than 500% the world's total annual GDP; and the world's currency trading markets now generate \$2 trillion in activity or roughly 17% of the U.S.' total annual GDP, per day. These ballooning financial repositories, now totaling more than \$100 trillion, absorbed waves of capital created by central banks with their elastic currencies thus temporarily mitigating the inflationary impact on consumer prices and seemingly creating a Shangri-La economy.

The above factors are not long-run factors that can continue indefinitely to contain pricing pressure post decades of aggressive expansion of the money stock by the Fed and other central banks. Because the money stock growth has been hidden with temporary techniques, whether the Fed reports M3 in the future misses the point entirely. Inflation has *already* been created but hidden with temporary market phenomena and measures.

As the U.S. and the world's economies now slow in real growth and decline due to the economic distortion and excessive burden of debt as a result of central bank monetary policy (see below), businesses which have issued bonds will be less able to generate income to meet bond payment obligations on these bonds leading to rising default levels. Governments, with slowing economies and being unable to generate adequate tax revenue to meet fiscal obligations, will turn to the printing press to make bond interest payments or to purchase bonds outright in a fruitless effort to contain interest rates. Declines in returns on the \$100 trillion in financial instrument investment 'silos' that, until recently, have temporarily contained and hidden monetary inflation, results in them now starting to disgorge some of the capital invested.

*"What we see at present is a battle between the central banks and the collapse of the financial system fought on two fronts. On one front, the central banks preside over the creation of additional liquidity for the financial system in order to hold back the tide of debt defaults that would otherwise occur. On the other, they incite investment banks and other willing parties to bet against a rise in the prices of gold, oil, base metals, soft commodities or anything else that might be deemed an indicator of inherent value. Their objective is to deprive the independent observer of any reliable benchmark against which to measure the eroding value, not only of the U.S. dollar, but of all fiat currencies. Equally, their actions seek to deny the investor the opportunity to hedge against the fragility of the financial system by switching into a freely traded market for non-financial assets."*¹³

Since Peter Warburton wrote these words in 2001, price inflation of commodity and monetary metals (gold and silver) has taken off with a vengeance signaling the Fed's past money creation. Initially, small portions of the financial instrument capital silos have now started to vest into commodities and tangible assets which hold intrinsic value as an alternative to the now declining and fundamentally unstable financial instruments. Compounding the problem is that, because of the Fed's repeated market intervention during market downturns and fund crashes, we see created the moral hazard of fearless market speculators in an environment of excessive monetary liquidity compounding the onset of future massive waves of commodity and consumer staples price inflation.

We are entering an economic phase very similar to the early 1970s where, after the money supply had been increased at double digit rates for a decade, commodity and consumer goods inflation appears in the economy. And we hear no coherently delineated Fed policy or exit strategy from the current economic environment where extreme pressure will be applied by inflation in consumer staples and commodities.

Upward commodity price pressures, belatedly signaling past inflation of the money stock, will continue to force up interest rates to much higher levels which will have a profound impact on our economic and social structures.

The Fed and other central banks' challenge is to try to maintain low interest rates and contain the \$100 trillion residing in the bloated financial instrument investment silos to prevent an economic dislocation while inflation in commodities and consumer staples accelerate. Such activity by the Fed would likely include large bond repurchases and other financial markets intervention which would be visible in the repurchase component of the M3 money aggregate (see http://en.wikipedia.org/wiki/Repurchase_agreement for repurchase activity definition).

Intervention in the markets to try to contain pools of capital to financial instruments is an interesting academic discussion however it will invariably fail. There are too many observant investors and, given the rapid transmission of information and capital, market turmoil is likely.

With regard to maintaining the façade of low inflation, central bankers know that the economy has enormous momentum and that the economy can take years to respond to monetary policy adjustment. After a decade of egregious Fed inflation of the money stock and the onset of an inflationary wave, this makes somewhat absurd the theater of CNBC commentators every 6 weeks waiting with bated breath for minor word changes in the Federal Reserve's interest setting FOMC statement.

It also makes the increasingly blanched expression on the face of Pimco's Bond King Bill Gross, as he appears on the CNBC panel to predict interest rates, a little amusing. For the past year Gross has appeared every 6 weeks claiming (almost now pleading) that the Fed has two more ¼% rate increases before it will have to stop.

The real conundrum to uninformed observers is if inflation is as low as the Fed claims, why continue to increase interest rates? In reality, a true consumer price inflation rate north of 7% and galloping commodity price inflation will take little heed of a 4% Fed Rate and additional ¼ point hikes. Raising rates high enough to pop the housing bubble will start a strong economic decline and a rapid transference of investments into safe haven classes. Bonds do not fit this description for reasons delineated.

In this way the "inflation targeting" policy as promoted by Bernanke is farce. The current onset of a strong price inflation wave after more than a decade of especially strong monetary inflation which has also induced distortions in, and malstructuring of, the economy will not and cannot be stopped by twiddling interest rates as the Fed has been doing. Inflation could only have been contained through prudent and responsible stewardship of the money stock over the previous decades.

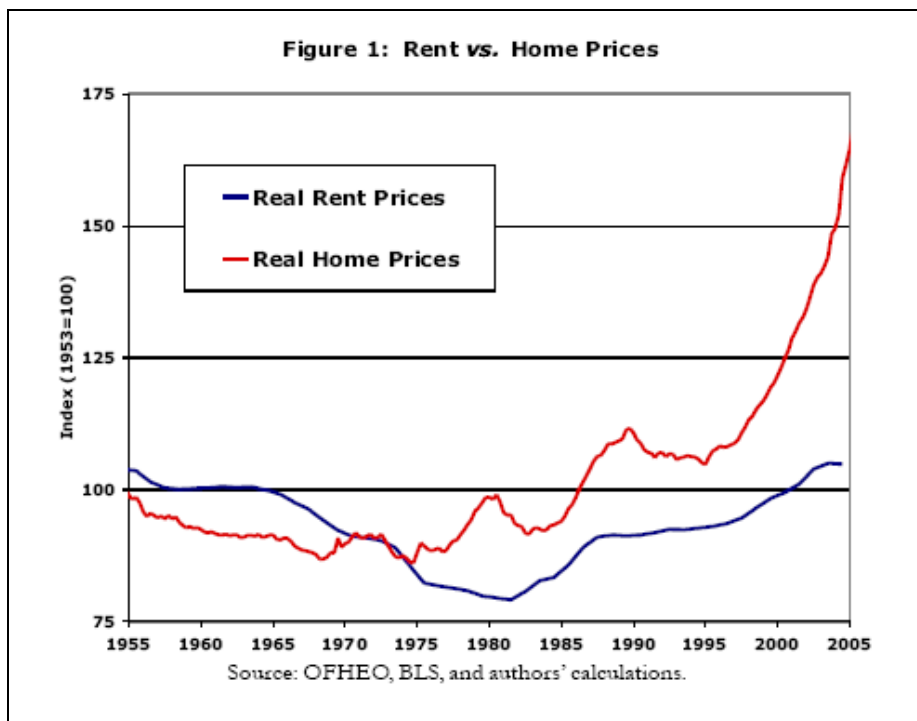
The economy was made vulnerable in 1973 by the previous decade of Fed inflation of the money stock - CPI inflation was then running at 8% and commodity prices raging - before the OPEC Oil embargo struck the economy with crippling energy cost rises that further spiraled inflation into the teens. Today, with growing true CPI inflation and price inflation in the commodity markets, the economy is vulnerable to exogenous events such as a disruption of the energy supply causing price spikes and rapid inflationary growth in consumer goods prices. One differentiation from the 1970s is that, after Greenspan's tenure, the economy has been left grossly mal-structured with numerous investment bubbles and unproductive enterprise from the prolonged credit cycle expansion, and we have far higher relative debt levels than in the 1970s.

2. The U.S. & Canadian Economies Contain Unsustainable Distortions Due to Central Bank Monetary Policy

While much has been written about the serial bubbles that were spawned starting in 1995 by the Fed's and Treasury Secretary Rubin's "strong dollar policy" dilution of the money stock, the Fed's January 2001 initiation of ultra-cheap money with what was to drop U.S. interest rates from 6.5% down to the ultimate Fed Funds 'emergency rate' of 1% in 2003 and 2004 compounded speculation in a housing bubble that was already visible. It

also inflated bubbles in the bond market, financial derivatives markets and re-inflated the stock market bubble. Canada and other nations' central banks followed suit.

While the Fed was warned in 2001 that there was already a housing bubble well underway and that lowering interest rates would compound this destabilizing phenomenon, the Fed maintained until very recently that a nationwide housing bubble was not possible as U.S. housing bubble was "heterogeneous" and there were no "arbitrage opportunities" between housing markets.



Source: Baker and Rosnick; Center for Economic and Policy Research (CEPR)

In February 2004, months after the Bank of England had warned in late 2003 of the dangers that variable rate debt instruments posed to borrowers in a rising interest rate environment,¹⁴ Greenspan in a speech at the Credit Union National Association stated that homeowners "might have saved tens of thousands of dollars had they held adjustable-rate mortgages rather than fixed rate mortgages" and that "American consumers might benefit if lenders provided greater mortgage-product alternatives to the traditional fixed-rate mortgage."¹⁵ This prompted commentary by Merk Investments:

*"There are already numerous variable and short-term instruments available for the sophisticated (or naïve) homeowner. Greenspan's speech is an encouragement to use these short-term instruments. As the Wall Street Journal comments: 'It is almost unheard of for an official at the central bank to offer advice on interest rates, over which it has enormous influence.'"*¹⁶

The popular press such as *Time Magazine* predictably responded to Greenspan's comments with articles such as "A Call to A.R.M.s: Are you too fixated on a fixed rate mortgage? You may be paying more than you should for peace of mind"¹⁷. In September 2005, a decade after the start of the housing bubble and 18 months after encouraging consumers to use adjustable rate mortgages (A.R.M.s), we see the *Financial Times* stating "Mr. Greenspan voiced the widespread concern within the Fed about the rapid spread of interest-only loans, floating rate mortgages, and other "more exotic" forms of home financing..."¹⁸

Greenspan has recently now gone so far as to admit that there "does appear to be signs of froth at a minimum in some local housing markets" and that "we certainly cannot rule out declines" but "the macro economic impact need not be substantial."¹⁹

Fed Chairman nominee Bernanke maintains that there is no housing bubble to pop.²⁰ But then again, the Greenspan Fed has long maintained that there is no way to tell an investment bubble until after the fact despite Federal Reserve FOMC transcripts from 1996 showing discussion about the growing dot.com stock market

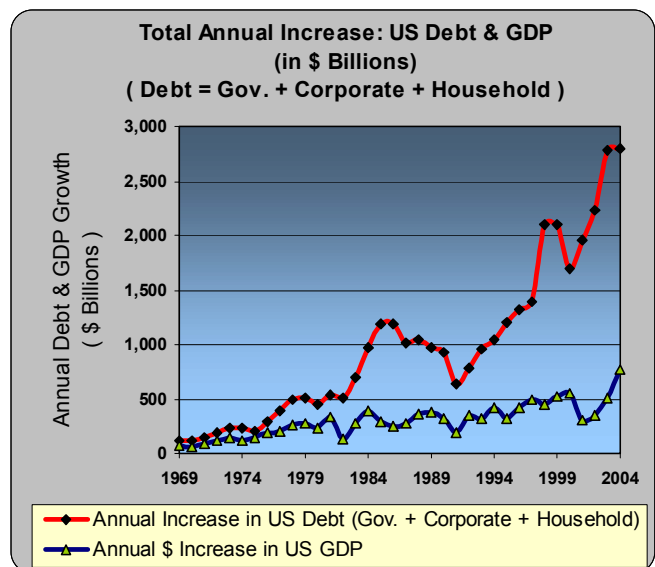
bubble; the Greenspan Fed also maintains that even if it had known a bubble to exist, there was no way to deal with the 1995 stock market bubble onset without raising interest rates so high as to cause a serious recession²¹ despite Greenspan insisting in the mid-1990's FOMC transcripts that Fed tightening of margin loan requirements would certainly stop the acknowledged stock bubble's growth.²² Greenspan has followed a repeated pattern of embarking on destabilizing policies, issuing muted warnings, then continuing these destabilizing policies.

In the current inflationary environment, several threats now present themselves to the U.S. and the world economy as a consequence of Fed and other central banks' loose monetary policy:

- The principal repository of citizens' wealth is represented by home equity. The lofty level of home prices associated with low interest rates have provided a false promise of wealth to consumers encouraging home "equity extraction" (debt increase) as consumers spent paper 'wealth' gains which can quickly evaporate. An increase in interest rates (such as if commodity prices were to rise sharply or foreign debt purchases were to decline) can quickly puncture the housing bubble truncating economic activity and leaving citizens hopelessly indebted with no savings for future retirement.
- Over Greenspan's long tenure as Fed Chairman, as America's debt has grown to unprecedented levels in terms of total debt versus GDP, economic distortions show themselves in the functioning of U.S. economy in terms of GDP growth per dollar of debt increase. Debt induced distortion of the economy from extension of the credit cycle has now increased to such an extent that on a sustained basis, \$ 5 of debt is required to produce \$ 1 of nominal GDP growth (not adjusted for inflation).

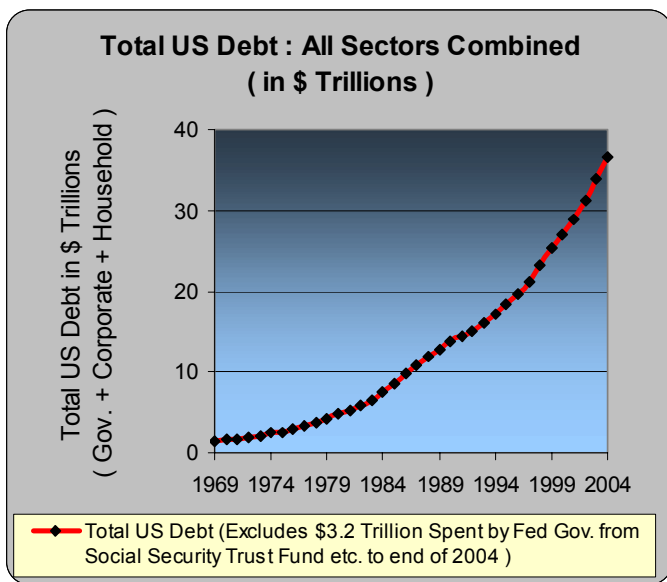


Data Source: U.S. Federal Reserve Flow of Funds

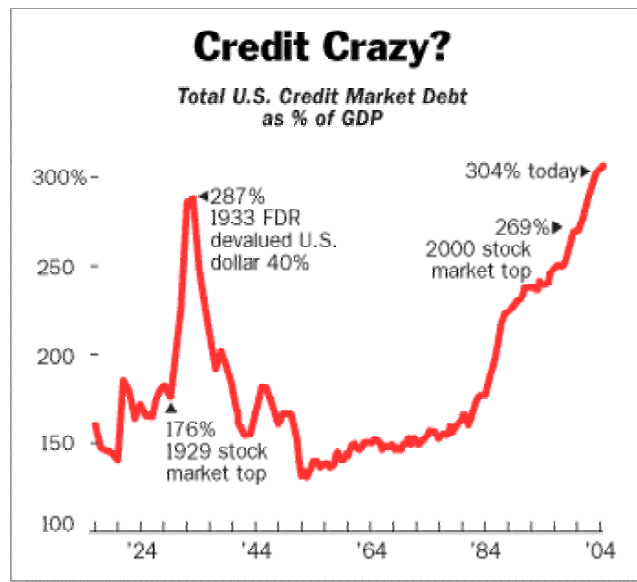


Data Source: U.S. Federal Reserve Flow of Funds

In 2004 alone, total U.S. debt increased \$2.8 trillion or at a rate of 24% of the nation's annual GDP. However, the GDP grew only 7% or \$763 billion to \$11.7 trillion in nominal terms. With a true inflation rate in the range of 6% for 2004, we now see that increasing the debt level by 24% produced only 1% of net growth – and Greenspan himself notes that \$700 billion of economic activity in 2004 originated from capital gains on home sales and real estate equity extraction (lines of credit, cash-out remortgaging, etc.).²³ In other words, the economy has become so malstructured that without unsustainable housing bubble activity, the economy contracted by \$600 billion in 2004. Subtract the temporary speculative activity by financial services companies boosting apparent economic activity, and GDP declines even further. With rising interest rates, the increase in debt required to continue the economy can no longer be maintained. (Note: U.S. Federal Government debt = \$8 trillion of the \$38 trillion total debt)



Data Source: U.S. Federal Reserve Flow of Funds



Source: Clapboard Hill Investment Partners; Barron's Magazine

In an environment of declining real economic net growth coupled with increasing inflation forcing interest rates higher in the economy, we see an economic landscape of investment bubbles and an economy laden with record debt and so malstructured that it barely responds to stimuli relied-upon by the Fed in years past. “Stagflation” is little more than a distorted and under-performing economy containing unproductive enterprise as a consequence of excessive debt, along with rising prices and rising interest rates following bouts of mismanagement of the economy’s money stock.

Asked during February’s Humphrey-Hawkins testimony to Congress on the state of the economy whether such high debt levels were healthy for the economy, Greenspan responded that the debt allowed people to drive the many new cars we see on the road these days.

Reflecting on the Fed’s FOMC meeting transcripts can be seen comments from Greenspan on the late 1990’s economy such as “We really do not know how this system works. It’s clearly new. The old models just are not working.”²⁴ That could be expected given the dot.com stock market bubble and unprecedented monetary injections that were underway.

As Greenspan’s departure at the end of January 2006 nears, the press has been effusive in its praise for Greenspan. Instead of concern about a rabbit warren of Fed Policy under Greenspan, the press celebrates his lack of rational and sustainable monetary policy at the helm of the economy which he was purported to so wisely and responsibly control.

Article following article now approvingly notes that “Greenspan abhorred rules”,²⁵ that he “preferred judgment to rules” and that this reflected his stance of “freedom from dogma.”²⁶ One constant artifact of the Greenspan Fed is that the U.S. has been steadily led far out on the plank of increasing debt and economic distortion. Canada, the UK, Australia, some Euro-zone countries, Japan and China have similarly followed erroneous central bank monetary policy choices of the U.S.. central bankers from these countries give Greenspan glowing reviews. (Japan’s own monetary expansion, with stock market and real estate bubbles that then crashed in 1989, preceded the initiation of the above central bank actions by 6 years which should have served as a warning to those who followed.)

Likewise, Bernanke’s confirmation hearings generally follow a similar theme of “I’m going to do stuff. Don’t worry; I will be responsible and the results will be good” and firm statements by Bernanke that he will continue Greenspan’s current Fed policy. Bernanke himself has stated “[I]f making monetary policy is like driving a car, then the car is one that has an unreliable speedometer, a foggy windshield, and a tendency to respond unpredictably and with a delay to the accelerator or brake.”²⁷ We do not hear Bernanke enunciate a coherent and deep understanding of the Fed’s erroneous policies and the peril in which the economy has been placed, a recovery strategy, and a commitment to shoulder the great but essential task of repair.

As background noise to the current situation, Alan Greenspan, former and current Fed Governors, and Robert Rubin - architects of the mid-1990s U.S. monetary juggernaut - now give frequent warnings about budget deficits²⁸ and “fiscal imbalances”²⁹ being an economic threat. Greenspan makes statements that “stability in the past fanned excess” [i.e., the current rampant speculation was caused by stability not the Fed policy of repeated monetary liquidity injections and market intervention when crises occurred from the October 1987 stock market crash and on] and they all warn that the large current account deficit places the economy at risk. True, high budget (fiscal) deficits result in unmanageable government debt and ultimately cause higher interest rates. And the large current account deficit combined with a low savings rate which they and successor Treasury Secretaries Summers, O’Neill, and now Treasury Secretary Snow promoted with their strong dollar / low interest rate monetary policies do place the world’s leading economy in a position of dependence upon foreign finance.

In this regard, as noted by Marshall Auerback:

“Encouraging strength in a dollar that is too low is constructive in that it reverses the flow of speculative short term capital in a fashion that restores long run equilibrium to the exchange rate... ..But the persistence with which the strong dollar has been pursued suggests that Rubin, Summers, and O’Neill have all been oblivious to these dangers, or simply chose to ignore them to great international cost.

For these gentlemen, a loss of competitiveness, a rising current account deficit, and a growing net debtor position, all associated with a very strong dollar, appear to always be outweighed by any potential risks from destabilizing capital flows out of U.S. stocks and bonds. As we have noted about Rubin in the past, this would appear to be symptomatic of the “U.S. short-termism” that one would expect from a trader from Wall Street, but not from leading policy makers within the U.S. government.”³⁰

Warning us now about fiscal matters and the large current account deficit borders on disingenuous.

The elephant in the middle of the room that gets no mention is the destabilized economy that has been so addled and distorted by debt and excess monetary liquidity that the continued over-consumption, over-indebtedness, excess speculation, goods inflation, and creation of the economic bubbles on which the economy relies can no longer be sustained – nor is it advisable to do so.

3. Central Planning of the Economy by Central Banks

Attempted steering of an economy through central bank modulation of the money stock and interest rates has long been warned to be a hapless and eventually tragic pursuit by Austrian School economists such as its most famous adherent Ludwig von Mises (see www.mises.org for a description of the Austrian School of Economics). Throughout history, Austrian School economists have been repeatedly shown to be correct in their warnings of the repercussions of central bank intervention into the money supply and interest rates. By allowing the market to set interest rates, as advocated by the Austrian School and as occurs under the gold standard monetary system, the interest rate is constantly adjusted by the trillions of consumer and industry decisions made each day thereby tailoring the cost of money according to the economy’s evolving needs. As a consequence, the cost of money and economic growth maintain a steadier equilibrium – both continually adapting to the influences of the other.

Instead, by intervening into the process of determining the cost of money and thus the debt level in the economy, and using other additional tools such as “unconventional measures” alluded-to by Bernanke, central banks artificially prolong credit cycles and lower interest rates setting into-play distortions and reverberations throughout the economy resulting in the surpluses, shortages, economic excesses, and volatility associated with all central planning systems. In extending the current credit cycle (better named a debt cycle) as Greenspan and other central banks have repeatedly effected throughout history, Fed policy has induced malstructuring of the economy which is littered with unproductive enterprises which are reliant upon the availability of capital at low interest rates that will now again shake-out as capital becomes less affordable in the increasingly inflationary environment, whether or not the Fed would like this to happen. As noted by economist Frank Shostack:

“When a central bank expands the money stock, it does not enlarge the (real) pool of funds. It gives rise to the consumption of goods, which is not preceded by production (and savings). It leads to less means of sustenance. As long as the pool of funding continues to expand, loose monetary policies give the impression that economic activity is being boosted. That this is not the case becomes apparent as soon as

*the pool of funding begins to stagnate or shrink. Once this happens, the economy begins its downwards plunge. The most aggressive loosening of money will not reverse the plunge...*³¹

As inflation now forces interest rates and the cost of money higher, the funding pool effectively shrinks.

Similar to bureaucrats when plans go awry, Bernanke now says he simply needs *more* interventional tools to make the economy function properly. Bernanke suggests that he needs “microregulatory” tools to control inflation.³² Reaching into the complex and delicate workings of the economy to microregulate markets and prices will not solve the macro problem of swamping an economy with money and debt for more than a decade.

In proposing to steer the economy, use of economists’ and academics’ mathematical “*econometric*” models may seem appropriate to some central bankers. However they do not reflect the reality of the complex workings of the economy and cannot replace the natural balance of interest rates and the money stock that is required. That the functioning of an economy may fit a curve for a period does not validate the predictive capacity of such econometric models. Nor do such models identify tipping points of criticality where natural systems (such as economies) which are distorted into a metastable condition when central planners intervene, finally let go with sudden stepwise change.³³ Neither, as we are asked to today, is relying on the personal intuition of central bankers such as Greenspan and Bernanke to knowingly balance the economy with their next idea, a viable alternative.

Centrally controlling the cost and volume of money by central banks also introduces a further distortion in the price of commodities that has numerous negative repercussions.

There exists in the economy a natural tension between investments in commodities and other financial instruments (general equities, bonds, financial derivatives, etc.). In a benign inflationary environment, strongly increasing the money stock can initially appear to have salutary effects on the economy without directly affecting commodity prices. In particular, when such a benign inflationary environment follows a previous strongly inflationary economy which has been characterized by high commodity prices, commodity producing companies (oil, metals, etc.) will have ample, even excess, defined reserves and production capacity which were developed during the preceding protracted inflationary period, to meet current market demand.

As the economy is initially hopped-up by central bank injections of monetary liquidity, this previously-developed excess commodity supply combined with superior and increasing returns (profit) in general equities and other financial instruments, serves to draw funds from commodity markets and financing from commodity companies into these better performing financial instruments. This initially results in further declining commodity prices as well as a decline in exploration and development activity in the commodity sector as commodity producers cut costs and operate from the excess mineral reserves and production capacity previously developed. With low commodity prices declining further for years (note that U.S. gasoline prices reached an historic low inflation adjusted price in 1999) from initiation of monetary stimulus but with an accelerating economy and accelerating financial markets, investment in developing further commodity reserves and production can decline precipitously even as the economy accelerates as was witnessed during the 1990s commodities bear years. It may be peak oil driving oil prices, but it is not peak copper, peak steel, peak coal, peak zinc, peak-cocoa, etc. driving these commodity prices.

Western and Chinese consumption now accelerate demand after years of commodity torpor and inadequate development of the supply structure. In this way, using Chinese production to cap prices and control evidence of consumer goods price inflation might have seemed like a neat idea to the Fed and Treasury when stimulating spending with their loose monetary policy; however the voracious Chinese appetite for commodities has now been unleashed. In the end, Chinese production of consumer goods only served to delay for a short period the evidence of central bank inflation of the money stock while freely transferring, to what was 25 years ago a marginally functional agrarian economy, the technology with which it can challenge the West militarily and economically.

Here lies another of the inherently disjunctive effects of the central banking “elastic currency” system, as the disruptive effect of monetary manipulation continually puts the commodities markets out of sync with the economy. The period from initial discovery of new mineral deposits to commercial production typically take 7 to 10 years. When development of the commodity reserve base has been disrupted by low prices, the production capacity of commodity producers cannot be developed and accelerated in time to counter the price rise associated with

increased demand. Artificially depressed commodity prices can then, in relative terms, suddenly rise driven by supply and demand factors but also as a consequence of capital vesting to return commodities to historical equilibrium price levels relative to the money stock and economic output – again, this can be especially pronounced in an economy such as currently exists where excess monetary liquidity has now created widespread speculative activity combined with investors seeking investments with tangible backing as portfolio insurance against market and economic instability.

Further damaging to the economy and the environment due to artificially low prices are wasteful consumption of commodities such as petroleum-based energy, low operating margins of commodity producers during decades-long commodity bear periods resulting in practices causing environmental damage, and, perhaps most damaging, the malstructuring of our society, energy infrastructure, and transportation systems reliant on artificially inexpensive commodities and hydrocarbon energy. After decades of artificially low energy prices, North American society is now ill prepared for the much higher energy and commodity prices to come.

Two major arguments dictate that the era of monetary and economic intervention effected by central banks must now come to an end:

- For the reasons outlined by the Austrian School and proved repeatedly through experience, central banks are not able to effectively emulate the constant adjustments of market forces in determining the supply and cost of money. Such central bank monetary intervention invariably fails with disruptive corrections when distortions have increased to the point of stepwise correction as well as leading to unsustainable asset bubbles, unproductive enterprise and speculation, wasteful natural resource consumption, and mal-structuring of our communities and society.
- Concentrating the power of controlling the economy in the hands of a few (or one) central banker and those who can influence them represents a national security threat to the economy. Countries that spend trillions in the pursuit of national defense and anti-terrorism war campaigns should consider that at the core of the nation with a central banking system are a handful of individuals whose decisions can completely destabilize the economy.

4. Corrective Action Must Be Initiated Now In Advance of Crisis

“The onset of a corrective economic adjustment down to sustainable levels is underway and we advise individuals to moderate their consumption and speculation and ensure adequate safe haven positions in their investments.”

After the dot.com stock bubble popped in March 2000, we did not – and we still do not - hear these words from those with a fiduciary duty to warn us. Instead, in a paradoxical turn, central banks, governments, mainstream financial services companies, politicians of all stripes and the media promote and cheerlead the unsustainable thus further compounding speculative excesses and increasing the damage from the ultimate and inevitable correction.

Because the \$100 trillion invested worldwide in financial instruments represent a bet on a distorted and declining foundational economic structure, a correction in the inflated value of these instruments and the low interest rate dependent housing bubble will inevitably occur to bring their value into balance with the productive demand and capacity of our weakened economic structures. When the excessive debt, unproductive activity, and economic distortion are removed from the economy by a decline in availability of artificially cheap capital (debt), the economy will be restructured for future productive growth. This restructuring cannot be achieved, as suggested by Friedmanites, by printing money and “growing out of” a post bubble deflation – ask Japan which year-after-year repeatedly announces that, now 16 years after its own stock market and real estate bubble burst, it is yet again, THIS time for real, finally emerging from deflation.

If the economy manages to continue on for a period, given the excessive levels of liquidity and inflated value of the financial markets as well as the onset of commodity tightness, like the 1970s we again are positioned vulnerable to the onset of a strong normalizing movement in energy prices and commodity prices which will spike interest rates and destabilize the economy. The real economy is in decline and the ultimate correction will be magnified by delaying ameliorative action.

Given the damage that has been sustained by the U.S. energy complex (especially natural gas production) as a consequence of Hurricane's Katrina and Rita in an already highly speculative and inflation-charged environment, there exists a very real possibility of dislocative energy and commodity price moves in the near future. It seems unconscionable to head into the depth of winter with its period of maximum energy demand risking having to, at that point, attempt a monetary system restructuring causing widespread economic and social chaos.

Given that the Bush Administration has alienated much of the World with its obdurate foreign policy, it may seem fitting that the rest of the World (with the Federal Reserve and the other central banks opportunistically jumping right in) play a game of Pin the Tail on the Donkey with George Bush laying the blame at the feet of his administration. Bush does seem to have succumbed to the hackneyed and incorrect belief that you can start a war, print money and then deficit spend your way out of an economic decline – throw in a nice asset grab at the same time (ethics & morality do not seem to have much purchase with desperate politicians). However, Bush and his advisors were wrong on all counts at a time that the post-dot.com bubble economic environment was correcting from decades of monetary malpractice by our central banks.

The world's economy is at risk of an economic upset dictating that it is time to put political opportunism aside. Our governments, either in unison or independently, must intervene to restructure our monetary systems now. Such a suggestion may seem radical especially to those who are benefiting from the current speculative and volatile financial markets in which vast fortunes are being made and financial services industry profits attain record levels. However, the consequences of not taking action at this time when the markets are relatively placid and attempting instead to impose such a restructuring in times of crisis risks social and economic upheaval that is unacceptable. One government has to have the courage to move first. It is time.

Addendum: Gold and the Media, Governments and Wall Street

As the principal indicators of the status of monetary health from scourges such as inflation and the indicators of economic distress, the rising value of gold and silver (bullion, precious metals equities, gold & silver pool accounts, etc.) are an unwelcome comment on the state of economic affairs. If engaging in monetary inflation to stimulate their economies, it would be essential for central banks determined to implement such policies that the price (and implicitly demand) of gold and silver not indicate the negative aspects of their action as this will force-up interest rates and curtail further such action by the offending central bank.

Financial markets and financial services companies benefit from the artificial economic stimulus and speculative fervor that initially accompanies such central bank monetary inflation. And because gold-backed currencies cannot simply be increased at will with a printing press and also prevent the later inflation of the money stock as a hidden tax with inflation consuming outstanding debt (allowing the financing of wars, social program spending, unsupportable tax cuts, etc.), gold is resented by both the financial community and governments.

There has been a substantial body of evidence first published by banking consultant Frank Veneroso (who analyzed historical bullion flow data indicating excessive gold entering the world market), the Gold Anti-Trust Action Committee (GATA) headed by Bill Murphy, James Turk, *et al.* that central banks of the world's industrial nations (including Russia) have engaged in a protracted campaign of oversupplying the market with gold via gold leases onto the world's precious metals market. Why leasing? Leasing allows central banks to supply gold to the markets for a period of time (the gold is to be returned at a later date, in the meantime earning a typical leasing income of 1% per annum) yet the central banks are still able to show the gold as a current asset on their books with this off-balance-sheet transaction. In this way, central bank gold supply data is obscured as there is no central reporting agency with *reliable* data into the notoriously opaque world gold market – all that the typical observer would know is that the price is steady or declining, implying that demand is low, that the markets are sound and inflationary policies are not underway by central banks.

During this same period of time, central banks have in a coordinated and highly publicized fashion trumpeted *future* off-sales of their gold inventories that periodically occur. Veneroso and GATA have noted that that Western central banks have announced and repeatedly stated their intentions to sell gold beforehand indicates that the selling motive is not profit maximization because such an announcement drives the price of gold down before the transaction occurs. Central bank selling combined with the silent supply of leased material that distorts the market price of gold, has made the true state of demand of the gold market very difficult to gauge.

Greenspan himself commented in 1998 during the dot.com stock bubble fervor that “central banks stand ready to lease increasing quantities of gold should the price rise”³⁴ fully understanding that the leasing vehicle was very difficult to measure thus implicitly stating a policy of price capping intervention by central banks. Given gold’s role as the primary economic warning signal, the corollary would be for the Chief Pilot of an international pilot’s union informing his passengers that there is a device on aircraft that is called a stall warning system and that passengers should take comfort in the fact that whenever such a device signals danger of stalling, pilots in his union are always prepared to flip a circuit breaker to make it go away. It is also interesting that Greenspan should suggest that leasing would increase in a rising price environment as the gold borrower, who typically sells the gold and invests the funds in financial instruments that for a period giving returns adequate to carry the leasing cost, would have to repurchase the gold at a later date and at a higher price to return it, potentially negating any profit (or worse). The message was clear – ‘When this stock bubble pops, don’t even think about running to gold investments and blowing the cover from our monetary policy, as we will make sure gold won’t rise.’

Greenspan intimated with this statement that it is the intent of those central banks to distort the price of gold with their holdings that, although putatively equal to 20% (32,000 tons) of the world’s total gold inventory, are finite. Veneroso’s analysis estimates that a minimum of 50% of the world’s central bank gold has already been leased-out and because of a chronic and growing mine supply vs. gold demand deficit cannot be returned to the central banks without the gold price moving much higher.

For a discussion regarding anomalies in the gold trading market, see: http://www.gold-eagle.com/editorials_05/speck120605.html

The precious metals mining industry has been largely mum on the information regarding the manipulation of gold likely due to several reasons:

- Mining companies depend on governments for mining concessions and permits to operate;
- Mining executives’ careers might be shortened if they engage in public policy arguments that initially bring public scorn to them and their companies. And it is unattractive, at the best of times, to take-on governments, the financial community, central banks, and the media;
- The push down of the gold price has allowed mining executives with the gift of insight to inexpensively access lasting tangible gold and silver resource assets that will steeply increase in value as the temporary price containment scheme ultimately fails (as happened with the ill-considered and publicly visible London Gold Pool gold price manipulation activity that failed miserably in the late 1960s. This drained half of the U.S. Treasury’s gold from an initial 16,000 tons of gold holdings to 8,000 tons of gold in 1972 ultimately followed by gold rising from 1968 price of \$35 /oz. to a peak of \$850/oz. in 1980); and
- From a game theory perspective, unless most mining executives were convinced by the data and took the risk of speaking-out, then those who did not act could potentially benefit by initially receiving the favors of governments, the media, and establishment investors.

The mainstream media have typically responded, if at all, to the concerns of Veneroso, GATA and others by, instead of analyzing the issue and the data, publishing articles mocking and denigrating the individuals concerned as “conspiracy theorists”, members of the “black helicopter crowd”, etc. Some refer to them as “anti-government” because of the stated concerns. The above groups’ concerns regarding the apparent intervention in the gold markets might better be characterized not as “anti-government” but as “anti-destabilizing practices by governments”.

Why the media, whose principal responsibility is to inform citizens with accurate and pertinent information, have taken a tack that in essence aligns with central banks, governments of the day, and the financial industry, who have all temporarily benefited from the speculative and investment excess to the long-term detriment of society at large, is not clear.

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- ³ “Debt Level Places U.S. at Risk”, The Boston Herald, April 4, 2004.
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