30 March 2009

The US Bail Out and the larger monetary story

Credit flows, changes in the world currency base, and the push to spend

There has never been such a sustained buildup of credit flows to the U.S. household sector as began in the late '90s. In recent times this has gone into reverse, more completely than at any time since the Great Depression. US Policymakers, investors and entrepreneurs are scrabbling to come to terms with this essential piece of the current financial turmoil.

There are good reasons why the household sector is paying down debt in an environment of declining asset prices and personal income. Falling asset prices reduce wealth faster than households can pay down debt. This has a number of very important implications, not the least of which concerns the restructuring of global growth away from a growing dependence on consumer debt binges in Anglo-American and associated developed nations. There is also the misguided policy objective of renewing lending to the private sector, which is the very core of the justification for the bailout and the broader Congressional stimulus plan.

A few members have e-mailed me with clarification of the concerns expressed in my reports on the US bailout. I still believe that the economically correct thing to do would be to let the excess capacity sort itself out, although this means job losses and people having to seek new ones. Factories close down and open up again, producing something else, although this is something that happens periodically and more sedately in normal times. Companies go broke and new companies spring up to take their place. Simply put that's what needs to happen! Then, after this restructuring, the economy can begin rebuilding on a more solid foundation.

But the Fed does not seem to see it that way, or does not want to admit to. Ben Bernanke is determined to stop a Japan-style depression from happening in the United States at whatever cost, and the only way he can possibly stop it, by his logic, is by increasing demand. By putting more money into circulation gives people more money to spend, and with rising prices this encourages them to spend now.

US house prices – fallen as predicted

Statistics have shown that U.S. home prices have been reduced to levels unseen since 2003, as data taken from latest rendition of the S&P/Case Shiller Home Price Index indicate. Last week's Dollar printing topped off 2008 with another record decline in property values. The numbers clearly show that December reported a 19.2% yearly fall for their 10 city composite, and a 18.5% slump for the 20 city composite, both records. This index has now fallen every month for two straight years, as the broad downturn in the residential real estate market continues. There are very few, if any, pockets of turnaround that one can see in the data. Most of the USA appears to remain on a downward path, just as predicted earlier.

A few members took our advice and sold there second home thus avoiding a big hit on its value. Since the property market was forecast right, members have e-mailed me asking whether I think that this will continue. I believe this home price trend will be shown to have continued through February and March. According to the National Association of Realtors last week, the median new home price fell to $200,900 in February. That is a record 18% fall from the same time a year ago and the lowest level since 2003. Considering the previous record fall this trend is still continuing.

Last week the Fed began buying U.S. Treasuries

Britain is already doing this, as we said in our last report and so is Japan.

When a U.S. Treasury bond is purchased, it is paid for with real money. Money changes hands. The important fact here is that there is no net increase in the money supply. But when the Fed buys a Treasury bond it creates the money to buy it and thus the money supply increases!!! It's called "monetizing the debt" or converting debt into currency. **Given the size of upcoming Treasury purchases, the total size of the U.S. monetary base is expected to increase by 500% in the months ahead.**

This will have a significant impact on the value of the dollar and on the price of gold, but this is not fully understood. Alas, the more we learn, the less we know! The more we find out; the more we find out what we have not yet found out!

Gold at least showed some reaction, down $28 to $923. But what happened in the gold market? It appeared that investors did not notice that the Fed has begun almost literally printing money? Why didn't the price go to $1,000?

We have worried that inflation was too obvious. One can see it coming a mile away, which is why we say the United States can pay off its debts in a currency whose value it alone controls!

But what if it weren't true? What if the Fed could not control the value of the Dollar? What if inflation did not happen as expected?

Here is something that is true: that which must happen will happen!

When the money supply is increased, the price of money must go down! That is why the price of gold is over $900 rather than, say, $750. When Investors see trillions of dollars going into the world's money supply, they know what to expect next. It is just a matter of time before the price of Gold increases significantly.

In my last report I said I would comment more on the recent Fed move, i.e. More money = more inflation; that's the rule. They are busy feeding the system with quantitative easing. Will the desired inflation result?

They want to lower the debt burden by instigating inflation. They want to increase the use of money by lightening it up a little, so that people are eager to get rid of it. They want to get lenders lending, and consumers consuming! They want to shift the burden of losses from the people who made them to the people who didn't! Well, what if people don't cooperate? What if the Dollar value increases and Dollar-denominated debts stay with the people who incurred them? It may seem impossible, but that is what happened in Japan a few years ago.

The Fed has no alternative but to try to inflate the currency, because that will reduce the debt load on consumers and, not coincidentally, on the government too. It will also induce people to spend money, rather than save it. This will increase the turnover of money, which will have a further inspiring effect on people's confidence.

As I said in my last report that if at first they don't succeed, the Fed will try and try again. Sooner or later, they will get the inflation they desire, first moderately, then at an increasing rate.

But there are major differences between Japan and the United States, and reasons to think that the Fed might succeed where the Japanese government failed. However, in a world in which paper depreciates, tangible assets will hold their value better**.** Unlike with paper, we cannot just create oil reserves or clear land or find water by pressing a few buttons at the Fed.

Will we see investors **buy Gold and gold stocks soon?** While Gold is a commodity, it has a unique monetary heritage. It was money in the sense that you could buy groceries with it and not so long ago either. People are very likely to return to gold as the Dollar's prospects decline. While this development has yet a long way to go it, should benefit RIO's Professional Investors Fund, which holds Gold. **I would also add that, this year in particular, has been good for Gold, thanks to lower energy prices and currency influences.**

The current actions by the Fed have the Chinese worried, their worry on the grounds that the Fed may succeed in debasing the Dollar. Hence, they are proposing a new monetary system based on Special Drawing Rights (on Gold), administered by the IMF.

I strongly feel that an international reserve currency should first be anchored to a stable benchmark and issued according to a clear set of rules to ensure orderly supply. Secondly, the supply should be flexible enough to allow timely adjustment according to changing demand. Finally such adjustments should be disconnected from economic conditions and sovereign interests of any single country. This crisis has emphasized again the need for creative reform of the existing international monetary system towards an international reserve currency with a stable value, rule-based issuance and manageable supply, in order to achieve the objective of safeguarding global economic and financial stability.

Market interest rates are prices and, as such, they communicate important information about real, underlying scarcity. When the central banks of the world decided to drive interest rates down to practically zero, they crippled the ability of the world economy to heal itself after the over consumption of the housing boom. **People all over the world need to be saving right now in UK they seem to be, and yet**

governments, for political reasons, are trying everything they can to squander what is left of the capital stock.

Summary points

While debt in the United States rose to an unprecedented 350% of GDP, in UK it went to 500% of GDP. Joblessness in Britain has risen above 2 million for the first time since 1997.

House prices before the crunch were unsustainably high in the United Kingdom, but have been becoming less so by the day. Some expect them to fall further before hitting bottom, but the latest encouraging news from the Bank of England and financial sector is that mortgage lending last month was significantly higher than expected and the average house price rose 0.9%.

Factories are closing, and layoffs are still increasing. The UK Government has bailed out the banks, but seemingly failed to bail out the little guys as well.

As retail and commercial real estate decline, the credit card sector and all its interrelated processing and back office support businesses will suffer and be forced to scale back. Many consumers, who have been living off credit cards and racking up debt to the limit, could lack the funds to service their debt, much less pay it off, and could be forced to default. Given the nearly $3 trillion in consumer debt at risk (excluding auto and mortgage) a default snowball could add momentum to the in-progress economic decline of 2009, unless the G20 meeting results help to restore confidence and put the right control packages for the future in place.

The Trends Research Institute provided copious data and 'Global economic' analysis to support our forecasts of economic upheaval. In the past year alone, we have provided so much hard evidence on housing starts, home sales, foreclosures, bankruptcies, bank failures, unemployment figures, stock indices, leading economic indicators, retail sales, etc., that further elaboration should be superfluous.

Absent from the economic scenarios ranging from second quarter recovery, deep recession and virtual depression, in some places, are the multiplicity of social, environmental, health, political, emotional/psychological and geopolitical factors that point beyond just recession. They emphasize a shift in the world economic order, recognized by the new players appearing at the G20

Perhaps, like me, you question the soundness of the banking system. I requested to withdraw a substantial sum from my Bank account. First they tried to dissuade me; then I was forced to sign a series of documents, including one acknowledging that, since I was carrying a large sum, I could be the target of a robbery! We have heard similar accounts from several members who, over the past few months, tried to close out mutual funds and assorted sinking equity holdings.

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