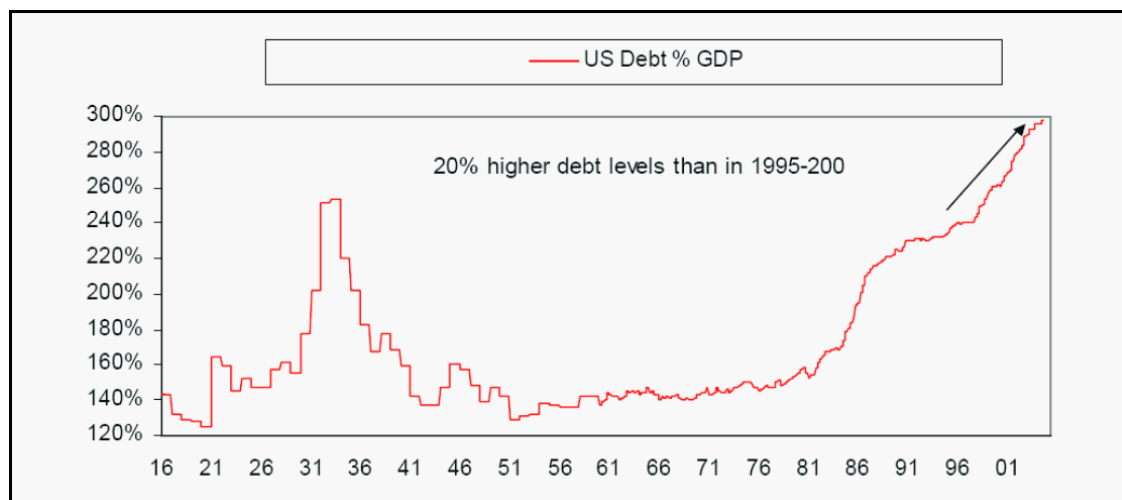


## Why the Fed has no other Alternative but to print Money!

In the past, I have demonstrated that economic growth and deflation is entirely compatible. The entire economic expansion of the US in the 19<sup>th</sup> century was a deflationary boom. Declining prices led to strong real income gains. As time went by, workers could buy with their incomes a larger and larger basket of goods because prices for consumer goods and commodities declined. In other words, whereas **inflation** is the equivalent of a loss of purchasing power of money, **in deflationary times** the purchasing power of money increases. In deflation my 100 dollars today are worth more in a year's time since they will buy a larger basket of goods and assets, whose prices are declining. In my opinion, there is, therefore, nothing wrong about deflation. So why is the US Fed so concerned about deflation that Mr. Bernanke even suggested dropping US dollar bills from a helicopter in order to combat it?

There is one condition under which deflation is a disaster and this is when total credit market debt is high as a percentage of the economy (see figure 1)

**Figure 1: Total US Debt as Percentage of GDP, 1916-2005**



**Source: Bridgewater Associates**

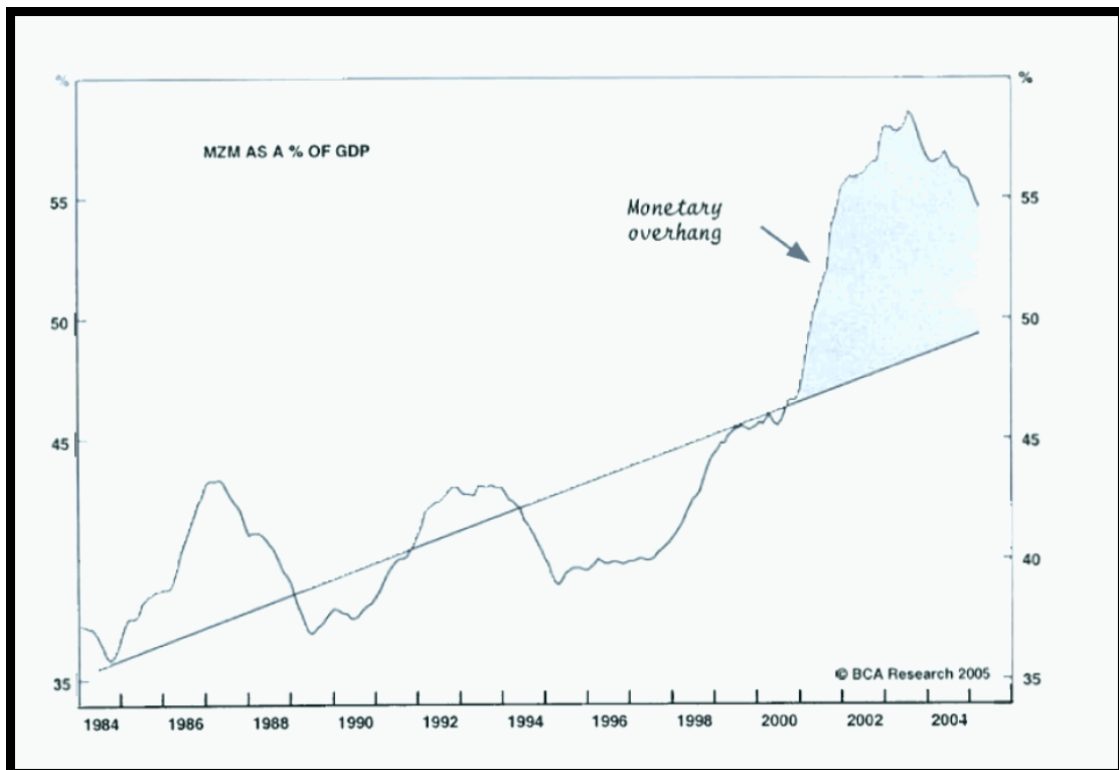
When debts are as large as there are now, deflating prices and especially deflating asset prices would wreck havoc in the economic system and lead to massive defaults and bankruptcies. I may add that, as can be seen from

[www.gloomboomboom.com](http://www.gloomboomboom.com)

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figure 1, between 1950 and 1980 the debt to GDP remained largely constant. But after 1980, and in particular after Mr. Greenspan became Fed chairman in 1987, debt to GDP exploded. Therefore, it is not deflation that is the problem, but the preceding debt inflation for which the Fed's expansionary monetary policies are fully responsible. So, having created a monetary and debt monster, the Fed embarked starting 2001 in a huge money printing operation in order to avoid deflation. Figure 2 shows that following year 2000, MZM as percentage of GDP exploded (see figure 2).

**Figure 2: MZM as Percentage of GDP, 1984 - 2005**

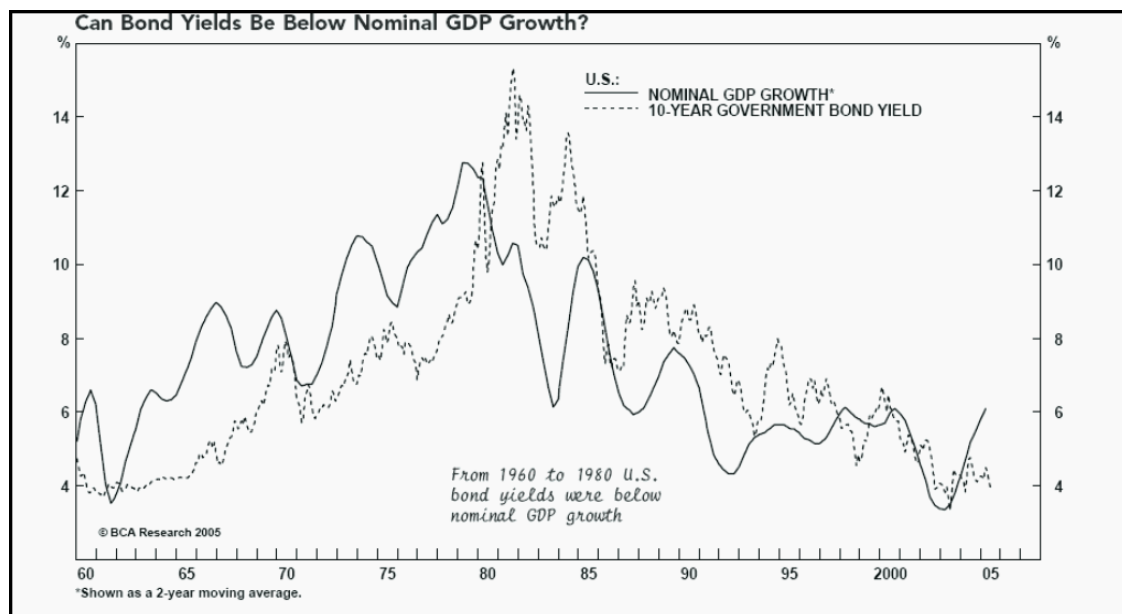


**Source: The Bank Credit Analyst**

Now, it is true, as my friends at Gavekal pointed out, that in recent times money supply growth has been decelerating. According to Gavekal, over the last six months, the US monetary base had been contracting, which is

normally a sign that monetary conditions are actually tight. Usually such periods of a declining monetary base are followed by stocks not performing as well as cash, and frequently also by some kind of financial accident. Now, I have no doubt that money has become tighter, which is also reflected by the US dollar strength since the beginning of the year. However, we should not overlook the fact that despite tighter money – the Fed fund rate has been increased from 1% one year ago to currently 3.75% - compared to nominal GDP growth and inflation, short term interest rates are still too low. In fact, at 3.75% the Fed fund rate is below the unofficial US inflation rate of about 5% and significantly below nominal GDP growth (see figure 3).

**Figure 3: Nominal GDP Growth and 10-year Government Bond Yield**

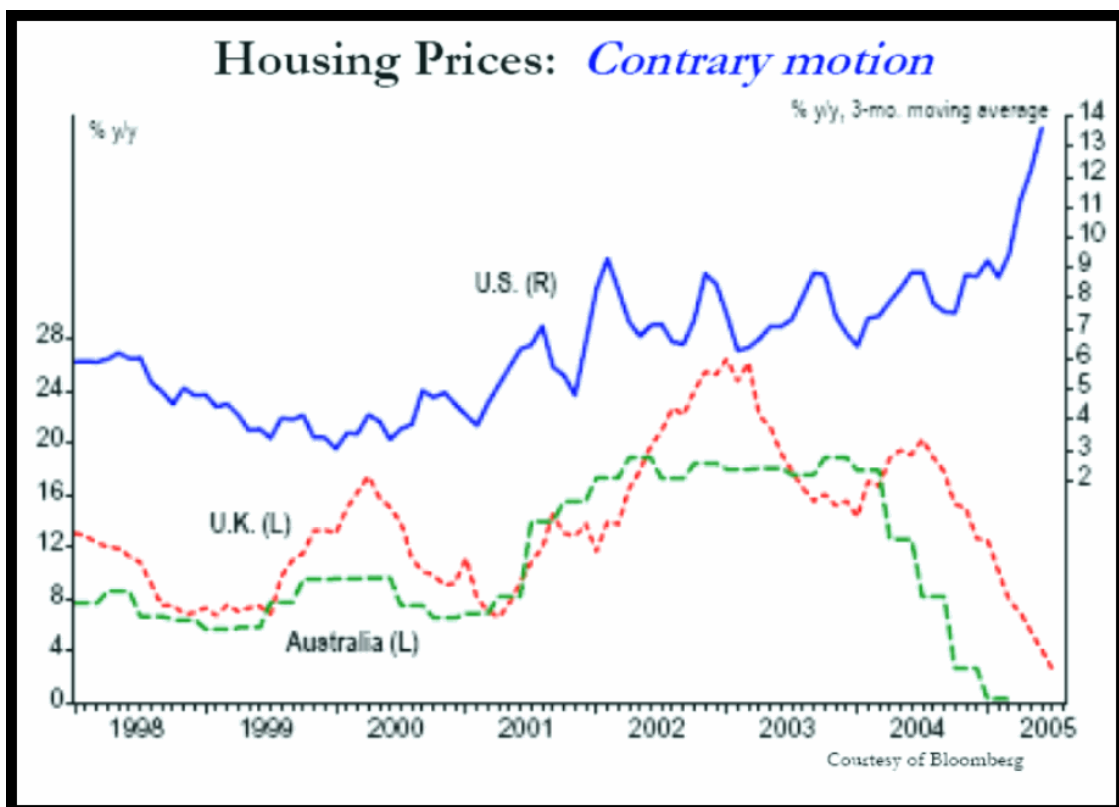


**Source: The Bank Credit Analyst**

Moreover, observers of monetary conditions may do well not only to look at money supply growth but also at credit growth, which has in recent times gone through the roof! According to Doug Noland of [www.PrudentBear.com](http://www.PrudentBear.com), year-to-date, US bank credit has expanded by US\$ 544.7 billion, or 13.5% annualized. Among this total, security credit gained

\$ 145.6 billion, up 12.7% annualized. Commercial and industrial loans have surged at an annualized rate of 18.8%. Real estate loans are up at an annualized rate of 16.7%. Year-to-date, asset backed securities (ABS) issuance is up \$ 451 billion, i.e., 21% ahead of comparable 2004. Home equity loan ABS issuance of \$ 286 billion is 24% above its growth in 2004's same period. I may add that the 13.5% annualized credit growth generated only a 3.6% GDP growth. In other words, US credit is growing about four times faster than GDP growth - not exactly a sign of a sound and well balanced economy. Still, the monetary overhang the Fed created post 2000 and the rapid credit expansion lifted US home prices significantly in recent years (see figure 4).

**Figure 4: US Housing Prices**

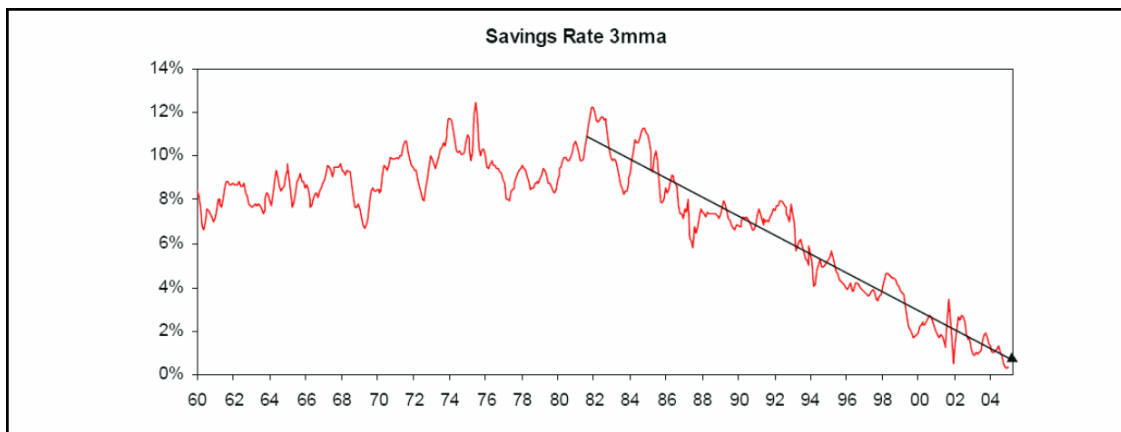


**Source: Bloomberg**

As a side, I may mention that the same way housing inflation decelerated in the UK and in Australia (see figure 4), in the US, this will sooner or later surely also be the case (in my opinion rather sooner than later). Moreover, in

the case of both Australia and the UK, once housing inflation diminished consumption also slowed down considerably. I would, therefore, expect consumption to slow down shortly in the US as well. But the critical point here is that the asset inflation, which replaced consumer price inflation starting 1980, led the American public to believe that rising asset prices – first equities and since 2000 home prices would be permanent features of the economic environment. Therefore, US households began to save less and less and to rely increasingly on rising asset prices to take care of their future retirement needs (see figure 5).

**Figure 5: US Savings Rate, 1960 – 1980**



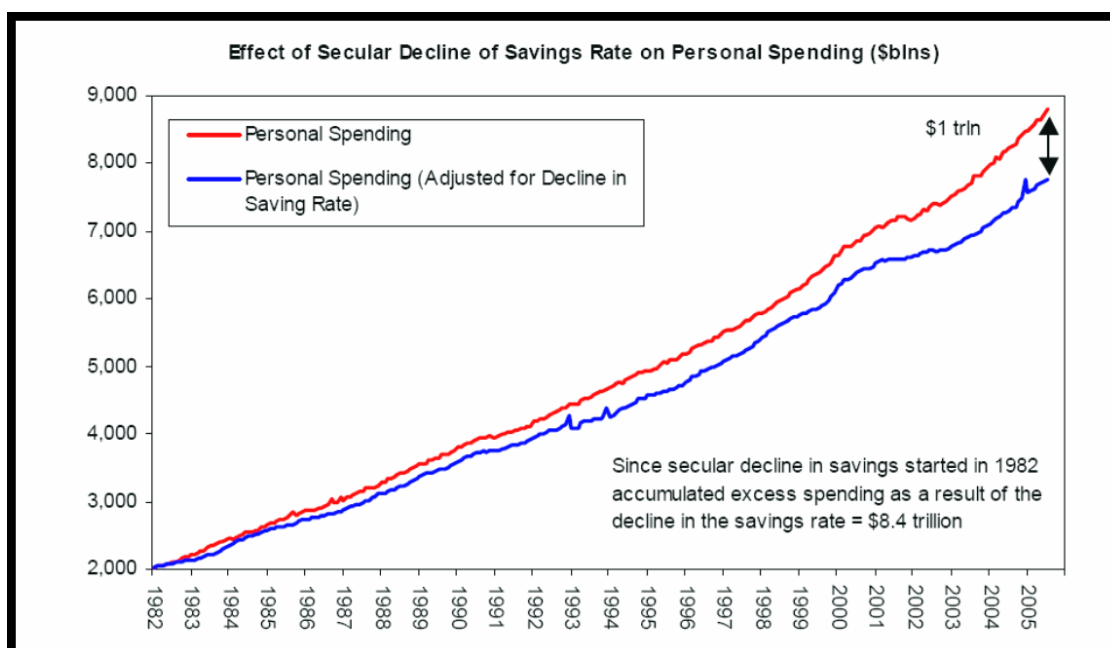
**Source: Bridgewater Associates**

I am not surprised that US economists and strategists continuously find a new “angle” to justify their overpriced stock and property market, and their currency, but what really baffles me is how the world, and also Mr. Greenspan still believe that the US economic expansion is “**sound**”. Consider the following: Your household spends all or even more than you earn every month while your next door neighbor puts aside 20% of his income and invests his savings into the shares of a company whose business prospects are favorable or into property investments or bonds. After 10 years, which family will be richer – the one that spends all its income and even borrows money to maintain its standard of living or the family that puts aside month by month money for the purpose of savings and investments? I do concede that not all investments will work out but - if well diversified -

the household that saves should end up far richer than the household that not only spends all its income but also borrows money. This is the situation in the world today. The US prints money and spends its “**illusionary wealth**”, which is created through asset inflation, while Asia has a high savings rate – a relationship which is evident from the growing US current account deficit, and the growing current account surpluses and the accumulation of foreign exchange reserves in Asia.

But there is another angle to the declining US savings rate. Over the last six years US households have been selling financial assets and borrowed money in order to support their consumption. Along with the decline in the savings rate, which began already 20 years ago, this has boosted US GDP growth above what it would have been if the savings rate had remain constant (see figure 6)

**Figure 6: Effect of Declining US Savings Rate on Personal Spending**

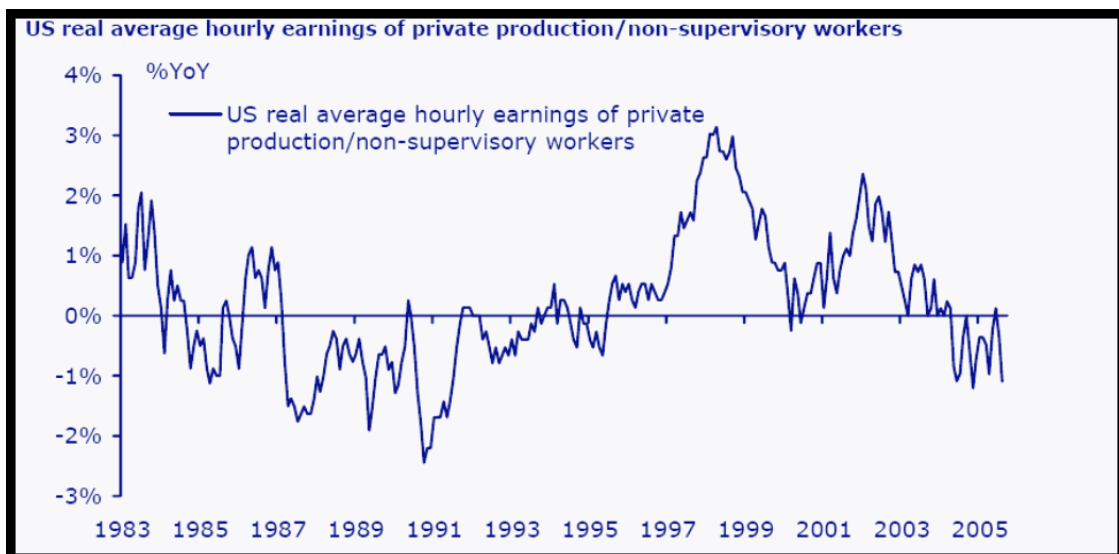


**Source: Bridgewater Associates**

The red line in figure 6 shows the current level of personal spending while the blue line indicates what personal savings would have been if the savings

rate had not declined. Consequently, according to Bridgewater Associates, if US households ever returned to just a normal savings rate, US GDP would collapse by about 7%! Now why would the US savings rate ever move back up (see figure 5)? Once the housing inflation comes to an end, and households can no longer refinance their homes at lower interest rates, consumer confidence will tumble and lead to a rising savings rate, and along with it, to a recession. This could happen sooner than expected, given the fact that the shares of the largest lender to the housing industry, Fannie Mae, just hit an eight years' low and that the shares of homebuilders now appear to have topped out! However, not to worry too much! The Fed, once it notices that the asset inflation, which supported consumption, has come to an end will once again turn on the money printing press. But will it help? I doubt since further money printing is likely to result in consumer price inflation exceeding personal income gains. As can be seen from figure 7, already now, hourly earnings are declining in real terms.

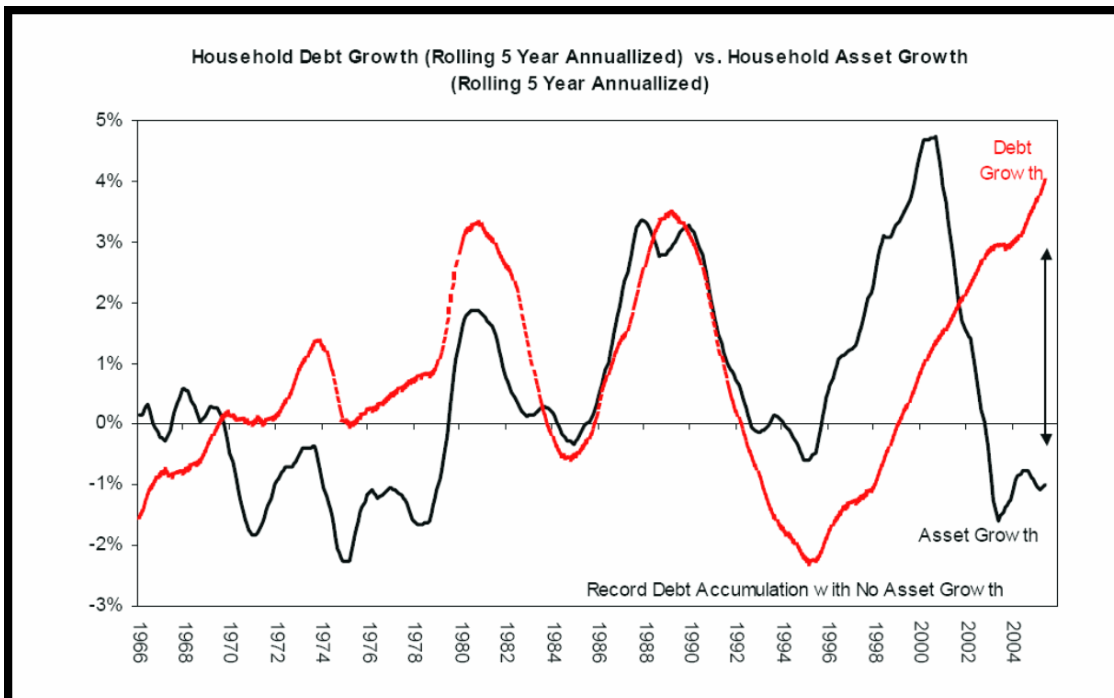
**Figure 7: US real hourly Earnings**

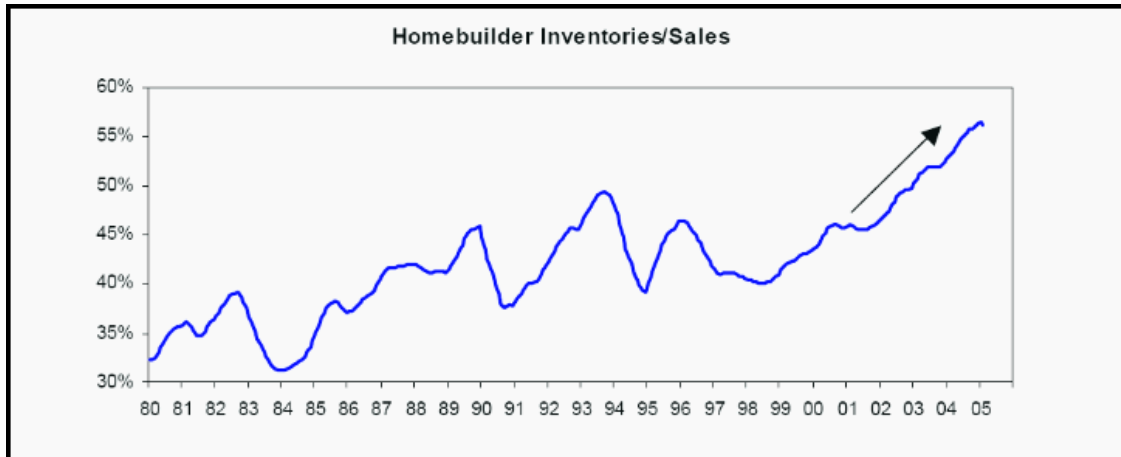


**Source: Chris Wood, CLSA**

So, the next time, the Fed embarks on its usual money printing exercise, consumer price inflation accompanied by renewed dollar weakness is likely to both exceed asset inflation – especially in the housing sector – and income

gains. This should ensure that the forthcoming recession will be characterized by consumer price inflation and simultaneous economic weakness. Maybe the rise in the gold price, which admittedly could be interrupted temporarily by profit taking, does begin to discount this unpleasant scenario. **Needless to say that under this scenario long term bonds would be about the worst possible investment!** I may add that when long term interest rates are below the rate on nominal GDP growth, which was the case in the 1960s and 1970s, consumer price inflation accelerates whereas when interest rates are above the rate of nominal GDP growth (1980 – 2000) consumer price inflation decelerates (disinflation). This relationship can be seen very clearly from figure 3. For investments the following should be clear: when consumer price inflation accelerates it leads to poorly performing financial assets – especially bonds. However, a whiff of inflation would be good for Japanese equities as it would move institutional and private money parked in bonds and deposits into equities and real estate.





**Table 1 Good Earnings; Bad Stock Markets**

<b>Year</b>	<b>Change In Stock Market</b>	<b>Change In Earnings</b>
2000	-16%	+25%
1974	-35%	+15%
1973	-27%	+28%
1962	-26%	+14%
1937	-50%	+14%

Source: Bob Hoyer, Institutional Advisors