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RBS tells clients to prepare for 'monster' money-printing by the Federal Reserve

As recovery starts to stall in the US and Europe with echoes of mid-1931, bond experts are once again dusting off a speech by Ben Bernanke given eight years ago as a freshman governor at the Federal Reserve.

By Ambrose Evans-Pritchard (http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/) , International Business Editor
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Entitled "*Deflation: Making Sure It Doesn't Happen Here*", it is a warfare manual for defeating economic slumps by use of extreme monetary stimulus once interest rates have dropped to zero, and implicitly once governments have spent themselves to near bankruptcy.

The speech is best known for its irreverent one-liner: "The US government has a technology, called a printing press, that allows it to produce as many US dollars as it wishes at essentially no cost."

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Bernanke began putting the script into action after the credit system seized up in 2008, purchasing $1.75 trillion of Treasuries, mortgage securities, and agency bonds to shore up the US credit system. He stopped far short of the $5 trillion balance sheet quietly pencilled in by the Fed Board as the upper limit for quantitative easing (QE).

Investors basking in Wall Street's V-shaped rally had assumed that this bizarre episode was over. So did the Fed, which has been shutting liquidity spigots one by one. But the latest batch of data is disturbing.

The ECRI leading indicator produced by the Economic Cycle Research Institute plummeted yet again last week to -6.9, pointing to contraction in the US by the end of the year. It is dropping faster that at any time in the post-War era.

The latest data from the CPB Netherlands Bureau shows that world trade slid 1.7pc in May, with the biggest fall in Asia. The Baltic Dry Index measuring freight rates on bulk goods has dropped 40pc in a month. This is a volatile index that can be distorted by the supply of new ships, but those who watch it as an early warning signal for China and commodities are nervous.

Andrew Roberts, credit chief at RBS, is advising clients to read the **Bernanke text** (http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021121/default.htm) very closely because the Fed is soon going to have to the pull the lever on "monster" quantitative easing (QE)".

"We cannot stress enough how strongly we believe that a cliff-edge may be around the corner, for the global banking system (particularly in Europe) and for the global economy. Think the unthinkable," he said in a note to investors.

Roberts said the Fed will shift tack, resorting to the 1940s strategy of capping bond yields around 2pc by force majeure said this is the option "which I personally prefer".

A recent paper by the San Francisco Fed argues that interest rates should now be minus 5pc under the bank's "rule of thumb" measure of capacity use and unemployment. The rate is currently minus 2pc when QE is factored in. You could conclude, very crudely, that the Fed must therefore buy another $2 trillion of bonds, and even more if Europe's EMU debacle goes from bad to worse. I suspect that this hints at the Bernanke view, but it is anathema to hardliners at the Kansas, Richmond, Philadephia, and Dallas Feds.

Societe Generale's uber-bear Albert Edwards said the Fed and other central banks will be forced to print more money whatever they now say, given the "stinking fiscal mess" across the developed world. "The response to the coming deflationary maelstrom will be additional money printing that will make the recent QE seem insignificant," he said.

Despite the apparent rift with Europe, the US is arguably tightening fiscal policy just as hard. Congress has cut off benefits for those unemployed beyond six months, leaving 1.3m without support. California has to slash $19bn in spending this year, as much as Greece, Portugal, Ireland, Hungary, and Romania combined. The states together must cut $112bn to comply with state laws.

The Congressional Budget Office said federal stimulus from the Obama package peaked in the first quarter. The effect will turn sharply negative by next year as tax rises automatically kick in, a net swing of 4pc of GDP. This is happening as the US housing market tips into a double-dip. New homes sales crashed 33pc to a record low of 300,000 in May after subsidies expired.

It is sobering that zero rates, QE a l'outrance, and an $800bn fiscal blitz should should have delivered so little. Just as it is sobering that Club Med bond purchases by the European Central Bank and the creation of the EU's €750bn rescue "shield" have failed to stabilize Europe's debt markets. Greek default contracts reached an all-time high of 1,125 on Friday even though the €110bn EU-IMF rescue is up and running. Are investors questioning EU solvency itself, or making a judgment on German willingness to back pledges with real money?

Clearly we are nearing the end of the "Phoney War", that phase of the global crisis when it seemed as if governments could conjure away the Great Debt. The trauma has merely been displaced from banks, auto makers, and homeowners onto the taxpayer, lifting public debt in the OECD bloc from 70pc of GDP to 100pc by next year. As the Bank for International Settlements warns, sovereign debt crises are nearing "boiling point" in half the world economy.

Fiscal largesse had its place last year. It arrested the downward spiral at a crucial moment, but that moment has passed. There is a time to love and a time to hate, a time for war and a time for peace. The Krugman doctrine of perma-deficits is ruinous - and has in fact ruined Japan. The only plausible escape route for the West is a decade of fiscal austerity offset by helicopter drops of printed money, for as long as it takes.

Some say that the Fed's QE policies have failed. I profoundly disagree. The US property market - and therefore the banks - would have imploded if the Fed had not pulled down mortgage rates so aggressively, but you can never prove a counter-factual.

The case for fresh QE is not to inflate away the debt or default on Chinese creditors by stealth devaluation. It is to prevent deflation.

Bernanke warned in that speech eight years ago that "sustained deflation can be highly destructive to a modern economy" because it leads to slow death from a rising real burden of debt.

At the time, the broad money supply war growing at 6pc and the Dallas Fed's `trimmed mean' index of core inflation was 2.2pc.

We are much nearer the tipping today. The M3 money supply has contracted by 5.5pc over the last year, and the pace is accelerating: the 'trimmed mean' index is now 0.6pc on a six-month basis, the lowest ever. America is one twist shy of a debt-deflation trap.

There is no doubt that the Fed has the tools to stop this. "Sufficient injections of money will ultimately always reverse a deflation," said Bernanke. The question is whether he can muster support for such action in the face of massive popular disgust, a Republican Fronde in Congress, and resistance from the liquidationsists at the Kansas, Philadelphia, and Richmond Feds. If he cannot, we are in grave trouble.