

What Hath The Printing Press Wrought?

Monetary policy, like presidents, gets more blame and more credit than deserved, but that is how we play the game. As noted last month, (see “Money and Those Pesky Food and Energy Prices”) many traders and analysts have a deep-seated and instinctive suspicion about government policies and data in general and about the Federal Reserve in particular.

While the author rejects conspiracy theories as a matter of course as they violate the principle of Occam’s razor, the simplest explanation is the best; sometimes a deeper and more skeptical look is warranted. For example, the pas-de-deux between China’s on-again/off-again revaluation of the yuan and U.S. quantitative easing fits the pattern of deliberate agreements between the two countries made at the highest levels.

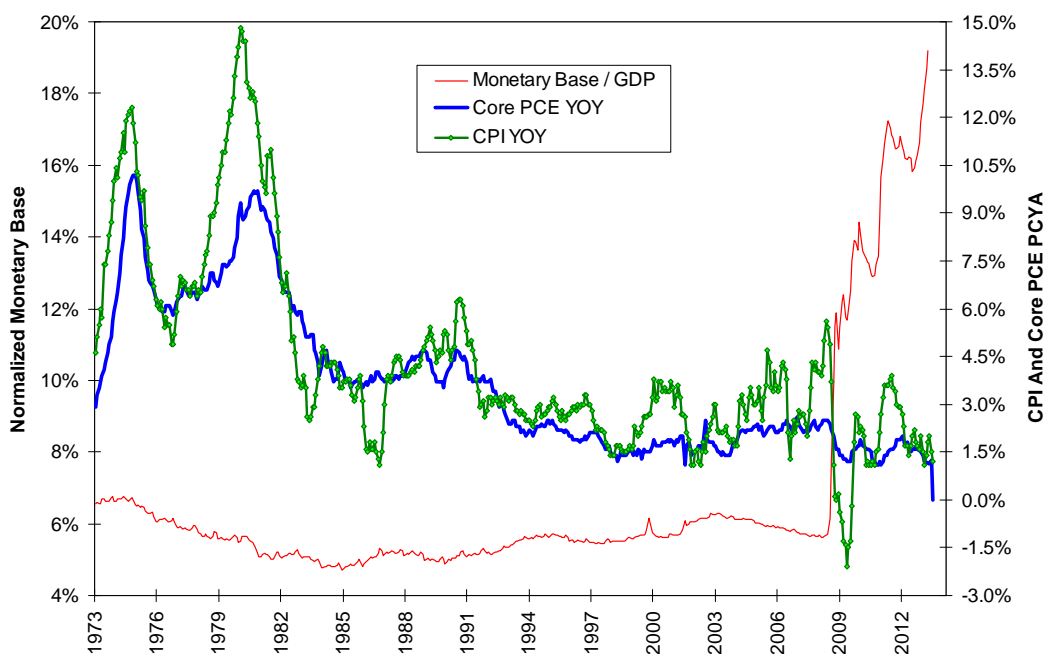
The topic at-hand fits this characterization as well: The historic easing of U.S. monetary policy after the 2008 financial crisis is viewed best through the lens of the Federal Reserve lowering the government’s debt service cost and thus enabling runaway deficit spending.

This is more than some macroeconomic curiosity. As artificially low interest rates affect the yield curve and currencies, they affect both stocks and corporate bonds and the relative performance of stocks and corporate bonds within subindices. Expectations of low interest rates also affect volatility and thus the environment in which traders have to operate.

More Money Yet To Create Higher Inflation

Even stranger, the grand experiment in money-printing has been carried on with relative impunity on the inflation front. It was a given for years the creation ex nihilo of hundreds of billions of dollars would be inflationary. However, the experience since the financial crisis has been otherwise. Let’s look at this in two different ways. First, the ratio of the monetary base (cash plus commercial banks’ deposits at the Federal Reserve) to GDP rose from 5.7% in June 2008 to 19.2% in June 2013. This is a lot of liquidity sloshing around capable of raising the dollar price of goods and services, but its relationship to two different measures of reported consumer inflation, the year-over-year changes in the CPI and in core PCE has been negligible and even inverse. No matter how you lead, lag or otherwise transform the data, the explosion in the normalized monetary base has not propelled consumer inflation higher.

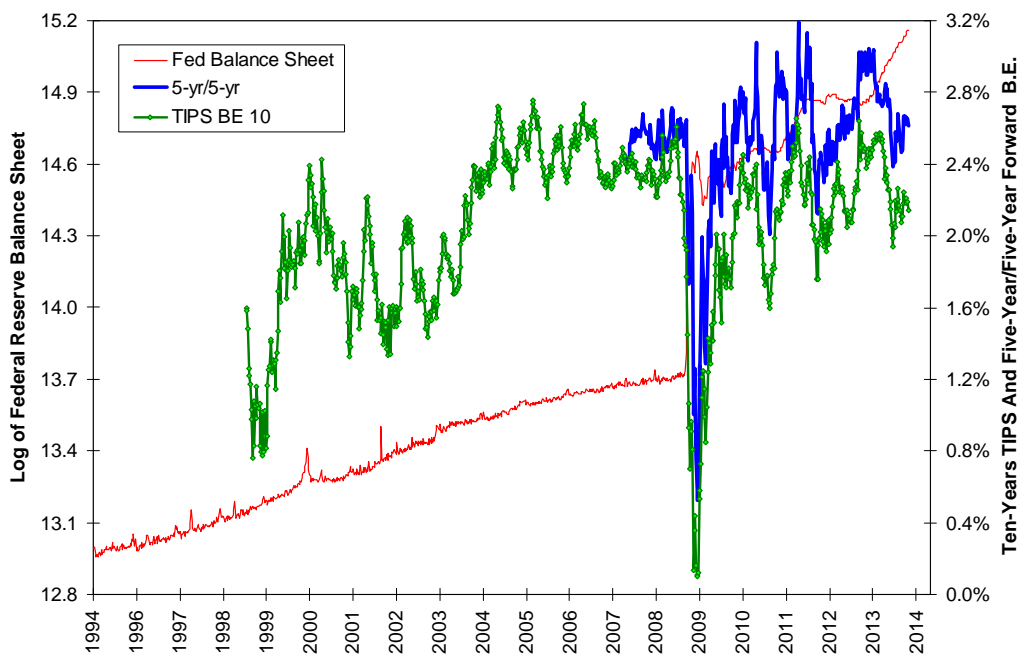
Normalized Monetary Base And Reported Inflation



If we turn from reported to expected consumer inflation as measured by two different TIPS-based measures, the ten-year and five-year/five-year forward breakevens and shift the monetary measure to the size of the Federal Reserve’s balance sheet, we get the same result. The expansion of the balance sheet from various bailouts and quantitative

easings has been so large it needs to be viewed on a logarithmic scale to make any visual sense, and even then it is visually arresting. This expansion has made the Federal Reserve the largest single holder of Treasury securities in the world, larger than the central banks of China and Japan, and has placed the central bank in the arguable position of monetizing Treasury debt. These actions once were reserved for countries widely derided as “banana republics” or some-such and were considered beneath the dignity of the world’s primary reserve currency issuer. Incredibly, the impact of this monetary expansion and of similar expansions by other major central banks on these measures of expected inflation has been minor.

Federal Reserve Balance Sheet And Inflation Expectations

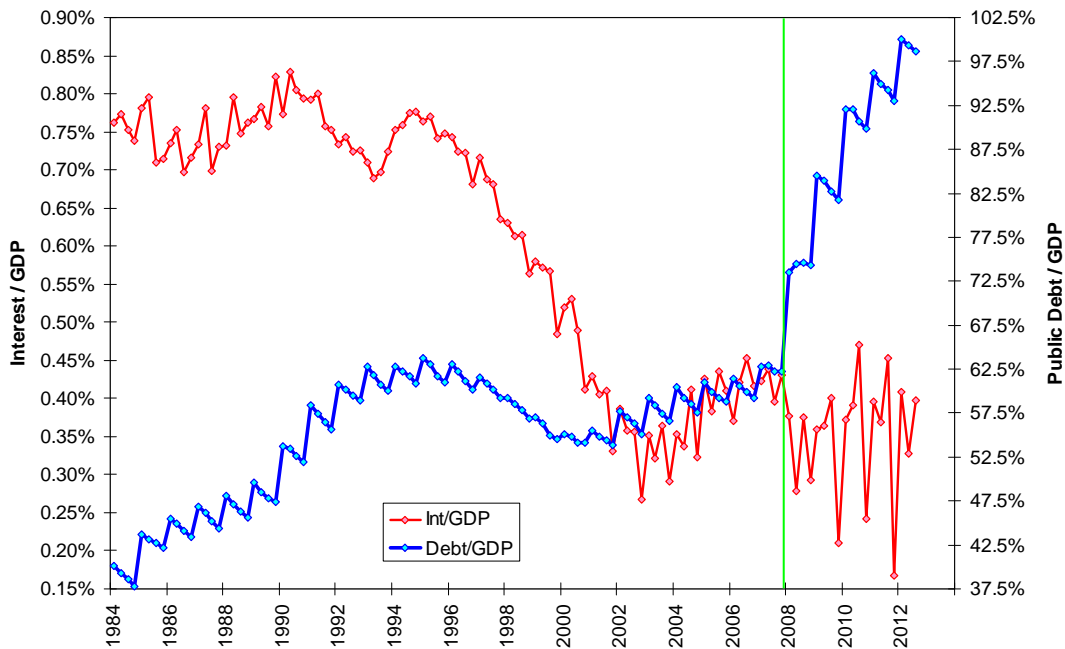


Debt Service

One of the central questions for any policy is, “Who benefits?” The answer here is devastatingly simple: The largest beneficiary of monetary expansion and low interest rates is the largest debtor, Uncle Sam himself. This can be illustrated by comparing the ratio of net federal interest outlays to GDP against two different macroeconomic variables, the ratio of public debt to GDP and the ratio of the federal deficit to GDP. Public debt is a stock concept; the federal deficit is a flow concept and is the primary driver of accumulated public debt.

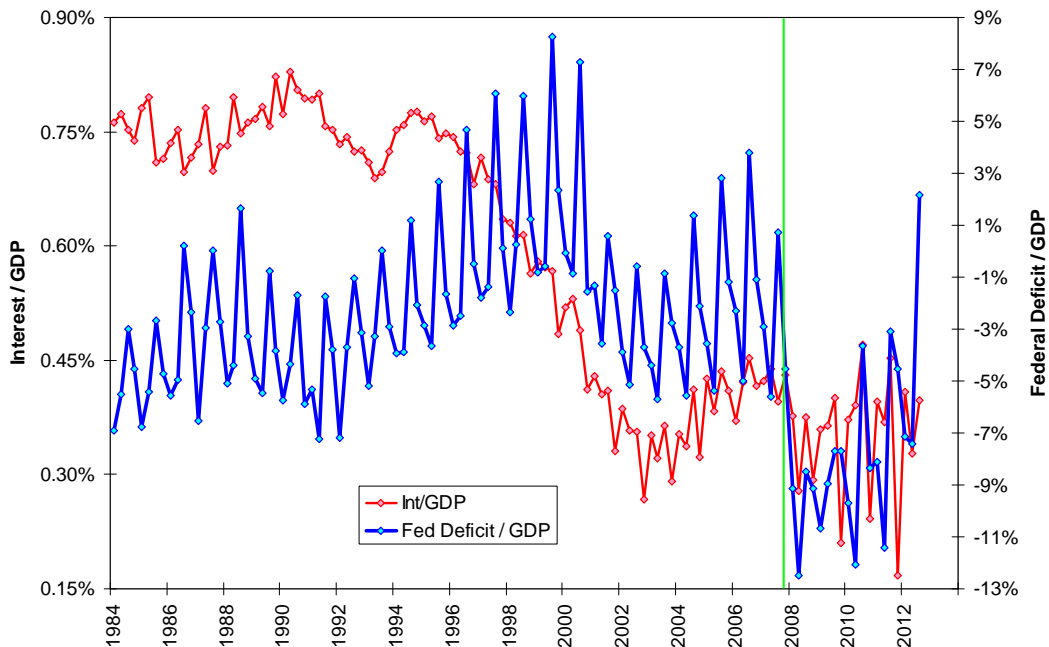
In the public debt case, the expansion beginning in the fourth quarter of 2008, marked with a vertical line, is striking. As this ratio ratcheted higher – the ratcheting is produced by seasonal effects in the federal budget – the ratio of net federal interest expenses to GDP moved lower. QE3 was expanded by December 2012 to \$85 billion per month of Treasury and mortgage-backed securities; the federal deficit averaged \$43 billion per month over the January-September 2013 period. Unsurprisingly, net federal interest payments over this period averaged \$20.8 billion on a national debt averaging \$16.685 trillion for an effective interest rate of less than 1%. The incentive for either Congress or the administration to address the burgeoning national debt under such circumstances is low; this did not, of course, prevent several episodes of debt-ceiling brinkmanship and a closure of parts of the federal government during October 2013.

Debt Service And Public Debt



The lack of incentive to reduce the deficit can be seen in its persistence at very high levels between the financial crisis and the first quarter of 2013. Once again, a political decision-maker can look at the deficit and conclude the costs of addressing it via higher taxes or lower expenditures are politically high while the costs of maintaining the debt are financially low. As long as the dollar does not collapse on world markets – and all other major central banks have been equally culpable in money-printing – or as long as hyperinflation is invisible, why change course?

Debt Service And The Federal Deficit



A Moment Of Never

The arrival of deficit spending in the 1930s was accompanied by the question of when the debt would be repaid. The answer, recognized only by a few at the time, was, “Never.” The debt would be serviced directly, inflated away or repudiated outright.

We are at a similar moment of recognition in monetary policy. The questions of when short-term interest rates will be raised from near zero percent and when hyperinflation will begin will be answered, "Never." The Japanese experience is instructive in this regard; they have had interest rates near zero percent since February 1999 and first engaged in quantitative easing in March 2001. Not only has Japan been vexed with deflationary pressures for much of this time, the debt/GDP ratio has moved well in excess of 200 percent with no signs of stopping anytime soon. The one attempt at renormalization, in the spring of 2006, ended swiftly as higher short-term interest rates precipitated an unwinding of carry trades and raised the cost of debt service to Japan's highly leveraged government surged. As the U.S. dollar is used widely in carry trades and as both the U.S. public and private sectors are highly leveraged, a similar response occurred in May-June 2013 as the Federal Reserve started discussing a tapering of QE3.

Those waiting for a public outcry against this cycle will have to wait a little longer. Not only has half of the electorate been relieved of the direct cost of government via tax policies, they are net receivers of government transfer payments and therefore have a direct interest in the game's continuance. Those who pay directly for the government and have large financial portfolios live in terror of the consequence of higher short-term interest rates. All parties involved have a vested interest in ignoring the true costs of government.

Trade and invest accordingly. Remember, no one in Japan after the collapse of the twin stock and real estate bubbles of the late 1980s thought they were entering a quarter-century of torpor. Why should it be different for us?