QETERNITY

The purpose, we are told, of Quantitative Easing (QE) is to stimulate the economy and, of late, to also create jobs. We are further told that the Federal Reserve's desire to trigger "animal spirits" is based on the idea that if people feel better or feel wealthier, they will spend and invest. The QE program, putting money into the economy, should make it easier. A leap, I know.

Initial evidence is that the QE process did create a lot of money, mostly serving to drive stocks and bonds higher and providing little, if any, economic stimulus, but some wealth effect for some investors. Some people felt better, many did not. The money was pumped into the economy by virtue of the Fed buying toxic assets from banks, giving them freshly printed cash and putting a few trillion of those toxic assets on the Fed's books where, we may assume, they will sit until hell freezes. At least the banks feel better and bonuses were paid again this year for generating a profit with zero cost money, freshly printed.

With the passage of time, however, deeper and more complex reasons for the Qs have surfaced. This brief paper explores what I suspect is the real and only reason for the Qs, the public reasons to date being so much camouflage. These thoughts weave gold, inflation and credit into a somewhat less-known scenario.

Gold Isn't Money

The opinions you hear about the gold standard, Nixon unpegging the dollar from gold and how much better it was in the days when gold was the medium of exchange, are resting on some pretty tenuous footings.

In the good old days before the Wars, currency in circulation (paper money) was backed by a fixed amount of gold. This contrasts sharply with paper money backed by the word of any government – that is called fiat money.

Gold, it was said, was in a nearly fixed amount, could not be duplicated and was a solid anchor to which to tie paper money. So far, so good. Gold-backed paper money offered ease of handling, ability to be denominated and less chance of forgery. (Many a gold coin was lead inside or clipped at the edges and, pre-Xerox, et al, counterfeit paper money was crude and near-always obvious.) Thus, we had a piece of paper worth its denomination in gold.

Any government that printed too much paper money ran the risk of holders showing up at the local Reserve Bank and asking for the gold equivalent. As the price of gold was fixed, this could rapidly deplete government gold stores and so excess printing was contained. Inflation, nonetheless, was still a possibility. If massive new quantities of gold were found, the government could then print large new amounts of paper currency convertible to gold. We know from hard experience that too much money chasing too few goods drives all prices up until a new equilibrium is found, with more goods being made available. Short-term disruptions were seen as likely, even with a gold-backed currency, but believed manageable.

But the most compelling problem with gold is that it is in near-fixed supply. It is very difficult to fund a fast-growing economy with a static money supply – in a gold-standard world, non-inflationary

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growth can only proceed at the rate gold is found. Great Britain, for example, adopted the gold standard in 1821, suspended it in 1914, returned to it in 1925 and finally abandoned it completely in the slump of 1931. Most economies used a gold standard from 1894 to 1914 and the U. S. adopted it in 1873 – but the slump caused its demise for us in 1933. Those disruptions – wars, recessions and the like were becoming a problem not so easily managed.

Various schemes to revalue a benchmark ounce of gold – restate its price – were then suggested. These schemes had as their intent allowance for its limited supply and allowance for an orderly, non-inflationary rise in its price to support economic growth. This, it was thought, would allow for both a stable gold-backed dollar and continued economic expansion. Key to the plan was by whom, when and by what method would new values of an ounce of gold be determined? The battle began: if you were owed money (a bank), you wanted to be paid back in the same gold/currency ratio you made the loan for. If, on the other hand, you owed someone money (a bank) your agenda was to use the newest dollars to pay back the oldest loans. Books are written on this struggle. Suffice it to say that no working resolution has been found, particularly when economic recessions occurred and stimulus was needed – and Congress was involved.

So why gold? I think that, of late, as investors watch the decline in the dollar, resulting from both an enormous amount being printed and an enormous debt growing in the background, they came to one of three opinions – and often all three:

1) This printing will create inflation, as it always has;
2) These debts will require even <u>more</u> printing and then inflation at severe levels; or
3) We will be forced to go back on a gold standard that reflects the level of excess paper outstanding; gold will therefore be much higher.

Woven in, of course, are the hardcore gold bugs who feel that only gold can provide a stable currency and only hyperinflation will occur if we don't go back. I have written previously about the dollar/gold link (*The Candyman*, January 2010) and the fact that the dollar is the world currency, the major trade-settlement currency and the medium in which commodities are priced. This makes the dollar deeply embedded in all global activity and exceedingly difficult to ignore or replace, so it must be dealt with. Gold then, to my way of thinking, becomes a hedge against a further devaluation of the dollar. Gold is insurance, a hedge, a mythical metal, a place of last resort, a comfort – a hedge. Nothing more. The key point is this: to go back to a gold standard the Federal Budget has to **first** be in balance – no annual deficits, no spending beyond tax receipts, no long-term unfunded liabilities. Without that in place, going on the gold standard again would not stop continued devaluation of the dollar because of all the prior deficits created with prior fiat dollars. A government in fiscal balance, though, doesn't need a gold standard.

<u>Inflation Is Understated</u>

A definition (and they vary) I would use for inflation is too much money chasing too few goods or services and subsequently driving the price of goods and services higher. How it is measured is the issue. There are many different indices of inflation, including what goods-producers buy, what non-city dwellers face and, of course, the ever-popular Consumer Price Index. This, the CPI, is based on a representative "market basket" of consumer goods. These include food items, clothing, services, transportation items (including gas and air fares) and housing. Each is given a specific weight in the Index and, until 1990, that was a constant, meaning that if Grade A beef was part of the food portion, Grade A beef was measured the same each time and in the same proportionate

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weight to the total basket. This CPI-U, meaning the market basket for all urban consumers is the broadest, most quoted and never seasonally adjusted index. Only errors will see it revised.

One more, the CPI-W, is for urban wage earners and clerical workers. Note the difference – "U" is all of us, "W" is workers. "W" is used to calculate cost of living adjustments, Social Security, etc.

The issues in both series are numerous. Neither measures the cost of a constant standard of living. Changes made over the decades reflect a Bureau of Labor Statistics (BLS) shift from a "**constant** cost of living" – same goods every month, same weight – to their academic view of a "**true** cost of living" (their word) where it was assumed consumers would substitute – if Grade A beef was pricey, they would substitute chicken, for example. This was called "maintaining a constant standard of **satisfaction**" by the BLS. To many who study this arcania, myself included, a constant standard of living means same goods, same quantity, no quality trade down and certainly no bureaucratic guess as to how I might substitute or end up "satisfied." I believe the plan, in the early 90's when this substitution theory was rolled out, was to minimize Social Security cost-of-living adjustments. Look to Newt Gingrich who induced Katherine Abraham, then BLS Commissioner, to change the process to a "judgment." Alan Greenspan chimed in as how it would help reduce the deficit, this plan of substitution, while it reflected some academic perception of consumer behavior. I am sure the statistics were simply marvelous.

Better still, however, is hedonic* adjustments. Some quality can be measured directly – an 8-ounce candy bar that becomes a 7-ounce candy bar with no price change is clearly a drop in value, if value is a quality measure. But when direct price measurement can't be performed, BLS computer statistical models – hedonic adjustments – are employed. So, when the BLS decides quality that has improved (i.e. faster computers, better quality gas, better drugs etc.), prices in the CPI are lowered to offset the higher quality. The consumer has little or no choice to opt out of paying for the improved product. An early example: government mandates to use a gasoline formula that would lower emissions added ten cents a gallon to gas costs. The price increase was excluded from the gas component of CPI because, in hedonic terms, you were happier and better off . . . you were "satisfied." You paid the increased cost, but headline CPI said gas cost the same. Textbooks, another absurd example, saw hedonic evaluation in whether the book had color pictures. If so, a cut in that price index for its higher value, but the out-of-pocket was the same (or likely more). The list of these hedonic tweaks is very long.

Of course, there are no adjustments that reflect things made worse. Try to find the Transportation Security Administration factor in your air-travel experience, or the late departures or the smaller seats.

For sheer guts, you have to hand it to the BLS. After all that, they maintain a "research" CPI [CPI-U-RS] that is designed to restate inflation history as if all the current "substitution" and "hedonic" factors had always been in place. I can't make this up. Readers wonder why I rail at academics working in government?

The impact of substitution and hedonistic adjustment is sizeable. It affects retirement benefits, Social Security, investment goal-setting and, worst of all, creates the illusion of growth in the

*hedonic: of or relating to pleasure – lost or gained (i.e. hedonism) economy being higher than actual. Growth is reported in absolute terms (called nominal growth) as being up, say 4%. When the price increase of goods made and sold is altered, thus understating the real price increases, growth is then overstated. Real inflation of a true constant basket might have been, for example, 5% whereas this new and improved hedonic-adjusted inflation may be stated as only 1% or 2%. Growth, then, was overstated by some portion of the difference.

Impact? Using 1982-1984 as the start point with a basket of goods for $100, the BLS says today that basket costs about $225 some 30 years later . . . about 2.7% average annual inflation. Pull out all the adjustments, hedonic tinkering and the like and a true constant basket is, in fact, $780 – some $555, more or less, higher. That works out to about 7.1% average annual inflation. Anyone who shops and notes less cereal for the same price, poorer quality meats, higher filler or sugar content, more expensive packaged food or simply higher gas, service, utility and travel costs, knows all this intuitively. If you don't shop for yourself, you need the experience. If you wonder why folks say they can no longer maintain a middle-class lifestyle – that their salary just doesn't make it anymore – this may well be a part of the answer. Salaries have risen about the same rate as headline inflation, says the BLS . . . we now know better. By the way, both political parties own this.

We have a weak economy at the moment. Inflation is a situation defined as too much money chasing too few goods. We certainly have too much money, if not in immediate circulation then clearly readily available at virtually no cost. The Fed and others argue, however, that there is so much excess labor, so much excess capacity to produce and even an excess of goods available that it would be impossible for inflation to take hold. History, however, shows no such correlation, no such barrier. Inflation and unemployment fell together between 1992 and 2001 and inflation and unemployment rose together in the 70's. Fiscally sound countries rarely suffer inflation, but prolific paper printers (QE 1,2,3, et al) ultimately do. The severity is yet to be determined.
Our point, then, is that not only is the headline CPI misleading as to true inflation, it also distorts our fundamental economic growth numbers. I can't decide which is worse – masking our daily reality or masking the fiscal and monetary policies that encourage, no, require, these statistical games.

Hypothecation Isn't Banking (with thanks to Tyler Durden)
In January of this year, I wrote about hypothecation in my Quarterly entitled *2017*:

> Hypothecation occurs when a borrower pledges collateral to secure a debt. The borrower has ownership of their collateral, but it is "hypothetically" controlled by whoever lent the money.

In this country, Investment Banking firms may lend client assets legally. They may use the funds they acquire to invest in other assets or to loan out and, further, they may legally borrow 140% of the principal asset. So $200 of assets may serve as collateral for $280 of loans. In other countries (the U. K. in particular), there are no limits – the firm may re-re-re-hypothecate for as long as a demand exists.

I wrote then that a massive amount of credit has been created with no meaningful asset behind nearly all of it by virtue of this process of re-lending on the same asset.

This re-hypothecation process is, in essence, a "shadow" bank. The traditional bank takes in deposits, sets aside reserves as regulations require and loans the rest. Loan quality is a function of how well the bank's credit analysts do their job. Loan losses are a measure of bank diligence as normal banking proceeds through time.

Shadow banking is merely unregulated banking – there are no matching deposits. It is credit generation on steroids – cash-on-cash-on-cash created from some probably forgotten initial asset. (I exaggerate only a bit) and based on faith . . . or hope.

This creation of credit obviously flows into the capital markets and feeds economic activity, but without the controls of conventional lending. It has the additional benefit, if you would, of doing so in a non-inflationary manner because it is not the Fed printing or creating money – it is solely a "shadow" source of funds – unseen, unmeasured and unregulated.

Durden notes that shadow banks may well be the ultimate non-inflationary funding source. The problems they create are time related. Shadow banks tend to shut down at the first sign of trouble. We saw this when money markets fell below their guaranteed $1.00 per unit within hours of the Lehman failure, money markets being large users of credit paper and much of it hypothecated. This issue has not gone away – they still shut down on a whiff of trouble.

The issue is greater than shadow banks being a non-inflationary source of unregulated credit. The issue is that they represent the major source of short-term credit and the most volatile.

We have, then, a bank of sorts with a peak liability of about $21 trillion in 2008 and a peak draw down of $1.5 trillion in a single quarter when Lehman collapsed. This de-levering of the shadow bank continues to this moment – roughly $150 billion per quarter. Currently about $14 trillion is still in play.

Shadow banking works when levering up in a growing economy, but if they decide to de-lever or reverse the hypothecate-re-hypothecate process, the immediate cut in short-term financing at these levels of magnitude can easily collapse the total banking system. Some call it a Ponzi scheme and, lacking assets, I concur. It is based solely on faith while conventional banks struggle for deposits to maintain viability. Rather makes the Basel Accord irrelevant.

We are now down to 2005 levels at about $14 trillion of shadow credit. The traditional banks have grown deposits (thanks to the Fed printing) of nearly the same amount. Parity of sorts – and meaningless. As shadow banks continue to de-lever – de-hypothecate – real banks must re-lever and lend to replace that source of credit and keep the users of that credit pool functioning.

What we have now is the Fed in a corner. It must continue to QE (QEternity) and, in so doing replace with an inflationary policy the deflationary impact of shadow banking. At some point, when this level of lending becomes a liability of the Government because of all the printed money created to sustain it, inflation arrives with spurs on. It is delusional to think, as Ben does, that the Fed can rein it in. The Fed has to continue to ease, to pump money into the banking system. Even with their balance sheets up to $2.8 trillion, set to rise to $5 trillion in 2 years, it will not be enough. Do you see how trivial $5 trillion is against that $14 trillion?

Now it is likely that not all $14 trillion of shadow assets will be pulled back. Perhaps only 3 or 4 levels of re-hypothecation instead of 12 or whatever it is – no one knows for sure.

The point is, QEternity is a fact, printing by the Fed is a fact, deflationary credit is disappearing and inflationary credit is building – and that's a fact also. The real banks now must fill in what the shadow banks leave behind as they pull out. Do you believe they will dump the best credits for the real banks to pick up? I didn't think so either.

Conclusion

Many believe the QE 1,2,3 phenomena have had the purpose of boosting stock markets and driving bond yields down. Of late, it is thought, new open-ended stimulus was to create jobs – a long reach in logic, but so argued by the Fed. It is becoming increasingly clear to me anyway that, as we noted in January, the sheer size of re-hypothecation may well be the biggest Ponzi ever and in desperate need of back up. The Qs go from "stimulus tools" to – what – saving the banking system, et al?

This economy runs on credit. It matters not that consumers have eased up on its use, as they are trivial, relative; the overall machinations of our economy are credit driven. Credit grew to its current size when it was clear we were no longer tied to growth balanced by the gold supply. Creative new sources of credit arrive regularly and we now find the shadow banks to be the largest supplier. Our economic growth link to shadow banks grows clearer. The Fed has no choice but to pump trillions into the economy to fund real banks as they are near forced to take the assets the shadow banks don't want. Refusing them could seriously disrupt any chance of a recovery. They do this beefing up of bank balance sheets by buying their toxic assets which also bloats the Fed's own balance sheet, yet another issue for another time. For now, the unintended consequences arising from shadow bank de-levering include

1) an increasing potential for inflation;
2) renewed interest in gold as a hedge;
3) penalized savers by virtue of abnormally low rates;
4) serious damage to pension funds from those same low rates; and
5) corporate cash hoarding to protect themselves, I suspect, from seriously reduced returns on their pension funds and an increased need for larger corporate contributions.

This circle of misrepresented inflation, de-levering shadow banks and the concurrent forced inflationary actions of the Fed expresses itself, I believe, in the only hedge against it: Gold.

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Some parting credits . . . to James Grant, always, for sound rational thoughts on gold, to Mark Sansoterra for keeping me focused on hypothecation, to Tyler Durden who writes for *Zero Hedge* and particularly to John Williams of *Shadow Government Statistics.*

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