How the Fed Lost Control of the Money Supply

THE WORLD IS AWASH IN FIAT CURRENCY. READ HOW THE FEDERAL RESERVE HAS LOST CONTROL OF THE U.S. MONEY SUPPLY.

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06 Feb 2007 at 10:02 AM EST

PALO ALTO, Calif. (ResourceInvestor.com http://www.resourceinvestor.com) -- The world is awash in money. This money has flown into all asset classes, from stocks to bonds, from real estate to commodities. In a world priced for perfection, should we enjoy the boom or prepare for a bust? Let us listen to Wall Street’s adage and “follow the money.”

After the tech bubble burst in 2000, policy makers in the U.S. and Asia set a train in motion they have now lost control over. In an effort to preserve U.S. consumer spending, the Federal Reserve (Fed) lowered interest rates; the Administration lowered taxes; and Asian policymakers kept their currencies artificially weak to subsidize exports to American consumers.

These policies have lead to one of the longest booms in consumer spending ever – U.S. consumer growth has not been negative since the early 1990s. However, it was credit expansion, rather than increased purchasing power, that has fueled the growth. Until about a year ago, consumers took advantage of abnormally low interest rates to print their own money by taking equity out of their homes. This source of money is drying up as home prices no longer rise and sub-prime lenders (those providing loans to financially weak consumers) are facing difficulties. More prudent homeowners have not yet been affected as they buy their home based on longer-term interest rates; until December these interest rates have stayed abnormally low. In recent weeks, these rates have ticked up significantly, and we may see the next and more severe round of pressure being exerted on the housing market. In this phase, we will see monetary contraction: money that has subsidized not only the real estate market, but also consumer spending, stocks, bonds and commodities may dissipate.

Why is it that asset prices have continued to soar despite the stall in home prices? Consumers have not been the only source of money creation. Corporate America is creating its share of money as cash flow positive businesses are piling up cash; but corporate CEOs seem to prefer to invest abroad, providing only limited stimulus to domestic money supply.

A massive source of money supply growth is purely of financial nature, it is volatility, or better: the lack thereof. Volatility in major markets was at or near record lows last year. With volatility low, risk premiums are low; when risk premiums are low, investors have an incentive to employ more leverage and still be within their risk comfort zone. What may seem like an abstract concept has propelled financial markets to the stratosphere.

Two groups that have been most aggressive at taking advantage of this are hedge funds and the issuers of credit derivatives http://www.answers.com/credit+derivative&r=67> . Take as an example, a report from the Financial Times last December: the paper reported that Citadel Investment Group, a manager of hedge funds, had $5.5 billion in interest expense on assets of only $13 billion. The hedge fund group routinely borrows as much as $100 billion. Note that this is only the leverage visible on the financial reports; the instruments invested in may themselves carry yet further leverage.

The world of credit derivatives has also seen explosive growth. European Central Bank (ECB) president Trichet at the World Economic Forum in Davos warned that the explosion of credit derivatives are a risk to the stability of financial markets. Specifically, he complained that the market under-prices their inherent risks. With risk premiums at record lows, issuers of credit derivatives can borrow money at or near the Fed Funds rate. And that in turn means that we do not need the Fed to print money, anyone can. That is precisely what has been happening; however, the credit created is not without risks; more often than not, credit derivatives contain risks that only the issuer properly understands.

A year ago, the Fed stopped publishing M3, a broad measure of money supply. Just because you lose control of something doesn’t mean you shouldn’t monitor it anymore. Of the major central banks around the world, only the ECB takes an active interest in money supply.

Why is it that the Fed doesn’t intervene and try to stem excesses in the credit industry? We find the answer by circling back to the consumer: if the Fed were to do something about the spiraling credit expansion in the derivatives markets, the imposed tightening would quite likely hurt the consumer. Typically, a recession would not scare the Fed, but globalization has put the fear of deflation on Fed chairman Bernanke’s table. Tight credit could cause a collapse in the housing market and in consumer spending; what has been a great boom would turn into a great bust.

The fear also spills over to the U.S. dollar. As a result of the current account deficit foreigners must purchase in excess of over $2 billion U.S. dollar denominated assets every single day, just to keep the dollar from falling. As the U.S. economy slows, foreigners may be more inclined to invest some of their money elsewhere. The rising price of gold reflects that many investors believe that the Fed rather see a continuation of monetary expansion than allowing a severe contraction. Fed chairman Bernanke has also made it clear in his publications that he favors monetary stimulus at the expense of the dollar to mitigate hardship on the population at large.

Market forces will try to bring this credit expansion to a halt. While a crisis scenario with an imploding hedge fund causing ripple effects through the financial sector is possible and likely, we don’t need a crisis for the party to end. What we need is increased volatility which we have already seen in the commodities and bond markets; the equity and currency markets have also indicated volatility may be on its way back. As volatility increases, speculators are likely to pare down their leverage. In our assessment, the economic slowdown induced merely by an increase in volatility may be sufficient to encourage the Fed to ease monetary policy once again. Any easing in this context will, in our assessment, have negative implications for the dollar.

Investors interested in taking some chips off the table to prepare for potential turbulence in the financial markets may want to evaluate whether gold or a basket of hard currencies are suitable ways to add diversification to their portfolios.