<u>What are the implications of all this developed world money printing?</u>
By Bruce Baker for clients of Puzzle Financial Advice
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I have prepared this paper, firstly to force myself to systematically think through the complex issues related to this topic (as this might give us some insights that might help us get a better investment outcome) and secondly, to help you understand the issues.

It is clear that no-one really knows the medium term impact of all this unprecedented money printing. As Mauldin says below, this massive money printing is a giant previously-untried central banker experiment. Because of the importance of the ramifications of this money printing, most of the investment-world thinkers are trying to guess/forecast the implications. Some recent references to this are:-

- Business Spectator – Alan Kohler "The inflation that didn't bark", in which Kohler asks the question of "Why all this inflation has not occurred when massive money printing usually causes serious inflation?"
- John Mauldin is a great collector of other peoples thoughts, as well as being a good thinker himself. Recent articles that reference this are:-
  - Mauldin's article on Japanese money printing that I circulated to you on 28/5/13, in which Mauldin speculates that the unprecedented scale of Japanese money printing will lead to a currency war.
  - Mauldin's 3/6/13 article in which talks about this money printing in these terms *"we are living in the midst of a gigantic laboratory experiment with all the attendant possibilities of something going BANG!"*. He also talks about how the incoming Governor of Bank of England being likely to resume printing UK pounds, and how the US Fed is berating the European Central Bank into getting much more serious about money printing. Mauldin also mulls the question (which has been centre stage over the last few weeks, since the US Fed publicly started pondering when they might start reducing QE3), of the implication for markets which have become hypersensitive (addicted some say) to changes in central bank monetary policy and changes to central bank money printing. https://d21uq3hx4esec9.cloudfront.net/images/uploads/ttmygh/6579/Jun_03_2013.pdf

Now, let us go back to basics. What is the logic behind this central bank money printing used in conjunction with very low cash rates? There are a range of different objectives here I believe:-

- **Increasing credit to boost the economic growth.** The US Fed has been trying to ensure that there is plenty of "cash" in the system for businesses to borrow, so they can invest and create jobs. Mind you, this part is not working because, as a recent article I circulated identifies, corporations are worried about the uncertain implications of the massive money printing etc and so are not generally not confident enough to invest in the money printing countries.
  - Mind you, do we really want increasing credit, because that is one of the big sources of problem/risk?
- **Driving down the currency value, making it easier for exporters.** The idea here is to get a boost in economic growth through exporting – this is also known as a "beggar thy neighbour" policy.
  - I think UK & Japan have achieved (are achieving) some benefit out of this.
  - Against the developed world, the US has not achieved this, but against the developing world, where the USA has long complained that currencies were being held artificially under-valued to achieve unfair advantage, this is succeeding in real terms. This is being achieved by US money printing causing significant inflation in countries like China. From a trade perspective if China has higher inflation than the USA, this is as good as

the US$ falling against the Chinese Renminbi.

- **Wealth effect.** This clearly is a factor in the US Fed's thinking. The thinking is, that by driving asset prices up (eg share prices) through low cash rates and money printing, and by also helping to support house prices, in nominal terms people become wealthier, and the theory is that people, feeling wealthier, will spend more, thus generating economic growth.
  - This time, I am not convinced that there has been any beneficial wealth effect. People in many of these developed countries are constrained in their spending because there is also a bubble in personal debt to GDP, but also in the USA, I have read that real wages have actually been falling.
  - Money printing certainly has had the effect of driving up share prices, but we now see serious risk of asset price bubbles being created.
- **A modern version of "financial repression".** By keeping cash & bond yields low, this makes it possible for highly indebted developed world government, to continue to fund their budgets. The problem is that if bond yields rise, budget deficits blow out because of higher interest expense on government debt. What is happening here is that central banks are being primary sources of funding of budget deficits. Further, central banks seem to be on a path where they may end up buying back a lot of outstanding government debt. But it also seems clear that there are some tough decisions to be made to reduce structural deficits in a lot of developed countries – including UK, Southern Europe, USA, Japan and I think also in Australia.
  - Now a key element in "traditional" financial repression (as discussed by Reinhart & Rogoff), is that there are two elements – keeping interest rates at negative real rates – and generating inflation – so that in real terms, over a few decades, the government debt bubble shrinks.
  - What are the benefits of inflation if you have a government debt problem?
    - The key element of the strategy is this. By keeping real interest rates negative, inflation helps shrink the debt bubble in real terms, while helping to keep interest expense affordable in the meantime.
    - But will any old inflation do? To solve the debt problem over time, the type of inflation generated needs to increase government revenue in nominal terms …. and the government must ensure that fiscal deficit must be kept below the point where the debt bubble rises in real terms.
      - I think the inflation you need is inflation that help cause tax collections to rise in nominal terms over time.
        - So **asset price inflation** can help increase the **capital gains tax** take. This would also help increase tax take on transaction stamp duties and death/wealth taxes.
        - **Consumer price inflation** can cause transaction taxes like GST, VAT tax take to rise.
        - **Wage inflation** can cause income tax collections to rise.
        - Potentially, **inflation can cause corporate profits** to rise in nominal terms over time, enabling the corporate tax take to rise.
        - Europe is talking about introducing (or increasing) wealth taxes, to also help increase tax revenue intake. I think that it is quite likely that this strategy will spread more widely over the next few years.
      - So how effective is central bank monetary policy on creating inflation at this time?
        - The **price of oil & other commodities has risen dramatically** since 2000. Largely is not reversible over the medium-term because the cost of producing those commodities has risen almost as much as the underlying commodity price. Sure, a global recession can cause a short-term commodity price fall,

but over the medium-term, commodity prices cannot come down much because (for most commodities) if it did, uneconomical production would be rapidly shut down, bringing supply & demand balance – at high prices.

    - The higher commodity prices does increase tax take for commodity countries which charge royalties (and resource rent taxes) on commodity extraction. Also higher commodity prices can increase corporate income taxes on profitable commodity producers, whose profits you would be expecting to increase in at least nominal terms over the medium-term. Clearly BHP's & RIO's profits (and taxes) have risen dramatically over the last 10 years.
    - But for countries which are not commodity producers, the higher commodity prices can potentially just reduce corporate profit levels for local producers – unless the local producer has pricing power (eg in a near monopoly and so a company can raise prices without risking loss of market share.)
        - Also higher commodity prices can act as a tax on consumers, as costs such as building rises – likewise petrol, bitumen for roads (which you pay for through higher taxes and council rates), food etc etc. Therefore, higher commodity prices also acts as an extra tax on consumers, thus reducing their available disposable income – and this can reduce consumer spending, potentially driving an economy into recesson.
    - So higher commodity prices is not helping indebted governments in all countries.
- **Asset price inflation.** Yes, central bank monetary policy is causing asset price inflation, but unless the rise in asset prices is sustainable, there is no tax collection benefit over the medium-term. Rather, over the short-term, there seems a very real risk that central bank monetary policy is blowing asset price bubbles that could be very destructive when they burst (with potential for further financial crises) – potentially causing medium-term reduction in government tax take.
- **Consumer price inflation.** At least as measured by official statistics, inflation in the developed world remains very low. Many argue that the official statistics are significantly under-reporting consumer prices inflation – such as here http://www.shadowstats.com/alternate_data/inflation-charts – and arguments why under-reporting occurs include reducing the government spending increases on CPI_indexed items such as social security.
    - But for the moment, let us assume that the official CPI numbers are correct.
- **Wage inflation.**
    - Some sources have indicated that their real wages were falling.
    - However, for the purpose of this discussion, I looked at the following official statistics from the US Fed:-
        - Average Hourly Earnings of All Employees: Total Private - since 2009. Wages have risen nearly 10% over 4 years.
            - http://research.stlouisfed.org/fred2/series/CES0500000003
        - CPI – since 2009. CPI has increased by 9.4% over 4 years.
            - http://research.stlouisfed.org/fred2/graph/?chart_type=line&s[1][id]=CPIAUCSL&s[1][range]=5yrs
        - So on this very simplistic test, using official statistics, wages seem to have just been keeping up with inflation. So the US at least, does not

        - seem to have a serious wage price inflation issue.
        - If so, then maybe wage inflation <u>may possibly</u> help with increasing income taxes over time..... but if current monetary settings are maintained, it might take a very long time for this to help fix the US government debt bubble. Given the size of US government debt, the size of the US budget deficit and the size of the structural US budget deficit problems in the US budget, the US will need to find something much bigger than current wage inflation to have much impact on their government debt bubble.
            - NOTE: In these times, when for a lot of private sector jobs, citizens compete directly, for the same job, with a Chinese person, or Indian, or Filipino or someone else in the emerging world, for the same job, it is hard to see wage price inflation breaking out in a significant way. More likely, I think, we will see wage price deflation in the developed world (price convergence as described in the 2003 paper by Russell Napier). This may then be a major obstacle for developed countries seeking to inflate their government debt problems away.
    - **Rising corporate profits** leading to high corporate tax take.
        - US corporates are at record levels of profitability (eg as a % of GDP), and I circulated to you recently, a paper that argued why this level of corporate profitability was unsustainably high – and must fall.
        - So it does not appear as if the US government debt bubble is going to be solved from this source.
- So at the moment, it is not clear that current levels of "financial repression" is solving the US government debt problem. This suggests that much more extreme "financial repression" may lie ahead.

So let me summarise.

Is this monetary policy (including money printing) succeeding?

- **In the USA**, it is not really obvious that it is. I think some of the things that are helping the US are:-
    - that they are becoming more competitive with the developing economies – because the US$ is falling in real terms versus these emerging economies.
    - Technology advances like new generation robotic manufacturing and 3D printing is bringing jobs back to the USA.
    - The shale oil & shale gas revolution in the USA – is a great boon to manufacturing – and the economy more generally as costs are being driven down. Likewise, the US is attracting investments in manufacturing where natural gas is a large cost component – such as chemicals, plastics, fertiliser. Investments in these industries, is being attacted to the USA, where that investment might previously have occurred in Europe or elsewhere.
    - And finally, with one of the most flexible industrial relations systems in the world, a lot of new jobs are being created at wage levels below pre-GFC levels. For example, my understanding is that new workers being taken on by car manufacturers in the USA, are being paid much much less than their pre-GFC colleagues.
- **In Europe** – what a mess. Europe has some great companies that get a lot of their profit from the growing emerging world. However, Europe clearly requires some major structural form – and I think the only choice they have is whether they do it proactively – or whether a crisis forces them to do it. So far all measures that they have taken have only managed to stop the ship sinking. So for Europe, there is no clear light at the end of the tunnel yet. So

no, no success here yet.

- **Japan**. The are a lot of people who are very hopeful that Japan might succeed (at least over the short and possibly even medium-term) with their new Abenomics policy which is still less than 6 months old. However, what happens if there is serious retaliation by Japan's Asian trading partners as Mauldin expects? We live in a very interconnected world, where outcomes in each country can be greatly impacted by actions in countries far abroad.
  - Mind you, Japan's government debt is gigantic – something like 240% of GDP – the biggest of all developed countries. That is a huge mountain to climb.
  - And Japan's population is shrinking – from memory, the aging population is projected to cause Japan's population to shrink by about 30% over the next 3 or 4 decades. This is a huge economic challenge.

<u>So let me try to distil all the discussion above.</u> In summary:

- There is a very real possibility that ultra-low interest rate policy together with money printing, will NOT solve the debt and other economic problems of the developed world, and there is a very real risk, that they might create an even bigger problem.
- If these policies fail, what then? Mauldin argues plausibly, that if current money printing low interest rate plus money printing fails, we will see money printing on a much bigger scale. The developed world central banks seem to have bet the bank on this money printing strategy, and seem not to be deterred, it at first they don't succeed. So it seems that it is quite likely that we will see far more serious money printing ahead. And if Mauldin is correct (as is very plausible) that the scale of Japan's money printing will cause competitive devaluation responses from its (at least Asian) trading partners, this also suggests much greater money printing ahead. Wow. We live in very unusual times.
- What does all this mean for the price of gold? I can see no alternative but this being very positive for the price of gold.
  - I suspect the driver of gold price has moved on from "as an inflation hedge", in case serious inflation breaks out – noting that the 1998 low, was after nearly 2 decades of falling gold prices while inflation remained fairly high.
  - I suspect the much bigger driver for gold price over the medium-term is likely to be that:-
    - in this world of massive money printing, what does the rapidly growing developing world want to put their savings (reserves) into – gold or US$/Yen/Pound/EURO where all these fiat currencies are being debased by their central banks? I think the answer to that is clear. The emerging world will increasingly put their savings into gold and other limited-supply assets that cannot be "printed".
    - And I suspect it is true that China is in the process of trying to buy enough gold so that it can, at least to some degree, back the Renminbi with gold.
    - China and India already account for about 60% of the world's annual demand for gold, and I think this demand can only rise as both of these countries get wealthier.
      - The Chinese government has been encouraging its citizens to save in gold.
    - And finally, it may well be true the gold bullion reserves of the US (for example) are already depleted. Suggestive of this, was Germany's recent request that the US ship about half of their gold held in US Fed vaults, back to Germany. The US Fed refused (perhaps because they did not have it to deliver), and would not even allow the Germans to audit their own US gold holdings. Germany had to agree that the US would ship the requested gold to Germany over the next 9 years …...
      - So we might actually find that over the next 10 years, the US Fed will be a very big buyer of gold as well, as it seeks to cover requests by countries like Germany to repatriate the physical US gold holdings home.
- And for shares and other assets, what does all this continued money printing mean? We are

increasingly at risk of see asset price bubbles. The main asset price bubbles that see evident at the moment seem to be:-

- Developed world government bond prices – and in other developed world debt.
- US share prices.
- It is likely that a bubble was building in yield-stocks such as bank shares. The May correction in bank shares may well just be temporary, if we continue in a low-interest rate environment for years to come.