Can Central Banks Buy Up Everything?

The Gowdie Letter
Friday, 3 February 2017
Gold Coast, Australia
Vern Gowdie, Editor

Can Central Banks Buy Up Everything?

- **Can Central Banks buy up everything?**
- **Richard Duncan's interesting solution to a serious problem**
- **Richard Duncan's presentation**
- **Joining the dots**

Dear Reader,

> *'Since the central bank can print as much as it needs to, there is no limit so you can stop any crisis cold merely by just buying up everything.'*
>
> Dr Alan Greenspan

Greenspan's frank admission on the lengths central bankers *could* go to if 'push comes to shove' has occupied my thoughts in recent times.

Would they really do that?

Well, during our exclusive interview in Baltimore two weeks ago, Greenspan did say, '*What there is a tendency to do, and this is true of all human decision-making process, is you'll go for that which gives you the least risk.'*

We know central bankers are not blessed with spines of steel. Tough decisions are something they avoid at all costs.

When the imbalances in the system start to auto-correct — like they did in 2008 — central bankers opt for the easier options of printing money, buying up assets and making the cost of debt as cheap as possible…reward the reckless banks, reflate the asset bubble and punish savers.

Therefore, it's highly probable the response to the next (and I think, far more severe) crisis could be a stimulus effort without peer. And that's saying something.

However, Greenspan did acknowledge the risk in buying up everything:

> '*The trouble is, what do you do then? If there is that sort of action taken several times, you engender a degree of uncertainty in the marketplace, which essentially destroys the viability of the structure.*'

I suspect the central bankers have commissioned a report on the effectiveness of the post-GFC stimulus. Hopefully the report concluded that, on balance, it does more harm than good. That it punishes savers and retirees, rewards zombie corporations, encourages more risk taking, distorts asset values and allows politicians to continue making unfunded promises.

The stimulus efforts are masking agents. They're ineffective in addressing the underlying structural problems of too much debt, too much capacity and too many boomers moving into the lower consumption phase of their lives.

In fact, they've made a bad situation worse.

No matter how critical the report might be, their response would be, 'What else could we do? Let the system collapse and rebuild?'

Even though they may privately agree that stimulus measures do not address the real problems, publicly they'll do whatever it takes. There is no way they can sit idly by and allow the markets to mete out the punishment needed to correct decades of debt excess. The results would be brutal and lead to social upheaval.

Richard Duncan's interesting solution to a serious problem

Richard Duncan was one of the keynote economic speakers at the recent Agora Economics conference I attended in Baltimore.

He believes the 'lesser of all evils' solution to the debt malaise is for central bankers to perpetually print money to enable the US to run expansive government budget deficits and trade deficits.

He argued the deficit spending should be targeted at new technologies and industries that will increase world trade and, in the longer term, add to US productivity.

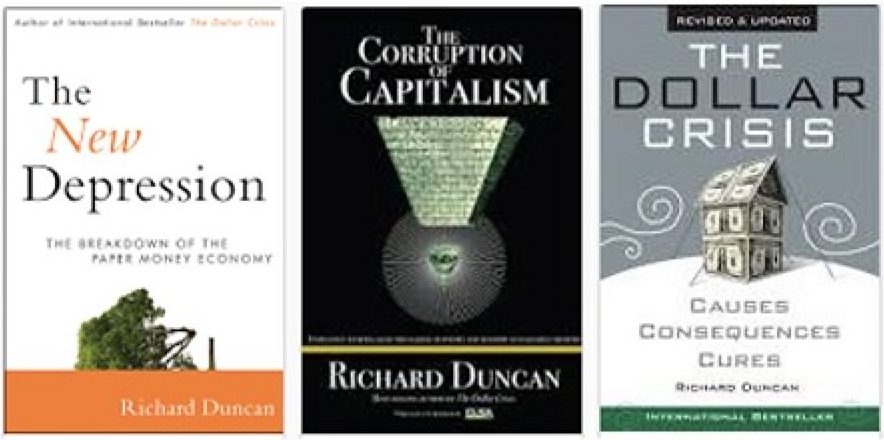
It was an interesting solution to a very serious problem.

In his opinion, the alternative — a system wide collapse — would come with too high of a personal cost and significant social unrest.

He is concerned the Trump administration's policies are increasing the risk of an economic collapse.

I first met Richard in Melbourne in 2014. He was a speaker at Port Phillip Publishing's 'World War D' conference.

Richard is the author of three books on the global economic crisis.



Source: booktopia
[Click to enlarge](#)

His first book, 'The Dollar Crisis', accurately predicted the GFC, and went on to become an international bestseller.

Richard has an impressive CV.

- Global of investment strategy at ABN AMRO Asset Management in London
- Financial sector specialist for the World Bank in Washington D.C.
- of equity research departments for James Capel Securities and Salomon Brothers in Bangkok
- Consultant for the IMF in Thailand during the Asia Crisis
- Currently, chief economist at Blackhorse Asset Management in Singapore

In the meeting with Greenspan, Richard and I were seated next to each other (he's on my left hand side).

[Click to enlarge]

Richard is a seriously smart guy and he thinks outside the box…making you consider a wider set of 'what ifs'.

The one thing the keynote speakers, Dr Jim Walker and David Stockman, agreed on, is that we find ourselves in a situation where there is no precedent.

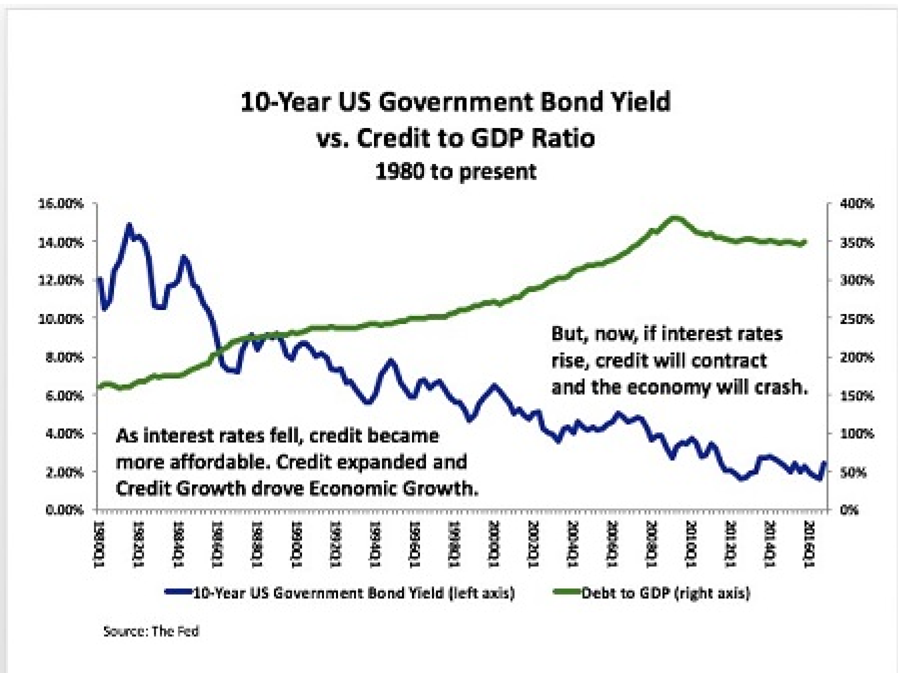
The world has never before got itself into such a financial bind, where it's become completely dependent on a continual supply of credit to remain functioning.

Something has to give. But we're all guessing as to what that something might be, and what the official response will be.

This week I'd like to share with you a snippet of Richard's presentation from the conference. All charts have been sourced from Richard's presentation.

Richard Duncan's presentation

Economic expansion since the 1980s has been a function of credit growth. As interest rates (blue line) fell, debt levels (green line) increased.



Click to enlarge

The continuation of this trend is totally and utterly conditional upon interest rates not rising.

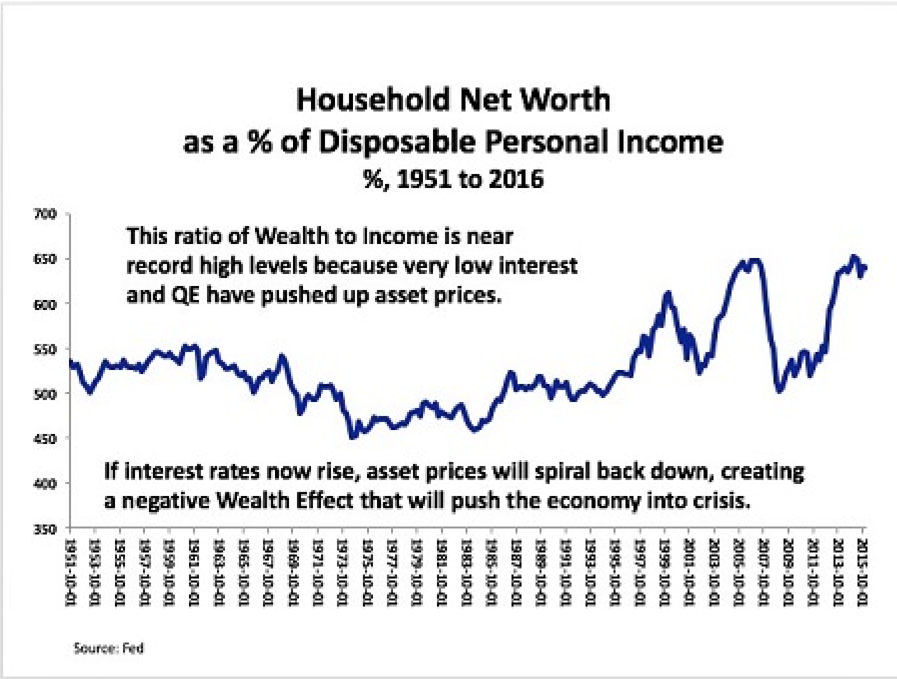
As the chart states, '*But, now, if interest rates rise, credit will contract and the economy will crash.'*

No argument there.

The Fed's accommodative policies — started by Greenspan, and followed by Bernanke and Yellen — have taken household net worth (as a percentage of disposable income) on a bumpy ride since the early 1990s.

Household income — while stagnating in real terms in recent decades — has still managed to bid asset values higher thanks to the availability of cheap and abundant money.

Household Net Worth is currently near a peak level.



Click to enlarge

During the 1970s, when interest rates were in the double digits, households could not afford to borrow excessively to bid up asset prices. Hence the below average Wealth to Income ratio.

It's no coincidence that when household net worth shrinks — a negative wealth effect — this results in a recession. People withdraw their spending power.

The current near record high ratio means the US economy (and by extension, the global economy) is finely balanced. An increase in interest rates, in Richard's words, *'will push the economy into crisis.'*

What could put pressure on US interest rates?

Click to enlarge

This is where President Trump's policies come into play.

Markets are getting all excited about the big infrastructure spend, tax cuts, military spending, lowering the US dollar to make exports cheaper, and putting tariffs on imports. In isolation this may all sound good, but the world does not operate in isolation.

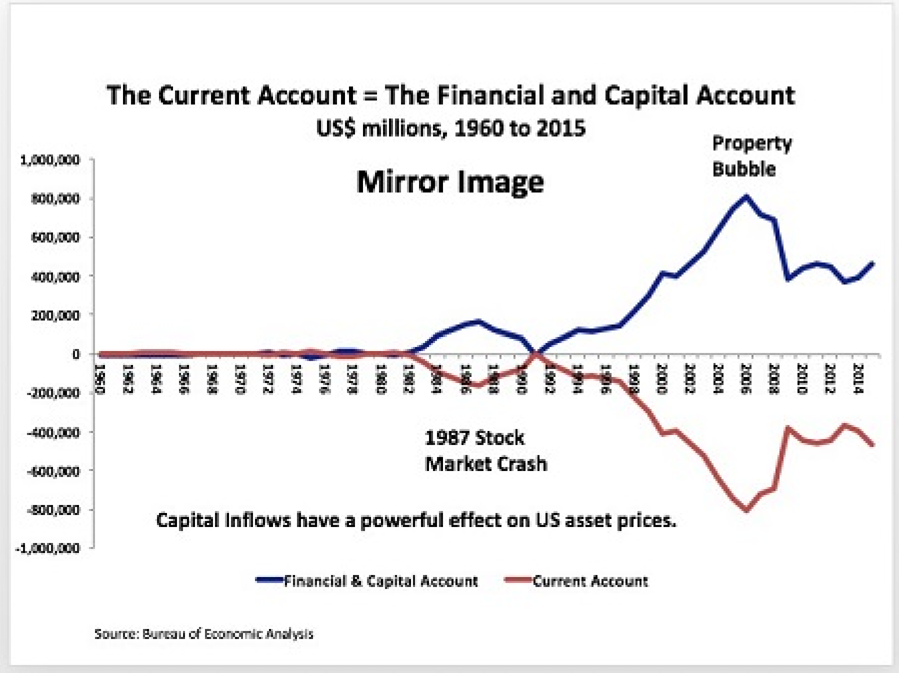
The unintended consequences of these policies could be inflation, higher interest rates and a collapse of China's economy…leading to a global economic crisis. One certain to hit Australia hard.

Cutting taxes while spending big on military and infrastructure will logically increase the US budget deficit.

Where does the US government source the money to finance the budget shortfall?

The US current account deficit (in simple terms, the difference between imports and exports) is offset by capital flows back into the US.

The capital flows provide a funding source for US government budget deficits via the purchase of US Government Bonds…think of China owning a trillion dollars of US Treasuries.



[Click to enlarge]

When the current account deficit shrinks (meaning less capital flowing back into the US) asset bubbles (1987 share market and 2008 property bubble) burst due to the contraction in liquidity in the US economy.

This is a correlation I've not seen before, and I found it rather interesting.

President Trump wants to reduce the current account deficit by implementing a 'buy America' policy…forcing companies to bring their factories back to the US, and imposing trade tariffs on imported goods.

If Trump is somewhat successful in his stated aim, then how does he finance the increased deficit for his tax cuts and grand spending plans? Does the Fed crank up the printing press and stand in the market to buy the bonds? What would the shrinkage in liquidity do to the current central banker asset bubble?

Secondly, inflation has been falling since the 1980s due to trade with low wage countries putting downward pressure on domestic wages. Importing less from low wage countries and 'buying America' means the cost of goods increases. Higher priced goods and services are inflationary and, in turn, this places upward pressure on interest rates.

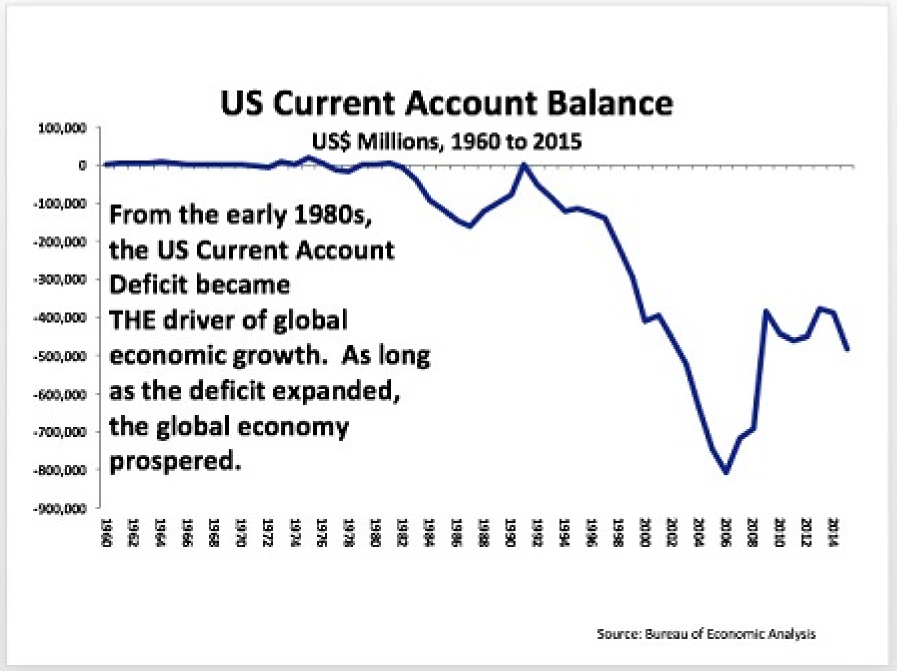
And increasing rates are the pin that could burst the credit bubble.

Thirdly, a significant increase in government spending could also see the inflation genie released. Taking the credit bubble closer to the pin.

Trump's policies — while playing well to the 'Make America Great Again' crowd — come with serious consequences. People should be careful what they wish for.

The US current account balance — a proxy for Americans spending more than what they earn — has been THE driver of global economic growth.

Again, no arguments on this assessment.



Click to enlarge

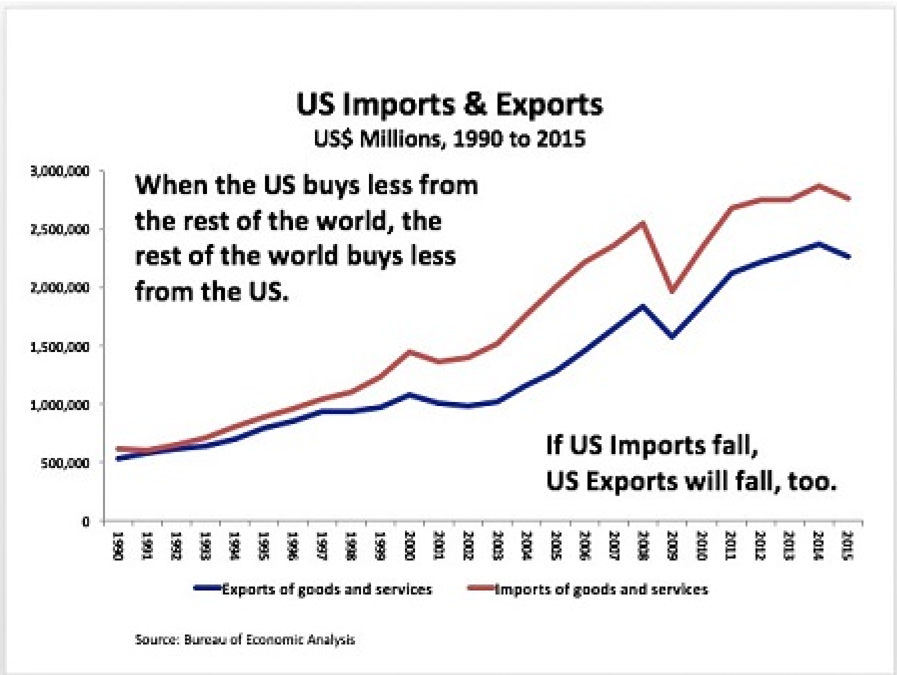
If Trump is successful in reducing the US current account, then it's curtains for the global economy…it becomes a lose/lose situation.

Without those excess (borrowed) US dollars floating around the world, then the world cuts back on its spending as well.

While taking aim at foreign imports, Trump is shooting US exporters.

Trump wants to raise the barriers on imports, but expects exports to remain constant. He's dreamin'.

The data shows that you can't have your cake and eat it too when it comes to global trade.

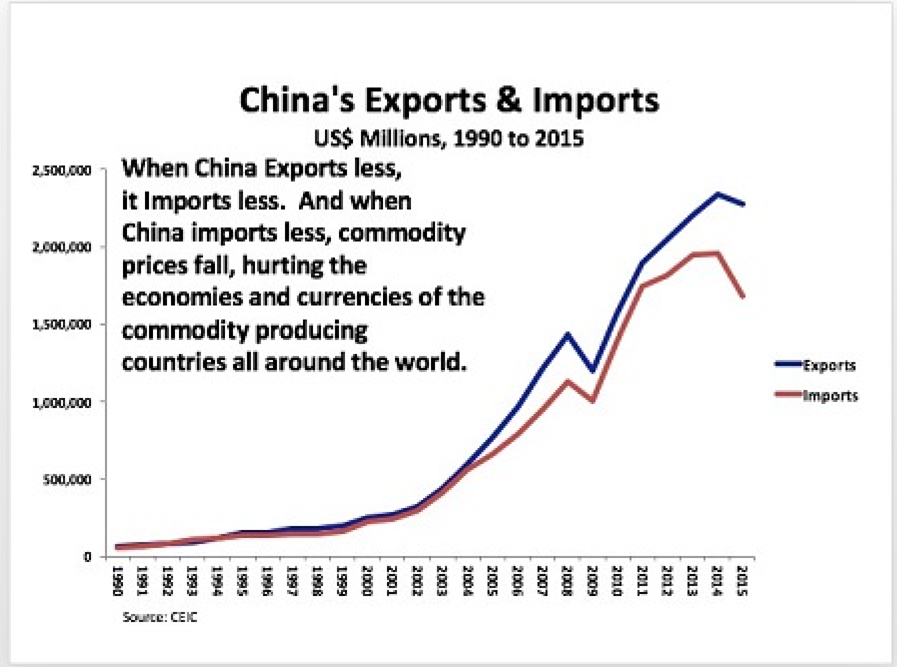


Click to enlarge

When the US imports less it also exports less. This is not good for US corporate earnings and by extension, US share values.

Correspondingly, when China's exports fall, then China imports less.

And therein lies a problem for China…and Australia.



[Click to enlarge]

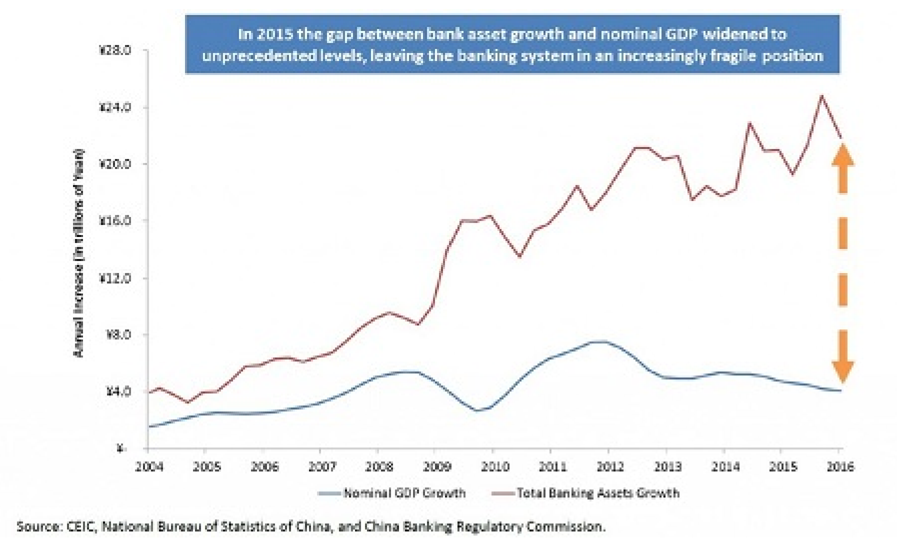
China's export revenue provides cash flow to fund the commitments of its heavily indebted corporate sector. Without the flow of export dollars, China's banking behemoth is under serious threat.

The following chart shows the 'secret' behind China's miracle economy.

The asset growth in China's banks has far outstripped underlying economic growth. The same debt financed growth strategy used by the Western world.

In February 2016, Kyle Bass from Hyaman Capital wrote a sobering report titled *'China's $34 Trillion Experiment Is Exploding'.*

The following chart and text is an extract from the report:



Source: Hayman Capital
[Click to enlarge]

'*China has allowed (and encouraged) its banking system to grow into a gargantuan $34 trillion behemoth (a whopping 340% of*

Chinese GDP). For context, consider what the United States banking system looked like going into the GFC of 2007-2009.

‘*On-balance sheet, the US banking system had about $1 trillion of equity and $16.5 trillion of banking system assets (100% of US GDP). If non-banks and off-balance sheet assets are included, it would add another $12.5 trillion to get to about 175% of GDP. US banks lost approximately $650 billion of their equity throughout the GFC.*

‘*We believe that Chinese banks will lose approximately $3.5 trillion of equity if China’s banking system loses 10% of assets. Historically, China has lost far in excess of 10% of assets during a non-performing loan cycle (The Bank for International Settlements estimated that Chinese banking system losses throughout the 1998-2001 cycle exceeded 30% of GDP).2 We expect losses in this cycle to exceed prior cycles.*

‘*Remember, 30% of Chinese GDP approaches $3.6 trillion today. Think about how much quantitative easing (QE) the US Fed had to create in order to entice $650 billion of common and preferred equity into the US banks and prevent a Japanese- deflationary bust. The Fed had to expand its balance sheet by roughly $4.5 trillion.*

‘*How significantly will the Chinese central bank have to expand its balance sheet in order to compensate for $3.5 trillion of lost bank capital? What will that do to the renminbi? What will happen to Chinese credit growth and broader Asian credit growth while this happens?*

‘*If the US Fed’s experience serves as a proxy for what could happen in China, we believe that China will likely have to print in excess of 10 trillion US dollars’ worth of yuan to recapitalize its banking system. The weakening renminbi is the product of larger banking system problems.*

‘*By the time the loss cycle has peaked, we believe the renminbi will have depreciated in excess of 30% versus the US dollar.*’

China’s banks and shadow banks have loan books that are hiding a significant amount of non-performing loans.

China needs export dollars…it does not need higher tariffs from the US.

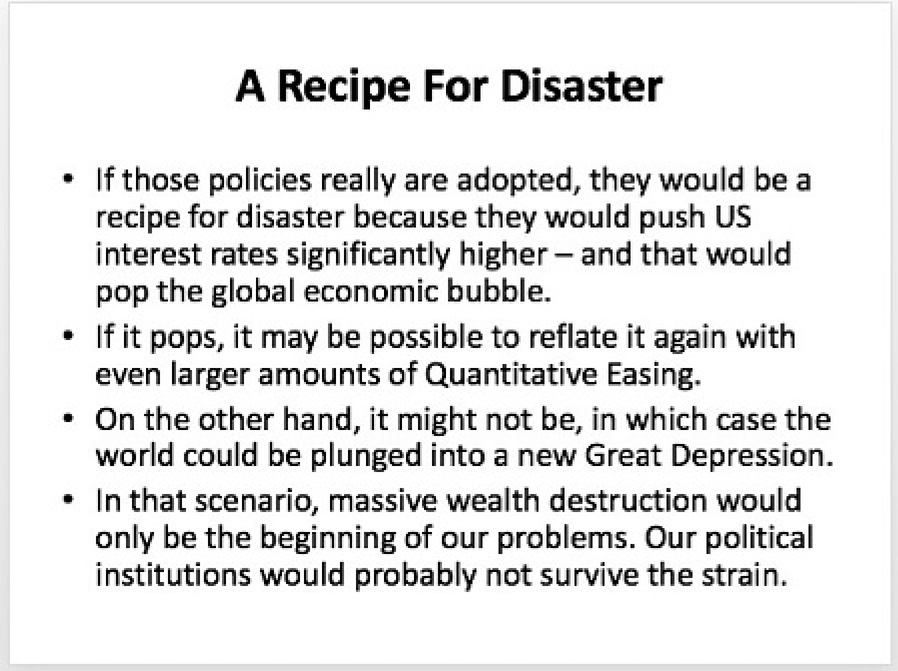
Does China continue to weaken its currency to keep its competitive pricing edge? Or, will Trump take the US dollar lower to combat China’s strategy? Do we enter into an outright currency war, with Japan and Europe also looking to protect their share of global trade?

A banking crisis in China is not good news for Australia. Our economy — mining and housing — has benefited substantially from China’s massive credit expansion. Without it we are sunk.

Joining the dots

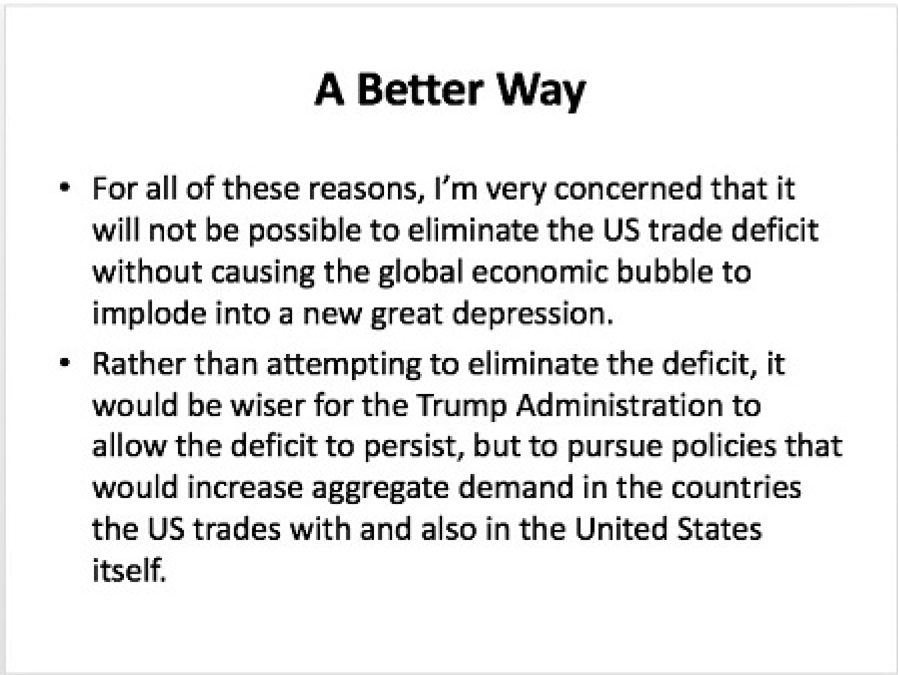
This is a small insight into Richard’s thinking, but it’s enough to highlight the extent of the destructive forces that are building within the global economy and financial system.

When you join the dots, we have a ‘Recipe for Disaster’.

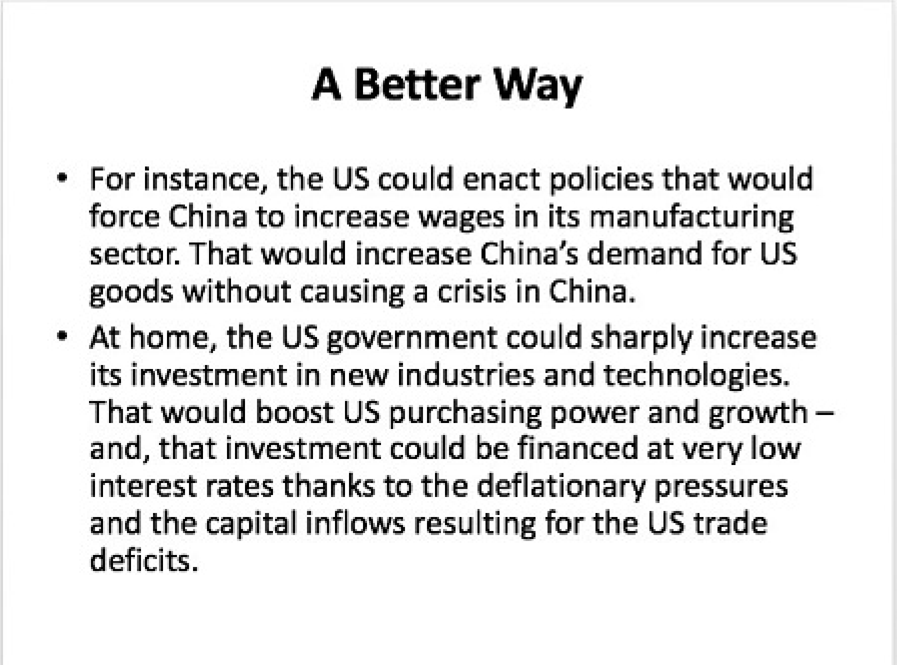


Click to enlarge

Richard thinks there's a way to avoid a new Great Depression.



Click to enlarge



Click to enlarge

The 'better way' involves running the printing presses to keep the liquidity in the system and, hopefully, use some of the additional dollars to '*sharply increase investment in new industries and technologies*'.

There's no doubt we (as in the global economy) have backed ourselves into a corner from which there are no easy ways to extract ourselves.

Richard's 'better way' solution has given me something else to listen out for when policy announcements are made.

If we do not hear anything, then our strategy of bunkering down for the coming Greater Depression appears to be the appropriate course of action.

Regards,

Vern Gowdie,
Editor, *The Gowdie Letter*

***The Gowdie Letter* Buy List**

Stock	Ticker Symbol	Exchange	Buy Price	Current Price	Buy Up To Price	Current Gain	Duration
British Pound ETF*	POU	ASX	$15.880	$16.42	N/A	3.3%	LT

Invest in GBP directly or via **BetaShares British Pound ETF [ASX:POU]. Buy 2% per month for the next five months. GBP has entered undervalued territory. Remain patient. This is a two-year plus investment.*

Prices correct as at 10:10am AEDT, 3 February, 2017.

Although it would be enjoyable to invest alongside you, it's more important to us to avoid conflicts of interest. Therefore, we don't own shares in any of the companies currently recommended in *The Gowdie Letter*.

on public forums. Please help us by reporting any research you find being distributed illegally.

To access your content online, please go to www.portphillippublishing.com.au and log in using your User ID and Password. If you can't find these, or can't remember them, please click on the lost password link in the login box on the website, or call 1300 667 481 any time Monday to Friday between 9am and 5pm AEDT.

If you would like to contact us about your subion please call us on 1300 667 481 or email us at cs@portphillippublishing.com.au

Port Phillip Publishing
PO Box 713 South Melbourne VIC 3205
Tel: 1300 667 481 Fax: (03) 9558 2219