Central Bankers Prefer Wreckage to Recovery

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Former Dallas Fed President Richard Fisher has been in the news again, making grandiose statements and criticisms of the current monetary regime. He is, as he has always been, concerned about inflation. Being a former protégé of Paul Volcker, it seems Mr. Fisher is determined to live up to the myth even when there is no basis for it. He proudly proclaimed in Tokyo in April 2009 his status as an unrepentant hawk "having voted five times against further accommodation during the commodity-driven price boom of 2008." To many, that was a record of failure and being wrong that stands out even amidst an ocean of it from that period. In reality, it was no different than any other failure as it was all in that category no matter which way any central bank turned **at the time**.

Figuring inflation around every corner, however, especially due to balance sheet expansion in the QE's, does not dismiss all of Fisher's policy criticisms. He has noted, quite correctly, that the Fed's track record of economic forecasting is atrocious, comparing it at one time unfavorably to his dry cleaner, "My local dry cleaner, I would say that if you took him and put him against the whole Fed staff in terms of forecasting, he's been far more accurate." And he has taken a principled, and correct, stand against "too big to fail."

In September 2009, Fisher, along with Harvey Rosenblum, wrote an opinion piece published in the *Wall Street Journal* titled in true Fisher style *The Blob That Ate Monetary Policy*. Referring to that article in a speech a few months later to the 27th Annual Cato Institute Conference on Monetary Policy, the then-President of the Dallas Fed remarked:

"We noted that the very existence of the blob of banks considered as too big to fail blocks, or seriously undermines, the mechanisms through which monetary policy influences the economy."

It is a key piece of monetary truth, even though it has stood, and still stands, at odds with his inflation obsession. If the big banks designated as such must remain because of their systemic importance and they do not act in the expected or intended manner then no monetary policy shall ever succeed. That was the verdict in 2008, starting August 9, 2007, and it remains so because 2008 was not a temporary matter as everyone, even Fisher, believed and still does.

A full part of the reason for all that is simple and clear, as Fisher also grasped in his speech with his usual dramatic flair. Interjecting Charles Dickens, he recalled Dickens' apt description of insurance, "A person who can't pay, gets another person who can't pay, to guarantee that he can pay." But where Fisher only uses that simplified truth in limited circumstances as he saw them then, it counts for the entire monetary basis that we see both then and now. In other words, what Dickens admonished of insurance had been turned into the very basis for the world's reserve currency. As China's PBOC Governor Zhou Xiaochuan correctly pointed out at almost the same time, the world had been not on a dollar standard but a credit-based dollar standard; *everything* of the past decades is contained within that single distinction. Or, paraphrasing Dickens, a bank that has no dollars, gets another bank that has no dollars, to guarantee that everyone has dollars.

It works, or seems to, so long as the guarantee keeps the faith. In very general terms, that is what happened on August 9, 2007; the faith was lost and so was the eurodollar paradise.

Leave it to Richard Fisher to include not just Dickens and blobs but also John Milton all in the same speech. Referencing Milton's *Paradise Lost* right at the outset of his talk, Fisher quoted starting with Line 98 of the epic poem the passage about the creation of man and his power to both stand and fall. It was a stark contrast to the usual not just of that time but as continues in monetary policy and central banks, the ongoing self-deliberation of their own perfection and omnipotence. No matter how badly they miss, time and again, it is never the central banker or economist who falls but rather my fault and yours. The rise of the eurodollar standard was Greenspan's maestro, but as it falls it is instead the economy and Bernanke's "courage" to nothing different.

That led to the deliverance of "stimulus" in almost continuous fashion, all in search of Keynes' aggregate demand. For all the trillions spent on it, there remains a curious and conspicuous global shortfall of demand - and now getting worse yet again. Where monetarism failed in the crash, fiscal "stimulus" was thought the resurrection. In the US, we were treated to the American Reinvestment and Recovery Act that, despite its deep preferences for **scientific posturing**, delivered no recovery. Because of that, Ben Bernanke's Fed was left as the only proffered answer to the continued assumed shortfall in demand.

Critics claim that such "austerity" here and everywhere else is to blame, but that is a contention born of the same narrowed monetary interest as what propels all the multiplied QE's. Having

reached the end of what nothingness monetarism has delivered, including not the slightest hint of calculated inflation, policymakers are now cycling back to "shovel ready."

In late February, meeting quite appropriately in China, OECD secretary general Angel Gurria said that, "central bankers have done almost as much as they could and now it should be up to governments to stimulate the private sector so that it could invest again." The true cycle is no longer the business cycle, it is or is becoming fully the stimulus cycle. Monetary policy and fiscal policy have begun alternating, spaced out by enough time that proponents believe the people will have no memory of any of the prior cycle legs. Thus monetary policy's greatest achievement will be in its own failure to erase the memory of the ineffectiveness and cost of the fiscal version that heralded it.

HSBC's senior economic advisor Stephen King was unusually blunt and honest a few weeks ago. He noticed that "economic activity around the world was slowly deflating", which in his view brought to mind a sense of **déjà vu**.

"These shortfalls are reminiscent of Japan's difficulties in the 1990s and beyond. Relative to projections five years earlier, Japan was nursing a 24 percent nominal GDP shortfall by the turn of the century. And many of Japan's problems are now being replicated elsewhere: Low bond yields, falling bank share prices and deleveraging."

To the economist, these are all "Japan's problems" to be answered by "stimulus", even if "stimulus" must go on for decade after decade. The word surely would have lost all meaning had it been used in some other setting, but in economics it is ironclad law that monetary and fiscal policy are stimulus even when for the length of generations there is no evidence for the claim. It is in fitting fashion that the Japanese are now leading the charge as the pendulum of the stimulus cycle swings back toward the Finance Ministry.

It was three years ago now that QQE had left many incredulous. We have become accustomed to massive intervention and monetary "shock and awe" especially in comparison to the quaint times before 2007 when heated debate centered around just reaching the zero lower bound, but even at a time where it takes some effort to rekindle shock QQE was impressive. That was entirely the point, a monetary program so large and indubitable that it "had" to work. Translating one element of "secular stagnation" into Japanese, the Bank of Japan quixotically tilts against the windmills of a "deflationary mindset" as the cause for why monetary policy programs never work. And there have been a lot, at least 11 QE's and perhaps as many as 22 (depending on how you define individual interventions).

In general terms, QQE was supposed to be so effective because it would break all believed boundaries of "money printing." The Bank of Japan would go so far that the people and businesses of Japan would have no choice but to act in preparation of a moneyed landslide into inflation. It seemed to work, but only at first. The CPI jumped, but it was more about yen than

activity. Not long after, as soon as Q4 2013, GDP was contracting again and Japanese households began a slide in income and then spending that is as-yet unbroken more than two years later.

The Bank of Japan has ballooned total bank reserves by more than 350% under QQE (and its late 2014 expansion), increasing the "monetary" base from ¥52 trillion to just about a quarter of a quadrillion yen. For all that, the calculated inflation rate is back close to zero again, the yen is "appreciating", and household income has collapsed in real terms by about 7%. It's as if all that money printing wasn't.

Economists in Japan are now debating whether the country is in yet another recession. GDP contracted in the last quarter of last year, and all signs point to another negative number in Q1; especially the latest batch of data released this week that saw retail sales plunge along with yet again household incomes, and industrial production fell by the largest monthly rate since the tsunami in 2011. This time, however, the economic disruption is entirely unnatural.

With the Bank of Japan's reputation deservingly sullied after QQE led only to more discussions of technical recession, and especially the fiasco over NIRP, once more the government there seeks to counter recession via "stimulus." The fiscal cycle is on its way as if there **weren't any before**:

"Amid a politically eventful year, calls are growing within the government and ruling parties to compile stimulus steps to gird the flagging economy ahead of a key summit and the Upper House election.

"Though doing so would go against the nation's efforts to heal itself fiscally, a pledge by Group of 20 economies to "use fiscal policy flexibly" is likely to be cited in support of stimulus at a time when global growth is weighed down by recent market turmoil."

None of that makes any sense under global conditions of continuous "stimulus." How can there be "recent market turmoil" when the number of QE's vastly outnumber the world's GDP growth rate? To ask the question begins to answer it. QE's and all "stimulus" are not what they are still taken to be. It is in Japan that all of that seems to have come together, including as the potential key to define why QE never was "money printing" in any iteration of any denomination.

As I pointed out **a few weeks ago**, the financial anomalies (I use that word from the mainstream or orthodox perspective) surrounding Japan are numerous, but not so much that they completely obscure traceable pathology. The record negative basis swaps in Japan, trading dollars for yen, really dollar liabilities for yen liabilities, indicates a massive dollar shortage. In some ways, that seems out of place given that the world has looked so much better since mid-February, but as usual China stands in the middle of the "dollar."

Speculation is to be damned when it takes the form of liquidations as it had prior to February 12, but embraced enthusiastically when in the direction set forth by unhinged visions of "stimulus." From that day forward, almost everything is up and up noticeably: oil, stocks, even junk bonds that were indicating something close to the end of the world, or at least default cycle fears reaching 2008 proportions. The Chinese have been in a very public war against speculators supposedly driving the yuan lower in exchange with the dollar, and so some of what the PBOC has done of late is supposed to count on that front as if they are winning.

Thursday, February 11, however, was in the midst of China's Lunar New Year holiday week meaning that for all intents and purposes financial China was closed. The eurodollar futures market that day had been heavily bid, which was very bad news in terms of economic interpretations, as a higher bid means lower expected future money rates. The June 2018 contract (which I hold as an important benchmark as it straddles the reach of monetary policy perceptions but far enough in the future to project more fundamental expectations) on February 11 was pushed all the way up to an unthinkable 99.165! Raw numbers alone don't do the projections full justice, as that meant money market participants (read: banks) were paying less than 85 bps to obtain 3-month LIBOR more than two years into the future. The eurodollar market was never so pessimistic even in the worst days of 2009.

Given that money backdrop, it makes perfect sense that oil, junk bonds and all else around the globe, including stocks in Hong Kong, would be in the depths of liquidations up to and including that day. The very next day, however, financial China partially reopened and magically the world shifted. One-week CNH HIBOR (offshore Hong Kong interbank borrowing and lending of Chinese yuan) had surged into the start of the Golden Week, pressed up to 6.354% in what is taken in the mainstream as the PBOC's fight against speculation, then dropped to 6.0815% February 11 and further to 5.5845% the 12th. Three-month HIBOR followed the same pattern.

Monday, February 15, curiously while the US was closed for President's Day, the PBOC fixed the CNY exchange rate to about 6.50 from around 6.58 or 6.59 where it had been stuck since early January. That was a huge move but entirely predictable. I **wrote** on Friday, February 12:

"With volume in Hong Kong heavy and losses severe in many places, there isn't a lot to suggest a durable turnaround in stocks, banking or currencies. The mess of imbalance survives in Hong Kong, meaning that it will likely continue to afflict the mainland only further eroding sentiment all the way around. It will be interesting how the PBOC reacts, as surely they will and must."

There is a lot of misunderstanding about what the CNY exchange rate actually indicates. When it dropped precipitously in August, the mainstream (and economists) took that as some kind of currency "stimulus" in the same manner as QQE was supposed to work in Japan. Even if that was the case, it didn't work, as China's exports absolutely collapsed in January and February this year, which points toward the real problem. A lower CNY exchange in wholesale terms means that Chinese banks (and perhaps some SOE corporates) are having problems rolling over their

end of the "dollar short." Since the PBOC fixes a hard trading band for the currency, there is a limit to the cost that Chinese banks can pay for "dollars." There is never any thought about whether this is the proper direction in the first place, an imbalance that market forces are aiming to cure; central banks just take it as a call to action against "speculators" since economics prizes only a neutered sense of stability.

In August 2015, that "dollar" stress or run had reached immense proportions to the point that the PBOC had a very dire decision to make - maintain a steady fixed exchange as it had done for the five months before that and force Chinese banks into perhaps "dollar" defaults on rollovers, or allow them to bid for as many "dollars" as they needed but at whatever cost it would take. They chose the latter option, which meant that Chinese banks were chasing "dollars" in what looked like "devaluation"; devaluation in wholesale terms suggesting instead the relative increased cost of those bids (there is more to it than just this process, but I omit these complications for the purpose of, hopefully, clarity).

From that view, we can infer what the PBOC might have done on February 12 (to start) and especially February 15 in the big reversal or CNY appreciation. It is quite likely that the Chinese central bank was supplying "dollars" in the form of forward cover to Chinese banks to counteract the liquidations (due to systemic "dollar" shortage) that had been building for months. In general terms, the PBOC was "supplying" "dollars" into the Chinese markets through its banks which has had the effect of stifling the run - temporarily.

This would not be the first time the PBOC has acted in that fashion, having undertaken the same processes but likely not to the same extent last August and September. It worked, then, too, or at least appeared to. When that forward cover started to expire around November, the CNY exchange started dropping once more, indicating Chinese "dollar" stress. At almost the same time, offset by a week or so, the Japanese yen began to appreciate (and, importantly, mirrored by UK sterling) contrary to orthodox determinations of relative money printing. It was very strong continuing evidence that China's "dollar" "supply" was being met (poorly) by Japanese banks. In other words, China's "dollar short" had built up in large part during the preceding years through Tokyo to Hong Kong.

That leaves indications of Japan's "dollar shortage" as relating to China's. Once February's forward cover relents and expires, what will Chinese banks be left to find especially from their Japanese "supply?" Not only that, there are serious and highly applicable questions as to how large of forward cover did the PBOC supply in February (and as far back as January), as that will determine the extent and stress of the unwinding. Anecdotally, the suggestions about that factor are not good as even the IMF was left recently to **publicly ask of China**.

Having detoured through the bowels of wholesale finance in the credit-based version of the world's reserve currency, the struggles of "stimulus" are more revealed. Nowhere is there a role for "bank reserves" which are the only tangible byproduct of any QE. As Richard Fisher noticed

in 2009, monetary policy is slave to the blobs especially if the TBTF's no longer wish to fulfill all the world's actual monetary functions. It has been assumed all along that they would because it was further assumed they would find reserves as money and therefore feel immediate stimulation. Bank reserves are instead just one possible kind of bank liability in a system of shrinking offered liabilities of all other kinds spread amongst all the nationalities of the "dollar" system. What is relevant, then, is not bank reserves but those liabilities; they are the money.

In that view, what central banks have done and might continue to do, and by extension the fiscal cycle of stimulus, is left to at best ineffectiveness and at worst, as we have seen of the PBOC's efforts and are likely to see in yet another "wave" of them, quite harmful. Yet, it is all still classified as "stimulus" no matter how bad conditions get. Economists want everyone to believe the world just suddenly stopped growing, as if economic sustainability has become some lost art of the ancients. No matter how little demand comes of aggregate demand efforts, nothing is to change including Orwellian obfuscation. Retreat is speculation; positive numbers are the benefits of TBTF. That leaves only one direction for anything, even if it is the direction where nothing works.

There is another passage in Paradise Lost that I think applies to these "stimulus" circumstances. Just before the poem's most famous line, Milton writes,

A mind not to be changed by place or time.
The mind is its own place, and in itself
Can make a heav'n of hell, a hell of heav'n.

That is Satan justifying his actions in relativistic terms, leading him to declare, "better to reign in hell, than serve in heav'n." It is the closed mind that finds such false harmony, and it speaks again to human nature and the absolute corruption of power and influence. Economics has been so corrupted by power and influence that it sees itself as the only answer even when it doesn't understand the problem; in fact, it cannot understand the problem as admitting the monetary evolution would undermine everything it stands for and its own place in its own hierarchy. And we are left to suffer the consequences of the rigidity of the purely political, that central bankers would rather reign over constant wreckage than serve in our recovery.