A View from the Trenches Toronto, Tuesday, November 24th, 2009

Good morning,

The widespread impression that the US deficit will continue set all non-money assets on a rally yesterday. Gold reached $1,174/oz. As we said many, many times over, it is as simple as that. Interestingly enough, with the 10am announcement on the 10.1% increase in the existing home sales (month-over-month), the market took profits in equity and gold.

Yesterday, I quoted comments from our April 28th letter (www.sibileau.com/martin/2009/04/28 "A Keynesian Perspective") on Keynes approach to monetizing financial crisis like the one we are in. I thought it was interesting to see Keynes' point here, because in my opinion, **Keynes is Bernanke's intellectual father**.
Keynes thought that a readjustment of prices to a new level in the quantity of money was possible, without further unintended consequences (from Chapter 13, "General Theory of Employment, Interest and Money", 1936). In his words:

"…Circumstances can develop in which even a large increase in the quantity of money may exert a comparatively small influence on the rate of interest..." (Have we not seen this happen in front of us over all of 2009?)

"…Whilst an increase in the volume of investment may be expected … to increase employment, this may not happen if the propensity to consume is falling off…" (Is this not what all economists keep telling us on the weakness of this recovery?)

"…***If employment increases, prices will rise in a degree partly governed by the shapes of the physical supply functions, and partly by the liability of the wage-unit to rise in terms of money***..*(…)…when output has increased and prices have risen, the effect of this on liquidity-preference will be to increase the quantity of money necessary to maintain a given rate of interest…*"

From this last paragraph, we learn that the exact price level at which prices would adjust would depend on productivity and unemployment rates. Please, remember that rates are a metric, which depend on time. Thus, timing was indirectly also accounted for. Of course, Keynes neglected the non-neutrality of money (i.e. fluctuations in the quantity of money do not affect all prices at the same time). Note that ignoring the non-neutrality of money is expensive, because if you do so, you miss on the rally we've been enjoying since March. But in the long term, it is true, there is an adjustment of prices to a new quantity of money, as long as your currency is not debased enough to push investors to massively dump it. In the case of a global crisis, Keynes correctly appreciated the value of monetary policy coordination to avoid a run against fiat money and proposed the creation of what later came to be the International Monetary Fund.

Where do I go with all this? Do I believe that there will not be an exit strategy after all? Not at all.

My view is that if Bernanke follows Keynes, the Fed will withdraw liquidity in the quantities that it sees in excess of demand (=excess supply). As long as it sees demand for a certain quantity of liquidity, that quantity will not be reduced and of course, further liquidity will not be provided. Let's call this Thesis No. 3, which I will test going forward and will elaborate more on (i.e. how do we measure "excess supply"?)

This view ***significantly differs from the mainstream opinion***, which holds that the Fed, once it starts unfolding its exit strategy, will seek to return the level of bank reserves, which are expected to rise to $1.35 trillion to the historical average of $10 billion (i.e. normal levels prior to the crisis; ***this strategy consists therefore in eliminating excess reserves***). This would represent a significant reduction in liquidity.

The difference here between the Fed and a typical inflationist third-world country would be in that third-world countries not only do not withdraw liquidity but also keep providing it indefinitely.

What do we make of it? In the foreign exchange market, such scenario should continue the depreciation of the USD against gold and those currencies that do not import USD inflation. Which are the countries that do not import USD inflation? Those countries where their central banks do not accumulate either USD or securities from their financial institutions in the asset side of their balance sheets.

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