

Good morning,

Since our last letter, perhaps the most relevant event has been Mr. Bernanke's speech, last Friday. Titled "*Monetary policy objectives and tools in a low-inflation environment*" (www.federalreserve.gov/newsevents/speech/bernanke20101015a.pdf), this was a speech that made waves. Essentially, it made the case that given an environment with low inflation, there is room to look for alternative policy. Will it be implemented as so many expect? The market's belief that it will grows by the day. After yesterday's release of capacity utilization (74.7% vs. consensus of 74.8%), the strength in the USD began to give way again...

As Mr. Bernanke put it, the topic of his speech was "...the formulation and conduct of monetary policy in a low-inflation environment...". Interestingly, he introduced the subject reflecting on the fact that: "...From the late 1960s until a decade or so ago, bringing inflation under control was viewed as the greatest challenge facing central banks around the world...". We wonder if Mr. Bernanke ever asked himself why it would be the case that since the Great Depression and until the late '60s the greatest challenge was to bring inflation under control. In fact, in the case of emerging markets, this challenge lasted well into the '90s and is the topic of the day again, as these markets seek to avoid the appreciation of their currencies by "printing" money to buy the US dollars Bernanke prints, thereby importing Ben's inflation.

If Mr. Bernanke would have asked himself why central banks in the past decades had such challenges, he would have surely found out that it was because his predecessors, just like he today, thought that a little bit of inflation would do no harm, and that the pain of having a high unemployment rate was bigger than that of high inflation.

If Mr. Bernanke did not underestimate our intelligence, he would surely realize that we know that in the end, even that little or high inflation generated no employment. In fact, inflation generates unemployment. Here's why:

Inflation destroys savings and produces a lower savings rate. This destruction also generates a shortage in the stock of capital, which deteriorates productivity. To be certain, productivity also declines driven by the uncertainty in relative prices generated by inflation. As productivity falls, it is less feasible to maintain a labour force at the existing level of wages. Therefore, entrepreneurs/firms can only survive if they can get access to lower "real" wages or to "cheap" credit, to finance their working capital (i.e. collections deteriorate as clients seek to delay payments to profit from inflation, and inventories rise because firms anticipate future higher input prices). Naturally, with inflation, credit disappears and governments find that the only way to keep the music going is by further debasing the wages of those employed.

This cycle spirals even faster in a global economy, because as a consequence of the fall in productivity and unemployment of resources, citizens of the affected nation must now import those goods that were previously profitably produced in their land. However, as their currency depreciates ("wins" the currency war) against the rest of the world, the cost of those imports rises, further cutting their ability to save. If the nation initially required an increase in the supply of money of \$1trillion of US dollars per year (as it is speculated Quantitative Easing 2 will entail) to keep the original demand level for goods, as this cycle runs its course, the need for additional liquidity will increase to replace the reduction in savings, wealth, chasing an even smaller amount of goods produced. The need for additional liquidity grows linearly at the beginning and exponentially at the end. This why it is never "politically" feasible to return to a "normal" state.

Yes, Mr. Bernanke is right. Any central bank has the tools to fight inflation later on. But none, absolutely none, has the political power to assume the cost when inflation is evident and high. It takes radical political change to break the cycle, the likes of which Reagan and Thatcher brought in the '80s. We see nothing close to this on the horizon for the next couple of years coming from any country.