BETWEEN DEBT AND THE DEVIL

The title of this newsletter is from a recent book by Adair Turner that discusses the financial crisis, the response from policy makers, and offers some radical suggestions to future policies to deal with the current global debt load, all with the goal of promoting stronger economic growth**. This book is timely given that the big economic story over the next year will be the Federal Reserve's (Fed) attempt to unravel its huge balance sheet of nearly $4.5 trillion**. Trying to understand the implications of these changes is important for investors because the Fed's moves along with other central banks around the world will impact valuations for all financial assets.

The book discusses the shortcomings of the economics profession that contributed to the financial crisis. Specifically, economic policies failed "to reflect the reality that individuals are not wholly rational and financial markets far from perfectly efficient. The second crucial failure was that modern macroeconomics largely ignored the operations of the financial system and in particular the role of banks." The outcome was an explosion of private debt creation much of which was used to fund ever escalating real estate prices instead of more useful expansion of production capabilities.

The radical part of the book argues that the world's central banks should consider creating fiat money (i.e. money printing) as a policy option to deal with the current global debt load and lackluster growth. Turner argues that our current system of private credit creation also creates money out of thin air and resulted in the financial crisis. To explain, let's say a bank has $1 million in deposits. It will then loan out 90% of the deposits ($900,000) which will then be put into another bank or used to buy something. The net result is that the amount of money has increased from $1 million to $1.9 million. In essence, money has been created out of thin air. The only real difference between private credit creation and the Fed creating fiat money is the entity creating the money –the private market or the government.

The prevailing wisdom when central banks started to increase their balance sheets dramatically in response to the financial crisis by buying debt was the fear that this action would result in high inflation. This sentiment was captured in this quote from an article in the *Financial Times* in June 2009: "Along the way inflation is likely to return, probably sooner and more violently than most expect, which will prompt investors to demand a higher return and make it even harder for governments to tackle the debt." Instead deflation has been the bigger issue over the past eight years! **Why hasn't this subtle form of money printing resulted in inflation?**

One form of fiat money creation discussed by Turner which might have significant relevance today is public debt write-offs. There's an argument to be made that this has already happened without serious repercussions**. Currently the Treasury Department owes the Fed a large portion of the $4.5 trillion (one part of the federal government owing another part of the same federal government). In theory that debt could be written off and replaced with a perpetual non-interest bearing debt owed from the Treasury to the Fed**. More likely despite all the talk about the Fed reducing their balance sheet we suspect very little will happen on this front. In either scenario we don't believe financial markets would care much either way. **It appears the market is comfortable with the new reality of the Fed's large balance sheet, as well as that of other major central banks. Perhaps this is the case because the asset side of the world's balance sheet has grown significantly too.** While most headlines emphasize the growth of debt the compounding effect of the world's assets gets much less attention.

However, there is an unknown point where fiat money creation could go from beneficial to disastrous. The markets will give us clues if we are headed in that direction but currently the message appears benign.

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