



The following is the text of a presentation Doug Noland made to the June 2003 Undiscovered Managers' Wealth Management Symposium in Chicago.

Contemplating the Evolution From the Way We Were to The Way It Is

“I generally try not to venture too far from my Bloomberg screen, and I’m not much for public speaking. Actually, when the folks from Undiscovered Managers initially invited me to speak, I at first hesitated. But they cleverly enticed me with the words “Paul McCulley is going to be presenting.” Well, that’s all it took, and I immediately signed up. There was no way I was going to pass up the opportunity to go head-to-head with my analytical nemesis - the most outspoken “inflationist” on Wall Street. And despite my disappointment that Mr. McCulley is not speaking, one of my objectives this morning is to convincingly refute his call for only greater monetary and fiscal stimulus. Such policies are little more than administering greater doses of narcotic to the desperate junky, while disregarding the underlying malady. It is my view that The Inflationists are indeed engaged in a desperate – and perilous - crusade to sustain an unsustainable Credit Bubble.

I imagine most everyone would agree that we are faced with an exceptionally challenging environment. There are these perplexing, contradictory views – are we facing deflation or inflation? Is this post-bubble or bubble; recession or recovery; bear market rally or the return of the bull? Is the economy fundamentally healthy or an unfolding disaster? Is the financial system sound or hopelessly unstable? There are convinced pundits and seemingly convincing analyses supporting diametrically opposed views. So, what the devil is going on here, and is there any hope for making some sense of it all?

Well, I want to be quite upfront on this: I am here today as a salesman. But don’t worry; there’s no need to hide your wallet. I am hoping to sell you on an analytical framework. It’s very much a work-in-progress, but I’m convinced that there is a better mouse trap. I believe The Inflationists are wrong – dead wrong. I believe the recent focus on “deflation” risk is misguided. I believe the generally sanguine consensus view is flawed and confused, specifically because it stems from an outdated and inadequate analytical framework.

While recognized by few, years of study have me absolutely convinced that we are in the midst of one of history’s great Credit Bubbles. As such, the greatest risks today are associated with the continuation of runaway lending, speculation and financial leverage. Failing to appreciate the root cause of the boom, the optimists invariably extrapolate unsustainable Bubble excess. Examples include the Internet stocks, NASDAQ, the dollar, and now the housing markets. We now are in the throes of a historic Mortgage Finance Bubble that, like the preceding telecom debt and equity Bubbles, will end in tears. The consensus view that the U.S. financial system and economy are fundamentally sound is

dangerously mistaken. The U.S. Credit system today is truly out of control, and the Fed is trapped in disastrous policies perpetuating the Bubble.

I believe that if one views the world through the lens of a sound analytical framework, it becomes clear that the Credit Bubble places the U.S. financial system, economy, and dollar at great risk for years to come.

I chose not to use a lot of slides today. My various charts of Credit growth all look quite similar; they are all mountains that just grow more steeply toward the sky. Some of my favorites are included in your material, but it's not a valuable use of our time to go through them individually. I'm here to sell concepts – to push a way of thinking about this most fascinating environment.

But I will begin by throwing out a few figures to put the ongoing Credit Bubble into some perspective. During the past six years total Credit market borrowings have surged \$10 Trillion, or about 50%, to more than \$32 Trillion. Over the same period, financial sector Credit market borrowings – including the banks, Government-sponsored Enterprises, Securities firms, asset-backed securities issuers, and mortgage-backed securities trusts – have doubled to \$10.5 Trillion. Total mortgage borrowings are up \$3.5 Trillion, or 66%, since the beginning of 1998.

And just last week the Federal Reserve released Credit data from the first quarter. I will briefly share a few highlights. Total mortgage borrowings increased at an annualized pace of \$916 billion or 10.8%. To put this into perspective, this is about three times the rate from 1997. And the first quarter's \$900 billion plus pace compares to the \$204 billion average during the first eight years of the 1990's. Financial sector borrowings expanded at a 9.7% rate during the first quarter. State & Local governments increased borrowings at a 10.1% pace. In contrast, non-financial corporate borrowings expanded at 3% annualized.

Importantly, while attention these days is focused on the potential for deflation and the apparent necessity for even more aggressive fiscal and monetary stimulus, what is not appreciated is that we have commenced a period of major divergence between weak economic performance and only greater Credit excess. I would argue this is indicative of the terminal stage of a protracted Bubble.

The consensus view holds that this is a post-Bubble recovery environment. But my analytical framework conveys to me that the previous corporate bond, telecom, and equity Bubbles were off-shoots of a much more momentous Bubble that today runs out of control through the Credit system. I would argue that the Federal Reserve's aggressive accommodation, to mitigate the fallout from booms turned bust in Mexico in 1995, Russia and LTCM in 1998, and then the technology and equity collapses, has nurtured only much larger and dangerous Bubbles in Mortgage Finance, Leveraged Speculation, and Risk Intermediation.

To hopefully bring some clarity and continuity to this unconventional and sometimes confounding analytical framework, I have chosen to break my presentation into four

sections: First, The Way We Were. Second, The Way It Is. Then, Ramifications for The Way It Is. And I will finish up with Today's Critical Issues.

The Way We Were:

Traditionally, the monetary system was a Decentralized System Dominated by Local Bankers. Bankers operated with a prudent, "Loans for the Long-term" perspective. Gain on sale accounting and marked-to-market did not exist. It was a controlled banking/monetary system. Loan growth was limited by reserve requirements and there was a limited supply of loanable funds. Supply and demand for these limited funds dictated interest rates, with the price of Credit a fundamental stabilizing force. Credit Availability was generally dictated by business profitability and the expected return on investment.

Bank deposits were the primary liability created during the lending process. Or, stated differently, deposits were the major monetary IOU issued during financial sector expansion. Hence there was a strong correlation between "money" supply, the general Credit environment, and economic performance.

Within this monetary regime, the Federal Reserve governed currency expansion and the payment system. The monetary system was anchored by bank reserves. The Fed carefully controlled these reserves that were "multiplied" during the lending process into new deposits. Management of bank reserves was basically control over system liquidity and the broader financial environment.

The economy could be analyzed as an Industrial Economy. Goods-producing industries were at the epicenter of the economic system – the horse pulling the financial and services carts. Financial expansion paralleled GDP expansion, or stated differently, the expansion of financial claims was largely matched by the expansion of production capacity. The trade position was normally balanced. Excesses were temporary and largely self-correcting.

Let's focus for a minute on Monetary Processes, or the means and channels whereby liquidity is directed from the Credit system to the economy and markets. They were relatively unambiguous back during The Way We Were. Liquidity was generally injected through bank lending to fund business and capital investment. It was a Decentralized ("local banker") Credit system, spreading liquidity fairly evenly throughout the real economy. Business profits were the driving force for monetary expansion. These processes demonstrated cyclicity, but were generally self-regulating. Asset inflation was the cart and not the horse, pulled by business lending. Finance flowed first to business, then to income growth, and then to asset prices. In stark contrast to today, the financial sector was lackluster. The "action" was in the real economy.

It is worth highlighting the notion of “stabilizing speculation.” With a controlled and self-adjusting Credit system, emerging imbalances would actually be held in check by speculators placing bets that these imbalances would be corrected and short-lived. In

fact, Milton Friedman years ago asserted that “destabilizing speculation” was implausible. This is a most important and pertinent issue. Dr. Friedman’s premise was almost tenable under The Way We Were’s monetary system, but such a hypothesis would be absurd today. More on the contemporary prominence of “destabilizing speculation” shortly.

And this leads us to Inflationary Manifestations, or the consequences of monetary inflation. Previous causes were not difficult to identify, and it was generally a case of Too Much Money – chiefly bank deposits and currency - Chasing Too Few Goods. Excessive lending and resulting money growth was the culprit, precipitated by the industrial sector bargaining for limited resources. A deficit running government sector inflated prices generally as it imposed larger demands on resources, while pressuring interest rates as it competed for limited loanable funds. Government deficits led to a general “crowding out.”

Trade deficits were an issue, but they were self-correcting. With a limited supply of loanable funds, heightened demand for borrowings pressured interest rates and tempered demand. At the same time, international central bankers recognized the benefits of, and were committed to, a balanced global system.

Pricing pressures were generally controllable through the straightforward management of bank reserves and government spending. Carefully managed bank reserves provided a Credit system anchor. And it was not unreasonable to focus on an aggregate price level, with Inflation Manifestations observable and generally indisputable.

On a Side Point: This simple Credit system, comprised of inert bank loans, a cautious central bank managing bank reserves, and balanced liquidity predictably entering the economy through the industrial sector, was conducive to economic modeling. But that was The Way We Were. We live in a profoundly changed world today. I will refer to it as The Way It Is. This section of my analytical framework draws heavily from the brilliance of Hyman Minsky, and specifically from his groundbreaking theories of the Wall Street Paradigm and Money Manager Capitalism.

The Way It Is:

We operate today with a dynamic, expansive securities-based Credit system, with myriad institutions, Credit instruments, vehicles, and markets. The contemporary financial system is profoundly distinct from The Way We Were’s bank lending-dominated monetary system. We are thus today forced to take a very broad-based view of finance and the divergent consequences of an especially vigorous and enterprising financial system.

Over time, the Enterprising Loan Originator and the Aggressive Investment Banker supplanted the Traditional Prudent Local Banker. This evolution has transformed the old boring bank loan into a prized speculative asset. Loans are absolutely no longer “inert,” but rather a treasured commodity in the age of aggressive marked-to-market, gain on sale,

securitization, and the “repo” market. This evolution has witnessed the cautious “Loans for the Long-term” perspective remade to the aggressive “It’s All About Volume.” There is today little concern for Credit quality as long as the loan can be sold. Credit quality is “managed” on a portfolio diversification basis, with individual loan quality virtually irrelevant.

Decades of notable financial evolution have culminated with what I refer to as Wall Street Alchemy. This wizardry of transforming endless risky loans into precious “money” and “safe” securities is subtle yet profound. Our system today operates with virtually insatiable demand for loans, with contemporary risk intermediaries the major players. Look at the GSEs: Fannie and Freddie’s books of business have more than doubled to \$3.1 Trillion in six years, and if we include Federal Home Loan Bank System assets, we’re now talking almost \$4 Trillion of GSE intermediation. The assets of “Structured Finance” – or, at least, the combined GSE, ABS, and MBS footings – have more than doubled since 1998 to \$8.3 Trillion.

This Unbounded Risk Intermediation imparts momentous changes throughout the Credit creation process. First of all, the system today enjoys an Unlimited Supply of Loanable Funds. This offers a stark contrast to The Way We Were’s tightly controlled banking system liquidity.

These days financial sector expansion is in no way constrained by bank reserve requirements. First of all, money market deposits are “multiplied” outside reserve requirements (“infinite multiplier effect”). The GSEs, as quasi-government entities with implicit debt guarantees, have unlimited access to market borrowings. They enjoy unconstrained IOU expansion, or liquidity creation. Leveraged speculators also create liquidity - the creation of loanable funds - through the expansion of financial sector liabilities. The broader financial sector possesses a blank checkbook to issue additional IOUs - contemporary “money” and Credit. Banks are now only one player in the “money” and Credit creating process and no longer the most dominant. The GSEs and “structured finance” have been bestowed Kings of “money”, Credit and liquidity.

And, importantly, there has been a complete breakdown in the relationship between the supply and demand for loanable funds and the price of Credit. As we have witnessed over the past year, it is possible to enjoy unprecedented demand for mortgage borrowings satisfied at collapsing rates. And with an unlimited supply of loanable funds in the marketplace, government fiscal deficits inflate financial claims without any offsetting “crowding out.” This is a Brave New Financial World.

With an unlimited supply of loanable funds at Fed-orchestrated “pegged” borrowing rates, it is perfectly rational for the financial sector to go for volume and aggressively

leverage. These dynamics have nurtured a systemic focus on asset and consumption-based lending, with real estate and financing leveraged speculation as today's most conspicuous examples. And with the explosion in risk intermediation and speculation, key risks are now managed principally through the derivatives markets. But these New

Age risk markets are viable only with the specious assumptions of liquid and continuous markets.

Financial evolution has fed, and been fed by, the evolution of Federal Reserve policies. With the transformation to a non-bank, market-based Credit system and the resulting irrelevance of bank reserves, there has been corresponding fundamental revolution with regard to the Fed's policy "tool kit." Our central bank is now compelled to peg short-term interest rates and promise to forewarn the marketplace of any intention to adjust the peg. It has also become necessary for the Fed to guarantee marketplace liquidity. Especially to accommodate the explosion of the derivatives markets, the Fed must guarantee continuous and liquid markets.

Nowadays, Federal Reserve operations work mainly by aggressively manipulating rates, yield spreads and, increasingly, market perceptions. In the process, the new "tool kit" bolsters leveraged speculation and unparalleled Credit Availability. The key analytical point is that the effects of today's operations are so much more disparate and unpredictable than when the Fed was managing the bank reserve "anchor". I would argue that the Fed is now held hostage to the markets - financial and real estate - and particularly to endemic Credit market leveraged speculation. In short, financial and central bank evolution has parented a mutant, uncontrollable Credit system. There is no financial system anchor, while the Fed's new "tool kit" emboldens speculators and nurtures excess.

I would argue that this unrestrained financial environment has over many years affected major structural changes to the real economy – foremost fueling the evolution to a Service Sector Bubble Economy.

I view the service sector economy foremost as a "monetary" (in the broadest terms) economy. The nucleus of today's economic system is boundless Credit expansion and resulting asset inflation, rather than goods production and business (capital) investment. It is my view that the significance of this transformation cannot be overstated. I was not surprised that a recent surge in television advertising and ad rates were one of the early indications of reflation's "success". This will also be another banner year for attorneys, real estate agents, insurance salesmen, and mortgage brokers, all direct beneficiaries of Credit and asset inflation.

I would argue that while profits remain the centerpiece of Capitalistic processes, financial and speculative profits today reign supreme. Manufacturing and capital goods profits become less relevant to the economic system by the year; financial and speculative profits seemingly become more commanding by the month.

And while the New Economy has proved resilient and appears at times almost miraculous, there is no avoiding the reality that our system is acutely vulnerable to any slowdown in Credit growth. The “seizing up” of the Credit market during the LTCM crisis, the Telecom debt collapse, and last year’s general corporate Credit crisis are examples of inherent systemic fragility.

It is important today to appreciate what I believe have degenerated into Dysfunctional Monetary Processes. We operate with a centralized, uncontrollable Credit system. There is a systemic propensity to channel excess liquidity to sectors and asset classes that offer the best opportunity for volume and/or demonstrate an inflationary bias. Such processes consistently - virtually by definition – foster runaway booms and unavoidable busts.

Today, liquidity is injected into the real economy primarily through the asset markets, as opposed to financing business spending and capital investment. During the past year, total mortgage Credit has increased a record \$937 billion, ten times the increase in non-financial corporate borrowings. Our financial system has become hopelessly disposed to fueling destabilizing asset Bubbles, and our central bank steadfastly refuses to address this most critical issue.

Importantly, financial speculators have come to dictate Credit Availability and system liquidity, with today’s Mortgage Finance Bubble a most conspicuous case in point. Recognizing that we have experienced an historic evolution in both the Credit system and the structure of the real economy, we then must appreciate that contemporary financial excess creates quite divergent consequences – or Atypical Inflationary Manifestations.

Sound analysis demands that we look broadly at the consequences of Credit growth. The key is the concept of Credit inflation - the new financial claims that create purchasing power - and Credit inflation’s divergent effects. These include myriad price effects throughout the economy and markets, with recognition that financial and non-financial asset inflation is a fundamental manifestation of contemporary financial excess. And, importantly, Credit inflation will also impact both the amount and nature - or, better said – the quantity and quality of economic “output.” Our focus is the inflation of a broad range of financial claims, with keen attention to the expansion of financial sector liabilities. We therefore minimize the relevance of narrow measures of money supply, the Fed’s balance sheet and, especially, bank reserves.

Today, the system suffers most from a case of Too Much Credit and Liquidity Chasing Inflating Assets. With financing asset markets the dominant Monetary Process, there is a strong systemic bias for Credit inflation to manifest into Asset Bubbles. We now see exactly this dynamic throughout real estate finance, as well as in the Credit market with inflating Treasury, agency, and mortgage debt prices.

Financial excess will manifest into over-investment in the “hot” sectors. Unbridled speculation dominates, thus we face incurable sectoral boom and bust dynamics. If it’s not technology or telecom, it will be real estate, healthcare, or energy.

Mortgage finance excesses stoke over-consumption and resulting interminable trade deficits. Consequences include the massive accumulation of foreign liabilities and a vulnerable dollar. I would add that this was a seductively manageable problem when U.S. asset markets were the vehicle of choice for the global speculators (recycling global dollar liquidity immediately and directly back to the U.S. financial sector), but this is no longer the case today.

Importantly, our dysfunctional Credit system distorts pricing mechanisms, creating extreme and unsound divergences. For example, the global economy suffers from widespread industrial overcapacity and downward pricing pressures throughout the manufactured goods arena. At the same time, there is strong domestic price inflation in major sectors such as housing, energy, tuition, insurance, and healthcare.

Similarly, there are extreme divergences in sectoral performance that impart major structural distortions to the real economy. Obvious examples include the protracted real estate boom versus the ongoing manufacturing bust. But, then again, this is the very nature of maladjusted Bubble economies.

Returning to my earlier side point, there is absolutely no way to effectively model the contemporary Credit system or economy. The economics profession must adapt and move beyond “The Way We Were” and its fixation on modeling and econometrics. Analyzing a complex, evolving market-based financial system with myriad institutions and instruments is surely at least as much art as it is science.

Ramifications for The Way It Is:

“Updating” Minsky’s “Money Manager Capitalism,” I have coined the term “Financial Arbitrage Capitalism.” The focal point is the current eminence of Credit market speculation. We operate today with an energized marketable securities-based financial system. At this point, it should be inarguable that contemporary finance incessantly nurtures leveraged speculation and resulting asset Bubbles.

This atypical strain of inflation is quite problematic as it is seductive and off-limits. After all, who in Washington today would be willing to call for restraint in mortgage lending? Not the Fed and certainly not Congress. To make matters worse, most mistake asset inflation for “wealth creation” and covet it rather than fear it.

Asset-based lending is self-reinforcing. Credit excess begets higher asset prices that provide greater collateral values that beget only greater Credit and speculative excess. Early economic thinkers a few hundred years ago appreciated that a monetary system backed by real estate was inevitably unstable. It may work like magic at first, as the added collateral promotes increased lending. But such monetary backing provides unlimited collateral for borrowing, with lending excess eventually inflating land prices and stimulating only greater destabilizing inflation. They knew that once commenced, there was neither a way to control the nature of the inflation nor a generally acceptable

way to turn it off. The old economic thinkers clearly understood inflation dynamics much better than our contemporary economists.

The Way It Is operates with uncontrolled “money” creation. This really is an extraordinary experiment with money. It is not backed by gold, precious metals, or even constrained by reserve requirements; nor is there any effort whatsoever to restrict its supply. The critical function of “money” creation has been assumed by enterprising loan originators and risk intermediaries focused on asset-based lending, commanding an anchorless system supplying unlimited liquidity. Lacking the discipline and fortitude to deal with lending and speculating excess, the Federal Reserve is today impotent to manage our “money.”

Today’s Dysfunctional Credit System responds abnormally to stimulus. Under Financial Arbitrage Capitalism, financial speculators have come to dictate system-wide Credit Availability. The Fed now must basically peg borrowing costs and guarantee a positive spread for the speculators in agency and mortgage-backed securities. This has created an environment where it is much more attractive “playing” financial spreads than it is investing in the real economy with its uncertain business profits.

We experience today a most virile strain of Destabilizing Speculation. Federal Reserve accommodation nurtures unmanageable and dangerous lending and speculative excess. And, in an important contrast to The Way We Were, the emboldened speculators nowadays confidently place enormous bets that these excesses will run unchecked.

A couple of contemporary dynamics are worth briefly mentioning. First, “Liquidity Loves Inflation.” Finance tends to flow in self-reinforcing excess to the sectors demonstrating an inflationary bias. Today, the Fed wields impressive power to “reliquify.” However, this new purchasing power adores the mortgage markets - homes, as well as securities - but despises manufacturing and capital investment. Secondly, market dynamics rule. Asset inflation – or what we refer to as bull markets – will tend to gain momentum and become increasingly unstable over time, culminating with dangerous speculative “blow-offs.” We have witnessed these dynamics repeatedly. Examples include SE Asia, Russia, Argentina, junk bonds, emerging market debt, Internet stocks, telecom debt, NASDAQ, and equities generally. Recently, a classic speculative “blow-off” has commenced throughout mortgage finance – a Bubble of historic dimensions.

The key point is the following: If greater amounts of liquidity are released throughout this dysfunctional financial system, the results will be only further destabilizing speculation and more spectacular booms and busts. The Inflationists dangerously disregard this unfortunate reality.

Perhaps it is helpful to think in terms of a Manic Financial Sphere face-to-face with a Despondent Economic Sphere. It is today much easier to achieve financial profits than true economic profits. So any liquidity deluge flows to, and “animal spirits” fixate on, the “business” of finance. The realm of Financial Arbitrage Capitalism is specifically fixated on financial and speculative gains, with no regard for true economic investment or

profits. Moreover, the degree of “easy money” and financial excess necessary to stimulate the maladjusted and Despondent economy will excite only more dangerous excesses for the Manic financial system.

This leads us to the critical issue of Financial Fragility. First of all, there are distinct “Problems with Volumes.” The system that has evolved will basically do everything in excess. Accordingly, consumption and asset-based lending win the popularity contest, as they offer seemingly limitless profit opportunities and less perceived risk than financing business investment. One consequence is weak debt structures created by too much debt of increasingly poor quality – underpinned by inflating asset prices. There is, as well, the paramount issue of Endemic Financial Leveraging, which I view as a gross Bubble of speculation. And there is the systemic fragility associated with heightened risk intermediation, with systemic risk expanding exponentially as greater quantities of increasingly risky loans are extended and “intermediated.”

There are important issues related to the Proliferation of Structured Finance. For one, there is heightened risk intermediation by thinly capitalized institutions not appreciating Credit Bubble dynamics.

Regarding the Proliferation of Derivatives, I have in the past used a flood insurance analogy: If inexpensive and easily accessible flood insurance becomes available, this development will arouse a self-reinforcing building boom along the river. The newly offered insurance will increase individual risk-taking behavior and set in motion dynamics that pyramid systemic risk. Yet the insurance business will thrive, the riverside economy will boom, and it will appear to happy onlookers as a “miracle economy.” That is, until the inevitable flood arrives.

For the system, derivatives provide the means for altering, disguising and transferring risk, but not the mitigation of risk. And, unfortunately for systemic stability, this risk is too often transferred to speculators and highly leveraged players without the wherewithal to manage this risk in the event of a systemic crisis. Moreover, derivatives and structured finance nurture risk-taking. Specifically, they cultivate aggressive lending and leveraged speculation.

And a few comments are in order regarding the Government-sponsored Enterprises (GSEs). These are very problematic, unmanageable institutions at the very heart of today’s Bubbles. The GSEs enjoy unlimited access to Credit, thus operating with an extraordinary capacity to expand liabilities and create system liquidity. They are the major force fueling a historic Mortgage Finance Bubble, fostering destabilizing asset-inflation, over-consumption, endless trade deficits, and severe economic maladjustment. Moreover, they are the leading creators of system liquidity. This role becomes paramount during periods of systemic stress. I argue that they now operate as the key “Buyers of First and Last Resort” throughout the Credit market, essentially functioning as a Dual Central Bank. They have evolved into the Liquidity Backstop, emboldening the leveraged speculating community. This is an especially powerful and dangerous role for the GSEs. But, at the same time, they are the “Guardians of the American Dream.” Especially in

today's environment, the GSEs are politically invulnerable, and the debt market knows this.

And this transitions smoothly to the U.S. Bubble Economy. Recall the old adage "You are what you eat"? Well, I say "An Economy is How it Lends." Financial Arbitrage Capitalism and its Dysfunctional Monetary Processes guarantee endemic unsound lending and the wholesale misallocation of resources. The character of liquidity now significantly impacts the nature of demand. The underlying structure of the economy is dictated by, and developed for, Credit-induced over-consumption, while the general economy has evolved to be asset inflation and services-centric. This ensures extreme investment and structural distortions.

The outcome is a lot of non-tangible "output" and "productivity," along with an enormous inflation of financial claims. The problem is there is little in the way of true economic wealth to support this inflation. Therefore, today's "monetary" economy is acutely vulnerable to any reduction in the growth of Credit.

Today's Critical Issues:

The paramount issue is the intractable Credit Bubble – the antithesis of the stability offered by The Way We Were. The old banking system was relatively simple to govern, while today's complex, expansive Credit system is virtually unmanageable. There are today three interrelated Bubbles. First, the Mortgage Finance Bubble. Second, the Leveraged Speculation Bubble throughout the Credit system. And third, the Risk Intermediation/"Structured Finance" Bubble.

There is also the critical dilemma that we Can't Even Turn These Bubbles Down, Let Alone Turn Them Off. Mortgage Finance is today the horse, while the economy is the cart. The Bubble throughout mortgage finance has become the overriding source for system liquidity and income growth.

Regarding GSE risk intermediation: The thinly-capitalized GSEs balloon exposure and use resulting boom-time experience to claim they will never suffer severe Credit losses. The GSEs have basically become the market, and the day they turn more cautious is the day the Bubble is in serious jeopardy. Unprecedented mortgage Credit growth has national prices levitated and many major localities in dangerous Bubbles. Any reduction in liquidity risks setting in motion a telecom-style bust.

Closely related is the issue of the Credit insurers. These thinly capitalized financial guarantors have written well over \$1 trillion of insurance. But what would be the consequence - what impact on Credit Availability - if the insurers were to back away from writing new policies? I argue this is yet another Bubble; it only functions well during expansion.

We have nowadays a Hot and Cold Problem. There is no functioning thermostat to even the temperature throughout the economy. Speculative finance will feed over-heating in one area, while out of favor areas freeze.

We face extreme divergences in relative prices. ECB chief economist Otmar Issing made some pertinent comments recently when he stated that the issue today was not deflation but the divergence of relative prices inherent to Capitalistic systems. I would argue that our deranged Credit system is fostering extreme and destabilizing price divergences. A few examples include: Healthcare versus manufactured goods prices; Silicon Valley home prices compared to Dallas; natural gas versus computers. And there is the divergence between stagnant wage growth of goods-producing workers versus surging income for real estate agents and mortgage brokers.

We face Unrelenting Credit booms and Busts: The U.S. and global financial systems are anchorless and rudderless. I would argue that uncontrolled Credit systems cultivate price distortions that are malignant to Capitalistic economies. Free markets and the effective allocation of resources require a stable monetary regime. Here at home, the unstable U.S. financial system and economy are trapped in historic Mortgage Finance excess. To maintain this Bubble and the attendant Bubble economy will require enormous unrelenting Credit expansion. This inflation of financial claims portends a serious dollar problem.

I would argue that the Demise of King dollar changes “everything.” We will now face rising prices for our massive imports. There will be an ongoing inflationary bias in commodity prices, especially for energy and precious metals. The specter of endless U.S. Credit inflation – dollar debasement – has also set in motion significant speculative flows to non-dollar assets and markets. This dynamic has already played a crucial role in the collapse of global yields and risk premiums, evidenced by heightened Credit Availability for many economies including China, India, Brazil, and Russia.

I am not sure what it all means, but this is not “deflation.” In aggregate, we remain in a protracted period of enormous Credit and speculative excess, with ultra-easy Credit Availability for most individuals, companies, governments, economies, and certainly the global speculators. Moreover, this inflation is accelerating. We today face a Bubble crisis not a deflation problem. Could the bursting of these Bubbles end in a deflationary Credit collapse? Absolutely. But I want to make what I believe is an important point: While it may be possible to mitigate deflation risk with further monetary accommodation, there is absolutely no curing runaway Bubbles with only greater Credit and financial excess. It’s impossible, impossible, impossible. The Fed and The Inflationists are fighting a losing battle. They have not only misidentified the adversary, they are aggressively Arming the true Enemy.

This is truly a case of The Implausibility of Federal Reserve and Inflationists’ Ambitions. Additional money and Credit will not right previous wrongs. With current institutional and market structures, it is absolutely impossible to evenly disburse inflation throughout the economy. Today is not “The Way We Were,” with a stable monetary transmission

mechanism and a functioning aggregate price level. “The Way It Is” operates with Dysfunctional Monetary Processes, severe structural economic imbalances, and Atypical Inflationary Manifestations. Additional stimulus is only further destabilizing.

First of all, more stimuli feed unsustainable asset inflation. It augments non-productive Credit creation, the inflation of dollar claims with little corresponding increase in true economic wealth. Additional inflation also creates erratic and unsustainable income growth throughout the economy. It fosters an unsustainable divergence between Credit expansion and the wealth-creating capacity of the real economy, intensifying already acute financial fragility. The point being, reflationist policies only exacerbate Bubbles and distortions, while further inflating the unserviceable debt held by our foreign creditors. As an economy, we are not adequately investing – and our domestic price structure makes it very difficult to compete globally. But we at some point will no longer enjoy the wonderful privilege of trading dollar financial claims for imported goods. We will need to trade goods for goods.

I believe we risk an Unfolding Dollar Debacle. The key analytical issue is the unrelenting and uncontrollable inflation of non-productive Credit – dubious dollar claims on the U.S. economy. This is the dollar debasement that will continue to weigh on our currency. And with the passing of King Dollar we face endless oversupply of new dollar claims in the face of waning global demand. The recent dollar speculative Bubble – with resulting artificial demand supporting the dollar in the face of ballooning supply - has now burst. But rather than adjusting to the new supply/demand dynamic, the Fed and U.S. financial sector are inflating the supply of dollar claims only more recklessly. These dynamics ensure a most serious dollar crisis.

The Fed is Playing a Very Dangerous game. Since 1998, the “activist” Federal Reserve has been aggressively engaged in Sustaining an Unsustainable Bubble. They almost reached the end of their rope this past fall. Even ultra-low rates and extreme Credit and speculative excess were insufficient to bolster the financial system and stabilize the economy. A desperate Fed responded by again changing the rules of the game. It not only implicitly promised the marketplace that it would maintain the short-term rate peg indefinitely, but the Fed would consider capping long-term yields as well. This is a truly historic development – and another huge mistake in a series of flawed policies. I fear this maneuver has recklessly opened the lending and speculating floodgates, inciting the final parabolic “blow-off” for the Great Credit Bubble. If this is the case, we are witnessing the absolute worst-case scenario unfold right before our eyes.

In conclusion, I actually sympathize with intensive “Keynesian” stimulus policies, but only as measures to assist the system through the difficult post-Bubble adjustment process. Aggressive stimulation today, on the other hand, is little more than John Law-style inflationism that foolishly perpetuates Bubble excess. Postponing the Day of Reckoning only ensures a more catastrophic crisis and painful adjustment later on.