WHATâ€™S THE FEDâ€™S PLAN B FOR THE COMING FISCAL CATASTROPHE?

Perhaps the most troublesome question that investors and business decision makers confront today is, "When will significant inflation and interest rate increases show up?"

The next quarter, the next year, the next decade? Everyone fears these, but no one can predict exactly when they will appear. Investment is severely hampered by this uncertainty. The potential inflationary/interest rate pressures exist largely as a result of Fed's massive purchase of government bonds and mortgage-backed securities.

But much of this increase in money is locked up in the banks because the Fed now pays interest on the bank reserves held at the Fed (and therefore it is not lent or spent), because of increased regulatory restrictions that discourage banks from making loans to small businesses and consumers, and because of the lack of demand for new loans. In addition, many individuals and businesses are holding unusually high sums to weather regulatory and economic uncertainties.

Yet, there are many factors that could trigger inflationary/interest rate increases that are largely out of the Fed's ability to forecast and control. After all, the Fed consistently underestimated the inflation of the 1970s, failed to anticipate the recessions in 1990 and 2001, which it induced, and was surprised by the Great Recession, in part caused by the Fed's providing the monetary fuel for the housing bubble.

For each of the last four years, the Fed (and the Obama Administration) has been telling us to expect four percent growth in the next year when the actual number has been approximately two percent. There is always economic uncertainty; but given the unprecedented debt-to-GDP levels in most of the world's major nations, almost any sizeable disrupter could set off a very steep rise in inflation and/or a great economic contraction.

While inflation may fundamentally result from too great a creation of money, the proximate or immediate cause of its actual development is much more a function of expectations of what will happen next. This, the Fed cannot hope to control.

Rarely does inflation develop gradually, monotonically or predictably; much more likely, at least in a context like the present, it is some sort of triggering event that detonates the explosive mix that already exists. Inflationary/interest rate expectations can change overnight, which will cause a sharp spike in the velocity of money (which has been declining for the past six years to record lows), as those who are sitting on idle or low-return funds seek to protect themselves by buying goods or real assets.

Markets react faster than central banks. History shows that when the central banks do act, it

usually takes them many months, or even years, to withdraw sufficient money to quell the inflation fires they lit.

Thus, in a sense, we are all waiting for the unpredictable trigger to occur. How could it happen?

The Fed and a number of other central banks, notably Japan's, are engaged in an attempt to cheapen their currencies in attempts to revive domestic growth -- which, of course, not all of them can do at the same time. Unexpected movements by the players in the currency wars could throw markets into turmoil, having a major affect on interest rates.

The Middle East is filled with erratic state and non-state players who could easily set off a series of events, military and diplomatic, that would shut down much of the oil shipments from the Persian Gulf for some period. Most central banks would probably increase the money supply to monetize the price effects of oil supply shortage. Almost any war scenario would have a similar outcome.

There are major internal political stresses in China and economic stresses in Japan, which could cause either or both countries to begin to cash in some of the trillions they hold in U.S. financial assets. This too would have an immediate impact on interest rates and inflationary expectations. The Fed would likely print more money to buy bonds to offset the foreign sales.

A terrorist attack on a U.S. port could cause supply bottlenecks, which would impede the flow of goods into the U.S. This could cause price spikes in many items -- and trigger broader inflationary expectations and a rise in interest rates.

Natural disasters present economic dangers beyond the terrible physical ones. Congress just voted a relief package for those who were hit by Hurricane Sandy in New Jersey and New York, further increasing the debt. A major earthquake in California could cause many- fold the damage of Sandy and could easily trigger inflation expectations.

There are forecasts of massive student loan defaults, which might cause Congress to engage in a "student loan bailout," which again would force the Treasury to sell and the Fed to buy more bonds. President Reagan's former budget director, David Stockman, and others have warned against a new housing bubble that they see developing. In order to forestall another big decline in housing prices, the Fed might well further expand its program of buying mortgage-backed securities, which, at some point, could trigger an inflationary response.

If inflation starts to rise, the pressure on government authorities to do "something" might become so intense that they engage in statistical fraud to avoid reporting real numbers, and/or price controls. The knowledge of such fraud would likely leak out, which could cause more inflationary panic. Argentina was just censured by the IMF for producing phony inflation statistics, and now the country has put a price freeze on many goods -- which will lead to shortages.

The recent large purchases of gold by the Chinese and Russian central banks, along with the investment hype, could trigger inflation expectations. These acts, coupled with the President's and his Democrat Party's unwillingness to admit the U.S. has a spending problem, are causing concerns among rational thinkers. These include former Fed bank presidents, who understand that at some point the growth in debt will result in an unsustainable interest feedback loop.

The probability of any one of the above-mentioned events (and many more that could be added to a list of potential triggers) may be small in a given year, but the combined probability of at least one or more of these events happening in the next three years is high.

It is doubtful that the Fed or the Obama Administration has a Plan B for dealing with any such shock. Politics-as-usual demands that those in charge be completely surprised when a shock occurs; that way someone else can be blamed.

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