

Myrmikan Research

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This, Sir, is no Dream

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Republican Senator Elihu Root rose on December 13, 1913 to oppose the Federal Reserve Act:

With the exhaustless reservoir of the government of the United States furnishing easy money, the sales increase, the businesses enlarge, more new enterprises are started, the spirit of optimism pervades the community. Bankers are not free from it. They are human. The members of the Federal Reserve Board will not be free of it. They are human. All the world moves along upon a growing tide of optimism. Everyone is making money. Everyone is growing rich. It goes up and up, the margin between costs and sales continually growing smaller as a result of the operation of inevitable laws, until finally someone whose judgment was bad, someone whose capacity for business was small, breaks; and as he falls he hits the next brick in the row, and then another, and then another, and down comes the whole structure.

That, sir, is no dream. That is the history of every movement of inflation since the world's business began, and it is the history of many a period in our own country. That is what happened to greater or less degree before the panic of 1837, of 1857, of 1873, of 1893, and of 1907. The precise formula which the students of economic movements have evolved to describe the reason for the crash following this universal process is that when credit exceeds the legitimate demands of the country the currency becomes suspected and gold leaves the country.

Root had been Secretary of War and Secretary of State. He was an attorney whose clients had included Andrew Carnegie, "Boss" Tweed, Jay Gould, and E. H. Harriman. The experience of history, not theory, informed his grasp of the credit cycle.

When a saver deposits \$100 into our fractional reserve banking system, a bank opens an account for the depositor and tells him he can have his money back whenever he chooses. Let's say the law requires a 10% reserve, as it currently does: the bank can lend the other \$90 of the deposit to someone else, for example, the buyer of a house. The home buyer agrees to repay the loan over ten or, perhaps, thirty years. Even though the depositor believes his money to be readily available, there is no way the bank can retrieve his money from the borrower sooner than the repayment schedule provides.

The home buyer takes the \$90 that the bank has loaned him and pays it to the seller, who then deposits it back at a bank as current funds. This bank, whether it be the

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same or different, treats this deposit the same way the original deposit was treated: it lends out 90% of it; another \$81 of debt and \$81 of new deposits are generated, which are then lent out; and so on. In this way, when a bank receives a deposit of \$100, the banking system doesn't lend out half, or even 90% of it—it lends out ten times the amount. The \$900 surplus is made out of thin air, *ex nihilo*. If reserve requirements decline to 5%, then the banking system can lend out \$2000 of term loans from the \$100 demand deposit.

Reread the last sentence. The brain almost forces a reconsideration of the process. Try explaining the paragraph above to the branch manager at your local bank and you will receive a blank stare or perhaps hostility. No one can argue with John Kenneth Galbraith's assessment: "The process by which banks create money is so simple that the mind is repelled."

The monetarist sees this magnification of money and concludes that as long as the money supply and the bank multiplier remain the same, then value in monetary terms will be stable. If, for some reason, however, depositors start asking for their money back, as they are right now in Greece, then the multiplier starts working in reverse: for every dollar withdrawn, the banks must destroy \$10 of credit money. For example, if the initial depositor of \$100 which turned into \$1000 asks for \$50 back, then the bank must reduce its loans by \$500, and the total money supply becomes \$50 in cash and \$500 in credit money, or \$550 instead of \$1000.

Few complain when the money supply rises: *the sales increase, the businesses enlarge, more new enterprises are started, the spirit of optimism pervades the community*. It's when depositors want their money back that the problems come, and it was to fight the resulting monetary contractions that the Federal Reserve was founded. According to Milton Friedman:

The Federal Reserve System was created by men whose outlook on the goals of central banking was shaped by their experience of money panics during the national banking era. The basic monetary problem seemed to them to be banking crises produced by or resulting in an attempted shift by the public from deposits to currency. In order to prevent such shifts from producing either widespread bank failures or the restriction of cash payments by banks, some means were required for converting deposits into currency without a reduction in the total of the two. This in turn required the existence of some form of currency that could be rapidly expanded—to be provided by the Federal Reserve note.

As we have witnessed since 2008, the Federal Reserve can indeed print enough money to keep the sum of deposits and currency stable. But, there is a fundamental flaw in the monetarist framework: it assumes that all dollars are alike, that as long as the money supply is stable, then the economy will be balanced. What it fails to consider is that the depositors could have bought certificates of deposits or bonds, locking up their capital to fund long-term assets. Instead, deposits represent the funds that depositors have decided they require at immediate notice. The banks take these current assets and lock them up into fixed assets by lending them—at term—multiplied ten times—overstimulating capital investment beyond that which societal savings can support.

While capital investment is being overstimulated, economic activity becomes frenetic: input costs soar. But, overcapacity amid competition start driving margins lower until profits disappear and the malinvestments can no longer pay the interest on the debt borrowed, much less return the principal. The capital is then liquidated at a fraction of its value. Banks, which finance the malinvested capital, are wiped out, and creditors lose their money. And then whole thing starts again.

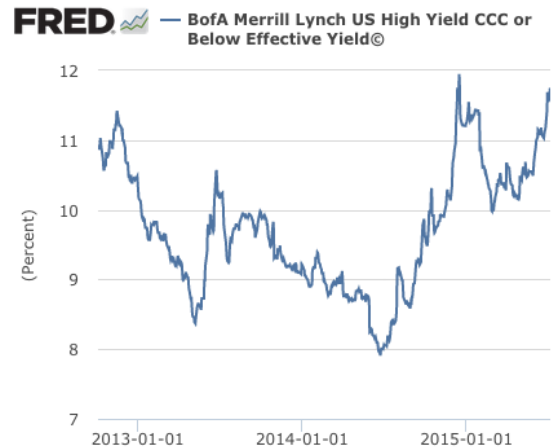
This is the repeated cycle Root had lived through. When the Federal Reserve prints the money to save the banking system, as it did in 1922, 1924, 1927, 1929, and so on through 2008, the result is to prevent the overcapacity from liquidating and to encourage the construction of more capacity. The Keynesians then confuse overcapacity for lack of demand, and agitate for stimulus and more money printing. The cycle begins again on a larger scale.

This current economic cycle began in 2009 when the Fed printed the money to save the banking system from the 2008 panic. After an “expansion” of six years, the unmistakable signs of fatigue are setting in. Every bit of credit has been squeezed out of the economy. Experian reports that used car loans in the fourth quarter of 2014 had an *average* loan-to-value of 137%—yes, that means companies are loaning 37% more than the car is worth! (and cars are rapidly depreciating assets). Try Googling: “vacation loan.” Before you can finish typing, Google will helpfully suggest: “vacation loan bad credit,” “vacation loan no credit check,” and “vacation loan wells fargo.” (Hint: they want your car). Or go to www.prosper.com which arranges “peer-to-peer” loans—the site boasts two million members and \$2 billion in funded loans for uses as diverse as “Vacations,” “Household Expenses,” and the all purpose “Special Occasions.”

But credit is becoming more scarce. The marginal user of capital in the business world is subprime, where yields are rising. When credit is scarce, business stop expanding. When expansion halts, input costs decline. Industrial commodities are priced on the margin and are especially sensitive to the economic cycle—the chart below shows that commodities are plunging 2008-style.

The Wall Street Journal reports that the debt load of the mining industry soared six-fold to \$200 billion over just the past ten years; meanwhile, according to Citigroup, large mining companies have written off 90% of the acquisitions they made since 2009. This was before the latest plunge in commodity prices.

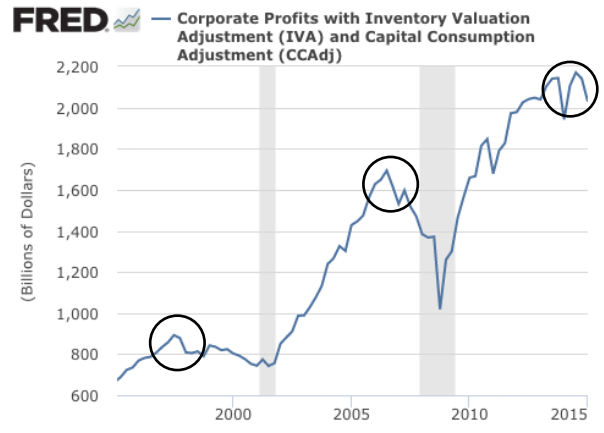
What now supports the debt?
What will happen to the balance



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sheets of those that lent the money? Hedges protect for a certain period of time—indeed, hedging is how marginal oil producers have continued to pay their bills over the past several months. But these are due to expire soon—neither the companies, nor their lenders, nor their lenders, etc., will escape the operation of the inevitable laws of economics. According to the Wall Street Journal, already: “U.S. regulators are sounding the alarm about banks’ exposure to oil-and-gas producers.”

Meanwhile, the left chart shows that corporate profits are just starting to roll over: *the margin between costs and sales continually growing smaller as a result of the operation of inevitable laws, until finally someone whose judgment was bad, someone whose capacity for business was small, breaks; and as he falls he hits the next brick in the row, and then another, and then another, and down comes the whole structure.*



And whose capacity for sound business could be smaller than communists? A month ago, CNBC had a story about Chinese farmers who have left the fields to play the stock market instead. One farmer had saved \$8,000 over twenty years of hard labor. He had doubled it in the market in one year. Why on this good earth should he whip a mule or drive a tractor when he can make money in the market twenty-times faster? The market was telling him to leave the fields for a computer terminal. What do the Chinese plan to eat while they are trading stocks?

It brings to mind the advice of a Chinese counselor to his emperor more than two thousand years ago:

At present husbandry runs the risk of decaying, and the number of people who seek to obtain copper, daily increases. They leave their ploughshares, they melt and cast, and blow the charcoal. The bad coins are daily made in larger quantities, while the five species of grain are not made to increase. The virtuous are led astray, whereas the wicked are respected; the people are falling into a snare.

Meanwhile, useful-idiot American professors profess that markets are always efficient. Jennifer Carpenter and Robert Whitelaw of NYU wrote in January: “This run-up is not a bubble, and so investors should not fear another crash. Our research shows that after a rocky first decade, which earned China’s stock market a reputation as a casino, stock prices in China predict future profits as well as they do in the U.S.,” a rather scary prospect at the present time.

In the past month, the Shanghai market has lost a quarter of its value. The communist government has intervened massively to stem the route, including ordering its banks to support the market and threatening to arrest short-sellers. None of it will work, of course. What will happen to the social fabric of China when the farmer and

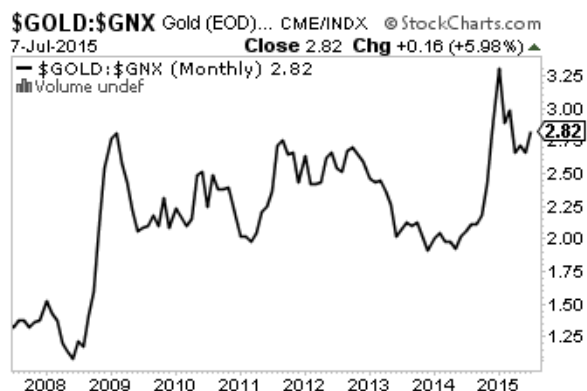
all the others like him lose not just their profit but their savings? What will happen to those who invested or lent money into China? What will happen to those who sell commodities to China? and to their suppliers? and to their lenders? and to their lenders?

Already over \$150 billion of derivatives cannot be priced because over a thousand Chinese companies have halted trading. Market participants are relearning that liquidity and shiftability are distinct concepts. Liquidity measures how fast an investment matures. Shiftability measures how easily an asset may be sold to someone else. Equities are inherently illiquid: they generate earnings (hopefully) over long periods of time. Equity interests may be easily shifted to others as long as credit is flowing. When the music stops, the last holder is stuck with the liquidity profile, if any, of the assets he owns.

Greece is non-story to the markets. The banks were given five years to unload their debt, which they did—to public institutions who bought it using taxpayer money. The coming Greek default will hit the balance sheets of government, which can only undermine the currency and cause inflation.

China is very different—these are private actors being wiped out, levered players, and soon those that lent them money, and those who lent the lenders money. It will require concerted monetary action to bail them out. Central bank balance sheets are about to get even more impaired.

One of the great unknowns has been: when China liquidates, does gold go up or down? We have our answer in terms of first order effect: gold threatens to break down through the three year base it has built. No doubt this is due to liquidations as borrowers scramble to raise currency to meet margin calls—though, as one should expect, even as gold falls in nominal terms, it is soaring as against industrial commodities.



It will soar in nominal terms too. Once the unravelling really gets underway and spreads to the banking system, developed markets will collapse and the Federal Reserve will face an awful choice: witness the greatest credit unwind since 1931, or print in a manner that will make Bernanke look timid. Gold could yet scare us to the downside, but its time is soon.