Myrmikan Research Update

January 22, 2016

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Unambiguously Good

On October 17, 2014, Larry Kudlow wrote:

> one of the absolutely stupidest things I have heard in recent weeks is that the recent drop in oil prices is bad. You heard me right. Serious people on financial television are saying lower oil prices are a signal of worldwide economic collapse. Here at home that translates to recession, deflation, a profits collapse, and rising unemployment. I've been around for a while, and I've seldom heard such gibberish . . . the recent $20 drop in crude oil is an unambiguous *good* thing for the American and world economies. *Unambiguous*.

We like Larry. There are only two school of economic thought in modern America with any influence on policy makers: the Keynesian and the monetarist, and at least the monetarist school understands that, as Larry says during the opening of each television show: "free market capitalism is the best path to prosperity!" The problem is monetarists share with the Keynesians the statist view that the market for money is best left to government appointed experts, which leads them into the greatest of errors, as exhibited above. The essence of the theory is flawed—it is impossible to quantify the money supply.

Carl Menger in the late nineteenth century explained that money is nothing more than liquidity—and so the market selects as money (the mediate good by which one good can be traded for another) the commodity with the least transaction costs. Gold has fulfilled the role of the preeminent monetary commodity for thousands of years because of its supreme liquidity characteristics—recognizable (peculiarly dense), durable (doesn't oxide), scarce but widely distributed—but it is hardly the *only* money. Goods may be traded in terms of silver or copper, in prisons the cigarette takes on monetary characteristics as the most liquid commodity, in ancient Greece it was the cow, in Mesopotamia grain, in Papua New Guinea the most liquid commodity remains the pig. How can one count the supply of monetary gold if every chalice, necklace, and ring stands ready to augment the money supply when the market so demands? And if all the gold suddenly vanished, then the market will substitute silver, then copper, then grain, then cows and pigs—how do you count that?

Nor is the task any easier in the modern context. The monetary base (physical cash and dollar reserves held by banks at the central bank) is a published statistic. Economists then argue over how to weigh M1, which includes demand deposits, against M2, which includes savings deposits, and M3, M4, etc.; and then they dispute whether more exotic measures such as the shadow banking system should be included.

This hole in the monetarist theory is nothing new. Walter Bagehot, who penned what many still consider the definitive text on banking, wrote in 1857: "Men of business in England do not . . . like the currency question. They are perplexed to define accurately what money is: how to count they know, but what to count they do not know." The Bank of Canada has examined forty-six different ways of determining the money supply. Milton Friedman himself concluded: "There is no unique way to express the real quantity of money," yet nearly all academics and policy makers continue to use the quantity theory of money as their foundation.

Mis-measuring money forms the current bull case for the markets and the economy. Ambrose Evans Pritchard wrote in early November: "I'll eat my hat if we are anywhere near a global recession" because, he argued:

> government policy has turned expansionary in the US, China and the eurozone at the same time. Fiscal austerity is largely over. The combined money supply is surging. . . . The torrid pace of worldwide money growth over recent months is simply not compatible with an imminent crisis.
>
> A combined gauge of the global money supply put together by Gabriel Stein at Oxford Economics shows that the "broad" M3 measure grew by 8.1pc in August, and by almost as much in real terms. This is the fastest rate in 25 years, excluding the final blow-off phase of the Lehman boom . . . the expansion of broad money in China has accelerated to an annual pace of 18.9pc over the past three months, thanks in part to equity purchases by the central bank (PBOC), a shot of adrenaline straight to the heart—otherwise known as quantitative easing with Chinese characteristics.

The flaw is that M3 is not a measure of money, but of credit. Let us review how banks create "money": a saver deposits, say, $100 at his local bank. The bank opens a demand account for the depositor. Assume the law requires a 10 percent reserve, as is common—the bank can lend $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 even thirty years, even though the depositor's loan to the bank is payable on demand! This alchemy is called "maturity transformation": the depositor's current funds come to finance a bid on long-term, illiquid assets. Most such assets demand a lot of commodities: if a house, for example, then steel or wood beams, copper pipes and wires, drywall, etc., and the machines to build it, and the energy required to run the machines, etc. Industrial projects such as ships, or mines, or mid-sea oil platforms themselves demand huge amounts of commodities to build.

Maturity transformation is only the beginning of the story: the home buyer borrowing $90 from the bank at term (financed by the depositor's $100 demand money) pays it to the seller, who then deposits it back at a bank as current funds. This bank, whether it is the same or different, treats this deposit the same way the original deposit was treated: it lends out 90 percent of it at term; adding another $81 of term debt and another $81 of demand deposits, and the process repeats *ad infinitum*. In this way, when a bank receives a deposit of $100, the banking system doesn't lend out half, or even 90 percent of it—it lends out ten times the amount! The $900 surplus is conjured out of thin air, *ex nihilo*. If reserve requirements decline to 5 percent, then the banking system can lend out $2,000 of term loans out of 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 dispute John Kenneth Galbraith's assessment: "The process by which banks create money is so simple that the mind is repelled."

This emission of money is nothing more than a balance sheet entry of a privately owned bank, yet these dollar deposits have the same faith and credit as if they were issued by the U.S. Treasury and are accepted as such in taxes. They create huge amounts of credit directed toward long term capital, which increases its price, lowers interest rates, and creates surging demand for commodities as projects financed by the artificial funds are developed. Every politician takes credit.

But, these long term projects come into being as an artifact of the fractional reserve banking system, not from consumer demand. Soon enough overcapacity starts sending prices lower. The malinvestments can't make their interest payments. Interest rates spike. Banks take heavy losses, and ultimately depositors must lose their funds, unless the central bank prints up the losses.

The plunge in oil that began over a year ago signalled the turning of the credit cycle. Then China popped over the summer and commodities began to fall faster. Then corporate interest rates began to surge. And, now, the bank losses come.

SUBPRIME CORPORATE YIELD SPIKES AS CAPITAL BECOMES UNAVAILABLE TO THE MARGINAL USER

Yesterday Deutsche Bank reported a $7 billion loss. As one analyst put it: "it would appear that either investment spend has been front-loaded or alternatively (and far more likely in our view) that the bank has also been forced to book elevated credit losses during the quarter." According to the *Wall Street Journal*, Citigroup and Wells Fargo have been forced to add to loss reserves against loans to the energy section. The CEO of PNC Financial Services Group admitted: "It's starting to spread" as regional banks have also reported mounting losses to the commodity sector.

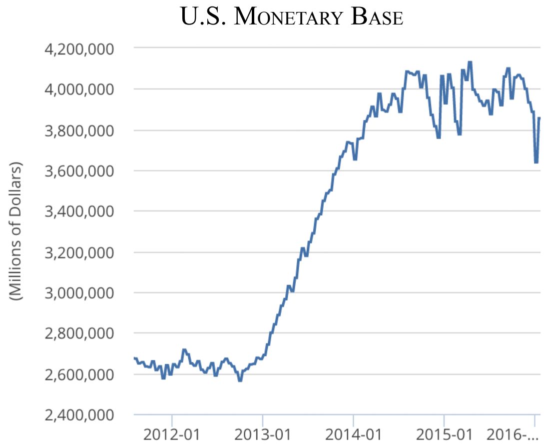
Under the gold standard, the end was brutal and short. Depositors demand their gold deposits; they are met with locked doors and police batons; eventually the near-worthless malivestments, which made up the bank's assets, are distributed to depositors in lieu of cash. This is what happened in the U.S. in the 1930s and in Cyprus recently.

The whole point of monetarism was to avoid this outcome. As Milton Friedman explained in his magnum opus *A Monetary History of the United States, 1867-1960*:

> 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.

When banks start to lose money, prompting pesky depositors to ask for their dollars back, the Fed is supposed to print them up. Behold the chart at right. Not only is the monetary base not increasing, it's actually shrinking!



So, it may well be, as Pritchard suggests, that the banking system is handing out loans to all and sundry. As he indicates, this also happened right before Lehman failed, as the banks extended credit lines in a desperate attempt to prevent the long-term, illiquid collateral from becoming completely impaired. But, the monetary base against which they are levering is getting smaller, meaning leverage is increasing, making the system more brittle, not less.

As banking losses mount, the Fed will be forced to unleash QE4. Gold will soar, and monetarism will lies in ashes, having been utterly refuted. Perhaps they will become Austrians.

It is unlikely, however, that the Keynesians are capable of embarrassment. Consider Alan Blinder, former vice chairman of the Federal Reserve, who wrote in the *Wall Street Journal*: "I never give stock market advice, and this no exception," and then proceeded to give stock market advice:

> the market is probably overreacting to news from China by a wide margin. In the case of oil prices, it seems even to have the direction wrong. . . . The Chinese stock market is not where big Chinese companies go for financing [and] . . . U.S. holdings of Chinese stocks are relatively small. What about oil prices? . . . when the price of something you buy goes down, does that make you better off or worse off?

He wrote these words *only yesterday*, betraying complete ignorance as to how the banking system affects the structure of production, confounding cause and effect; and he is said to be one of the greatest economists of our time. Indeed, economic ignorance would be the only reason why Fed officials are not already panicking. They will. And gold will respond. Myrmikan maintains that current credit conditions are *unambiguously* good for gold. We shall know shortly.