Myrmikan Update

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The Economy Can't Handle the Truth

Former Federal Reserve Vice Chairman Alan Blinder is widely misquoted as saying: "The last duty of a central banker is to tell the public the truth." The attribution of the false quotation persists because it so accurately describes the function of a central banker. The fractional reserve banking system is based upon confidence and, since a central bank's first duty is to maintain the stability of credit, central bankers must exude confidence at all times. The greater the confidence, the longer the system can survive.

But, as Austrian economists have shown, confidence cannot undo the laws of economics. Like any Ponzi scheme, the fractional reserve system must periodically collapse because wealth creation cannot stem from an eternal expansion of credit. Betrayed and confused, the little people march into the halls of power and hang the perpetrators from the nearest lamp posts.

Chairman Bernanke recently delivered a lecture series on central banking. This was no academic exercise, but a public relations campaign to justify central banking in general and his stewardship of the Federal Reserve in particular. The Chairman focused his initial lecture on the first corollary to the quotation above, which is that central bankers must disparage the gold standard at all times since it threatens the existence of central banks.

In a free market, interest rates are controlled by the market, by definition, not a politburo. For example, in a free market, rates must automatically and necessarily rise when capital is scarce in order to attract more capital, creating a true economic stress test for businesses employing leverage. Andrew Mellon's solution to the credit bubble of the 1920s stemmed from this understanding of markets and capital: "Liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate…" In his lecture, Bernanke recited Mellon's statement, calling it "heartless," but he omitted what came next:

> . . . it will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up from less competent people.[1]

The last sentence is critical. As thoroughly described by Jens Parsson in *Dying of Money*, inflation moves the control of assets from the conservative to the reckless, from producers to managers. In a free market, debt is only desired, and available, to fund productive assets that self-liquidate the debt. Banks transact only with solid businesses that grow in a stable manner. Those who borrow to excess are soon liquidated, along with those who lend foolishly.

1 Of historical note, the only source for Mellon's quotation is Hoover's 1937 memoir, and there is a view that Hoover was parodying Mellon, blaming him for the depression that cut short his presidency. Nevertheless, like the Blinder quotation, its accurateness in describing a perspective makes the attribution irrelevant.

But, if a central bank continually devalues the unit of account, the most aggressive managers issuing the greatest amount of debt obtain the best relative performance. Their success and willingness to issue debt that can never been liquidated, and only rolled over, enables them to buy out the more prudent managers. Similarly, banks who fund the reckless can deploy more capital at higher rates, outperforming and then absorbing their competitors.

As businessmen focus on building paper empires instead of wealth, an increasing amount of economic activity involves non-productive work. Parsson wrote in 1974:

> There was this statement of the inflationary lunacy, which might well serve as an epitaph to the great American boom: “Up to now the idea was to make money only with goods or machinery or something else. But more people are realizing that there is a way to make money with money and save the trip in between.”
>
> Legions of Americans — investors, conglomerators, brokers, advisers, lawyers, accountants, analysts, clerks, programmers, bureaucrats, and so forth — served the business of making money with money and creating absolutely nothing even as a byproduct. . . .
>
> Paperwork and office workers proliferated, as they did in Germany [during its hyperinflation]. The Xerox machine and the IBM machine, both paperwork machines, were the twin monuments of the decade. Bank buildings and office buildings were the most conspicuous form of construction.

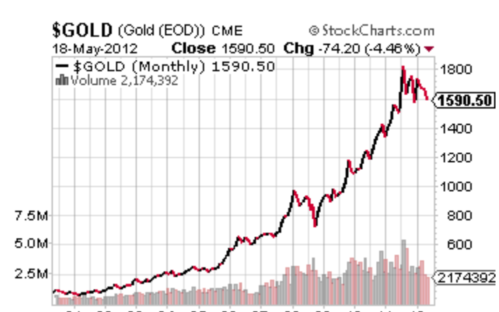
Rising interest rates topple paper towers built on credit and return the control of assets from the reckless to the prudent. It is precisely this process that Bernanke retards by keeping rates at zero, and it is the reason why the economy has not and cannot recover.

During the question and answer period of his first lecture, Bernanke veered from the unsound to the absurd as he opined that a gold standard could not function in the modern world:

> The gold standard would not be feasible for both practical reasons and policy reasons. On the practical side, there is just the simple fact that there is not enough gold to meet the needs of a global gold standard, and achieving that much gold would be very expensive and cost a lot of resources.

Here he repeats the same error as central bankers in the 1920s who attempted to keep the price of gold constant even while every country involved in World War I had dramatically expanded its stock of paper money. There is always enough gold provided it is priced correctly. Nor do currencies require 100% backing by gold bullion to be convertible on demand. As Bernanke himself discussed earlier in his lecture, when a gold standard is credible, there is little demand for gold since it is always more convenient to hold currency in paper or electronic form than gold coin. Only when a central bank is 1) illiquid, 2) insolvent, and/or 3) when it forces interest rates below the market rate, will market participants seek to redeem their currency for physical gold.

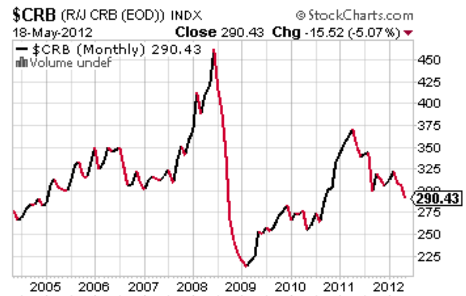
Bernanke’s Fed is currently engaged in all three sins listed above, and, since holders of dollars can no longer redeem their notes for gold, they exchange them for gold in the open market instead. A cursory look at the gold price reveals it has been in a parabolic uptrend for the past ten years as global central banks become ever more illiquid and insolvent.



Chairman Bernanke is free to state that a gold standard is impractical, and the market is free to ignore him. In February of 2011 J.P. Morgan began accepting gold as collateral, joining CME Group and other clearing houses. Last May the EU's Committee on Economic and Monetary Affairs agreed to allow central counterparties to accept gold as collateral. It is rumored that Greece had to pledge their gold reserves as a condition of the latest bailout. Most recently, Iran has been negotiating oil sale agreements in gold with India and China. Gold is reentering the monetary system, despite ethereal Princetonian theories to the contrary.

Even as gold continues to consolidate, and gold stocks dive into depressionary levels, sovereign purchases remain robust. According to the IMF, in March Russia added 17 tons to its reserves, Mexico 16 tons, Turkey 11 tons, and even (or especially) Argentina added 7 tons.

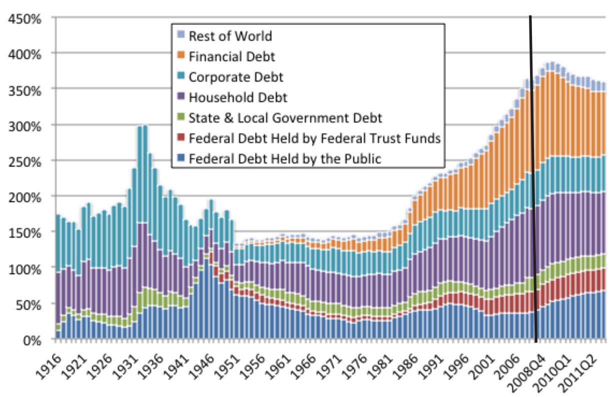
These countries are not buying gold because of what has happened to the value of their Treasury bonds. As the chart at right shows, commodities priced in dollars are virtually unchanged from where they were eight years ago. The next chart shows that the yield on the 10-year Treasury has plummeted during this time, increasing the value of previously issued Treasuries. American sovereign debt has been a fantastic investment.



Instead, foreign central banks are loading up on gold because of what they know will happen to the value of the dollar once interest rates begin to rise. The empires built on paper (the large banks and the federal government being the worst offenders) will collapse along with the value of their liabilities.

The chart at bottom shows that American debt levels in terms of GDP have barely contracted since the beginning of the crisis. What this chart does not reveal is that over the past thirty years this debt has been refinanced at ever lower interest rates. Any uptick in rates would increase the burden of this debt and cause the whole financial system to freeze.

Total Debt to GPD Ratio



Notes: Pre-1960 data from Series X 393 of Historical Statistics of the United States Colonial Times to 1970. Post-1950 data from The Federal Reserve Flow of Funds Report. Annual data through 2007; thereafter quarterly data.

As Paul Brodsky of QB Partners pointed out in a recent interview, the debt burden is \$53 trillion, but there are only \$2.7 trillion of base money with which to service interest and amortization payments. The Federal Reserve must create new dollars at a sufficient rate in order to keep societal debt payments current. If it does not, then the economy becomes squeezed as borrowers scramble to find dollars with which to maintain their loans lest they default and lose their claim on their assets.

It was a reasonable bet, especially in this context, that the Federal Reserve would continue its 100-year tradition of juicing the economy during an election year. In fact, Goldman Sachs and Pimco continue to predict that the Fed will ease as soon as but no later than June, since enhanced money printing between July and the election risks a serious political backlash that might undermine the Fed's independence.

The market seems unconvinced. Gold has reached new 2012 lows as the broader markets stutter. There is still a chance, since Bernanke well understands that Fed action is more potent when it surprises the market, as a June printing would. But, if the Fed does not act, the markets would have to survive without monetary stimulus through the election, and that could cause a market crash and complicate Obama's reelection prospects.

In particular, not acting would test one of Bernanke's main theses. One of the recent debates in economic circles is whether prices and interest rates respond to *stock* or *flow*. Bernanke's assumption is that, given efficient markets, the market can foresee how many Treasuries exist and will be issued. Therefore, when the Fed announces it is buying a certain number of Treasuries over a certain period of time, prices immediately adjust to the new, lower anticipated *stock* of Treasury. When the program ceases:

> our expectation is that, at whatever point that the purchases end, that financial markets being quite forward looking will have anticipated that, and that the effects ought to be moderate.

Bernanke seems not to have noticed the correlation between rising markets during money printing and falling markets when the printing stops. In fact, the behavior of the markets would support the Austrian economic contention that an inflationary economy requires an increasing *flow* of money printing to remain stable.

Markets may anticipate, but when the interest payment is due and the margin clerk is calling, views of the future become irrelevant: assets must be sold. Fortunately for the long-oriented speculator, Bernanke is likely to rescue markets if they fall too far. As he testified in late April:

> Of course, we'll continue to monitor the situation, and if we believe that financial conditions for whatever reason are inconsistent with our macroeconomic objectives, then we will act to fix that.

When the next crisis comes, as it must, the central banks of the world will face the same choice as in 2008, only on a larger scale. They will have to decide whether to allow the major banks to fail, wiping out trillions of dollars of paper wealth and plunging the globe into a 1931-style bond market failure depression, or to print money on an even larger scale.

That crisis may be here now, which, perhaps, is what the gold markets have been telegraphing for months. Last week saw a mini bank run in Greece, with depositors pulling cash from the ATM machines, and rumors of similar withdrawals in Spain. Currency withdrawals are highly deflationary, especially when a banking system is levered 17-to-1 as in Greece or nearly 20-to-1 as in Spain.

But, currency is small change. The real movements of capital occur by electronic transfer from periphery banks to German banks. When a Greek depositor wires money to his account in Berlin, no money actually moves since the definition of "money" is no longer a physical asset such as gold, but an ethereal concept recorded in electrons on a hard disk somewhere.

The Greek bank shows the transfer as a liability on their books to the Greek central bank, which then shows a liability to the ECB. The German central bank records a claim on the ECB, and then grants a claim on itself to the destination German bank. Normally, to balance the claims and liabilities, the German bank would lend money either back to the Greek bank directly or through intermediary banks. As this money travels back to the Greek bank, the central banks' liabilities to each other are unwound.

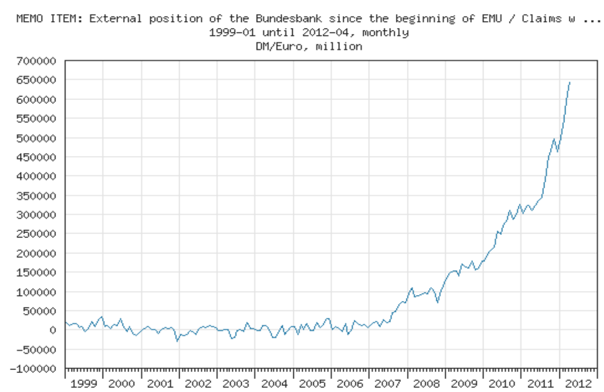
As explained by the President of the Bundesbank Dr. Jens Weidmann:

> Prior to the financial crisis, these [central bank] balances more or less offset each other. . . . With the onset of the financial crisis . . . private sources of funding, including the interbank market, contracted, were regarded as too costly or all but dried up.

In other words, interest rates would have risen and toppled the insolvent borrowers. So, the EU monetary authorities decided to leave the assets and liabilities unbalanced.

> Whereas before [the crisis, the ECB] provided only the bare minimum of central bank money, the Eurosystem has now largely taken over the liquidity functions of the interbank market and other cross-border capital flows. . . . This was possible because the Eurosystem has progressively expanded its provision of liquidity since the onset of the financial crisis, now providing unlimited amounts (full allotment), at low interest rates and for significantly longer maturities. At the same time, the Eurosystem has perceptibly lowered its collateral standards, e.g. for ratings.

The end result is that euros fleeing to the perceived safety of German banks have created a huge imbalance between direct liabilities of the banks to their depositors and their assets made up of derivative claims against periphery banks. The graph at right shows the current size of these "Target2" "assets" just for the Bundesbank to be €644 billion. As of March, the Bundesbank had total assets of €1.002 billion.



Dr. Weidmann argues: "As I see it, the Bundesbank's Target2 claims do not constitute a risk in themselves because I believe the idea that monetary union may fall apart is quite absurd." He wrote this on March 15, 2012. It gets better:

> Whether and to what extent losses arising from liquidity provision actually impinge on the Bundesbank's balance sheet does not depend on the volume of the Bundesbank's Target2 claims. This is also true for the hypothetical scenario, which has sparked much public debate, of a member state with a negative Target2 balance potentially exiting monetary union. Even in such a case – which I consider to be highly unlikely – the risk remains rooted in the nature and volume of the liquidity provision. This might result in partial defaults on the ECB's claims. However, any losses sustained by the ECB would have to be borne jointly by all Eurosystem central banks, irrespective of the size of their Target2 balance.

In other words, the Bundesbank's claim is not directly on Greek banks, but on the ECB's balance sheet. Weidmann is saying that if Greece drops the euro, then Germany will not bear the full brunt of the default because Italy, Spain, Belgium, etc., will bear their share.

In 1933, Barrons wrote:

> It has been aptly observed that the stages of deflation since 1929 have been the flight from property (chiefly securities) into bank deposits, next a flight from bank deposits into currency, and finally, a flight from currency into gold.

The Greek stock market has lost nearly 90% since October 2007. The money fled first into Greek deposit accounts, and then to German deposit accounts. Long lines at ATMs in Greece and Spain reveal the beginnings of the panic into currency.

The only way to support a bank losing its currency is through allowing the books to go unbalanced, as the Target2 graph demonstrates, and/or the wholesale printing of currency. Already, Citigroup's chief economist Willem Buiter has begged for "helicopter money drops." Even the normally sober Ambrose Evans Pritchard of the Telegraph writes: "A world slump is preventable if leaders act with enough panache . . . by launching mass purchases of assets outside the banking system." The model is Japan, which just boosted its asset purchase program to 40 trillion yen, including purchases of common stocks and equity ETFs. It is hard to imagine these actions would not accelerate the flight from currency into gold.

On the other hand, if policy makers fail to act, then the paper empires beyond Greece will collapse. Nominal values will at first sink, with broader markets mimicking the returns of the Greek stock market. Then, as central bank balance sheets (burdened with phantom assets) themselves crash, values will at some point shift suddenly and dramatically to physical assets. This will herald gold's parabolic rise, which will occur in the context of rising interest rates that return values from the reckless to the prudent.

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