Myrmikan Update

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The Long Monetary March

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Long ago in ancient China, a counselor warned his emperor:

> 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.

At the 2013 World Economic Forum in Davos, more than two thousand years later, Icelandic President Olafur Grimson remarked:

> One thing we learned after the collapse of the banks in Iceland is that the Icelandic banks, like the British and American and other banks, have in fact become hi-tech companies – hiring engineers, mathematicians, and computer scientists – and when they failed, the innovative sectors our of economy, the IT sector, hi-tech sector, in fact blossomed and have been doing much better in the last three years than ever before. So the lesson of that is, if you want your economy to be competitive in the innovative sectors of the 21st century, a strong financial sector that takes the talent from these sectors is, in fact, bad news . . .

Human nature does not change, nor does the nature of institutions. The Siren song of wealth without toil ever tempts the counterfeiter. But, effort diverted toward creating money inhibits the creation of the wealth which the money is supposed to represent. The financial crisis is the reconciliation of one to the other.

In our fractional reserve banking system, Federal Reserve Chairman Ben Bernanke is not the only one who blows the charcoal: private banks create dollar deposits against collateral pledged by borrowers. The dollars, once created in this manner, have the full faith and credit of the United States through the FDIC, however shoddy the banking practices that created them. This would be as if the underweight, counterfeit copper coins of ancient China could be exchanged at the palace for face value into standard coins. The counterfeiters would soon be rich, the state broke, and the economy in shambles: more or less the current state of affairs.

Having grasped this pearl of ancient wisdom, President Grimson pondered:

> Why are private banks not, like airlines and telecommunication companies, allowed to go bankrupt if they have conducted in an irresponsible way. The theory that you have to bail out banks is a theory

> about bankers enjoying for their own profit the success and then letting ordinary people bear the failure through taxes and austerity, and people in enlightened democracies are not going to accept that in the long run.

Private banks have not been allowed to fail because they have threatened politicians with withholding favors and the public with economic armageddon if their debt-money is not fully supported by the state. Consider JP Morgan Chase CEO Jamie Dimon's recent statement at the Council on Foreign Relations:

> The catastrophe is that if you have a default of Greece before you have a firewall for Italy and Spain, there is a very good likelihood you could have a run on the banks in Italy and Spain. Italy and Spain don't have the wherewithall to stop the run on the banks. They need the money – they can't print euros – they have things called central banks, but they can't print euros, which puts them in a very difficult position. And that's why you need a banking union or an FDIC deposit scheme.

The message is clear: Europe must print sovereign obligations to support the bank-money. And print they will. Former Goldman Sachs ECB President Draghi has promised whatever quantity of Outright Monetary Transactions be required to save the euro. Ex-Goldmanite, former Governor of the Bank of Canada, and current Governor of the Bank of England Mark Carney announced at Davos that he also stands ready to save bankers:

> There continue to be monetary policy options in all the major economies. Those have to be framed in the context of [pause] the mandate. The mandate is a decision of [pause] the democratic, uh, you know, it is a decision of the, uh, government or, in the case of the Eurozone, it is the decision of governments through the constitution.

It is rare for a high official to trip so visibly while trying to link the concept of democracy with the current authorities, and Carney's verbal stutter was compounded by a factual error: the constitution of Europe was never ratified, having failed in two referendums, and instead was implemented most undemocratically by the Treaty of Lisbon.

President Grimson may be correct that people in enlightened democracies may not accept the wholesale appropriation of wealth by bankers and destruction of the economy, but the Western world has strayed far from democracy and even further from the Enlightenment, and its governments now grasp for power through vast, incestuous, corrupt bureaucracies typical of declining empires. It is precisely in such environments that bad money thrives.

In fact, bad money can only exist where an oppressive state attempts to control the market. Many are aware of Gresham's Law that bad money drives out good, but few understand the law applies only in a context in which the state mandates that one type of money be overvalued and another be undervalued. When heavy and light coins are given the same credit, the light coin is spent and the other kept. Without legal tender laws, however, Gresham's Law works in reverse: the market won't accept the debased money, and there is no incentive for private or public agents to counterfeit.

The progression of stable money, to inflationist policies, to economic and government collapse, and then a natural return to good money is a pattern so familiar across times and cultures that no theory is needed to predict the sequence.

Although the first of these progressions in terms of paper money occurred during the Sung Dynasty in China, roughly a thousand years ago, policy makers seem unable to learn from history. Paper money in China began as warehouse receipts for essential items such as rice due months in advance. The claims would circulate as money until they neared expiration, at which point they would flow towards the relevant merchants, and new warehouse receipts would be issued. Because they were constantly expiring and being reissued, all the time backed by real goods in or en route to warehouses, there was never any threat of over-issuance.

These warehouse receipts were similar to the pre-20th-century real bills market of Europe. Under that system, for example, a wholesaler buys from a manufacturer on 90-day terms, and then sells to a retailer a month later also on 90-day terms. The wholesaler thus owes money to the manufacturer a month before he has collected from the retailer. Before banks existed, the wholesaler would pay the manufacturer with his bill on the retailer. These bills would circulate as money, constantly expiring and being reissued, but always in direct proportion to the level of trade.

Writing in 1761, Edmund Burke extolled the beauty of these systems: “Real money can hardly ever multiply too much in any country, because it will always as it increases be a certain sign of the increase of trade, of which it is the measure, and consequently of the soundness and vigor of the whole body.”

In ancient China, as later in Europe, the system was so successful that soon receipts for money itself also began to circulate. Like the 17th-century Bank of Amsterdam, the sole function of private Chinese banks was to accept metallic money and issue notes against it. Writing in the 14th century, Chinese scholar Wang-k’i records:

> If the law of redemption shall be carried out an equal amount of copper money should be deposited when notes are issued, as it was when in Sse-tsuen for the first time bills of exchange were emitted. The *private persons* [emphasis added] who managed this issue took care that the notes came in when the money when out, whereas when the notes were issued the money deposited, and in this way metallic money and notes circulating side by side measured all merchandise of the empire, and in those days there was not the least reason why they should not circulate.

Unlike agricultural commodities, which decay, forcing warehouse receipts to be constantly renewed, metallic money is more temporally liquid, meaning the notes can remain in circulation indefinitely. Moreover, since the liquidity of fully backed bank note exceeds that of metallic coins, the notes are rarely redeemed. The pile of unwanted metallic collateral is a temptation too strong to ignore. Banks sooner or later always emit unbacked notes, expanding the money supply, generating a credit boom. The government witnesses this alchemy of money from nothing and insists on its take, expanding the state.

Eventually, the credit fueled boom turns to bust, and the state must resort to the printing press to fund its continual growth. As Burke further observed:

> this paper money may and does increase, without any increase of trade; nay, often when trade declines, for it is not the measure of trade of the nation, but of the necessity of the government. It is absurd and must be ruinous, that the same cause which naturally exhausts the wealth of a nation, should likewise be the only productive cause of money.

Whenever the state tinkers with the value of money, setting interest rates, enforcing price controls, or outlawing competitive money, the clever and connected profit while others are misled by the false price signals into making transactions that dissipate their wealth, diminishing social cohesion. As a Chinese commentator observed in 140 B.C.:

> To receive back only one piece for the value of two pieces [because of inflation] is more painful than being beaten with a whip and cudgel, or being imprisoned without knowing why. Even more than the grief of such a treatment, it makes that nothing is henceforth to be relied upon.

Without proper price signals and ability to rely on contracts, economic coordination and division of labor must fail. The wealth exhausted, the bust intensifies, and then no one wants the proliferating notes that have lost their backing. As Wang-k'i lamented:

> But in the present time they do not know how heavy they shall make the punishments, simply to compel the people to circulate the notes, but in proportion as the punishments became more severe, the use made of the notes became less, and this resulted at last in their not being current any longer and their circulation being out all at once.

Eventually social disorder compels the dissolution of the state, or at least abandonment of the oppressive laws. Gresham's Law then works in reverse: the market revives sound money, and the economy recovers.

By studying history and recognizing the progression, the investor can gauge his position and confidently predict the future, as did Wang-k'i:

> But now the paper money circulates, and the quantity of metallic money is little, the result of this will be, not only that no commodities are to be had or to be seen, but also will it be cause that even no metallic money will be had or seen any more. But since corruption and misery of ancient and modern times have succeeded each other till this very day, it has always been that when matters had reached climax, a change was nigh . . . when the paper money is now abolished it may result in the re-appearance of the stored up metallic money.

In fact, the paper money was abolished and metallic money did reappear after the collapse. And, such was the trauma, for hundreds of years no Chinese would accept anything paper as payment. But, inevitably the cycle begins again.

A French diplomat visiting China, wrote in 1869: "Notwithstanding it is no legal tender, it is everywhere accepted and seldom it occurs that the bills issued by some bank or other circulate at a discount." The translator of the Chinese texts quoted above, writing in 1877, helpfully added: "Considering the history we have related this statement in my opinion might be reversed and run: Because it is not legal tender and because it is no concern of the State it is generally accepted as money."

This little history well highlights the cycle of paper money and brings into relief our current situation. The problem is not that private parties are able to create money, it is that the state mandates that all such money, and its own, be valued equally. A race to the bottom ensues, the most wicked becoming the richest.

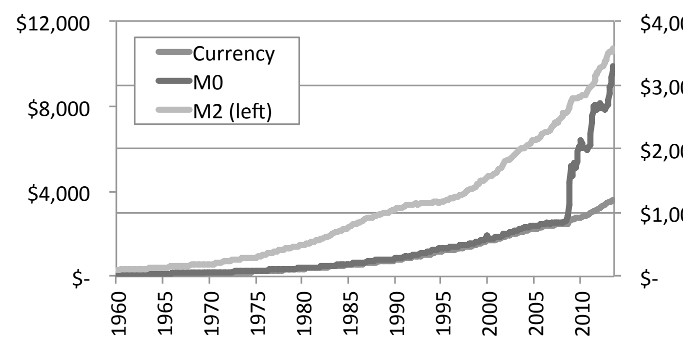
In a speech on February 7, Fed Governor Jeremy Stein described how the banking system no longer waits for retail customers to take out loans to create new money, that process being too inefficient to feed bankers' avarice. As he explained:

> The insurance company might approach a broker-dealer and engage in what is effectively a two-way repo transaction, whereby it gives the dealer its junk bonds as collateral, borrows the Treasury securities, and agrees to unwind the transaction at some point in the future. Now the insurance company can go ahead and pledge the borrowed Treasury securities as collateral for its derivatives trade.

This is why the notional value of derivatives stands over a quadrillion dollars: derivatives are the product of converting private bank debt into a sovereign promise. The dealer collects the higher yield of the junk bond while retaining ownership of the Treasury, and the insurance company gets to use junk converted to triple-A credit to create new financial instruments. For the financiers, this is truly the Keynesian "miracle of turning stone into bread" since both win. But derivatives are a zero sum game. If both parties to the transaction win, there must be a third party who loses.

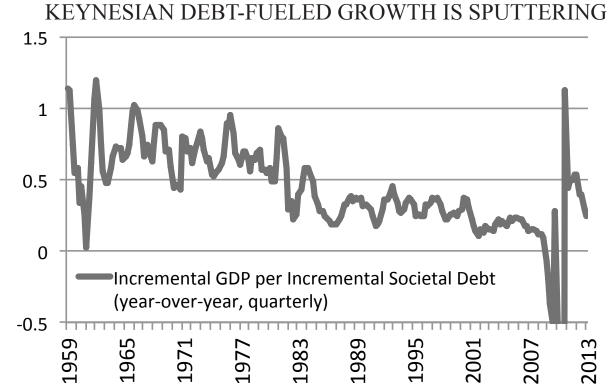
When the daisy chain of derivatives teetered in 2008, the Fed pledged over $16 trillion to support it, for otherwise the entire financial system would have collapsed. But, in doing so, the Fed made good both sides of the derivative bets, transmuting the bad money into a sovereign liability. The general public were the losers: they were made to pay *ex post facto* for the bilateral gains of the bankers. In fact, the Fed had no choice. Those running the banks had long since withdrawn their profits, converting them into ownership of other assets, so the bad money backed the deposits of the retail customers.

MONEY GROWS PARABOLICALLY



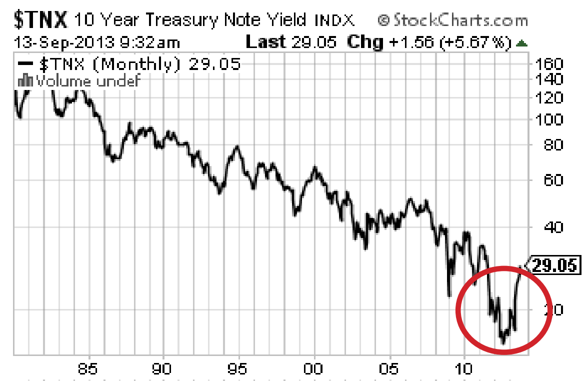
The problems have gotten worse since 2008, not better. Money is still growing while the economy stagnates. The Fed will be continually tested to see how much of the bad money it will back. The new "bail-in" policy of Europe and the U.S., post the Dodd-Frank Act, is an effort to save the official money from more dilution. But, the tipping point has been passed. The Fed's balance sheet is awash with toxic mortgage-backed securities, the bad money of private actors, and worthless 30-year Treasuries, the bad money of government.

KEYNESIAN DEBT-FUELED GROWTH IS SPUTTERING



Source: United States Department of the Treasury

The boom is over. Incremental debt no longer stimulates the economy and merely widens the gap between money and wealth. With the regulatory capture of the state by the major banks complete, the bankers will continue to melt and cast while productive fields remain untended.



And the paper money, which, as Wang-k'i tells us, enables "the grand khan to spend outrageously," is being rejected. Congress cannot spend if no one will accept its money. Few have noticed that Treasury yields bottomed over a year ago, even while the Federal Reserve purchases $85 billion per month in duration risk, and even fewer understand that a credit-based economy requires not low rates but falling rates. How heavy will they have to make the punishments to compel the people to accept government IOUs? But, even so, the use made of them will become less.

As Wang-k'i anticipated, the metallic money is going into hiding. The various depositories of gold in the ETFs and at the COMEX have seen sharp declines. Western financial commentators interpret as a rejection of gold as the paper price falls, but gold isn't consumed. If gold leaves one hoard, it enters another. Western gold is being shipped to the East.

Once specie goes to the East, it does not return. The Romans discovered this more than two thousands years ago. Chinese and Indians were happy to export silks and spices, but had no interest in Roman goods. They accepted only silver and gold, draining the West of money. In fact, there was a good economic reason for this absorption of metal.

Ancient China had plentiful copper deposits, but very poor gold and silver mine supply, the reason copper served as the basis of China's money for thousands of years. Because copper is useful, many emperors tried to convince their subjects to use iron money instead, with disastrous consequences:

> But now there arose another difficulty. Every one could easily get iron, and as the government itself could not resist the temptation to make large profits by the casting of money, false coining was greatly promoted; so that, when that iron money had been in use about ten years the circulating mass of it was like a mountain. The price of all commodities rose rapidly. Henceforth exchange was effected by cart-loads of money without caring for the number of the coins, and who quarrelled for a single string of 1000 pieces?

Since silver's liquidity profile makes it better money than copper, the Chinese absorbed as much Roman silver as they could, freeing the copper for other uses. The utility of liberating the copper for commercial use far exceeded anything the Romans could export.

Nearly two thousand years later, the British repeated the Roman experience, sending durable silver to China, which was absorbed into Chinese money supply, in exchange for consumable tea. Facing a large and growing trade deficit, the British resorted to getting the Chinese hooked on Anglo-Indian opium to equalize trade and had to invade China twice when they tried to kick the habit.

Americans are unwittingly repeating the Roman and British experience. For more than a decade China has shipped the West consumable trinkets while we had them hooked on Treasury bonds. But, like the Arabs in the 1970s, the Chinese have discovered the best use for overvalued dollars is to exchange them for gold and other commodities.

As volatility in the bond market, engendered by the Fed, creates stresses in the banking system, margin calls have sent the prices of gold and silver tumbling well below true value. The Chinese and Indians are scooping up as much as they can while the sale lasts. When the current liquidity squeeze ends, there will be that much less gold in the West to speculate on, with that many more dollars issued, so prices will have to reset correspondingly higher.

Gold will continue to vanish into private hoards against the day that "even no metallic money will be had or seen any more." When the paper money is finally abolished, Gresham's Law will cause the market to reject all substitutes for wealth. Only metallic money, valid claims on metal, warehouse receipts for goods, or real bills will have purchasing power or command assets. Gold mines will once again be viewed as mini-central banks.