March 2011

In May 2007 we wrote a lengthy piece called "The Value of a Dollar" in which we argued the following:

> *"Consistently excessive money and credit growth has taken the US economy past the point of no return. What (policy makers) have done consistently - and will continue to do - is inflate the money supply and promote more credit, thereby sustaining asset prices at the expense of the purchasing power of the US dollar. We argue the US dollar will ultimately lose its status as the world's reserve currency. In fact, we believe events currently unfolding may be foreshadowing the dollar's eventual demise and replacement."*

This paper updates those views and provides further perspective.

Apropos of Everything

By Lee Quaintance & Paul Brodsky

> *"Truth is tough. It will not break, like a bubble, at a touch. Nay, you may kick it about all day, and it will be round and full at evening."*
>
> \- Oliver Wendell Holmes, Sr.

Each passing month brings wider and deeper global economic imbalances accompanied by what we perceive to be a general misunderstanding of their cause and impact. The source of these imbalances is the global monetary system. It continues its trend towards demise, as it must, and current events indicate an acceleration of this trend.

The current monetary paradigm was structured and developed over the twentieth century *by* liberal democracies *for* liberal democracies that, through unified sovereign management and coordination, controlled the perception of value and how the free world would account for it. The system was not structured to accommodate the dynamic shifts in global economics, trade incentives and political alliances brought about, ironically, by the consequences of democracy's triumph and the emergence of large, formally closed economies into the global economy.

Serious consideration as to the inadequacy of the current regime has not been addressed since the onset of credit weakness in 2007, which was and remains a manifestation of a broader currency problem. Widely differing economic incentives and political agendas in developed and developing economies further suggest that a new, unified monetary system is highly unlikely without substantial friction first. We suspect broad acceptance of a new system will ultimately come only after manifest crisis. "An event"; however, is not a necessary condition for the demise of the current monetary regime or, for investors, substantial asset revaluation. This paper discusses:

1. **Allegory of the Cave**: *The current global monetary system – how it works and how it differs from the monetary system as it is widely perceived, the incentive structure of various participants in the system, and the natural pressures on it to fail and change*

2. **Best Intentions & Unintended Consequences**: *The new monetary regime we suspect the consensus of global policy makers would like to have, and why it will not happen*

3. **Devaluation & Transformation:** *The next global monetary system, and the implications for assets and wealth*

This report includes section 1 only. Contact Paul Brodsky (pbrodsky@qbamco.com) for sections 2 & 3.

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Allegory of the Cave
The current global monetary system – how it works and how it differs from the monetary system as it is widely perceived, the incentive structure of various participants in the system, and the natural pressures on it to fail and change

In Plato's Allegory of the Cave, it was suggested that men forced to face a cave wall their entire lives would see only shadows of figures behind their backs. That they could not see the actual figures led them to believe, without doubt, that the shadows were reality and that no other reality existed. We use Plato's allegory to describe the stark difference separating contemporary wealth, money and the exchange of economic value from erroneous popular perceptions of them. The fundamental difference is profound and has led to an environment in which economic, financial, political and even social incentives have been greatly distorted and broadly misunderstood.

Monetary Dynamism

In 1913, the US federal government became responsible for sponsoring one fungible US currency, replacing the previous system of disparate individual banknotes issued by independent banks. Treasury gave the Federal Reserve System, a new privately-owned central bank created by Congress, exclusive rights and discretion to print and manage the supply of Federal Reserve Notes, now colloquially referred to as "dollars". In that same year, the government instituted a federal income tax payable only in dollars (1% of income), thereby ensuring the dollar's broad adoption.

Dollars were made exchangeable for gold at a fixed price of $20.64/ounce, which was meant to enforce monetary discipline on the banking system. This was thought necessary because excessive credit extension or money printing would dilute the purchasing power of each dollar, in turn giving incentive to dollar holders to exchange their dollars for scarcer gold. As bank regulator, the Fed was charged with making sure US banks kept adequate reserves to satisfy potential demands for gold in the event confidence in the dollar declined.

It did not work so well for the Fed (or, consequently, anyone else). From 1917 to 1929 the US monetary base grew quite substantially and bank reserve ratios declined by 50%. The credit and asset bubbles this produced led to a bust in 1929, a sudden re-marking of asset values to reflect lower credit valuations, and economic dislocations resulting from the underfunded lending system. The monetary discipline of the gold standard had been bypassed throughout the 1920s by banks and regulators through acceptance of a policy of *unreserved lending*, not only in the US but Europe as well. (We discuss this in more detail below.)

Despite this, the US dollar would become the world's reserve currency. The US entered the two world wars after other economic superpowers had already run up substantial debts. America benefited from heavy exports, much of it in food and munitions during the wars. In addition, the US offered potential dollar holders deep capital markets, an established court system, and a powerful military. Finally, and perhaps most important, the US had accumulated over 21,000 metric tons of gold, far larger than any other nation.

As World War II drew to a close dollars were broadly used in non-US bilateral trade, held in reserve by global businesses and official accounts, and the primary currency used to quote the global exchange of goods, services and assets. Thus, the US dollar was firmly established as the world's only reserve currency and its hegemony was unchallenged. In 1944 in Bretton Woods, New Hampshire, the US and the UK framed a new monetary order intended to govern commercial relations among free market economies in the post-War era. The most important outcome of Bretton Woods was that major global currencies would be exchangeable into US dollars, which in turn would be exchangeable into gold at $35.00 (President Roosevelt devalued the dollar to $35/ounce in 1934).

This system would ostensibly maintain currency discipline among global sovereign trade partners. Again, if they did not practice sound money policies then they would see their currencies exchanged for gold. However, once again the Bretton Woods system did not address the fundamental flaw that allowed governments and banking systems to ignore the gold-exchange discipline -- fractional reserve lending, which allowed lending institutions to continue synthesizing future demand for money by issuing credit that would not have to be exhausted. This allowed all governments and banking systems to more or less cheat together, to manage money and credit growth beyond (or in spite of) contradictory natural commercial incentives. (We discuss this in more detail below.)

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In 1961, Yale economist Robert Triffin warned that a national currency that also serves as an international reserve currency poses natural conflicts for its policy makers, who must navigate both domestic and international aims. The specific dilemma would be that the flow of dollars into and out of the US could not occur at once to meet opposing objectives, and would thus create a wide and unsustainable negative balance-of-payments account for the issuer of the reserve currency.

Indeed in the late 1960s, US trade partners began exchanging their dollar reserves for official US gold holdings after the US ran significant deficits from costs associated with domestic preferences -- executing the Vietnam conflict and expanding entitlement programs. In 1971, after US gold reserves had already been depleted from over 21 thousand to about 8,300 metric tons, President Nixon defaulted on the dollar/gold exchangeability feature negotiated in 1944 at Bretton Woods. Dollars and all other global currencies had officially lost their *asset-backed* status. A *debt-backed* monetary system had begun.

And so began the modern era in which there would be no explicit or implicit monetary discipline. Public, for-profit banking institutions had a license to effectively print the coin of all realms. Since 1971 commercial banks have been able to lend money into existence by issuing unreserved credit. Since the 1980s, investment banks have also been able to do the same thing, by marketing structured fixed-income product to bond buyers through a “shadow banking system”. By issuing debt without practical limitation governments could also spend without fear of immediate budgetary discipline. The combination of a fractional reserve lending system and a debt based currency was the perfect recipe for a super-cycle of credit boom and bust. Thus explains 1971 to 2011.

The only thing more certain than periodic change in monetary regimes (1913, 1944, 1971…) is the predictable pervasive certainty that it will not occur. This time is no different. History and current conditions make a new global monetary order a certainty and current conditions show clearly the transformation has already begun.

Money, or So it Seems

US dollars are debt, technically (Federal Reserve notes) and in practice. Their ongoing value is supported by a system of government oversight that ultimately relies upon convincing private counterparties to use them in transactions. As all modern global currencies are directly or indirectly benchmarked to the US dollar, they too are unreserved debt, literally and functionally owed by sponsoring sovereign governments and backed by the full faith and credit of their taxpayers.

The fundamental question all global commercial counterparties must answer upon each transaction is: “will my currency maintain its purchasing power until the next time I need it?” If a quorum of economic counterparties begins to answer negatively, the currency in question will soon lose sponsorship and fail.

The US government will sponsor about $2.7 trillion (after QE2) in *base money* (currency in circulation plus electronic bank reserves held at the Fed). Though we and many others continually note how much the quantity of base money has risen (up from about $850 billion in 2008), the newly-bloated quantity of base money still remains vastly insufficient to settle all dollar-based transactions. A generally-accepted system of credit extension and debt assumption has filled the void separating the quantity of base money and the perceived exchange of value for wages, goods, services and assets. This is a system of financial leverage posing as money. (See “Leveraged Debt”.)

In economies allowing lenders to create credit (and thus systemic debt) with little regard for their own reserves, actual money needed to back that credit (to repay the debt) must be created in the future. The money simply does not exist when the credit is created. The more credit issued by the banking system, the wider the gap separating outstanding debt and the base money needed by borrowers to repay their obligations. It is a lending system that must either fail or that must destroy the purchasing power of the currency in which the debt is denominated. *One may draw a straight line from a baseless money system to baseless credit, to boom and bust credit cycles, to overleveraged economies, to credit deflation and then monetary inflation, and finally to monetary system demise.* Indeed, history shows a perfect record of destruction of monetary systems where assets and commerce are valued in baseless currencies.

See Important Disclosures at the end of this report.

Wealth, Money, Price, Value & Inflation

Why can't central banks make everyone rich by printing and distributing more money? Because money that a central bank can create does not create *wealth* (sustainable purchasing power). New money may provide purchasing power to its bearer relative to the value perceived by sellers in exchange; however, an increasing money stock dilutes the purchasing power of each outstanding currency unit. Growth in the money stock has no impact on aggregate wealth and actually makes existing money holders poorer because their purchasing power gets diluted. *In fact, aggregate global wealth cannot be created or destroyed at all, merely shifted.*

Price, or the quantity of currency needed to purchase a good, service or asset, must increase with money creation. Why? Because sellers of goods, services and assets demand the same *value* in exchange for their wares. In an environment of diluting money supply, prices must rise to meet stable value. *So price is determined as much by the supply and demand for money as it by the supply and demand for a good, service or asset it is used to buy*.

Credit is simply a claim on future money. The more credit issued and outstanding, the more claims on future money. The wider the gap separating money from credit, the greater the built-in demand for money production. Thus, money and credit growth literally equals the loss of purchasing power -- which is inflation -- even if it does not yet appear in popular "inflation" indexes. As Milton Friedman taught, inflation is always and everywhere a monetary phenomenon.

Not Inflation

In spite of the indisputable logic above, the link connecting money and credit growth with the popular perception of "inflation" is broadly overlooked, even among most professional economists. In fact, seeking to determine *future price levels* by accounting for current money and credit growth seems to be almost a disreputable theory within the contemporary economics community.

Rather, most economists over the last two generations have been trained in the Keynesian tradition as "political economists". They model the discrete demand for goods, services and assets relative to their supply, within the context of changing fiscal policies, and try to solve for nominal changes in output and prices. Some may consider relative currency fluctuations in their models, but very few consider absolute currency growth. As it relates to the price level, the focus of their work tends to be projections related to the Consumer Price Index (CPI), a subjectively managed index that tracks a changing basket of consumer goods and services. The percentage change in the index has become commonly known as "inflation". "Real" growth is calculated by subtracting the growth in the CPI from nominal output growth (GDP) and "real" returns by subtracting the growth in the CPI from nominal returns.

A Flawed Benchmark Metric Ensures a Distorted Economy

The Consumer Price Index is deeply flawed as a barometer of purchasing power loss. It does not count the growth in the quantity of credit ("when issued money"). Thus, it does not discount latent and necessary inflation (money printing), only manifest changes in goods and services prices. Also, widespread criticisms of its method of interpreting data (subjective reliance on hedonics, use of substitution, etc.) would seem justified. At the very least this subjectivity compromises its integrity as an objective barometer of purchasing power loss.

Nevertheless, the CPI over time paints a fascinating portrait of naïve indifference among professional observers intent on using it. In fact, the graph below showing the CPI over the last forty years illustrates a curiously slow and reliable increase in the index that implies a level of consistency normally not found in physical science, let alone behavioral economics. It is the "science" of winking and nodding that makes contemporary economics so dismal.

The graph also implies a fascinating attribute of modern money -- an engrained acceptance of the loss of the dollar's purchasing power. We know from the lack of public outcry that an entire generation of consumers and investors has not cared about their currency losing 450% of its purchasing power (based on an indicator generally regarded as an accurate measure of inflation). People have been apathetic towards trend level "inflation" as long as wages grew in kind or, in the case of those able to invest, as long as returns-on-assets were perceived to be greater than their sense of purchasing power loss.

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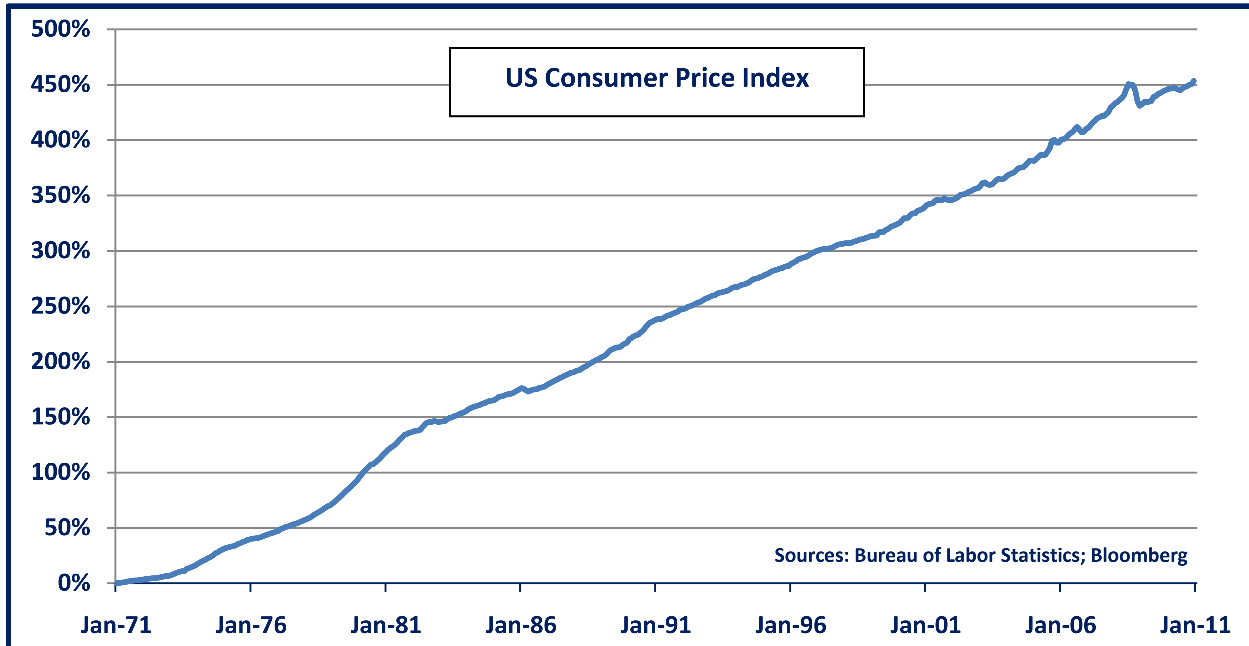

Did wages grow in kind with the CPI? Not quite, judging from the growth in the minimum wage. In 1970, the minimum wage was $1.60/hour and is presently $7.25/hour, a 350% increase.[1] Would benefits have made up the difference? Yes, and then some (but not for everybody). Since 1970, defined-benefit retirement plans gradually replaced defined contribution plans in the US, which greatly benefitted retirees. Pensions tended to be invested in the financial markets. Since 1970, the US equity market grew over 15 times and bonds probably compounded at least over 400%. Assuming pensions were invested half in the stock market and half in the bond market, we can assume that benefits easily made up the difference between 350% wage growth and 450% CPI growth. Thus, Americans have not cared about the loss of the purchasing power of their currency.

There are two obvious issues that should pop out: 1) it has been necessary to invest in appreciating financial assets to maintain one's purchasing power, and 2) investing in financial assets has been unavailable to all workers that comprise the economy's factors of production, and certainly unavailable to all workers in the same proportion. *So then, inflation is a monetary phenomenon produced unilaterally by banking systems that places disproportionate burdens on their societies. Inflation further demands currency holders seek a financial return so that they may maintain the purchasing power from their wages.*

The US dollar has been a store of wealth only if it was invested – not if it was saved. This matters, not only from the perspective of the inequity for all users of the currency, including the majority of wage earners comprising society's factors of production at the lower rungs of the chain, but also from the perspective of the currency looking forward. Can financial assets provide a future return for all users of the currency sufficient to keep the currency viable? We think the answer to this question is a resounding "no".

Inflation, properly counted as a monetary phenomenon or improperly counted as the increase in a subjective basket of goods and service prices, ensures *nominal* equity prices are biased to rise over time. However, financial assets are already encumbered by debt and they cannot produce positive *real* returns when adjusted for the necessary amount of money dilution needed to produce gains. Low interest rates also imply less or negative bond returns. In fact, it seems clear that the only reason the US dollar has been able to remain viable as long as it has given a 450% compounded "inflation" rate is because asset prices have continually discounted future revenues.

[1] U.S. Department of Labor. Web: http://www.dol.gov/esa/whd/flsa/.

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Current debt levels -- the product of past currency discounting -- now ensure that future revenues will be received in increasingly inflated dollars. So not only could wage earners not have saved dollars and other currencies and maintained their purchasing power, wage earners today are compelled to disgorge their currencies even more and replace them with purchasing power hedges.

Inflation is Good…In a Bizarre World

The confusion surrounding inflation continues today. In fact, it has become generally accepted for monetary policy makers to target inflation. The Fed's target is currently 2% and most everyone is rooting for the Fed to achieve this goal. Most bizarre to us is that the debate of the day is whether the Fed will drain enough reserves in time to prevent "runaway inflation". Frankly, we do not know what that means. Inflation is money printing. It has already occurred in record amounts and the yawning gap separating outstanding debt from outstanding money insures there will be much more to come.

By the time observers get confirmation of rising goods and service prices in the CPI basket they will have already been priced out of their purchasing power. Alternatively, if people are concerned about "deflation" (not *draining reserves*, which would be an accurate definition, but a falling CPI), then they need not be concerned. As the graph above shows, any hiccup in the "low and slow inflation" program, such as that in 2008, is met with overwhelming force in the form of true *monetary inflation*.

Trend-level CPI as a policy mandate is almost too strange to contemplate when one considers that it ensures each generation will be stripped of the real value of its production, wages and savings. To date, central bank Zero Interest Rate Policy (ZIRP) and Quantitative Easing (QE) have successfully levitated the CPI enough to save it from its brush with the perception of "deflation". (We can all be pleased its trajectory has resumed apace so that the purchasing power of savings for the next generation will seem to decline as steadily as the last.)

Deflation (money draining or credit deterioration) is strangely not a policy option, perhaps because it would hurt creditors first. However, deflation would force an economy to shift its factors of production towards industries in which it could compete. (We discuss this in more detail in the Section: "A Utopian Economy that Serves to Define the Organic Economic Path".)

The basic lapse in logic that promotes moderate inflation and fears even minimal deflation (everywhere but Germany) has left economists (including at the Fed) in the strange and uncomfortable position of having to openly tout confidence in moderate inflation as the primary economic driver. The goal of discussing confidence seems to be to get consumers borrowing so they can spend and invest more. This new demand, in turn, would grow the economy. We think economists should not have goals at all, other than to accurately understand economic relationships; but if they do, then they are mistaken to necessarily make their goals centered on "growth".

The Harmful Preference for Bigness

Is economic growth always preferable or are there circumstances under which contraction would serve the public good? We would answer this question as follows: *Real* growth is always preferable but *nominal* growth is not. By nominal growth we mean a simple increase in aggregate economic output and by real growth we mean an increase in aggregate economic output *adjusted for the loss of its currency's purchasing power, specifically the dilutive effects of money and credit growth*.

Growth that is not deflated for the purchasing power loss of currency means little. By way of extreme example, in 2008 Zimbabwe's economy contracted almost 19%. In 2009, it grew 5.69%? Why the miracle turnaround? Because its central bank diluted its currency by 231,150,889% over that year to a dollar exchange ratio of over 300,000,000,000,000:1. (The Zimbabwe dollar was effectively abandoned in April 2009 and Zimbabweans have been using foreign currencies ever since.) It was not such a miracle after all. Anyone holding Zimbabwe dollars or assets denominated in them from 2008 to 2009 suffered from doing so even though shares of Zimbabwean stocks were some of the best performers…in nominal terms.

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The purpose of discussing the extreme travails of a small economy like Zimbabwe is to show the dangers of not recognizing the separate pathologies contributing to nominal versus real value and growth. Solving purely for nominal growth or nominal returns can be deceiving and dangerous.

Sophisticated Finance, Unsophisticated Economics

How different is the G7 and its coordinated economic policy apparatus from discrete examples seen recently in places like Zimbabwe, Argentina and Russia? The only difference is in the broad perception and acceptance that the global monetary system managed by large, developed economies is stable because it is in fact *the global system*, and therefore it cannot be an aberration. This fails logic.

There is no denying that outstanding advancements in technology and logistics that began and spread quickly through the G7 in the last generation built substantial *capital* (wealth or resources used or available for use in the production of more wealth). However it remains unclear how widely that capital was distributed or what proportion of assumed wealth that sustainable capital comprises. An economy can appear stronger or bigger simply by synthesizing bigger numbers through currency or credit issuance.

If tomorrow the Fed were to proclaim that each one dollar bill is a three dollar bill, and told merchants they should start charging three times more for their goods and services, told consumers they should expect to pay three times more, told employers they should pay their employees three times more in wages, and so on; then nothing in the economy would have changed except the *numeraire*. Nominal GDP would grow more or less by three times and there would be no change in production, productivity or employment levels. This mind exercise provides insight into how credit-based economies can use inflation to manufacture the appearance of beneficial growth when their societies are willing to judge progress in nominal terms.

It seems the great majority of economists, economic policy makers, and politicians in the West have mistaken nominal growth for capital growth. In classic economics using currencies with fixed exchange rates, nominal growth would almost equal real growth. However, in a global economy wherein all currencies are baseless -- continually manufactured and judged only against each other -- nominal and real growth are two very different things. Nominal growth and asset values are meaningless during periods of substantial money and credit growth – the more money and credit growth, the more meaningless.

Bigger is Not Necessarily…Bigger

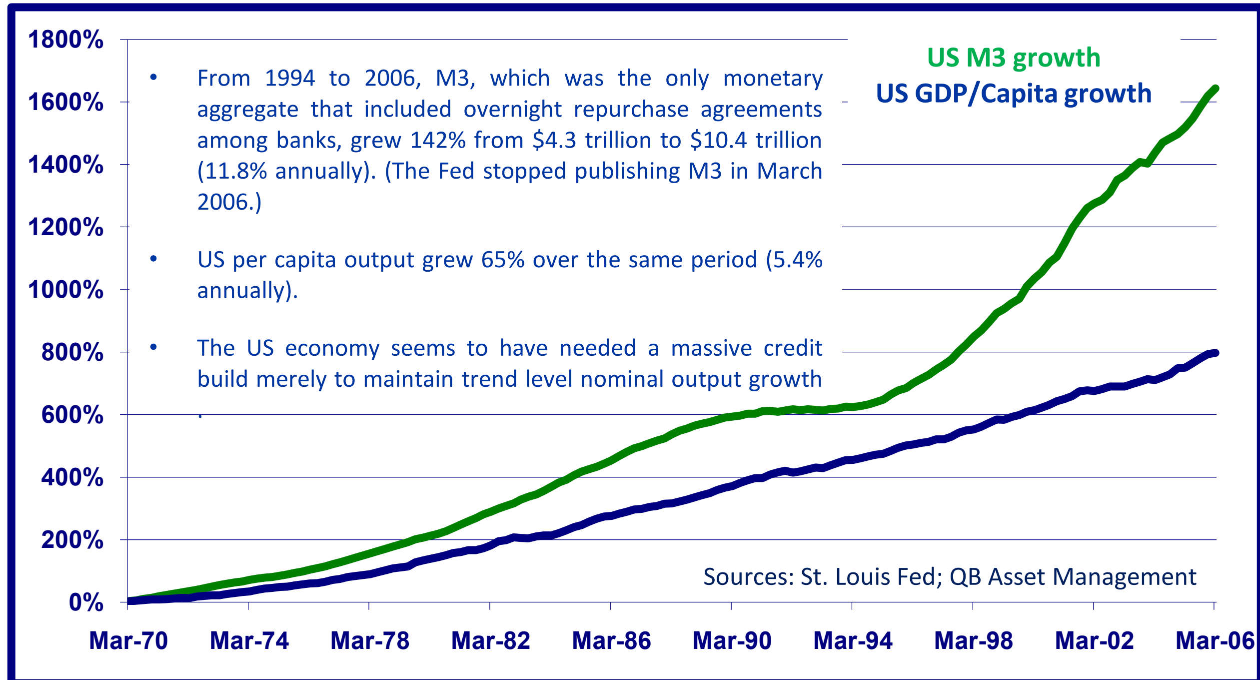
At about $15 trillion in annual nominal output, the United States is the world's largest economy in nominal terms. How big would it be had there been no money and credit growth over the last forty years? Much smaller.

The continuing emphasis on asset prices un-adjusted for money and credit growth is the very reason asset bubbles are blown. After all, the credit must flow somewhere. We reprise the graph below to show how the US economy levered itself through unreserved credit. The green line is the growth in M3 and the blue line is output growth from 1970 to 2006. M3 was the only monetary aggregate that included overnight repurchase agreements Wall Street banks used to finance their balance sheets. From 1994 through March 2006, M3 grew almost 12% annually. (Though Wall Street banks still rely on repurchase agreements to finance their balance sheets, the Fed ceased reporting M3 in March 2006.)

From 1994 to 2006, Wall Street continuously tapped into an ever-increasing supply of *overnight* credit and then helped distribute *term-funded* debt throughout the economy. *From this systemic debt mismatch the entire global economy, using the US dollar as its reserve currency, ultimately became dependent upon the Fed and its ability and willingness to fund its constituent banks overnight. This process provided the nexus upon which the value of all term credit, debt and assets rely.*

From 1994 to 2000 this term credit flowed broadly into financial asset markets. When equity markets blew up in 2000, it flowed into housing. When that credit finally blew in 2007 there was nowhere for it to go except back to the Fed. This is occurring today. So while it may seem that above trend economic growth (and wealth) was created

from 1994 to 2006, we would argue the majority of it did not create sustainable capital and so was not real growth. It was not wealth at all. Unreserved credit was created that would someday have to be reconciled.



While the size of the US economy in nominal terms may be unparalleled, it is very unclear whether it would be the largest economy were it to be judged in terms of annual unleveraged, sustainable capital created (real growth). Further, it seems indisputable that credit needed to synthesize nominal output growth finds its way into financial assets (now including real estate because it is funded through securitization). The finance-based monetary system is the cause of financial asset bubbles.

Meanwhile, the irreconcilable leverage on the US balance sheet suggests that the US and all other economies relying on 1) US consumers for revenues, 2) US dollars as a benchmark for their national currencies, and 3) financial assets denominated in all currencies to produce a financial return that provides positive real savings; are susceptible to a systemic collapse in the current global monetary regime. How did it get to this point?

Economic & Financial Relativism

Why does a bond trader make three times more money than a neurosurgeon? Does society really value a person who can leverage others' future obligations more than and one who can repair three or four lives a day? A reasonable person would obviously place the bond trader with the pro athlete and conclude that in certain circumstances society rewards scarcity over personal preference. So what are the circumstances at play?

In a credit-centric economy it is critical to sustain the general perception that currency is tangible, that it has lasting real value. The easiest way to do this is to use complex models to quantify value. As we have established, currency is debt and so bond traders doing bond math can quantify this abstraction. The problem, however, is that they can only quantify value in relative terms, compared to some future notion of purchasing power loss or to other bonds and currencies. Indeed, it is a rare person clever enough to do math in his head while ignoring systemic leverage that necessarily produces negative absolute real interest rates.

The question of which occupation would be "more deserving" must be an individual one. We get Tom Brady and others get Lionel Messi but few get Stephen Hawking and virtually no one gets (or should get) Billy Bondtrader. Nevertheless, society rewards guys that best leverage other peoples' money – including the neurosurgeon's money. In an economy that rewards leverage, a physician can only leverage her time.

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Wall Street today is a poorly understood concept, even among many of those who work there and report on it. Conceptually, finance is all about helping capital formation, bringing working capital to capital producers. However, intermediating between capital producer and investor becomes a trickier business as capital itself becomes a smaller and smaller portion of an economy.

When the means of financing capital formation outstrips the organic need for capital formation, and the businesses devoted to financing capital formation have incentive to grow, and the policy and regulatory bodies overseeing those businesses give in to short-term political desires, then systemic economic incentives unite to leverage the system. Investment and commercial banking becomes the tool to lever the economy, whether or not capital is created.

How can the financial industry get away with distributing non capital producing financial products when there are two sides to every transaction? Wouldn't the market balk at buying and owning financial assets promising negative real returns? The answer is theoretically yes but practically no. In a credit-based economy where wage earners are insured they cannot save and retain their purchasing power, and where investors become used to owning financial assets, and where direct investors carry leverage on their own balance sheets, and where institutional investors are judged relative to indexes or against each other; the principal objective of *the markets* becomes generating *relative returns*.

This allows sustainable economic fundamentals and financial markets to go their separate ways. Financial gain becomes the highest priority among asset holders and those catering to them. *Maintaining or increasing purchasing power across all economic and market conditions over time* is not a generally-accepted investment objective (boy, the looks we get by suggesting it should be).

This perverse state of affairs shortens investment horizons and gives *the markets* incentive to chase returns. Pressure builds on investment funds to go along with momentum or speculate on momentum reversals. Otherwise their constituent investors will withdraw their money and their fees will decline. Fundamental analysis and assets with sustainable valuations are de-emphasized. Quantifiable measures for risk are hidden as leverage grows and market volatility declines.

Eventually something unforeseen happens, asset liquidity takes priority and most assets become correlated and fall. (Rinse, repeat.) It is all perfectly rational behavior because the "money" invested is in reality other people's credit. The capital markets have little to do with capital creation or creating lasting wealth. They simply make and transfer credit in various forms like stocks, bonds and derivatives.

The Exorbitantly Privileged

Valery Giscard d'Estaing, the French Minister of Finance under Charles de Gaulle in the 1960s, coined the term "exorbitant privilege" to describe the extreme benefits that accrue to the sponsor of the world's reserve currency. The US, he noted, could never be short its own currency and so it never need fear a balance of payments shortfall (or fear missing a coupon payment). Later in the decade, Nixon Treasury Secretary John Connally glibly told his European counterparts that the dollar "is our currency but your problem". It was good to be the king.

Americans can no longer claim sanctuary in its currency. The dollar has become most everyone's problem and privilege may only be enjoyed by a few. When excessive global credit is naturally compelled to contract, as it is today, the most privileged of privileged, the most holy of holies, the most supreme among us, appears to be the world's largest banks.

An objective study of the past shows that this outcome is as it would have to be because banking systems have been at the center of resource allocation in developed economies. Banks lend money into existence by issuing credit that must be repaid in money. *They lend money they have not earned, charge borrowers interest on it, and force borrowers to surrender property if they are not paid*. They used to do this at the behest of kings on behalf of kings, but now they do this with the endorsement of democratic governments on behalf of themselves. As Mayer Amschel Rothschild (1744-1812) famously said: "Permit me to issue and control the money of a nation and I care not who makes its laws."

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Economic Cycles -- A Century of Conditioning

Since 1913, the only limitation on large banks to extend credit has been the approval of their regulators, who in turn answered to their parliaments, who in turn have had to answer to the people…but over frequent election cycles. Political incentives suggest there has been constant pressure on banks and their regulators to continue lending regardless of economic conditions. Meanwhile, the incentive structures of bank personnel and shareholders suggest there has also been pressure on governments to maintain liberal bank reserve ratios. Thus, money had to become a politically-corrupted media of exchange rather than a means of storing the fruits of production.

As a result, credit extension and debt assumption are at the center of Western commerce to an even greater degree than when money was exchangeable for gold. When nominal credit and debt balances expand, so does commerce and economies in nominal terms. Of course credit and debt balances may theoretically contract. This used to happen occasionally when politicians, monetary policy makers and banks were willing to be only *long-term greedy*, allowing occasional and brief credit contractions (i.e. “recessions”). Credit excesses were digested at such times and businesses and individuals would soon come back to borrow, leading nominal output higher. Such credit management describes what most economists have come to view as the “economic cycle”.

Most economic observers in the current era seem to presume that economic cycles arise out of the natural condition of man and his “animal spirits”, which sway back and forth between greed and fear. We believe people do not have incentive to behave this way. Men and women would work and save their wages for future consumption if their wages were denominated in a store of value, not in media of exchange produced and overseen by institutions with incentives to dilute it. Whether or not consumers, producers and investors in society explicitly recognize it, they are given incentive to borrow through the credit build-up phase and they have become conditioned to expect shallow periods of digestion while credit excesses are flushed.

This familiar system was irreparably compromised by the sheer magnitude of systemic leverage that was built into the system by 2006. Underlying commerce became dwarfed by asset and debt values that comprised the system’s balance sheet and which had to support each other. This financial leverage became highly susceptible to small changes in commercial activity, trade patterns, finance rates and demographics. The substantial economic volatility this leverage engendered was further exaggerated by pressures from exogenous economies not beholden to maintaining the credit-centric monetary regime. This state of affairs had to arrive eventually.

Leveraged Debt

	1994	2006	2011	Increase (2006 – 2011)	Ratio to Monetary Base
USD Monetary Base	$431	$842	$2,700*	+220.7%	
Total Public Debt Outstanding (Treasury)	$4,692	$8,507	$14,519	+65.9%	5.4 : 1
Outstanding USD-denominated Claims*			$70,000 *		25.9 : 1

*All figures are in billions. 2011 Monetary Base assumes completion of QE2 in June. Outstanding USD-denominated claims have been estimated and includes all public and private sector debt outstanding (Treasury, mortgage, auto, consumer, corporate, state, and municipal debt, as well as unfunded federal obligations in current dollars.
Sources: USD Monetary Base - St. Louis Fed; Total Public Debt Outstanding - TreasuryDirect.

See Important Disclosures at the end of this report.

Since the functional breakdown of Bretton Woods in 1971, the purchasing power value of dollars has been insured only by the assets of the Federal Reserve System. The Fed's tangible assets are Treasury's official gold holdings, marked at $42/ounce, plus the market value of its premises. Recently it has been forced to expand its balance sheet to include mortgage-backed securities and Treasury obligations. The Fed is not thought to be a credit risk because, even though it is owned by overleveraged private banks, it is implicitly backed by the US Treasury, which may ostensibly collect income taxes in the currency and in whatever amount the Fed can owe.

The magnitude of the systemic leverage that has been created in the US and that continues today is substantial. The top row in the table above shows the US Monetary Base. We can see it almost doubled from 1994 to 2006 and then Quantitative Easing increased it substantially in the last few years. Yet despite this enormous growth in base money, there still is not nearly enough money in the system to repay US dollar-based claims. The second row shows that the Fed would have to manufacture about 5 times more dollars than exist today merely for the Treasury to be able to meet its obligations (which would also presume no one else had base money). This is an obvious problem both fundamentally and for the global perception of dollar hegemony.

The $70 trillion dollar figure in the third row is a conservative estimate of total dollar-denominated claims (others have used over $100 trillion). These claims include Treasury debt and other unfunded federal obligations, as well as mortgage, auto, consumer, corporate, state and municipal debt. Seventy trillion in dollar denominated debt on top of $2.7 trillion in currency and bank reserves with which to repay it means *the US economy is levered roughly 26 to 1*. Certainly the gap doesn't need to close completely – there will always be credit balances larger than the base money stock. So then is a credit-based global monetary system necessarily unstable?

A Truly Unsustainable Regime

One may argue (and most economists implicitly do), that a highly leveraged economy is not necessarily unstable because there would never be a reason to replace all economic activity with actual money or a reason to convert all assets to money. The thinking is that all buyers and sellers of goods, services and assets within the system would never want to settle all accounts and convert everything to cash at once. This further implies that the system can run as long as wage earners accept credit for their labor and asset owners accept credit for their property. It is generally accepted that as long as the popular demand on the currency is only as media of exchange, not as a store of value, then the system can endure. So some argue that credit may be perpetually extended and debt may be continually assumed and economic leverage may be continually built.

This is patently false. A credit-dominated monetary system is inherently unsustainable and must eventually fail. History shows that credit build-ups run smoothly until they are no longer supportable by commerce and the factors of production that produce it.

A credit build-up is a regressive process. As credit permeates through the system driving prices higher, low wage earners reach a point where they can no longer use their wages to maintain their relative standards of living or save their wages to defer consumption. Economic incentives will first drive them to be more productive. Eventually, they too must use credit to maintain their standards of living. Workers struggle to service debt because the growth in wages does not keep pace with the necessary increase in money and credit production. Aggregate consumption in terms of unit sales naturally falls, which forces employers to use less labor. Unemployment rises and a negative economic feedback loop begins.

Ultimately, ever higher aggregate credit/debt balances must require the majority of an economy's factors of production (labor and capital producers) to accept capital redistribution (from indebted wage earners and capital holders to creditors and money leveragers).

During the end of this cycle, property is transferred disproportionally from those with access to less credit to those with access to more credit -- unless the political dimension inserts itself to prevent that, which it inevitably sees as its function. Expedient intervention comes in the form of even more money printing. The purchasing power value of aggregate wages and savings are continually diluted for those working and saving in inverse proportion to the systemic leverage that government subsidizes.

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So in theory and as we are seeing in practice, the current global monetary system is only as stable as the willingness of commercial counterparties (private sector and government) to take on more credit and debt in exchange for goods, services, labor and assets. The great and obvious flaw is that in a credit based monetary system wealth is not gained through labor or saving.

In the end, a decline in confidence in the media of exchange serves to de-leverage the broader economy by collapsing the wide gap separating outstanding claims on base money (debt) from base money itself. The broader risk from this is that the regressive nature of such inequity is destined to be popularly recognized by societies' factors of production – the conditions that typically lead to social unrest.

Managing the Unstable Monetary System

When the markets or economy stumble politicians across the ideological spectrum tend to pressure monetary policy makers for solutions to recapture short term nominal growth, even if those solutions (easy money and attendant financial engineering) may create or deepen longer-term structural economic problems. Exhibit A is the virtual consensus – not even up for debate among rational people – that Treasury and the Fed saved the economy from Depression in 2008 and that doing so was a good thing.

Would we be mad to think otherwise? It is a matter of preference. Treasury and the Fed should not have intervened in 2008 if they wanted a long term fix. Yes, had they not intervened then there would have been widespread defaults, bankruptcies and bank insolvencies, as well as higher unemployment than that experienced. However, if the 1930s are any guide, weak banks including many of the largest ones would have failed, asset prices would have adjusted to provide positive *real* rates of return, wage rates would have been revalued to a more competitive global scale, workers would have shifted towards more sustainable industries, and employment and asset prices would already be starting to rise.

To intervene should not be presumed "a given" but should be recognized as a policy preference that may or may not reflect the preferences of society. Obviously, most businesses and laborers would opt for intervention if and when asked if they would like help in the near term. It is safe to assume then that policy makers are on solid political footing in satisfying the preferences of their constituents by printing money. It is the easy choice.

Would enduring a difficult period of necessary digestion have been worth it? Again, we can debate this hypothetical question but we raise it because it may not be as theoretical as it first seems. We believe the G7 will experience this choice again, perhaps sooner than most think (if the Fed truly does stop with QE2?). With each passing period suspending debt reconciliation the consequences grow greater.

Political behavior should be expected among elected officials. A recent example is the Dodd-Frank legislation that attempted to enforce rules on commerce and market behavior rather than address the root cause of economic imbalances – systemic leverage and the source of it, fractional reserve lending and the monetary system itself. Indeed, getting more credit to businesses and consumers was not only accepted wisdom but a bipartisan objective.

Political calculation also seems to have taken over the ostensibly "independent" role of monetary policy makers who seem to be solving for short-term financial fixes. For example, the Fed is aggressively seeking to further leverage aggregate private sector balance sheets today to increase *nominal* growth and asset prices. The alternative, de-leveraging the system by doing nothing or by actively embarking on more restrictive monetary policies, is not an option discussed seriously. The build-more-credit-to-suspend-asset-and-debt-reconciliation policy is so engrained into conventional policy that "independence" at the Fed is seen as "politically non-partisan", rather than pursuing monetary policies with political agnosticism.

Indeed, monetary policy makers and others have expressed great relief that unlike the 1930s, the contemporary monetary system has more flexible currencies with which to provide monetary support. If it were possible to have a candid conversation with the Chairman of the Fed, we suspect he would defend this support by noting that widespread credit defaults would legally shift ownership of assets from debtors to creditors, beginning with debtors at the lowest economic rung. He might argue this would negatively impact the economy. Though this would be true, it also seems to be more of a political issue about which a monetary body should not care.

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The Fed's True Mandate

The Fed claims its mandate is to effectively stabilize prices (in US dollar terms) within the context of optimal US employment. However, the Fed is only licensed to control the quantity of money and credit and so its ability to achieve this objective is directly linked to the efficacy of changing money and credit stocks on price and employment. Are they always closely linked?

It seems they most certainly are during periods of credit build-ups, when the Fed can control the pace of it. But the two do not seem to be linked in the rare but inevitable period when the population is already highly levered and the credit bust arrives. At these times, debt service takes priority because debtors recognize that the benefit of taking on more debt is small compared to the capital or utility from consumption the new debt would produce.

When the Fed Chairman clearly and repeatedly argues that the most critical indicator of inflation is the expectation of inflation, (as Alan Greenspan and Ben Bernanke have both done), then he is declaring that the Federal Reserve System is in the business of managing expectations, of subjective analysis, of reflexive speculation and preemption. *The Fed is in the business of building and maintaining confidence that adequate growth without punitive inflation is possible and sustainable, in the US and implicitly abroad, and that it can do all this by using its only tool – adjusting the stocks of US money and credit.*

This is not possible as a secular mandate. That the Fed can achieve its objectives is, as they say in diplomatic circles, not completely factual. As with all games of confidence, it is a great and utter prevarication. The public business of the Fed – projecting confidence in such a manner that a quorum of smart people won't question the logic or consequences of its actions – is a pursuit worthy of challenge and likely to be challenged.

In QEI, the Fed manufactured money (a few keystrokes) and then used it to buy assets from the banking system. This was a bailout of "systemically critical" banks, not of private sector debtors. It was openly discussed that the banking system must be strong so it can then lend to businesses and consumers (re-leverage the system). Why then didn't Treasury use the new money the Fed created to send homeowners checks with which to pay down their mortgages? Wouldn't that have served the same purpose and even have been economically stimulative? Instead, the Fed gave newly created money to the banking system to stabilize their balance sheets.

In QE2, the Fed is creating money and giving it to the government. It is telling Congress and the public that inflation is not a worry because it has the means of withdrawing excess reserves whenever it wishes.

The Fed formally denies it is monetizing debt through QE. How can it deny such a charge? By adopting a definition of monetization as a *permanent* swap of new money for debt, the Fed maintains it will drain bank reserves once the economy does not need its help. Indeed, Alan Greenspan recently stood up for the Fed's ability to withdraw "excess bank reserves" on TV. He claimed that the Fed could easily drain reserves prior to bank multiplication of them into more credit that would trigger "too much inflation". We agree the Fed could mechanically drain reserves. But why would it when doing so would engender the exact economic scenario it is desperately fighting today? Why should anyone believe central banks will ever drain reserves when the "economy gains its footing"?

In the end the public debate is off point. The source of instability in the system is a dramatic shortage of current reserves with which to reconcile existing unreserved (unfunded) debt obligations. Debating reserve removal is akin to discussing a weight loss program for an anorexic. So why is the Fed printing money and giving it to the banking system and government? Because helping banks helps its shareholders and helping government helps its overseer.

If the Fed were to sit by idly at a time when the US economy is naturally compelled to shift resources and capital to more efficient, sustainable and competitive factors of production, then nominal growth would surely fall and unemployment would rise. But for how long before a stronger, more sustainable economy would emerge? The clear answer is too long for the Fed's masters.

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The idea that a central bank lets the economy be the economy except when "animal spirits" in the private sector force it act as the adult, which was (and remains) the Fed's reputation (never actually true), has been so obviously and publicly debunked that even academic economists (with consciences) would be challenged to teach it.

The one reliable polestar on which observers can bank is that in an overleveraged global economy the Fed and other economic policy makers would rather protect the integrity of the banking system than the structural basis on which the broader commercial economy sits. Draining reserves is out of the question and always will be for the Fed, as it always has been. *The ultimate role of a central bank is paper alchemy -- to turn unreserved credit into base money reserves, and it seems more likely each day that this is shaping up to be their ultimate act.*

Watch What They Do

We have watched the Fed and other central banks professionally since the 1980s as traders and investors. Our view is that one should not fight the Fed, ever, because it can and will print endless money and extend infinite credit (to itself, if need be) to protect the nominal value of assets, credit and the property that collateralizes it. But that does not mean one should take monetary policy or its rationalizations at face value.

We were stunned (stunned!) during Chairman Bernanke's March 1 testimony when he declared there was not enough gold to support the US money supply. Surely he knows, as we all should, that at a higher gold price there is plenty of gold to support not only the US dollar but all global currencies. Perhaps, it must be asked, does the Chairman's job description include necessary public deception rationalized by some notion of *the common good* -- that notion being that a popular preference for gold would diminish the preference for the currency that central banks manufacture, and therefore would diminish the power over economies narrowly given to governments and banking systems?

To grizzled bond traders this high brow pump and dump of dollars makes it easier to discount baseless policy jawboning. (Does the SEC have jurisdiction over the Federal Open Market Committee?)

Almost laughably on cue, the Financial Times also reported on March 1 that Italian banks, seeking to improve their capital ratios ahead of this summer's stress tests, petitioned the Bank of Italy to value gold at market prices. As the paper reported; "the lenders, which are shareholders in the central bank, are lobbying for their (gold) stakes to be marked to market. That way, the Bank of Italy's gold reserves, and the surging price of the precious metal, would at a stroke transform their capital ratios." The Fed Chairman should take note: the value of gold, like the value of Google's equity market capitalization, is not just dependent on the amount of shares outstanding. It is also dependent upon its price.

For those that have read our past discussions about how we think the future will play out, this should seem quite familiar. The process of marking gold to market in terms of a currency is a devaluation of that currency. It is the process of monetizing assets, not debt. (We will have much more to say on this in the third section of this paper.)

Gillian Tett, also writing for the Financial Times, further highlighted recent activities undertaken by the Swiss National Bank, which tried desperately last year to cheapen the Swiss franc. Currency intervention is nothing new, but it seems that the SNB was unsuccessful and was left with SFr 21 billion in losses for its trouble. As Tett pointed out, the SNB's losses were offset by its gold holdings, which appreciated; however, the SNBs owners are growing nervous that the central bank has increased its risk profile. This, she points out, may only be a symbol of a far larger problem: "The European Central Bank owns an (ever swelling) pile of periphery eurozone bonds; the Fed's balance sheet has more than doubled in size, to $2,500 billion, as it has gobbled up mortgage-backed bonds and Treasuries; and the Bank of England also holds a large pile of gilts and mortgage assets."

So central banks in developed economies have entered the capital markets full force. They are the only market participants with printing presses and mandates from their treasury ministries to keep their host economies afloat and they are not above shading the truth to their market competitors. They are printing money to buy financial assets, distorting market prices and value, exaggerating an already dangerous level of systemic moral hazard, ultimately insuring increasing – not decreasing -- market and economic volatility, and, it must be said, issuing false claims. Their balance sheets have just begun to swell with paper no one else wants or can afford to carry.

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Plan B

The policy of backing credit *with* credit is being manifested transparently. Government-sponsored debt is increasing so that governments can continue funding shortfalls in tax revenues the private sector cannot provide. In effect, governments and banking systems in developed economies are self-dealing so that their economies do not have to mark-to-market the liquidation value of debt and the assets the debt supports. As politicians bicker about fiscal trivia, central banks blame everyone but themselves, economic participants in developing economies continue building capital, and economic and market observers in the developed world hope for the best; aggregate debt is not being extinguished. In fact, it is being reliably expanded.

The unstated policy objective may seem to be to bide time until the non-financial private sector collectively decides, (against all logic, ability and overt signs), to once again produce and consume ridiculous quantities of goods, services and assets (lever itself up further). This cannot work.

Thankfully, we think there is a logical Plan B, which is to inflate already leveraged currencies and transfer bad debt into "bad banks" (i.e. central banks). This process has already begun.

Our Logic

Inflation is already here and there will be much more of it coming. The constituencies hurt by inflation are net savers, bond holders, people living on fixed income and future taxpayers. Still, there is nary a peep in the markets. There several reasons for this:

- There are relatively few people that would have positive net worths today were current asset liquidation values adjusted for the debt that encumbers them.
- The bond vigilantes that Bob Rubin told President Clinton he had to please or else they would raise rates and jeopardize his political agenda are either are no longer mandated or paid to care about *real returns* or, ahem, have migrated into precious metals because virtually all bonds offer negative real rates.
- The generation that is retired now, (not to mention the majority of practicing economists of all ages), have been conditioned to judge the loss of purchasing power by watching the Consumer Price Index or other baskets of goods and services, currently running at about 1.5%, year over year.

The table is set for US dollar hyper-inflation, which would not trigger debt defaults but would meaningfully reduce the popular burden of debt repayment.

The Fed's actions so far have been unequivocally clear: It is not a provider of monetary and economic discipline. It is not an independent mechanism for balancing the availability of money and credit with the long-term economic interest of the United States or the global economy. The Fed and other central banks seek to inflate prices slowly during a normal credit build-up (as the CPI graph shows), and when the bust comes they inflate even more. Central banks are first and foremost enablers of money and credit growth regardless of the season. Presently, they have the means, incentive and political cover to inflate their monetary bases infinitely and indefinitely.

There are only two ways to ease systemic debt burdens: 1) let credit deflate and endure the pain of widespread bank failures and asset depreciation or 2) inflate (de-value) the money needed to repay the debt. If this choice is not made and executed in the political dimension, then it will occur naturally in the global economy. We are fast approaching the point at which a stark choice must be made between saving the central banking system and real net creditors OR saving private banks and real net debtors.

We think bad debts that cannot be extinguished will find their way onto central bank portfolios where they will die. The most logical course to expect is for the Fed to continue inflating the US monetary base, which should continue to pressure other central banks to do the same with their currencies. Central banks will become the necessary "bad banks" in developed economies. (We will discuss this in more detail in the third section of this paper.)

See Important Disclosures at the end of this report.

The End of Banking?

Should we fear for the safety of the banking system? No. We should not mistake banking systems for banks. Individual banks are fungible vehicles within banking systems. In a baseless monetary regime, individual banks – even those with substantial market share and political power – are systemically unimportant because deposits are credits that are not backed by anything on hand. There should be no pretense anymore that anything exists in a bank vault that implies safety for depositors. (The notion of a bank run, like that at Northern Rock in England in 2007, is utterly quaint. The poor depositors lined up around the block were actually waiting for electronic credits from the Bank of England.)

The only practical cost of bank failure is the cost of changing the signs on the door (or online). Of course, the cost to investors in the bank's capital structure, to the bank's employees, and to systemic confidence among all depositors can be quite high.

The non-regulatory component of central banking is no longer necessary. Government funding could be easily and transparently accomplished without central bank open market operations having to act as intermediary. Treasury ministries could distribute their debt directly to private dealers and/or the public at large. Credit could be priced by the markets -- lenders competing directly for borrowers.

The Politics of It All

Whether or not there was once good reason to endorse and promote a centralized credit-based monetary system, it is quite difficult for an objective observer to see its value today. Indeed, the natural inequities promulgated by fractional reserve lending are beginning to enter the public consciousness. This has taken on a political tinge.

Self-described Libertarians seeking to "end the Fed", Tea Party politicians threatening to maintain debt ceiling limits, and others looking for significant spending cuts, have been the first responders. Those most concerned with individual liberties would naturally recognize first the almost complete centralization of economic and political power in the banking system. (Banking systems seem to have gained power over their governments because governments are indebted and are now relying on central banks for funding.)

Conservative politicians want to slash spending and reduce taxes. However, given the late stage and magnitude of the leverage, such fiscal measures now seem more theoretical than practical. Spending cuts and tax relief may work towards improving the aggregate balance sheet of governments, and would theoretically raise private sector incentives that historically lead to output growth; but the amounts that would have to be cut from public budgets to make a difference would almost certainly have an immediate deleterious impact on near term employment, wages and tax revenue, which would lead to "unacceptable" output contraction. Practically, it seems a non-starter.

Some are calling for a return to the gold-exchange standard. This too seems to be a political non-starter, at least currently. However it is a subject that we think will gain notice and acceptance as debt overwhelms public balance sheets, as debt service continues to gain priority over budgets, and as more conventional political solutions fall away. Individuals and the few politicians that have openly discussed a gold or gold-exchange standard have been on the fringe right, politically speaking; and so this issue has become popularly thought of as a "conservative" one. There is more than a little irony in this popular perception.

We think liberal-minded politicians will ultimately embrace a hard money system. As we have attempted to show, the true source of the systemic credit and debt build-up has been fractional reserve lending, which is a regressive means of wealth distribution. It benefits high earners and investors at the expense of those that do not have "excess savings" to invest. As we have seen, this system benefits the working class least because it shifts sustainable purchasing power from the factors of production to lenders and leveragers with the deepest pockets. And as we are seeing presently, when the credit bubble bursts this system hits the working class hardest because it has very little cushion.

See Important Disclosures at the end of this report.

It would seem that lawmakers holding the view that government should, can and does adequately oversee a fairer distribution of resources than lessaiz faire economies would recognize the futility of the current system? This does not seem to be the case yet.

Those thinking of themselves as more liberal do not seem to recognize that the working class would be better off, and would gain social, economic and political power if it was allowed to become the economy's factors of production again. Hard money and the wages paid in it could be saved as a store of value. Laborers at all wage levels and those that produce necessary resources and capital could save today for consumption tomorrow. We think liberal politicians will be forced to acknowledge this as conditions deteriorate.

We think politicians across the political spectrum will eventually be forced by voters to support a gold-exchange standard (over the temporary disapproval of banks). It would appear to shift power back to the people. A gold-exchange standard will again be popularly seen as the answer. However, as history shows repeatedly, the real issue is not the money per se but fractional reserve lending. We would guess fractional reserve lending would remain the law of the land and so banks will be able to inflate another day. (More on this in Section 3.)

Is such a turn of events really possible? Yes. Most everyone is ambitious: some for love, some for respect, some for money, some for truth, some for justice. The same is no doubt true of politicians. In the US, politicians running against the center are already beginning to win. It seems only a matter of time before liberal forces form a party to challenge its political establishment, as the Tea Party has done on the right. Those on extreme ends of the political spectrum would then have a great enemy in common – the banking system and centrist politicians that support it.

While the temptation among politicians to consider the arguments of banks must be strong, (not to mention the difficulty of refusing the substantial campaign funding they offer), it would seem that broad respect, popularity and votes would accrue to politicians that *run against the banks*. This would not be novel. In fact, political success from front-running monetary system change is an extrapolatable probability. Those expressing outrage derived from the perceived cause of gross financial inequity at economic turning points include Andrew Jackson, William Jennings Bryan, Vladimir Lenin, FDR, Fidel Castro, Ronald Reagan, and Lech Walesa to name a few.

A Utopian Economy that Serves to Define the Organic Economic Path

The natural tendency of man is to want more and keep more for his labor, which means the natural tendency of the global economy in times of political failure is to become more economical.

A theoretical two-factor global economy including only the US and China would easily resolve all economic imbalances and serve the public (itself). US workers and Chinese workers producing the same good would compete on more or less the same wage scale using the same currency. Wealth would flow to the most efficient producer and/or the most innovative. When one side gained advantage, workers on the other side would either work cheaper or migrate into fields offering other opportunities. Global prices would be consistently driven lower (or else new competition would enter), but price declines would be commensurate with affordability. Why? Because the currency in which global wages were earned would be explicitly tied to the price of goods, services and assets.

Price would reflect lasting value. Saving yesterday's wages would purchase more tomorrow as competition, innovation and population growth would continually drive prices lower. Nominal prices would be the same as real prices because the growth in the global money stock would match the rate of growth in the supply of whatever backed the currency (gold?). There would still be credit and banks in this Utopia but credit would be collateralized by borrower and lender, which means debt would be extinguished once loans served their purpose. Credit would be priced discretely. Banking and shadow banking would continue but would be smaller businesses.

Aggregate production would rise with population growth and innovation. People that save their wages would have the option of increasing their leisure time or working more to gain more savings. Individual workers could work fewer hours and their employers would be able to retain productivity levels by hiring more workers. Capital would be distributed to labor and the factors of production in proportion to productivity and innovation.

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Geopolitics

The ability to print the coin of the realm and encourage unlimited credit creation has certainly had its advantages for the US and the G7. By increasing the nominal size of the global economy through credit that cannot be extinguished, (but not advertising it), the West helped force formerly closed economies to open their markets if they wanted to be able to afford global resources, which were being valued at credit-inflated prices. Whether it was an ingenious premeditated conspiratorial plan or merely the consequence of bungling political ineptitude, the great credit build-up in the West certainly had an impact on geopolitics.

Contrived plan or not, the impact of the past credit build-up and the inability of the G7 to collapse its debt without inflicting pain on itself poses a very different balance of power currently. The way we see it, leaders in the West are perpetuating the popularly held view that credit equals wealth so that producers of global resources will continue to accept that credit in exchange. Leaders in centrally-planned economies seem willing to play along with the credit-equals-wealth game only until they have sufficient access to sustainable resources.

It seems to an outside observer to be a game of chicken. To oversimplify again, in a two-factor global economy consisting of a centrally-controlled authoritarian political regime (like China) and a more democratic, transparent one (like the US), the centrally-controlled economy is continuing to synthesize growth by distributing its own currency (pegged to the dollar) to its workforce in order to produce more exports and to over-build domestically. The more transparent economy is continuing to synthesize growth by distributing its currency to the rest of the world in order to engender more consumption and to over-build.

Everyone has an inflation problem. The difference separating economies is that inflation is showing up more in China today because China has to print Yuan whereas the US can inflate the rest of the world through credit that no one counts as inflation. All the world's currencies are in great danger of being mauled and all the world's policy makers are trying to outrun each other, rather than trying to outrun the inflation bear. Maybe the solution to the uprisings in the Middle East and North Africa would be to extend the people credit (and call it money) with which to buy food? (Or would that expose the fraud?)

This brings up a very practical dilemma facing global governments today. As granularly connected and transparent as global businesses and individuals have become and will continue to be in ever greater numbers, the function of government in commercial matters is pressured to decline. Global access to the Internet connects global production and consumption and naturally reduces the power of governments that has heretofore come between man's tendency to want more and keep more for his labor and government's tendency to control that channel.

Each reader may have a particular preference for the proper magnitude of government economic involvement, but the critical point here is that it should be becoming clear to all that government lies between two consenting global commercial counterparties. When economic borders start to seem as silly to uneducated laborers in China as they no doubt do to Jeff Immelt today, then governments will find their authority and power have been undermined. People in free societies everywhere seem to be intuiting this already, and the younger among us seem to have a greater appreciation for it.

Governments are institutions, and so even if they are led by brilliant men and women they will be slow on the uptake. The upcoming elections in the US may be the last in which US politicians can invoke "us vs. them" patriotic themes to gain favor among the very workers they intend to keep globally uncompetitive. (Next time, "us vs. them" might be taken as "us vs. government".)

Expectations

Capital ownership and the power over production in developed economies must and will revert back to the factors of production. Their inherent incentives, along with the potentially antagonistic official policies of central planners in large and competitive developing economies, can and likely will overwhelm the best efforts of Western policy makers and the best interest of banks.

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It would seem that a controlled, government-sponsored systemic change would be the preferred outcome. However, over-indebted populations should not be able to come to terms with the inequity of their economic systems before even more capital is transferred from the factors of production (stressed debtors) to banks and other leveragers with deeper pockets. The potential for growing debtor non-compliance and even social unrest, given the preponderance of debtors in credit-based economies, seems a legitimate concern.

We presume Western lawmakers are overlooking systemic inequity because, (if they have given it any thought at all), they would prefer a slow and methodical change in the system to a sudden one. We further presume the rationale in this would be that a sudden economic de-leveraging would lay bare the fundamental inequities and risk indicting the system's purveyors (themselves). However, just because taking it slow may be preferred, the reality is that a smooth transition is impossible. The debt is only being transferred, not extinguished.

It would further seem that banking institutions would have incentive to compromise preemptively so that they might salvage some wealth and power. However, the shareholders and bondholders of individual banking institutions would doubtful agree to take substantial losses or to be wiped out. Given the public capital structures of banks and the fiduciary demands of bank owners and managements, there could not be a preemptive compromise sufficient to bring adequate relief. Banks would have to mark down the value of their assets (public loans) by too much to remain solvent.

We think it is most likely that both creditors, represented by central bankers and fiduciaries overseeing bank capital structures, and debtors, represented by increasingly angry and aging debtors, consumers and frightened politicians, will come to loggerheads. A liquidation event of Western banks is certainly possible, if not probable. (Again, we caution against thinking of bank liquidation events in terms of "bank runs", as in the past. In baseless monetary systems that allow infinite money production, all bank depositors would be made whole in nominal terms immediately via electronic credits. There is no gold in bank vaults for which depositors need compete.)

The Right Analogue but with A Different Outcome

The Great Depression was a credit event, brought about by excessive net unreserved lending in the 1920s. A better term for it would be "The Great De-Leveraging" because the notional value of credit contracted suddenly and severely to reconcile the amount of actual money in the system (which then was the quantity of dollars exchangeable into gold). The gold-exchange standard did not allow policy makers to fight credit contraction in the 1930s by issuing even more unreserved credit. As a result, bank loans could not be paid back, which forced banks to write down the value of their assets or, more predominantly, to close.

Though there have been disruptions to banking systems and economies so far from 2007 to 2011, central banks' abilities for substantial monetary printing have suspended the extreme credit deterioration that would have otherwise occurred. This seems to have led to a feeling of cyclicality among most politicians, policy makers, economists and investors. Such a perception could not be more inaccurate. Aggregate balance sheets have not been repaired. Aggregate debt has not been extinguished. In fact, debt has grown substantially since 2008. The same credit deflationary pressures exist today that existed in 1929 and 2007 (only larger). Nothing has been reconciled.

Central banks are boxed. While they have the tool to suspend credit deflation denied them in 1929 (money printing), their aggregate economies cannot produce enough real growth (nominal growth in excess of money and credit growth) to exit from the global debt trap. The outcome we see is global monetary default, but unlike the 1930s, we think default will come in *real terms* for most debtors. They will repay creditors to satisfy loan covenants but they will do so with inflated dollars. This would be the most expedient way out of the debt trap for politicians and the only way that promises to maintain peace and even future prosperity. Aggregate global wealth will not be lost, as it cannot be lost, but it will change pockets in substantial magnitude.

Timing the Change

Historian Niall Ferguson has been lecturing recently that empires, like ant hills and rain forests, are complex adaptive systems. Hapsburg Spain (16th century), Bourbon France (18th century), Ottoman Turkey (19th century)

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and Post-War Britain (20th century) had different, unpredictable catalysts that historians now point to as triggers to their demise. However Ferguson rightly observes that each empire had one great and obvious vulnerability in common that made it easy for them to succumb to failure: unsustainable debt-to-revenue levels.

Ferguson believes the US is an empire approaching what physicists might call "self-organizing criticality", a condition that attracts energy precisely to the *critical point* at which the system will transform. In such a state conditions change from apparent stability to instability quite suddenly. This presumes economies can be arrhythmic (which all experienced traders and investors would confirm is the normal state of the markets). The catalyst or amplifier can only be known in hindsight, and in fact is relatively unimportant.

We have not called the United States an empire, but we will suggest it controls the global monetary empire, or as Bill Bonner and Addison Wiggin wrote years ago; an "Empire of Debt". We have told investors for four years that step-shift change could take a long time or paradigm shift could come next week. The current monetary regime, which is a complex adaptive system, appears to be in a state of relative equilibrium currently when viewed in its own terms, such as exchange rates, price levels, state sponsorship and unity, and participant compliance. The only thing we think we know for sure is that the tinder on the forest floor is piled high and it is very dry.

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This report includes section 1 only. Sections 2 & 3 will seek to address anticipated political and market reactions. Contact Paul Brodsky (pbrodsky@qbamco.com) for sections 2 & 3.

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