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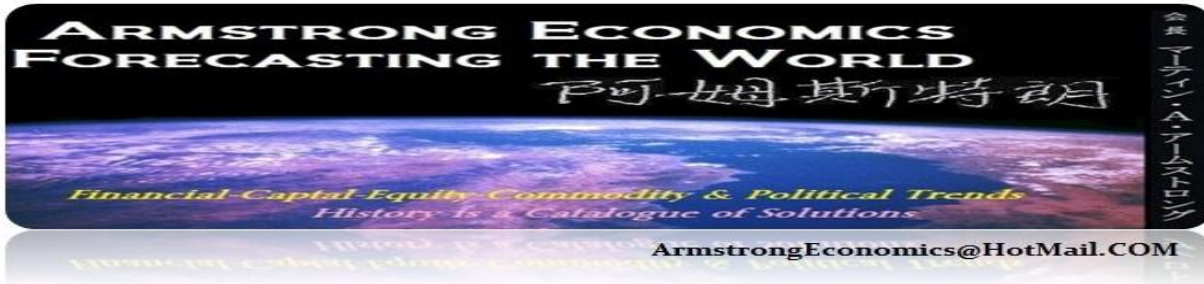
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# Federal Reserve v ECB

Copyright November 17<sup>th</sup>, 2011



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# ANALYTICAL & WORLD ECONOMIC CONFERENCE

DECEMBER 3<sup>RD</sup> & 4<sup>TH</sup>, 2011 AT THE

## The Westin Philadelphia



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The **Analytical & World Economic Conference** is being held in Philadelphia, December 3<sup>rd</sup> and 4<sup>th</sup>. This will be held at one of Philadelphia's finest hotels located in the heart of the city within walking distance of Independence Hall, the Liberty Bell, first Bank of the United States, US Mint, the Constitution Center, and of course Ben Franklin's print shop and his grave.



The price of \$2500 for the weekend is a substantial reduction from the normal \$10,000. However, we are trying to open this up to private individuals and fund managers in addition to the institutional clients. To preserve limited space, we are compelled to limit the attendance to 3 seats per institution.

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# Federal Reserve v ECB

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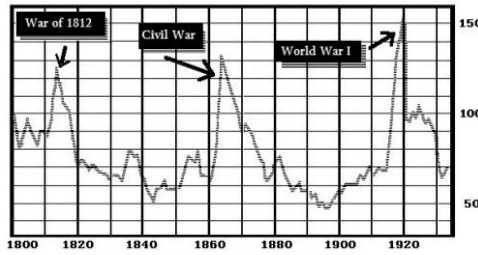


**NE** of the top 10 questions has been concerned about the actions of central banks. Much of the rhetoric has only served to confuse the issues, but even far more important, all this yelling, screaming, and finger-pointing has masked a very serious issue that is going to become a **PRIMARY** focal point next year. That is the difference structurally between the Federal Reserve and the European Central Bank (ECB).

As always, there are the people who just stand up on their soap boxes ranting and raving about everything from fiat currency to debt deflation. Often these prognostications sound logical, but upon close inspection, they fade away under the cold light of day. The “**DEBT DEFLATION**” theory is that the money supply is leveraged by banks and as debt is reduced, the money supply contracts and therefore we end up with **DEFLATION**. The problem with this theory is its one-sidedness. It is absolutely true that private debt has been contracting and taken by itself in isolation, we are experiencing **DEFLATION**. However, we also have government and this is offsetting the **DEFLATIONARY** influences from the contraction in private debt. We still get economic stagnation but this is largely because the increased borrowing by government is **NOT** being targeted at stimulating the economy through specific spending in social programs. What is happening is there have been the \$700 billion TARP that merely stabilized banks, \$1 trillion on war where the money was largely exported, and 40%+ of all debt in the USA is held by foreign investors so the interest paid to service the huge debts is also largely exported once again failing to “*stimulate*” the local economy. So we have economic stagnation (low growth) with rising debt burdens; the worst of both worlds – not **DEFLATION!**

Since we are not experiencing **DEFLATION** in general prices other than jobs and housing, this brings us to the other side of the coin toss – **INFLATION**. Here we have the gold standard crowd arguing we are going into hyperinflation because money is not gold and it is just all fiat worthless paper. Money being fiat tends to center around paper currency as if this were the only fiat money ever to exist. Ever since government began issuing “official” money and had their own bills to pay, the practice of declaring money to be worth **MORE** than its tangible intrinsic value has taken place.

US WHOLESALE COMMODITY PRICE INDEX  
1800-1934 (1926 = 100)



The three great commodity waves used by Kondratieff  
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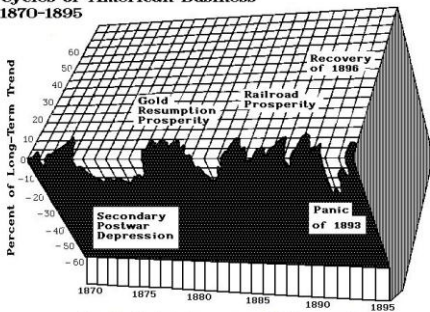
**Purchasing Power of Gold Fluctuated at all times**



US \$20 Gold 1949-1932

Those who think somehow that a gold standard will miraculously solve all our problems live in some fantasy world of pure fiction. While it is true that the \$20 gold coin issued in 1849 through 1933 for 84 years remained the same fineness and weight producing the image that there was some sort of gold standard that worked, need to look at history.

Cycles of American Business  
1870-1895



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The very waves of inflation used by Kondratieff showed that the purchasing power of gold even as money rose and fell despite the fact the weight of the coin remained unchanged. There was no such flat line in economic activity simply because gold was being used as “money”. It was Karl Marx whose ideas of Communism were designed to eliminate the business cycle by confiscating **ALL** wealth. If there was no private wealth, he presumed, we could then end this vicious cycle of boom and bust. And then there was the post-

war Bretton Woods where the once \$20.67 per ounce of gold from 1849 was set at \$35. Well that lasted until 1971 when on August 15<sup>th</sup> Richard Nixon closed the gold window. A gold standard by itself FAILS to restrain government spending and by no means has it **EVER** produced a period where the value of **MONEY** is a flat line. This harping about a gold standard will cure everything is like the girl’s father in the movie *My Fat Greek Wedding* who believes **Windex** cures everything. The gold standard never stopped inflation & deflation nor did it ever stop government from borrowing & spending. Money has **ALWAYS** been fiat to varying degrees because government makes a profit by issuing it. Hyperinflation will not take place simply because money is paper. China issued paper money since the 1200s and there were periods of inflation as well as deflation indistinguishable had the money been gold coins. So what is really going on?



# You can put a bag over their head, but all Central Banks are NOT all the same!

This now brings us to the primary question about central banks. They are simply **NOT** all the same! There is a substantial difference between the **Federal Reserve** and the **European Central Bank (ECB)**. The accounting at the Fed allows for it to **CREATE** money as needed and thus Ron Paul's attempt to get into the books of the Fed created a firestorm. The Fed did not wish to open its books to allow the world to see how it is actually run. Now the fiat crowd will argue that the Fed can just create money in a very **ELASTIC** money supply. This is true and it was intended from the very outset that when economic declines appeared, the leverage within the system would implode and thus to ease that contraction, more money had to be injected to slow the collapse.

Banking began after the Dark Ages as simply a place to store your money. You paid a fee and they held it. The banks figured out that they could lend money and make a profit while it was just sitting there. This scam became the norm and then we ended up creating fractional reserves meaning if a bank held 6% of the funds on deposit it was enough to operate normally meeting the demands for people to withdraw their funds when all things remained equal.

In time of crisis, confidence in the banks collapsed and more people now wanted to withdraw their money that exceeded 6%.



## UNCLE SAM'S NEED OF AN ELASTIC CURRENCY

PRESIDENT ROOSEVELT: "You see, those galluses ought to have rubber in them, so that when Uncle Sam stoops to move the sheaf there won't be much strain on the buttons."

From the *Pioneer Press* (St. Paul)



created a “run” on the bank.

The banks **BORROW** short-term on a **DEMAND** basis and lend the money out long-term such as mortgages. During a crisis, if more people than the 6% wanted their money, the bank failed and thus



Bank runs still happen today as they have always taken place historically. Pictured here is a bank run from the Great Depression and an English bank run from 2007 in Birmingham. It is always the same event – a collapse in confidence. This takes place because the fundamental structure of banks has been built upon this idea that they borrow short-term paying a lower rate of interest and lend long-term charging a higher rate. The structure is built upon this notion of a normal yield spread with the profit being long minus short-term rates.

The purpose of an **ELASTIC MONEY SUPPLY** is to allow the quantity of money to increase when there is effectively a run on the banks. This was designed to prevent a depression where banks fail and their assets (loans outstanding) are sold for pennies on the dollar causing real estate to collapse in value as the leverage within the entire system implodes and collapses. If money supply were **ELASTIC**, it could then expand during such periods and contract as confidence returns and the panic subsides.

Because the Fed was designed with this ability to increase the money supply on an **ELASTIC** basis, this has helped to ease the bank failures that would otherwise take place. The problem is not so much with this theory and design as it is with the political ineptitude of understanding what this mechanism true does and what are its limitations? Because of the fiat crowd ranting and raving about the Fed, they are only adding to the whole confusion about the design adopting the same mistakes made by the politicians who also clearly do not understand what the Fed was all about. This original **ELASTIC MONEY SUPPLY** idea was **NEVER** intended to be a permanent practice. The politicians assumed the Fed was designed to **FIX** the economy somehow (the details escaping them), and this has migrated transforming the Fed into now taking over institutions “too big” to fail and is somehow supposed to sterilize whatever bad effects may be created by the politicians spending more than they should. The **ELASTIC MONEY SUPPLY** was a good intension that if left alone meant **TEMPORARY** and that the expansion would then contract back to normal once the crisis was over. If it were restricted to that role, it would be helpful in easing economic contractions. But as politics goes, they never can leave anything alone for very long.

So how does this contrast with the **ECB**? Here in lies the problem. The **ECB** is **NOT** authorized to create an **ELASTIC MONEY SUPPLY**. Consequently, the **ECB** cannot continue to just buy-in sovereign debt of member states as the market forces come down upon them. The **ECB**, unlike the Fed, will run out of money and then there will be a *very public* crisis whereby the **ECB** will have to be recapitalized. Now the fiat money crowd will argue that is the way it should be. The problem then becomes **PUBLIC** and now we introduce politics into the equation. This warns that the **CONFIDENCE** in the entire banking system in Europe may collapse because there is no automatic **ELASTIC MONEY SUPPLY** so bank failures and sovereign debt collapses cannot be dealt with immediately behind the scenes.



The fiat money crowd is fixed on this issue of money. That is **NEVER** the problem. In the west, precious metals became a medium of exchange based upon their intrinsic value. In Lydia (Turkey), coinage began as a means of to solve a convenience. Instead of having to test and weigh the metal over and over again, the idea emerged where the city intervened and produced a standardized weight and imprinted the badge of the city (lion). This idea of money being intrinsic was pre-coinage. Once government began to get involved, the value rose relative to the actual cost to manufacture the coinage and like today, politicians always spent more than they had so they debased the coinage to make it spread out going further. Merely because the coinage was gold or silver did **NOT** stop the same process of fiscal mismanagement then as compared to today.

The problem is spending and debt, not what we call money. To solve the problem is to directly attack the issue. Imposing a gold standard and hoping somehow this will restrain government is wishful dreaming. It is like fining your wife because she failed to get you to take out the trash. We have to outlaw government borrowing except in times of war and then **ONLY** if attacked! Anything shy of that is just not going to work; so right church – wrong pew.

This issue of how a central bank functions and the purpose of an **ELASTIC MONEY SUPPLY** will come to the forefront next year. The **ECB** will have to be restructured since the European politicians refuse to address the structural problems in Europe and its almost single currency. Either the monetary system is revised, of the **ECB** will have to be recapitalized. Something will have to give in Europe.

**(WEC) World Economic Conference**

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European banks are now being forced to pay insurers and pension funds to take over their illiquid sovereign bonds in exchange for better quality ones because the ECB lacks this ability to create an **ELASTIC MONEY SUPPLY**. European banks are desperate to secure much-needed cash and are having to turn away from the **ECB**. The **ECB** has now become the main provider of short-term funding in Europe as lending between banks is mostly shut down as everyone fears this debt game of musical chairs. They are scared to death what happens when the music stops. The European debt crisis is entering a new phase as banks are now running out of the good quality collateral to secure the short-term money.

The banks are now turning to the swaps market with institutional investors. But the **ECB** is not a bottomless pit because of its structure and we may see the next crisis that will shock the hell out of everyone when the **ECB** requires recapitalization. This will give the impression Europe has completely **FAILED**, but it is a structural problem that would not have been an issue had the politicians simply consolidated the debt creating a single European debt cutting string that binds them together relegating all member states thereafter to whatever they issued would no longer be acceptable as reserves for banks. But no! The politicians have to bring down the whole damn financial system because they are stubborn and outright brain-dead when it comes to economics. So now we will have an **ECB** crisis and that will create the IMPRESSION Europe has failed and we could see wholesale bank runs throughout Europe.

The question becomes how long can these liquidity swaps continue? Will this cause a run on institutional investors if the European public understand what is going on behind the curtain this time? This is now no longer a REPO transaction that is a 24 hour swap market. We are now extending REPO in a quasi-central bank function. The **ECB** is being marginalized because of its structure.

The major Italian banks met with the **ECB** officials in Frankfurt pleading with them to increase access to its borrowing for Italian banks. This is all a concern that goes to the problem of having to recapitalize the **ECB**. The emergence of this new market for liquidity swaps has led to the UK's Financial Services Authority (FSA), to issue a report last July pointing out the new risks in this development. Spreading the problem around, some U.S. banks are jumping into the market entering into these liquidity swaps with European banks in the tens of billions of dollars. In Europe, unsecured borrowing among banks was virtually non-existent. We are on the edge here of a very serious economic implosion and it is ALL driven by politicians ignorant of the risks who pray at the foot of their bed at night to just make it go magically away. They are **ALL** betting on just growing our way out **AND THERE IS NO PLAN B!**