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## Apropos of Everything (2&3)

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### Note to Readers

*The response to Section 1 of this paper was beyond anything we could have imagined. Requests for Sections 2 and 3 have come from all corners, many from people with whom we were previously unfamiliar. We are pleased our thoughts resonated, and to the one who wrote “bummers like you keep harshing on everyone’s mellow” we encourage you to endure the following sections. There is a happy ending.*

*Whereas we feel the subject matter supporting Section 1 is grounded firmly in logic and empiricism, we acknowledge that much of the discussion in the sections that follow is the economic equivalent of dark matter – inferred yet undetectable gravitational forces. It is based on speculation, very reasonable and logical speculation in our view yet speculation just the same. These are topics that cannot be modeled.*

*For the record, this is not a newsletter and we do not charge for what we share (nor do we intend to). QBAMCO is a small, independent asset manager that manages small discretionary investment funds (in which we look after much of our personal capital). After almost 50 years (collectively) trading all types of fixed income, derivative and equity products, we concluded that systemic leverage was irreconcilable in the West and that it would eventually demand a paradigm shift in the global monetary system. Since we opened our US Fund in February 2007 it has been devoted to this general outlook. This piece, as with others we publish, is the byproduct of our investment research.*

*Cyclical extrapolation (i.e. near-term mean reversion) strategies have been and remain a secondary input for us, which further implies that the Fund will likely remain unpopular among investors seeking stable returns. We are comfortable with this. We believe the great majority of investors that drive market pricing today have gathered around a sense of risk-aversion that is entirely backward looking and will prove wealth-destroying. For better or worse, we take strategic, thematic positions within the context of our broader macroeconomic outlook. We seek to benefit from recognizing outcomes early and profit as subsequent adapters shift market values in our favor. We value our own views above all else so that we can be confident in the risk-adjusted investment expressions that optimally fit our biases. The greater the gap separating our sense of relative value versus the markets’, the more likely we can “set our own price” and wait for popular discovery.*

*We do not mind sharing our work with others. In fact we send our letters directly to other fund managers and Street traders who have asked for them. Nor do we care if others take our thoughts and make them their own. Awareness should not be proprietary. While we are disappointed that few on the public stage have attempted to introduce our sense of reality to a wide audience, and sad that current popular ignorance may lead to a broad sense of betrayal and relative economic hardship for many in the “investor class”, our attempts to educate by sharing our work gives us clear conscience to try to take professional advantage of it. If you find this work remotely worthy of sharing, feel free to do so. (We are not interested in public advocacy.)*

*Though we freely share our broad macroeconomic views, we do not share tactical investment ideas or specific Security recommendations. We apply our views selfishly for our Fund investors and for ourselves. We must stress that we are not financial advisors. Non-QB Fund investors should follow their own counsel and all should read the important disclaimers at the end of this piece. This report includes sections 2 & 3 only. Contact Paul Brodsky ([pbrodsky@qbamco.com](mailto:pbrodsky@qbamco.com)) for section 1.*

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:** *New monetary regimes global policy makers are discussing, and why they will not come to pass*
3. **Devaluation & Transformation:** *The next global monetary system, and the implications for assets and wealth*

## 2. Best Intentions & Unintended Consequences

*New monetary regimes global policy makers are discussing, and why they will not come to pass*

In section 1 we tried to lend perspective to the current global monetary system, its weaknesses and predisposition to fail, whom it benefits and harms, and the natural incentives of various participants to push it towards demise. Though obvious to us and many of you, this state of affairs has not been widely addressed by global leaders responsible for steering public economic policies. And though there have been some overtures towards public acknowledgement made by prominent people, such talk has no doubt been seen by active Western policy makers as inconvenient and maybe even irresponsible discourse. Officially, a “strong dollar policy” remains in effect.

Pressure to change the system first came from leaders of small economies without a historical say, irritants like Hugo Chavez and Mahmoud Ahmadinejad, and was then perpetuated by leaders of emerging powerful economies with more economic clout, like Hu Jintao and Vladimir Putin. More recently we have seen occasional moments of acquiescence from representatives of the status quo, like Nicolas Sarkozy and World Bank President Robert Zoellick. Just this week, Chinese authorities have been re-asserting that the Renminbi should take its place at the center of global trade, and the Hong Kong Monetary Authority announced it is actively considering new rules that would pave its way. There seems to be an undeniable growing acknowledgment that the current global monetary regime does not fit the current global economy.

Still, consensus valuation metrics in established financial markets remain firmly anchored in the notion that currency values are defined against each other -- not vis-à-vis the items they must purchase such as food, fuel, finished goods and services, labor, production and assets.

Some with ability and willingness to invest independently have migrated towards expressions that anticipate change. High profile investors including John Paulson, Paul Singer, George Soros, Paul Tudor Jones, David Einhorn, Ray Dalio and others seem to have concluded in varying degrees that the future for the US dollar looks very different from its past. (As far as we know, only Soros has taken a stand that the dollar cannot satisfy the future needs of the global economy.)

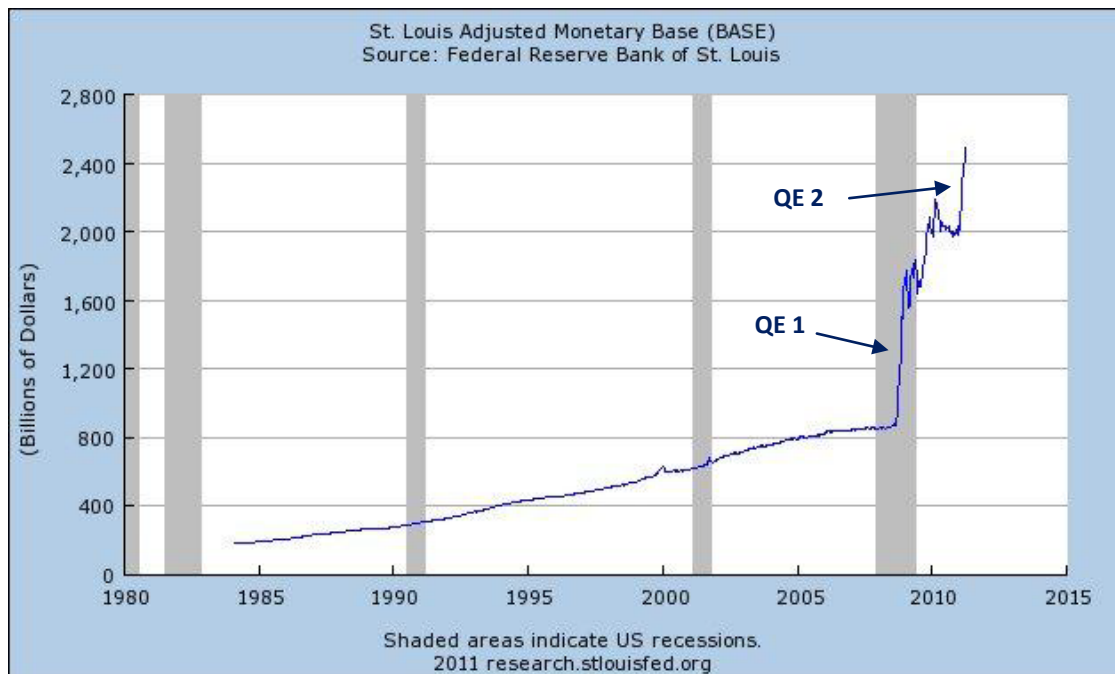
As investors, we see a widening gap separating the already well-established march towards a new monetary system and an “official ignorance” among active Western policy makers (and genuine ignorance among most investors) that this change is occurring. Among those that dare to think ahead, there have been three solutions discussed:

1. Replacing the US dollar with an existing currency that would then be the world’s reserve currency
2. Using multiple reserve currencies
3. Converting all existing currencies to a new common global currency managed by an impartial authority.

We think none of these options will come to pass. The global monetary system will remain firmly US dollar-based...up until the time the system crashes and a hard money system is officially adopted. Section 2 addresses the whispered alternatives and why we feel they will not be adopted.

### A Review of the Fundamental Story

In 2008, following what most call “the bursting of the credit bubble” (better termed “the natural and necessary contraction of the debt-to-money ratio” or, more commonly, “de-leveraging”), the Fed manufactured money from thin air in an unprecedented amount. Base money (M0) was created by the Fed and credited to bank reserve accounts in an attempt to offset natural credit contraction. This first round of quantitative easing (“QE1”) was pure inflation. As the graph below illustrates, the US Monetary Base (bank reserves held at the Fed and currency in circulation) grew 130% virtually overnight:



Source: St. Louis Fed; (QE1, QE2 labels affixed by QBAMCO)

As we have discussed before, TARP, TALF and the other programs that comprised QE1 were not directly stimulative to the broad economy because they did not exhaust debt. QE1 was mostly stimulative for its recipient organizations, and this now seems very obvious by their subsequent performance. As we wrote at the time, there was very little chance that a banking system multiplier effect would prove widely stimulative. Bank assets (loans) would have to continue to be carried on balance sheets at levels that had very little cushion for sudden delinquencies and defaults, and at levels that would not allow for widespread value reconciliation. The US banking system remained far too levered after QE1. Banking system capital reserve ratios remained far too low.

QE2, announced two years hence and also portrayed on the graph above, is currently raising the Monetary Base by another \$600 billion (or more) and is also not directly economically stimulative. The Fed is manufacturing new money to purchase Treasury debt. The Fed is devaluing the dollar, and in turn forcing all other currencies to devalue in-kind, so it can continue to fund the US government revenue shortfall. The critical point here is that aggregate debt is still not being extinguished. Balance sheets are still not being de-levered.

The current market debate is about whether and when the Fed will endeavor upon QE3. Having the debate at all shows advancement in market thinking from no awareness of the consequences of QE1 and very little pushback for QE2. The markets are beginning to come to terms with the nexus of the fundamental problem facing the global economy – the relationship linking a growing money stock and declining real wealth. (We urge readers not to politicize this discussion. We are not taking sides and we are likely to surprise readers with what we think will ultimately occur and reset the global system.)

Against the backdrop of the Q3 debate, the only promise the Fed continues to make is that some day, when the time is right, it will sell bonds from its balance sheet and take the proceeds from the sale out of the system, thereby draining reserves. (St. Augustus, the Fed – Lord make it chaste but not yet.) With overnight interest rates close to 0% and the markets more aware of the impact of devaluing currency on assets, making this promise is the only Fed action remaining.

If the Fed were to ever drain reserves, (we are skeptical it ever will), such an operation would not necessarily de-leverage the system. It would shift debt from the Fed's balance sheet to the markets' and withdraw bank reserves, thereby reducing the money stock. But the Fed would likely only do this amid a strong credit environment, which implies it would actually help widen the credit-to-base money gap, in effect helping to lever the system even more.

The days of policy makers being able to manage a sustainable build-up of unreserved credit have come and gone. The debt-to-money gap cannot be closed by issuing more credit and the act of printing debt-money merely shifts obligations – it does not deleverage the system. Yet, the system must de-lever or else real output, employment and production will be pressured to fall. Letting aggregate credit deflate without offsetting monetary inflation would be too great a shock to the system and not politically tolerable. The only way out is to manufacture more money. *Money printing equals inflation which equals currency devaluation, and there is no mechanical or serious political roadblock preventing it.*

#### What about a Debt Jubilee?

For thousands of years, as part of Middle East tradition, it was accepted that there would periodically be a wholesale cancelling of debts and the restoration of land to the poor. This was known as a “debt jubilee”, a practice consistent with ancient customs that valued religion and morality over contracts and the rule of law. Indeed the Old Testament addresses this very subject: “Land must not be sold in perpetuity, for the land belongs to Me and you are only strangers and guests. You will allow a right of redemption on all your landed property.”<sup>1</sup>

Of course in modern times all debt is not tied to land. Nevertheless, would it be realistic to apply the concept of complete debt forgiveness across the full spectrum of encumbrances today? We doubt it. A debt jubilee would set a precedent that would make the barbarous relic seem downright high-tech. It would be tantamount to declaring that modern societies are structured around super-legal principles. Our sense is that if such a scheme were proposed, even during the most chaotic of times, the party who did so would be ignored by creditors and debtors alike (or, to keep the metaphor going, he would be smote and flogged). Let us dismiss this idea and move on.

#### Official Devaluation Done Wrong

It would be mechanically easy to overcome the burden of repaying overwhelming public and private sector debt. Policy makers could close the vast Debt-to-Base Money gap as much as they choose and they could do so immediately with four simple steps:

1. Treasury issues securities until the market finally begins choking on them.
2. Policy makers announce even more egregiously large budget deficits to come.
3. Treasury then issues a quadrillion dollars of short-term paper directly to the Fed.
4. Treasury uses the proceeds from the sale to retire all outstanding term-debt in the market for pennies on the dollar.

*The steps above should not be taken seriously and we give it zero chance of occurring.* It would summarily destroy the real value of dollars and all outstanding dollar-denominated credit. It would de-stabilize the global economy and destroy confidence for a very long time. Its cynical approach would create mistrust among allies and trading partners. But mechanically it would work, which is why we mention it.

#### Replacing the US Dollar with an Existing Currency

Some in the West have worried that China, arguably the largest global economy in *real terms*, (using the metric of GDP deflated for necessary future Western monetary inflation), will insist that the Renminbi become the world’s reserve currency. We think this is not possible (and we think the Chinese know this too).

First, the world’s reserve currency must have substantial global assets denominated in it. Yuan-denominated stocks, bonds, property holdings and foreign reserves would have to be liquid so that global investors could

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<sup>1</sup> Leviticus 25:23-28

exchange perceived value. Available Chinese capital markets and property are tiny in a global context (as currently valued), and it seems highly unlikely that they will soon gain sufficient sponsorship from wealth holders in more mature economies. Second, China's domestic social order remains an authoritarian regime that does not promote liberal commercial exchange, and China does not have an established judiciary that gives counterparties confidence they can settle disputes fairly. China is obviously aware of these issues and by all accounts unwilling to change its social order sufficiently to placate Western liberal democracies.

Further, China has shown an unwillingness to "play ball" with economic policy makers in developed economies. When adversity has stricken its Western trade partners, Chinese policy makers have consistently executed exchange rate and monetary policies that benefit its domestic goals but continued to pressure its importing customers. The concept of a global reserve currency is a social construct with which China is unwilling to abide.

*So although its economy may be one of the strongest in the world, China's political, social and financial infrastructures are too immature and inward-looking to establish enough confidence among global trade partners to allow the Renminbi to become the global reserve currency.*

We also think proposals from China and Russia for *regional reserve currencies* should be seen as public posturing and summarily dismissed. Given China's or Russia's immature or dubious credit histories, small capital markets and curious records of jurisprudence, it would take at least a generation before global perceptions change to where genuine confidence among wealth holders in those neighborhoods would prevail.

The Euro, Yen and other already established major global currencies may have many of the components necessary to be a stand-alone reserve currency; however recent events show extreme, even life threatening vulnerabilities. Most are suffering for the same reasons the US dollar is suffering – they are debt-money representing vastly over-leveraged economies. As we are seeing today, there is no real challenge to the US dollar among other major currencies for global hegemony. The US dollar is the tallest little-person in the room, and so we think talk of another baseless currency replacing the dollar is unrealistic.

### Multiple Reserve Currencies

Some have argued that although the dollar will remain the strongest currency, other currencies will rise in stature, leading to a global monetary system with multiple reserve currencies. We do not see this as a possibility either. In a global monetary system in which all currencies are debt-based, maintaining confidence in a currency's underlying support system is the primary driver of global sponsorship. As the notion of confidence is not tangible, all debt money must ultimately default to the confidence given the strongest currency -- the one perceived as the safest into which all others can be exchanged if need be.

A multiple reserve currency regime comprised of debt-based currencies would also provide no benchmark off which to calculate real value, other than prices expressed in the strongest currency. If the strongest currency were to remain the US dollar, then nothing would change from current conditions. Labeling the Euro, Yen and Renminbi as "reserve currencies" would be meaningless. Each would tacitly continue to be priced off the dollar, as would all global assets.

Further, the sponsors of "lesser reserve currencies" would no doubt continue to try to weaken or strengthen their currencies through intervention and interest rate management. Net exporters (i.e. China, Japan) would be partial to a weaker currency in optimizing global trade and, as we discussed in section 1, maintaining a relatively strong currency as the US has mostly done since 1971 is unsustainable without subsidizing consumption through an unsustainable leverage build up. Again, this describes the world today – a USD-based system.

Most damning to the notion of multiple reserve currencies would be that such a system would have an obvious omission. China no doubt knows that the issues that make the Renminbi unworthy of being *the* reserve currency also make it unworthy of being *a* reserve currency. So if the US dollar is generally perceived to be far and away the safest and most liquid baseless media of exchange, (a perception with which we would agree), then any attempt at a global regime with multiple reserve currencies could not include the Renminbi -- and thus would be scotched.

We do not see room for more than one true reserve currency, or incentive for any other currency board to want to oversee tertiary media posing as a reserve currency. Simply, markets demand one benchmark monetary unit off which all other currencies, goods, services and assets may be ultimately valued.

### The Heir Apparent

Is there a viable currency to replace the US dollar when over-leverage, economic imbalances and consequent money printing ultimately lead to an overwhelming decline in confidence in the dollar as a store of value? *Special Drawing Rights* (SDRs) are thought to be the *economic illuminati's* ace in the hole – the “nuclear option” if and when popular confidence in the existing regime evaporates.

SDRs are an active currency but they have not been widely distributed and so they are not used as media of exchange. They are issued by the International Monetary Fund (IMF) to its membership, which is comprised of 187 sovereign nations. For all the world's economies to adopt SDR's as media of exchange, global politicians, commercial participants and wealth holders would have to accept the IMF as the sponsor of the means of storing and exchanging wealth. Is this possible?

Let us review the organization as a potential independent sponsor. According to the IMF's website: ““The IMF was conceived in July 1944 when representatives of 45 countries meeting in the town of Bretton Woods, New Hampshire...agreed on a framework for international economic cooperation. They believed that such a framework was necessary to avoid a repetition of the disastrous economic policies that had contributed to the Great Depression.” The IMF mission was to “ensure exchange rate stability and encourage its member countries to eliminate exchange restrictions that hindered trade.””<sup>2</sup>

Fair enough. Let's look further. The IMF's *Articles of Agreement* suggests requisite sovereignty. For example:

- “Article VIII, Section 7. General Obligations of Members: “Each member undertakes to collaborate with the Fund and with other members in order to ensure that the policies of the member with respect to reserve assets shall be consistent with the objectives of promoting better international surveillance of international liquidity and *making the special drawing right the principal reserve asset in the international monetary system.*” (Ed. Emphasis added)
- “Article IX, Section 3. Immunity from judicial process: The Fund, its property and its assets, wherever located and by whomsoever held, shall enjoy immunity from every form of judicial process except to the extent that it expressly waives its immunity for the purpose of any proceedings or by the terms of any contract.”
- “Article IX, Section 4. Immunity from other action: Property and assets of the Fund, wherever located and by whomsoever held, shall be immune from search, requisition, confiscation, expropriation, or any other form of seizure by executive or legislative action.”<sup>3</sup>

We could continue on, describing the granting of complete immunity from judicial process to the IMF's officers and the Fund's immunity from taxation within all member jurisdictions, but we think you get the picture. The IMF seems at face value to be an independent, sovereign organization with the ability to objectively issue and oversee the world's money and capable of doing what it pleases without review or consequence.

The observable function of the IMF since the demise of Bretton Woods in the early 1970s has been as financial intermediary between have and have-not countries, effectively serving as a mechanism to redistribute money when currencies or economies of third-world or developing nations falter. Most recently, the IMF has been selling a portion of its gold hoard to small and burgeoning central banks. Thus, the IMF seems to have shown that it takes seriously the interests of all its members.

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<sup>2</sup> International Monetary Fund; <http://www.imf.org/external/index.htm>.

<sup>3</sup> International Monetary Fund; Articles of Agreement; <http://www.imf.org/external/pubs/ft/aa/aa09.htm>.



### Looking Deeper

Is the IMF really a super-sovereign entity credible enough to issue and oversee the global reserve currency? Further consideration creates doubts. For example, the IMF's most recent public activity has been selling its gold hoard at market prices "to generate profits to fund an endowment that would diversify the Fund's income sources away from lending income"<sup>4</sup>. Yet the nature of these gold sales does not engender confidence, from the market nor do we imagine among many of its members.

Consistent with an agreement signed by Euro zone central banks in August 2009<sup>5</sup>, the IMF sold the first tranche of what will eventually be a total of 2,000 tonnes (metric tons) of gold over a five-year period. The gold is being privately placed at prevailing market pricing at the time of each sale. From October 2009 to December 2010, the IMF claims to have sold about 403.3 tonnes (almost 13 million ounces), which generated "windfall profits" of about SDR 1.75 billion (about \$2.75 billion).

The first half of this first tranche, about 212 tonnes, was sold to the Reserve Bank of India, the Bank of Mauritius, the Central Bank of Sri Lanka and the Bangladesh Bank. A private investor, the Sprott Physical Gold Trust, then made an offer to purchase the remaining 191.3 tonnes. The IMF did not consider this offer. While the IMF may sell its gold privately to whomever it wishes at whatever exchange value each party agrees, the rejection of a public tender offer from a bonafide investor serving the public raises serious questions. Do these gold sales imply an agenda beyond IMF income diversification? Are the gold sales a means of transferring gold among its members, and if so, for what reason? And why are central banks interested in gold?

An IMF press release in December 2010 reported only that the balance of the first tranche was sold but it did not provide the buyer(s)<sup>6</sup>. We presume the lucky buyer(s) passed scrutiny not only from the IMF board but also the Euro zone sellers. We also presume that there were terms established that surrounded the transaction. As it does not release audited financial statements to the public, it is impossible to confirm whether the IMF actually owns and custodies the gold it claims to have and has sold or whether it acts as intermediary among its members. We may presume that IMF members (or some members) are aware of specific assets, their derivation and the terms of operations while others are not.

And so the shadowy fashion in which the IMF operates raises suspicions among public market participants and must raise suspicions among members as to its priorities. Is the IMF a tool of other sovereigns? Are these transactions a means of equilibrating official gold holdings among economies? If so, why?

### Special Drawing Rights

According to the IMF's website, "the SDR is an international reserve asset created by the IMF in 1969 and serves as its unit of account. The currency value of the SDR is determined by summing the values in U.S. dollars of a basket of major currencies." The SDR basket includes US Dollars, Japanese Yen, British Sterling and Euros, and the proportion of each is changed once every five years. The IMF quoted a value of almost 230 billion SDRs as of March 25, 2011 and as of February 28, the SDR exchange rate was .6357. We presume the US dollar value of SDRs approximates \$360 billion, give or take.

The United States holds 18.3% of all SDRs and enjoys 17.34% of IMF voting rights, far and away the largest share. China, the world's second largest economy in terms of nominal GDP, holds 4.14% of all SDRs and controls 3.94% of voting rights. The table below lists the top 10 members of the IMF as of March 25, 2011:

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<sup>4</sup> <http://www.imf.org/external/np/pp/eng/2011/031611.pdf>

<sup>5</sup> <http://www.ecb.int/press/pr/date/2009/html/pr090807.en.html>

<sup>6</sup> <http://www.imf.org/external/np/sec/pr/2010/pr10509.htm>

Member	Percent of SDRs Held	Percent of IMF Voting Rights
United States	18.32%	17.34%
Germany	6.33%	6.02%
Japan	5.79%	5.50%
France	4.67%	4.44%
United Kingdom	4.67%	4.44%
China	4.14%	3.94%
Italy	3.07%	2.93%
Saudi Arabia	3.04%	2.90%
Canada	2.77%	2.65%
Russia	2.59%	2.47%
<b>Total</b>	<b>55.39%</b>	<b>52.63%</b>

Sources: International Monetary Fund; <http://www.imf.org/external/np/sec/memdir/members.aspx>; QBAMCO.

All 187 current members of the IMF hold SDRs and have voting rights; however, there does not appear to be a rigid formula for determining proportional weightings for SDR holdings or voting rights. Obviously, China's share does not seem to represent the comparative size of its economy or its economic momentum and there are other obvious quirks that seem to imply IMF rights are inequitable (e.g. Belgium holds 2.00% of outstanding SDRs while India holds 1.81% and Brazil holds 1.32%). So we ask again: is the IMF credible enough among its member economies to oversee SDRs as the super-sovereign global currency?

#### IMF = Inviting More Finance

Judging from its policies, the IMF remains biased towards accommodating certain economies over others. One does not have to look far to substantiate this claim. According to the first page of the overview in the 2010 IMF annual report:

“During the year, the IMF remained at the center of the international community's efforts to return the global economy to a sustainable growth path. Efforts focused on providing policy advice to members to support recovery, reinforcing the global financial safety net, and fortifying the international financial system.”

We are compelled here to point out a subtle but very major “tell” that likely gives pause to many IMF members to adopt SDRs as the world's reserve currency. “Reinforcing the global safety net” and “fortifying the international financial system” are the first priorities of financiers, not the first priority of capital producers with growing domestic production. The IMF board seems to see sustainable global growth as being a discrete function of a healthy financial system. This is a very Western (and very contemporary) idea. A healthy *financial system* disproportionately benefits importers and weak capital producers and penalizes exporters and strong capital producers that are less in need of financing their commercial activity.

If the IMF were to argue against this accusation by asserting all nations would benefit by saving the current global financial system because the level of global trade would be maintained; then we would counter that although the exports of capital producers like China, India, Brazil and Russia (and even Germany) would be stabilized, deeply indebted economies like the US and much of the EU would benefit far more. Yes, global trade would decline and exporting capital producers would suffer without financial help, but the fate of indebted importers would be far worse because they would be forced to reconcile their over-leveraged balance sheets. Consistent with our criticisms of the Fed in Section 1, the IMF's actions disproportionately benefit certain constituencies.

#### SDRs = Surplus Dollar Receptacles

Let us suppose that by some Herculean show of collective foresight and statesmanship, global leaders preemptively press the monetary reset button and proclaim to the world that as of, say, January 31, 2020, the world will use SDRs as its media of exchange. Should we celebrate?



No, the structural flaws that trouble the current monetary system would be magnified many times by adopting SDRs or something similar as a common currency. First, the SDR is a derivative on derivatives -- a baseless currency that rests atop other baseless currencies. It would unlikely gain respect among the world's wealth holders, commercial counterparties and savers. Second, consider that the fundamental problem being experienced with the Euro today would be exaggerated by a multiple of 11 times (187 IMF global countries divided by 17 Euro zone countries). There would be 187 different growth rates and fiscal policies and only one monetary policy to deal with them.

There is another practical issue to be considered. The only instance where SDRs would logically be called into action would be at a time of distress in the current system. At such a time why would other economies agree to give the US dollar an 18% weighting in SDRs? Further, why would the United States accept a meaningfully diminished weighting when it could simply create a new currency it could then control unilaterally? It would be easier to pass a camel through the eye of a needle than to find an equitable conversion rate for 10 existing major currencies used by 187 nations at a time of US dollar distress. (If you think the G20 is dysfunctional now...) The economic volatility, inequality and currency cheating (leveraging) that would occur are too great to fathom. It would seem the SDR regime would end almost as soon as it begins.

#### What About A Semi-Hard Currency?

There have been rumblings recently that the SDR should include gold as a portion of its underlying currency basket (as hinted by Robert Zoellick). Gold bugs love such talk but we would advise more tempered expectations. *Gold cannot be included in the SDR basket for the same reason there cannot be a multiple reserve currency system. Gold would implicitly be the sovereign currency within the SDR basket, which would then destroy the entire concept of the broader SDR as the reserve currency.* It would be dysfunctional in the practical sense.

Let us assume tomorrow the world's elders proclaimed SDRs were the global reserve currency and that its basket would be comprised of some weighting of Dollars, Renminbi, Euros, Yen, Sterling and gold. Say gold was given a 15% weighting in the basket. Foreign exchange traders would quickly arbitrage all inefficiencies so that SDRs and its six components would more or less trade in equilibrium to them. So far, so good, but this theory does not hold up when we go through practical iterations necessary when and if confidence in SDRs wanes.

As we wrote last November ("Towards Capitalus"), *partially* backing a currency with gold is functionally impossible. Say we have SDR 100 and we decide that we would prefer to hold gold. If SDRs are "15% backed" by gold, we would exchange our SDR 100 and receive SDR 15 of gold and SDR 85 of the other currencies. If we wanted more gold for our SDRs we would then have to get back in line and exchange our SDR 85 for SDR 12.75 of gold (SDR 85 x 15%) plus the other currencies. We could do this forever but never fully redeem our SDRs for gold, or for any one of its components for that matter. "Partial backing" is a concept lacking any foundation in logic or practicality. A precondition of any currency must be redeemability. Anything less than 100% redeemability is easily gamed.

When push comes to shove, the notion that the IMF is an objective intermediary and credible issuer of a widely adopted media of exchange seems irreparably compromised and the idea that the SDR can be broadly welcomed as the world's reserve currency does not hold water. Functionally speaking, the IMF is an agent of Western policy makers and it would only be able to maintain credibility if the US and its friends continue to see it as useful, which is precisely why it cannot accommodate a wider world. Thus, we fail to see how SDRs could become the world's reserve currency (regardless of how many Western Economic Nobel Laureates suggest it).

#### Geopolitical Rhetoric

So if we are right that the idea of the SDR as the global reserve currency is *Dead on Arrival*, then why is there continued discussion about them? Perhaps because leaders in centrally-planned economies are as adept as those in more open ones at geopolitical grandstanding?

Zhou Xiaochuan, Governor of the Peoples Bank of China (PBOC) has repeatedly called for an overhaul of the global system, suggesting just last month that the US dollar be replaced by SDRs and monitored by the IMF. This

prompted US Treasury Secretary Timothy Geithner to respond that Washington is "quite open" to Chinese proposals for the *gradual development* of a global reserve currency run by the IMF. Gradual indeed. Time is the one element in which each side shares an interest. *The SDR is a red herring, everyone knows it, yet it is in global policy makers' current best interests to continue "hinting" about its future role.*

#### How About a Basket of Hard Currencies?

The question among many that see pending doom in debt currencies and value in tangible assets is whether there might be a global currency backed by a basket of commodities. The thinking is that such a basket would back the new currency with assets having more transparent value. We do not think such a currency would work, conceptually or practically.

First, a medium of exchange cannot be an asset unto itself because there must be separation between the ability to save (in currency) and the process of investing (in assets). An honest wage demands good currency that may be saved without risk. Deploying excess purchasing power demands assets in which investors may take risk. For a fair and sustainable currency, there must be a conscious decision among all economic participants, including wage earners at every level, of whether to save or invest. A commodity-backed currency would not provide this.

When we apply the concept above to the real world we can easily see the second, more practical reason a currency cannot be backed by commodities. Commodities are generally depleting resources. Their values are also subject to preference and innovation. Changes from year to year in their above ground supplies are uneven, subject to changing demand, weather and innumerable other factors. Were the world to adopt a commodity-backed currency as its store of value, resource-rich territories would gain immediate wealth while others would lose it. Governments of resource-rich nations that would benefit most from such an arrangement, with the possible exception of Russia, do not have military strength sufficient to enforce compliance.

Further, incentives would surely lead to a race to extract commodities regardless of current demand or collateral damage to workers and the environment. This explicit incentive structure would in turn surely lead to provincial and possibly even global military conflict. Even narrow-minded politicians laboring under the tyranny of the short-term would see that the consequences of such an arrangement would make adopting it foolish. We think any motion for a commodity-based currency would also be dead-on-arrival.

#### Suspension of Disbelief

There certainly does not seem to be much conviction or foresight behind geopolitical rhetoric surrounding the current monetary system, whether it is suitable for the global economy and, if not, a monetary system that could replace it. Most have been tangential afterthoughts. Following the bursting of the credit bubble in 2008, French President Nicolas Sarkozy proposed a new global monetary order before deciding later to scale back his ambitions. A list of "indicators" to assess economic imbalances now seems best to Monsieur. Très pragmatique.

We have come to understand that politicians executing the most critical policies are *making it up as they go* – that there really is no there, there. This is a frightening proposition for most people because it is most comfortable to be told tomorrow will greatly resemble today, even if that may not be true. We want to be lied to. We want someone else to fix the fundamental problems we know intuitively cannot go away without hardship. (To be frank, we're not sure this is such a bad thing, all in. A big screen TV, food on the table and a modicum of dignity and what more can we ask for?)

Our leaders have a tough job. Our social contract with them is that we will let them boost their egos and exert their power in return for allowing us not to sweat the small stuff. We have come to see elections as sporting events. Even if the other team wins we know there will be another game or season. We watch as spectators, trying to recruit others to our team. Understanding policy is a secondary issue, for us and therefore for our elected officials. To generalize unfairly, being a politician in a republic today is no different from anytime in the past -- it is a job given to overachieving egomaniacs with intellects that reflect their constituents'.

But politicians appoint policy makers who, with career government operatives with true expertise and genuine interest in the greater good, have no excuse. We presume these bright men and women suffer from one or more of the following conditions: 1) their personal neediness to be accepted trumps their ability to express what they may know to be true; 2) if it has not happened before then they are wired to believe it must not exist; 3) they ascended to their positions precisely because they suffer from one or both of the first two conditions.

As investors we are unconcerned with what politicians and policy makers say or intend to do. Our professional interest is not to try to like them or hope they succeed. It is whether the decisions they make will affect incentives, and if so, how? This leads us to two closing conclusions:

1. politicians and policy makers following their own natural incentives to kick the can down the road will succeed up to the time when their own cans are kicked down the road, and
2. independent postulations that seek to include the incentives of all concerned should be more accurate than the best intentions of bright, articulate, earnest men and women from around the world genuinely seeking to do good for their constituents (or on behalf of special-interests trying to do well).

No matter what the titles or job descriptions are, individuals trying to exert power by relying on their legal authority will find they have far less power than they (and most of us) believe because they must operate through large institutions with disparate legal and practical agendas. It would seem that true power to shift incentives and priorities could only be found in sensible ideas and the will of the majority to make them happen.

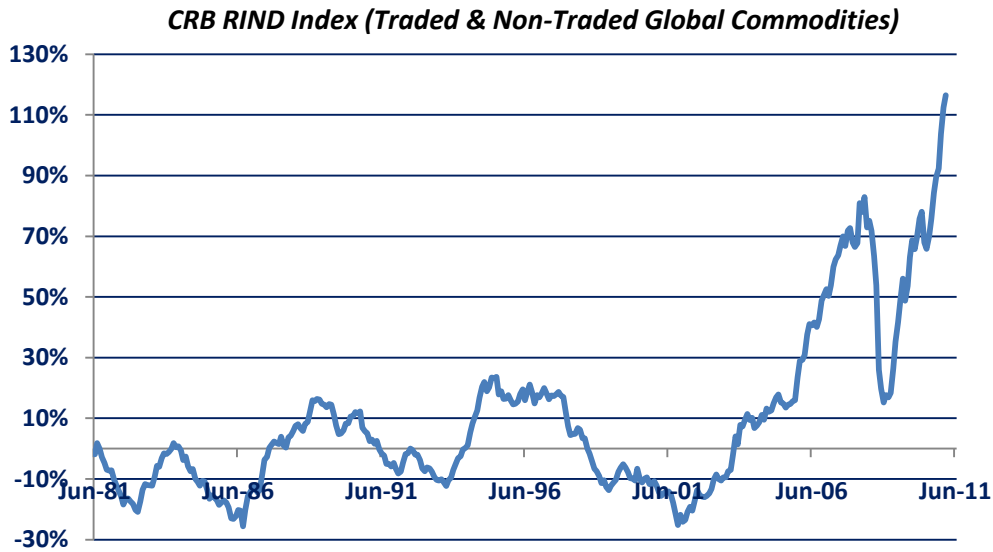
*We think the will and power of politicians and policymakers are vastly inferior to natural market incentives, which is where the real power lies. The dollar will remain supreme until it and the entire global monetary system fails, and there is nothing Ben Bernanke or anyone else can do about it.*

**3. Devaluation & Transformation**

*The next global monetary system and the implications for assets and wealth*

We debated whether to call Section 3 “Devaluation & Transformation” or “Transformation and Devaluation” because we could not be sure (or possibly know) which would be generally recognized first. We finally opted for “Devaluation and Transformation” because the world is already experiencing substantial currency devaluation. Currency devaluation is apparent through the process of prevailing inflation, even if the majority of economists and market participants are looking elsewhere. Transformation will come after this becomes more widely known.

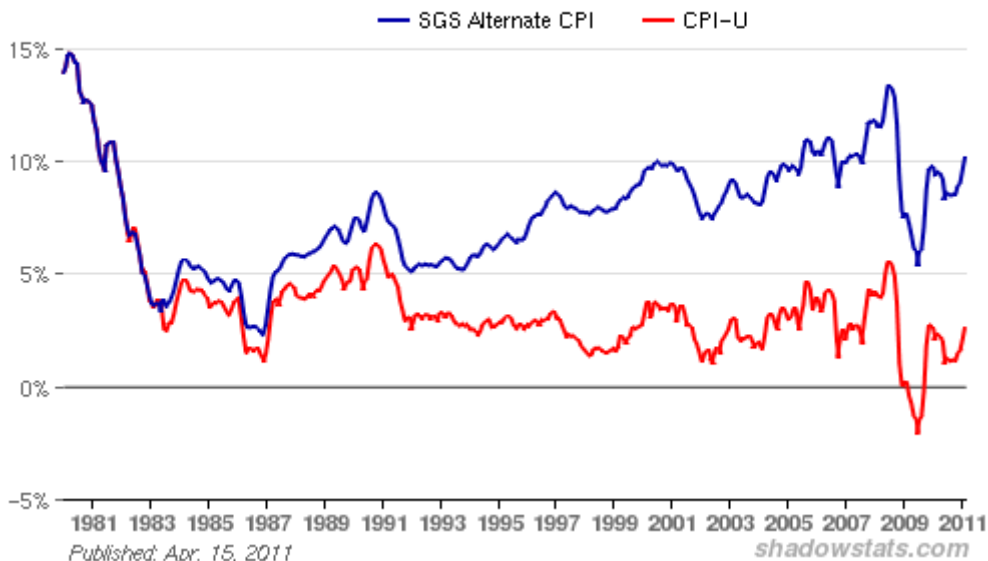
The top graph below shows the percentage increase in prices for “the stuff we need” and the bottom graph shows the annual percentage change in the BLS’s CPI and the SGS Alternate CPI, which calculates the CPI as it was calculated in 1990. Shadow Government Statistics puts annual CPI growth above 10%.



Sources: RJ CRB; Bloomberg, QBAMCO

**Annual Consumer Inflation - CPI vs SGS Alternate**

Year to Year Change. Through Mar. 2011. (BLS, SGS)



Published: Apr. 15, 2011

shadowstats.com

Courtesy of ShadowStats.com

In section 1 we criticized fractional reserve lending, which greatly distorts commerce, unfairly leads to inequitable wealth distribution within societies, and, in a debt-based monetary system, necessarily sews the seeds of monetary system demise. In section 2 we argued why commonly proposed solutions for a new monetary regime must fail because they do nothing to address the fundamental issue – overwhelming Western debt and the continued perpetuation of it. In section 3 we discuss the relevant issues that point to how a new monetary system will be constructed and we postulate how it may come to pass.

### Monetary System Considerations

We think that once the existence and implications of widespread currency devaluation are widely recognized, the pace of devaluation will accelerate until the current system fails. The notion that following the collapse of the dollar system the world's wealth holders and capital producers would accept another common debt-based currency in which to exchange capital and preserve wealth is highly unlikely. *We think that when the dollar system fails it will have to be replaced by a hard money system.*

First, we should all agree that there are two possible forms of monetary systems -- one that is endorsed by the majority of major trade partners and one that is more disparate in nature, and therefore not a *global* system at all. The former naturally provides the world's economic participants with more efficiency and transparent valuations for goods, services, labor and assets than the latter. So, the natural inclination of economic participants with a global purview is to gather around a form of currency that makes commerce efficient, less tribal. Further, governments like having taxing power over their citizenries, implying they are unlikely to accept as legal (for any extended period) a more random barter or black market system where willing counterparties privately exchange value "off the grid". Thus, we think there will always be a global reserve currency and a new one will be sought.

So then the problem before us is that the current system is failing, the public sector does not have a solution for it, and there must be a new *global* monetary system to take the place of the current one.

*We expect the free market to set the future terms of global exchange.* We do not write this out of ideology or hope but because it is the only possible way for necessary transformation to occur. As the current system breaks -- whether acknowledged over time, through a sudden event or via official proclamation, wealth holders in all corners of the planet will set about finding value equilibriums for their assets and production. In fact the markets imply this has already begun. We would cite rising prices of precious metals and scarce resources in the face of "an uneven economic recovery" as the migration of wealth towards better warehouses of purchasing power.

Recognition as to the cause and impact of current trends seems to be broadening out and accelerating. At some point we would think that some stores of purchasing power will begin to rise parabolically in terms of existing currencies. Levered assets, offering negative real returns regardless of whether their prices may rise nominally, will lag. Some asset prices will no doubt fall in both nominal and real terms. We are highly confident this must occur. While we have quite a bit of conviction about various stores of value, how they will interact with events and with each other, and the path that events are likely to take; we have little conviction as to the timing of actual events.

### Transformation -- Official vs. Market Forces

We think the markets will continue devaluing various major global currencies as each comes under rotating pressure. The longer this lasts and the attendant higher the costs of goods, services and assets in all currencies relative to wages and output, the nearer we approach widespread confidence loss. Eventually, we expect the price function in the free market to break down, forcing the referees of the current system to call an official time out.

Though pressure to change the system should continue to build among global savers and in Western markets among investors, we think manifest transformation can only occur following a generally acknowledged crisis. As in 2008, we think policy makers will seek to return the markets to a state of "normalcy". Again, their only potential prescription would be money printing, yet this prescription would be the precise activity wealth holders would be rejecting. Thus, we think policy makers will quickly realize, if that do not know it already, that they are unable to mandate the *value* of goods, services, wages and assets via proclamation. It would have to be the other way around – the markets would have to determine value.

Only the private sector can decide how much a three-bedroom London flat is worth in crude oil terms, how much a factory full of Chinese workers is worth in New York private school tuition terms, or the value of Kansas acreage in Apple shares. When markets and economies seize, there will simply be no definable dollar prices at which a '61 Lafite, a Pontiac and its parts, or a container of Bok Choy could be exchanged. We expect governments will be limited to trying to help the private sector sort out *the means of quantifying* that value. And so policy makers will only have input into defining the medium of exchange.

We have no doubt that some consumers and vendors will immediately try to begin exchanging value prior to official proclamation of a new medium. Value exchange might occur versus other goods, services and tangible assets (barter) or in terms of a medium of exchange in which counterparties feel reasonably sure will maintain purchasing power. However, the renewal of higher level commerce and trade may be a little trickier to jumpstart. A business inventorying barrels of oil would not be willing to exchange them for any amount of paper.

The important thing to keep in mind is that property will not necessarily change hands, especially if the transition is swift. We would wake up the next morning and still own our homes. Businesses that owned factories would still own them. If laborers had jobs on Tuesday they would have them on Wednesday, even if their bosses have no idea how to pay them. (Obviously, a lengthy, drawn-out process of declining confidence in currencies leading up to this period could elicit behavior that would affect property and production quite meaningfully.)

What we are discussing here is only a new way of *measuring* wealth and production, not the expropriation of them. If wealth and production are indeed transferred during this process then it will be the result of: 1) creditors legally enforcing their claims on distressed debtors; b) the market re-prioritizing its sense of value; and/or 3) governments using the transformational period to change laws and regulations that then serve to transfer wealth among economic actors (or towards governments).

Incentives suggest the time span to adopt a new system of value measurement would be brief. Otherwise black markets and bartering would gain influence and governments would lose control. *This should make us optimistic that at some point a new way of measuring currency will come swiftly. We do not think international trade will stop for an extended period and we think the period of dysfunction will be relatively brief. There will be one new benchmark currency to take the dollar's place and it will become obvious to all what it must be.*

#### The Default Currency – Paper with Gold Backing

Gold has no mystical powers. Like today's money, gold has very little intrinsic value because it does not provide its owner with much functional utility, apart from (cost-inefficient) electronic conductivity and a universal attraction to its aesthetic. As with paper money, one cannot eat it or use it to build shelter (although one could burn paper money to keep warm!). Gold is simply another medium of exchange that finds broad sponsorship when other media fail to provide sanctuary from purchasing power loss.

While gold advocates are quick to recount all the properties that make it the perfect currency (scarcity, divisibility, transportability, malleability, storability, non-corrosiveness, political impartiality, difficulty to counterfeit, fungibility, and redeemability), we think all such attributes will take a backseat to the one property that will make it the basis for the next monetary order – precedence. In an environment in which private sector counterparties are quickly losing faith (or have already lost faith) in all paper currencies and in which the political dimension is powerless to proclaim another baseless medium of exchange, all incentives will align towards expediency. *We think it is highly likely that precedence and familiarity will make gold the default basis of the next monetary system, and that the mechanics of the next system will be modeled after the Bretton Woods Agreement.*

#### Addressing Common Criticisms

Before proceeding, we are compelled to address a few common criticisms often levied against gold as a basis for currency.



**Common Criticism:** “There is not enough gold in the world to accommodate the size of the global economy.”

**QB:** There is plenty of gold, at the right price, to accommodate the size of the global economy. In fact under a *gold-exchange standard*, only one ounce of gold would theoretically be sufficient because that one ounce is divisible. Paper currency would be distributed representing some increment of that one ounce. (The problem with one ounce in a *straight gold standard* would be redeemability.)

In its simplest theoretical form there can only be two identities that equal each other: the value of money must equal the value of all things not money (let’s call it “stuff”). Presently, all currencies including dollars and gold are competing components within the money bucket and everything else of value is in the bucket of stuff. An exchange of value does not have to use both buckets. In a simple example, one may exchange: 1) food for a blanket; 2) Euros for a business, or; 3) dollars for gold. The first exchange occurs completely in the stuff bucket. The second exchange pairs off value between the money bucket and the stuff bucket. The third exchange occurs entirely in the money bucket. This concept is logically profound and practical as a polestar for the relative value of each bucket to the other.

A preference for gold is an expression of the expectation for a devaluation of baseless currency vis-à-vis gold, given the aggregate exchange value of the stuff bucket. It is completely independent of widgets, farmland, and 25 year-old Scotch whisky. While the dollar price and gold price of such stuff changes, their intrinsic value does not. Unreserved credit denominated in dollars, yen or gold to date has merely distorted exchange values (and has done so in a cyclical fashion throughout history -- e.g. the business or credit cycles). The aggregate value of the stuff bucket does not change but the intra-bucket exchange values do.

Thus, in a gold exchange standard the value of gold would have to represent the value of all goods, services, labor and assets in the world, the same way paper currencies do today. The relevant issue is not the size of the money bucket but its composition, and so the criticism that there is not enough gold to accommodate the size of the global economy is fallacious.

**Common Criticism:** “Gold as a basis for money is too inflexible to accommodate a dynamic global economy.”

**QB:** The only reason to have gold as a basis for money is to enforce discipline on money lenders; they would theoretically not be able to lend out more gold than could be produced. So, the “inflexibility” that gold exacts is undeniable. In fact, that is the entire point.

It comes down to societal preference. A fixed exchange rate monetary system rewards real production and saving and penalizes leverage and political maneuvering. A flexible exchange rate system rewards the clever use of borrowed funds and penalizes savings and real production. We may all decide for ourselves which we prefer.

Objectively, it would seem that when one economy or economic bloc is at or near the top rung of the global economic ladder, then advocates for these economies should not want a *dynamic* global economy (who wants change when you’re at the top?). In fact it would seem that advocates seeking to perpetuate the stature of developed economies today would seek a shift to a fixed exchange monetary system, as doing so would lock-in systemic wealth.

*Whether they know it or not, those expressing the common criticisms above are also expressing: 1) a preference for governments and banking systems to be partners in all exchanges of value, and 2) the continuation of current trends that are transferring aggregate wealth from developed economies to developing economies.*

**Common Criticism:** “The gold standard was already tried and failed.”

**QB:** The gold standard did not fail. The consistent failure has not been what backs (or does not back) money; it has been tolerating a system of fractional reserve lending that in turn allows lenders to cheat by

creating and distributing unreserved net credit. This has perpetuated a debt culture of boom and bust. So, depending on your politics, either the public sector has repeatedly failed to adequately regulate lending, or private sector economic agents have repeatedly failed to recognize the real devaluation in their currency and have deserved to lose their purchasing power when busts have come.

**Common Criticism:** "In a modern economy, price deflation is death. Suppose you're an investor and an entrepreneur comes to you with a proposal to build a factory, and the business plan shows next year the factory will cost 1% less to build and the products will sell 1% cheaper. Why build a factory today if you can get a 1% a year increase in purchasing power just by keeping gold in your mattress? You would need a very big or very certain return to lend it out or invest it."

**QB:** Exactly. Risk should be commensurate with reward. There should be no economic activity unless real sustainable margins support it. Using the example above, if enough decision makers delayed building factories it would be the result of genuine economics. This might mean that GDP might not grow and even shrink. So what? Affordability would increase in kind, labor would shift to where production is competitive, and the purchasing power of one's savings would rise. The factors of production would benefit because efficiency would rise and labor would benefit because wages could be saved for future consumption.

**Common Criticism:** "Under a gold standard fewer factories would be built, real interest rates would be higher, and entrepreneurs and established companies would not have access to the cheap capital that generates high growth rates."

**QB:** And under a baseless money system we are seeing no factories being built, unreserved credit is inaccurately defining wealth, interest rates are negative in real terms, and the wealth gap is expanding as wealth is being transferred to economies actually producing capital. Under a sound money system (not only a gold standard but a more fully reserved lending system), the RIGHT amount of factories would be built, nominal interest rates would be low and real interest rates would be positive because there would be no inflation (the currency would retain its purchasing power). There would not be "cheap capital" or "expensive capital" -- there would just be fairly valued capital.

**Common Criticism:** "When you get strong growth globally and a fixed amount of gold, you end up with not enough money to go around, and then a you have a banking crisis."

**QB:** At the right money/gold exchange rate there would always be the right amount of money, whatever that is. At equilibrium gold pricing, all debts would be fully reserved, which means that no new money need be created for the size of the economy. Banks only have crises because they issue more credit than they can cover.

We have noticed that the common criticisms of gold as the basis for a monetary system tend to confuse several issues, notably the relationship between quantity and price, the generational tendency to consider only nominal vs. accurately calculated real growth, and the misguided sense that arguing on behalf of the status quo serves the sustainable best interests of the West.

#### Gold – Stable Currency or Volatile Commodity?

In the West, gold continues to be largely misunderstood as a commodity implicitly dependent upon overall output growth, like consumable commodities. We think the process of buying gold in physical form or even buying mining properties is the process of converting one's paper currency to hard currency. This act of conversion should be distinguished from the act of speculating on the future pricing of consumable commodities like oil, copper and wheat, which depend upon dynamic global supply/demand trends and shifting market preferences.

Despite a lot of chatter to the contrary, Western investors have virtually ignored gold. Less than 1% of all gold futures holders takes physical delivery. Thus, owning or shorting "paper gold" on liquid exchanges implies an accurate gold/USD exchange value for only about 1% of the notional amount traded. The barometer of gold's complete value in US dollar terms is not determined by speculators with mismatched funding.

The value of other forms of paper gold may also be misleading. Gold ETFs total about 70 million ounces, or only about \$120 billion and the aggregate market cap of gold and silver miners is far less than Google's. The smallness of the paper gold market compares to about \$26 trillion in global pension money alone – a sector that has dedicated only about 0.55% to precious metals expressions. If we include all investment portfolios, we get a commitment of just 0.15%. (If you like to round your basis points that would be 0%.) So for all the public clamoring, media attention and cheesy late night commercials looking to buy your gold, the yellow metal has not been endorsed by financial asset investors as a legitimate investment.

This may be entirely rational. We would expect that exchanges would close trading in such instruments during a period of chaotic transition. This introduces the risk of not being able to convert exchange-traded derivative paper to physical bullion. The necessary time span and valuation gap upon re-opening, and the unquantifiable means of settling all open-interest contracts and shares, would make such assets illiquid at the exact worst period for illiquidity to occur. And it seems entirely possible that there would be counterparty risk in all paper gold, even if such contracts are guaranteed by clearing agents.

We think it is accurate to think of physical bullion as a currency and equity in precious metal miners as sustainable gold investments. All other precious metal derivative forms, notably futures and equity-linked vehicles with pricing derived from futures, should be considered trading vehicles with limited range.

Physical bullion is held in strong hands, which has further implications for the future behavior of exchange pricing. Should fundamentals remain the same, commodity traders selling gold futures and equity traders selling precious metal ETFs should not be able to take exchange prices down in any great degree or for any length of time. (In fact it seems that many market technicians have recently learned that their charts are not applicable to precious metals.) There would simply be a supporting bid from official and private parties seeking to convert paper currencies into bullion.

We would argue that central banks and state-owned investment authorities holding trillions in paper dollar reserves and obligations have an ongoing bid that is relatively insensitive to exchange pricing. (The amount of gold that one may actually take delivery of from exchanges is very small at current pricing. By implication, if a central bank or monetary authority were to try to take more than is typically delivered then the exchange price would rise materially.) The large global currency converter is far more concerned with fundamentals, has deeper pockets, and therefore has far more staying power in their positions. (Perhaps this explains why policy makers from all sides are taking their time?)

Gold futures and other "paper gold" being priced on global exchanges, as well as other derivatives being priced off of them, do indeed seem to have an element of speculation among participants today, most of whom may not understand the factors that ultimately define the merits and risks of their speculations. If they did understand, we argue they would: 1) not see gold as a hedge against a rising CPI but as a hedge against the global deleveraging process; 2) bid prices much higher than where they are today, and; 3) take delivery of physical bullion rather than rolling their contracts.

When the exchange price of gold rises or falls on any given day, we think it is most accurate to think of this activity as the value of dollars falling or rising as the market continually handicaps the likelihood of the dollar's viability. (We argue later that the market has mispriced not only the potential but the current terminal value.) Of course this is subject to being gamed by large global players. Every day the London fixing declines, those with access to physical bullion may purchase it at lower levels.

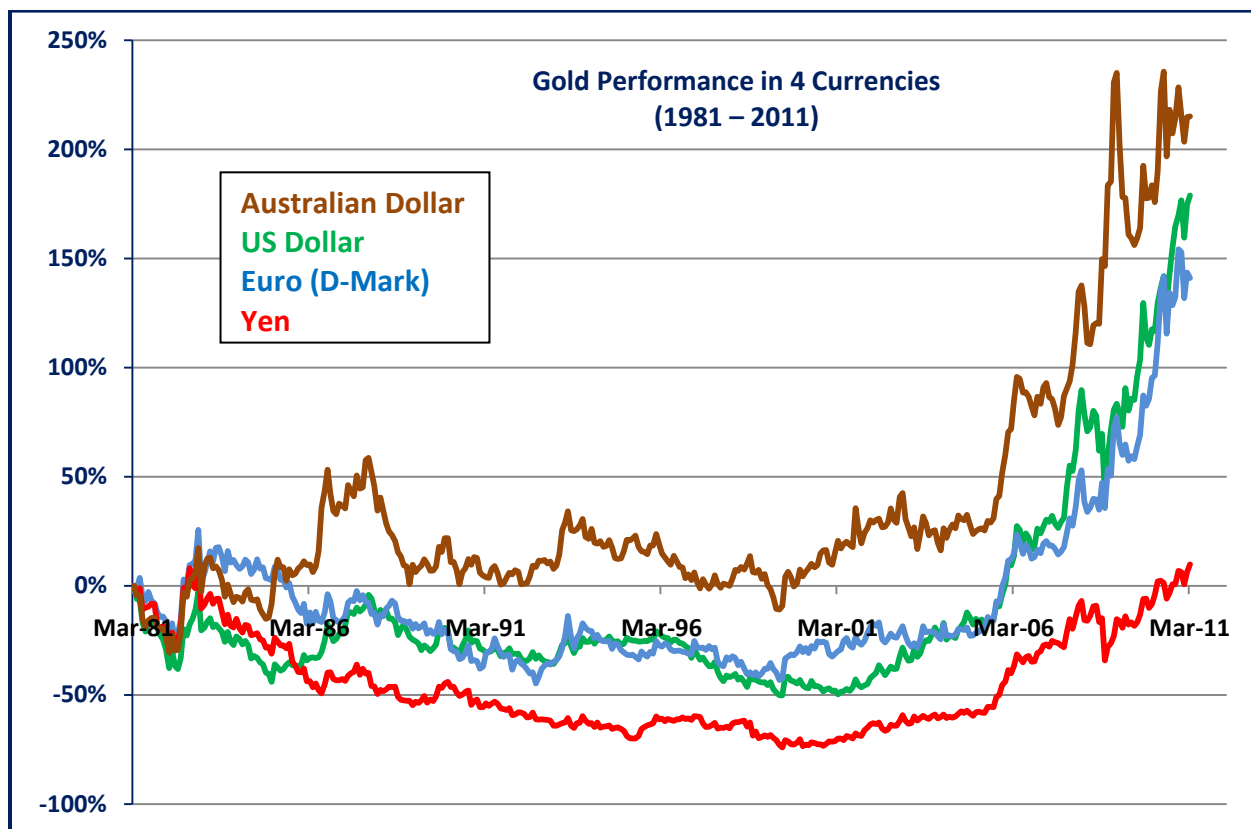
Nevertheless, whether the result of intuition, the slow absorption of sound logic coming from independent analysts, the lack of obvious investment opportunities in more familiar industries, low interest rates and therefore little opportunity-loss from not being invested in income producing assets, or the seasoning that only a multi-year established bull trend can offer, gold seems to be losing some of its Western stigma as the sanctuary of uneducated hillbillies toting around shotguns and Spam. Right or wrong, global central banks and many of the world's most sophisticated wealth holders have begun accumulating it.

We think there is quite a long way to go before the broader population of financial asset investors internalizes relationships that makes them able to analyze whether gold, as a hedge against the deleveraging process and as a store of purchasing power, is prudent. And regrettably, there seems to be very little chance that the broader population will ever know. We taped an interview on a major network news show last year and after going through what we thought was a 45-minute cogent explanation of the fundamentals driving gold prices higher, we were amused and saddened by one of our lines they chose to air -- "I like shiny things."

Natural Devaluation

You can't fool Mother Nature. The process of diminishing purchasing power in a currency is the process of currency devaluation. *Natural forces are leading the US dollar, and therefore all other global currencies, to be devalued vis-à-vis gold.*

The graph below shows that the devaluation process is already well underway. A graph of rising gold prices expressed in various global currencies illustrates the degree to which wealth holders have been exchanging their home currencies for a more sovereign one. It takes many more US Dollars, Aussie Dollars, Euros and Yen to purchase an ounce of gold than it did a few years ago. Again, one may either think of this as the price of gold rising in various currency terms or the value of currencies falling in gold terms. The net effect is the same: baseless currencies are uniformly being devalued against gold. Those that converted at higher exchange rates (lower gold prices) have more purchasing power today as a result.



Thus far, devaluation has been slow and orderly. The price of gold has risen steadily since 1999, not coincidentally commensurate with the credit-generated peak in corporate equity prices. It made perfect sense to ignore gold from 1981 to 2000 in favor of a strategy of borrowing – outright or implicitly -- to buy financial assets. The time until the private sector credit build-up would end (2006) remained far away and the current returns from financial assets were too great to ignore. In their blow-off phase from 1995 to 1999, corporate equities generated positive real returns even when deflated for credit growth. It would have been irrational to own gold.

After the corporate equity bubble burst in 2000 and credit migrated to real estate, it became entirely logical for gold to begin rising in anticipation of its bust. Unlike stocks, real estate prices were lifted by a self-generated multiplier effect. Fed models implied no need for tighter credit because it seemed that balance sheets were in equilibrium -- assets and liabilities were ostensibly increasing in tandem at a sustainable rate. However the universe of bond buyers was uninterested in the absolute level of credit. The only thing that mattered to buyers of residential and commercial mortgage-backed securities was the spread between their funding levels and the income from their assets. The Fed was oblivious to the systemic duration and credit mismatch it was creating. Gold was not. The credit bubble would eventually have to burst and money would have to be manufactured.

Today, gold continues to creep higher in all currencies as it discounts the necessary de-leveraging. Obviously, there must be items off which the currency in question loses its purchasing power. Gold has always been the currency of last resort if and when baseless currencies stumble, and so it is the currency against which all others are being devalued today. We are in the second inning (baseball, not cricket) of the de-leveraging process. The process of devaluation has just begun in terms of magnitude. *After it becomes obvious to all that money printing does not retire debt, the most expedient means of de-leveraging the system will be pegging money to an asset.*

The Shadow Gold Price (SGP)

When we opened our Fund in February 2007, we had a very high level of conviction that gold was cheap in fiat currency terms. However, as former bond traders, we struggled with finding a framework in which we could define “fair value”. The massive dose of central bank money printing in 2008 provided us with inspiration. *The fair value of gold would have to be the price at which its aggregate value would back all outstanding baseless currency -- in effect, the price at which debt-based currency would be transformed into asset-backed currency.*

QBAMCO Shadow Gold Price								
Change in USD Monetary Base	-25%	-10%	FLAT	+10%	+50%	+100%	+500%	+1000%
Monetary Base (billions)	\$1,950	\$2,340	\$2,600	\$2,860	\$3,900	\$5,200	\$13,000	\$26,000
Official US Gold Holdings (millions of ounces)	261.5	261.5	261.5	261.5	261.5	261.5	261.5	261.5
<b>Shadow Gold Price (in US dollars/ounce)</b>	<b>\$7,457</b>	<b>\$8,948</b>	<b>\$9,943</b>	<b>\$10,397</b>	<b>\$14,914</b>	<b>\$19,885</b>	<b>\$49,714</b>	<b>\$99,427</b>

This table illustrates a potential metric for future US dollar devaluation, based on our Shadow Gold Price. The US Treasury is believed to own 8,133.5 tonnes (metric tons) of gold. Each tonne converts into 32,150.75 troy ounces, meaning US official gold holdings approximate 261.5 million ounces. (The US gold hoard has been almost completely stable for forty years, and so we have kept US official gold holdings constant.)

As per the Bretton Woods Monetary Agreement that lasted from 1945 to 1973 (the last global fixed exchange rate system), the method used to calculate the exchange rate of paper money to gold was to divide the US Monetary Base by official US gold holdings. If this precedent were to be re-established today, current conditions imply a US dollar devaluation to almost \$10,000 / gold ounce. Such devaluation would imply that US dollars would again be fully backed by Treasury assets.

To put this table in perspective, the Fed already increased the US Monetary Base over 200% since 2008, from about \$850 billion (\$3,251 implied SGP) to an estimated \$2.6 trillion (following the completion of QE2). It is important to note that the Monetary Base only constitutes systemic bank reserves held at the Fed and currency in circulation. It does not include upwards of \$70 trillion in US dollar-denominated claims, a significant portion of which conceivably must be ultimately be repaid in money from the Monetary Base that does not yet exist.

In a report distributed to our investors in December 2008 we divided Federal Reserve Bank Liabilities by US official gold holdings and dubbed it “The Shadow Gold Price”. A few months later we began using the more conservative denominator, the Monetary Base, in our calculation. As it turned out, dividing the US Monetary Base by US official gold holdings happened to be the very formula used in the Bretton Woods system to establish the global fixed monetary exchange rate. Our logic was confirmed by long convention.

Under the Bretton Woods Agreement, the fixed conversion rate was mandated to equal \$35.00 per ounce, the gold-implied price at which all currencies would be exchangeable for dollars. If the Fed were to print too much money, then holders of dollars or any currencies exchangeable for them could exchange their paper for gold at \$35. If, theoretically, the Fed were to drain reserves, then holders of gold could exchange it for dollars. In this system, dollars and/or gold would theoretically retain their purchasing power. (Again, the reason for a fixed-exchange monetary system was to instill discipline on politically-motivated money creation so that the purchasing power of money could be sustained.) Given the amount of money printing and devaluation that has already occurred in dollars and all other global currencies since the demise of Bretton Woods, it is obvious that gold could no longer be priced at \$35.00.

The “Flat” column in the table above shows our current SGP, which implies the substantial devaluation of purchasing power of the US dollar that has already occurred. Are we nuts? Are we asserting gold should be valued at \$10,000/ounce when it is trading around \$1,500/ounce in London and New York?

The SGP’s purpose is to provide a sense of magnitude as to how much the US dollar has already been devalued and how much further it may be devalued. (Obviously there can be no guarantees about future pricing.) *We believe the Shadow Gold Price provides the intellectual framework for the magnitude of necessary future global currency devaluation.* We feel most comfortable with this metric for two practical reasons: 1) there is recent precedent for its use and 2) it actually produces a lower figure than other valuation metrics that include systemic credit in their calculations.

#### Official Devaluation Done Right

In Section 2 we included “Official Devaluation Done Wrong”. There is a more reasonable solution to the current debt fix that could be adopted immediately (or following a crisis when policy makers have enough political cover). This solution would place the global economy on a sustainable economic path and we are also confident that the masses would gladly endorse it.

We would think the actual process would theoretically look something like this:

- The Fed would enter into an agreement to purchase Treasury’s gold stock. Every Federal Reserve Note created to purchase this stock would be inflationary (additive to the existing stock of base money). (As an important aside here, much of the stock of US Treasury debt could be retired with these proceeds.)
- The Fed would then tender for any and all privately-held gold up to its established target price.
- If no privately-held gold is tendered, the expansion of the base money stock is limited to that created and swapped with Treasury in exchange for its gold. If, on the other hand, privately-held gold is swapped to the Fed, then the base money stock grows commensurately. Clearly, the trick for the Fed would be to find the “right” gold price that would increase the stock of base money by a notional amount targeted by the Fed. This, at first, would not be easy.
- The Fed would engage the private market in order to establish the credibility of the dollar’s new “gold-backing.” Otherwise, confidence would become uncertain again. It would not be enough to simply claim gold-backing – the Fed would have to establish a market-clearing gold price in order for its newly-orchestrated policy to be credible.

Practically, we would expect the following three-step process:



1. To remediate all past monetary inflation and reset the global monetary regime, the Fed would tender for privately-held gold at or near the Shadow Gold Price (currently about \$10,000 / ounce).
2. As the Fed purchases gold, the gold would flow to the asset side of its balance sheet. The Fed would fund those purchases through newly-digitized Federal Reserve Notes, which would flow to banks in the form of net new deposits. This would be a discrete monetary inflation event (devaluation) and a simultaneous deleveraging.
3. Once the Fed acquired enough gold from the markets, a gold price peg for the US dollar would be established.

Would this be a gold exchange standard? Yes, if that nominal exchange value is maintained in the open market by the Fed. No, if the Fed decides to periodically adjust the benchmark gold/USD exchange rate following the original exchange. Tinkering with the official gold price would be a pure example of a monetary agent conducting monetary policy (as opposed to targeting the Fed Funds rate as they do now, which in reality is executing credit policy, not monetary policy).

We think this operation would be seen as credible by the markets and by global economic policy makers. We further think some form of this operation will be done, whether the result of market-forced crisis response or, less likely, preemptive policy.

#### Inflationary or Deflationary?

If the US unilaterally devalued the dollar to gold and then fixed the price, would it be inflationary or deflationary? We think the answer to this question is entirely a function of the price peg level selected. If it is set too low it would ultimately be deflationary and if set too high it would ultimately be inflationary. Because the markets would be keenly aware of the immense gap separating the total stock of unreserved debt outstanding from the base money stock, (a direct function of the size of the Fed's balance sheet). The Fed would have to accommodate the markets.

As we discussed in Section 1, when a modern bank makes a loan it is really loaning money today that will not exist until the Fed creates that money tomorrow. This game of "catch up" creates a "synthetic dollar short". So, if one concludes that the Fed must continue to aggressively expand the monetary base in order to re-establish and/or maintain the solvency of the banking system, then a much higher gold price is ultimately called for should the Fed look to back the dollar with the existing Treasury gold stock.

The current gold price necessary to simply reserve the existing stock of base money is almost \$10,000/oz. *pro forma* for QE2 and correspondingly higher than that if more QE is coming. (We think there will be more whether it continues to target US Treasury obligations or, ultimately, gold. If we are right then this would imply ultimate reconciliation would be sooner rather than later, as the Fed is holding a burning match. The longer it delays, the higher the gold price would have to be.)

So it seems highly unlikely that any mechanism enacted to back the dollar with gold could be deflationary today. That said, if the price level peg is too low, what is inflationary at the margin today may be insufficient to retire the unreserved debts due tomorrow. In our view, this peg would have to be somewhat dynamic at the start until a true equilibrium ratio of base money to debt can be found.

The mess that we call a modern banking/monetary system took many years to create. We think a rational framework to re-establish long term equilibriums tomorrow will take much iteration before some sense of balance and stability is ultimately achieved.

#### Consequences of a Properly Administered Currency Devaluation

The benefits of such a properly administered formal devaluation would be immediate and profound to debtor economies. Global debtors would welcome it. The majority of people in developed economies are deeply in debt

vis-à-vis the liquidation values of their assets. In practical terms, nominal wages and asset prices would rise following the devaluation while the notional principal balances of debt would remain constant. The burden of repaying debt would thus be greatly diminished, not the principal amount debt itself.

This would mean that banks and their shareholders, (that tend to be concerned only with nominal asset prices, revenues and earnings), would be relatively unaffected. In fact, the true solvency of Western banking systems would be reestablished because most bank assets would appreciate in nominal paper money terms sufficient to once again secure loan books.

Creditors and paper cash holders would suffer, including bondholders, savers, retirees, and foreign dollar reserve holders. But this may not be as painful in practice as it may first appear conceptually. Many individual bondholders are also asset holders that would benefit from a nominal shift higher in asset prices and improved nominal creditworthiness of their bonds. As with banks, lenders in the securitized shadow banking system such as pension funds would also benefit from the rising ability of debtors to repay their obligations.

Pensioners, on the other hand, would most certainly find that while the bonds their pension funds own have suddenly become “money good”, they will be paid with bad money (already devalued). However, they too would benefit from the broader process of devaluation because their home or corporate equity would be more likely to rise. Additionally, it would seem inflating away the burden of repaying debt today would be far more beneficial to them, as it would act as a substantial economic stimulant. As for net savers, there are very few of them today in the United States. Cash balances are held against debt balances and levered financial assets. As for retirees living on fixed-income, we would presume fiscal programs coincident with a formal devaluation would somehow compensate them for lost purchasing power from the devaluation.

There is no way to sugar coat the fact that foreign dollar reserve holders would see a significant loss of purchasing power in their reserves. We may put our consciences at ease, however, by suggesting that the cost to them of devaluation is the price exacted for US consumers subsidizing the build-out of their economies. In the case of China, the West bought their exports on credit, which allowed them to convert to more market-oriented economies and build out their infrastructures.

Dollar devaluation would equilibrate global wage rates. Labor in debtor nations would become competitive with those in lower-cost exporting nations, which in turn would bring trade more into balance. Having a sound currency would allow prices to fall without having a deleterious impact on employment because affordability would rise in kind. Workers would naturally migrate where opportunity lay. This would naturally diversify the factors of production in the West back towards manufacturing, which in turn would greatly increase employment sustainability. Critically, workers would be able to save their wages rather than having incentive to consume more than they need or desire, or to speculate on over-levered assets.

The only reason we can think of that the United States would not eventually opt to sponsor an official dollar devaluation is because Treasury does not hold the gold it claims. But we do not see that as an issue. The United States holds the most valuable asset in the world...by far.

#### The 800-pound Gorilla in your Pocket

*We thought long and hard about including the following in our discussion. We ultimately decided to include it because we feel military might is undeniably a key economic factor that is and will play a key role in the peaceful transition of the global monetary system.*

If we acknowledge that the collective value of its deep markets, objective judiciary, model of relative openness, established wealth and economic inertia and military strength is priceless, then we must conclude that the US can and ultimately will unilaterally determine how global value will be measured in the future. Should the world be fearful of this?

Without getting too existential, the US is a set of principles based around pragmatic fairness. It has been very lucky to have a large land mass with good soil and borders too remote for easy foreign aggression. These attributes have

attracted seven or eight generations of opportunists from around the world. Its people and leaders may be individually no better or worse than those of other nations, although its aggregate society may have benefitted over time from constant immigration, creative destruction, diversity and regeneration. Since its principles define it as an entity, and these principles arguably pre-date its constitution, its well-established laws have been occasionally modified, usually peacefully, when the two cannot be reconciled.

Powerful secular nations and religious movements throughout history have trampled others' liberties. We would argue the US is a different sort of entity. It may at times be too aggressive and bossy to its friends and belligerent and ruthless to its enemies, but when the US kills innocents it demonstrates genuine shame and when it takes property it tends to share the spoils. The result of its conquests has been to lift humanity rather than to cleanse it. This demonstrated principle alone leaves the vanquished with a fear only of economic inequity at the hands of America rather than a genuine fear of mortal danger.

If you are willing to give the argument above credence then you should be compelled to acknowledge that the US is willing to link military operations to its economic best interests, or at least, that the US military operations may have an economic component to them. Otherwise, the US would not be interested.

#### This Hypothesis Applied

We watched last month as allied forces began enforcing "a no fly zone" in Libya, tagged "Operation Odyssey Dawn". It was promised that it would be a short-term operation ("days not weeks") and that the US led forces would quickly hand it off to NATO, which it quickly did. The decision to use military force seems to have been made quickly; there was no apparent diplomatic/UN-consensus effort made, opposition forces do not have a hierarchy of control with which to self-govern, and NATO is comprised of the very same US-led forces enforcing the no fly zone. (Apparently a no fly zone is no longer shooting threatening planes out of the sky but preemptively attacking enemy combatants who might fly in them someday.)

If an odyssey is a long voyage (Odysseus took ten years to return home to Ithaca following the Trojan War), and a dawn is a beginning, then we guess Operation Odyssey Dawn is the beginning of a long stay of Western forces in Libya. Or maybe it was merely a case of unfortunate branding? Whatever the case, it seems clear that the G7 continues to stand firm against tyranny and oppression...in *energy-producing* countries.

The Financial Times reported on March 22 that Libya's central bank held 150 tonnes of gold and kept it in-country, rather than in the US, UK or Switzerland as is more common practice among global monetary authorities.<sup>7</sup> This stash amounts to about \$6.5 billion at current pricing. Additionally, according to IndexMundi, Libya ranked 18<sup>th</sup> in the world in the amount of foreign exchange reserves and gold with over \$69 billion.<sup>8</sup> A cynic might argue that such riches and the promise for future revenues from oil production held by a universally-despised thug were easily-obtainable, and that taking them would be politically safe. Add in the prospect of spreading democracy, and it would seem that intervention became too difficult a notion to ignore.

We continued down this road to get a better feel for incentives that may be driving geopolitical decision making in the G7. We looked at territories experiencing social strife, from civil wars to civil disobedience, and cross checked them with their FX reserves (including SDRs) and gold<sup>9</sup>. By comparing and contrasting countries experiencing social unrest with their balance sheet wealth, we composed the table below. (Of the nations experiencing social unrest we omitted those with exceptionally large economies, strong militaries or those that are members of strong economic blocs. They are not in jeopardy of military action against them.)

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<sup>7</sup> Financial Times; March 22, 2011; "Gold reserves key to financing struggle"; Jack Farhy and Roula Khalaf

<sup>8</sup> Index Mundi; <http://www.indexmundi.com/g/r.aspx?v=144>; Source: [CIA World Factbook](#) - Unless otherwise noted, information in this page is accurate as of January 1, 2009

<sup>9</sup> [CIA World Factbook](#) - "This entry gives the dollar value for the stock of all financial assets that are available to the central monetary authority for use in meeting a country's balance of payments needs as of the end-date of the period specified (January 1, 2009). This category includes not only foreign currency and gold, but also a country's holdings of Special Drawing Rights in the International Monetary Fund, and its reserve position in the Fund." Unless otherwise noted, information in this page is accurate as of January 1, 2009.

<b>Reserves of Foreign Exchange &amp; Gold of Nations Currently Experiencing Social Unrest</b>	
Algeria	99,330,000,000
Libya	69,510,000,000
Nigeria	50,330,000,000
Egypt	31,140,000,000
Colombia	23,140,000,000
Iraq	21,260,000,000
Angola	12,290,000,000
Yemen	7,871,000,000
Syria	6,039,000,000
Bosnia and Herzegovina	4,500,000,000
Azerbaijan	4,000,000,000
Bahrain	3,474,000,000
Ivory Coast	2,500,000,000
Congo	2,242,000,000
Uganda	2,100,000,000
Georgia	1,300,000,000
Sudan	1,245,000,000
Moldova	1,050,000,000
Ethiopia	840,000,000
Haiti	220,600,000
Burundi	117,700,000
Eritrea	22,080,000

**Sources:** index mundi  
<http://www.indexmundi.com/g/r.aspx?v=144>;  
 International Monetary Fund; CIA World Factbook;  
 Wikipedia; QBAMCO

It should be stressed that the simple table above only includes liquid assets and does not include natural or productive resources that may be found within their territories and the potential revenues that may be harvested from them. However, the table makes plain that Libya would be a more attractive target than, say, Sudan, from a “balance sheet” perspective. Economically speaking, whoever “buys” Libya is paying less than the cash on its balance sheet.

Perhaps more to the point, comparing Libya and Sudan purely in terms of capital-on-hand indicates the magnitude of difference in obtainable spoils. Libya could not be passed up or left alone to fall into anarchy because, frankly, too much wealth was there for the taking. One might reasonably also see this as a defensive maneuver if it were thought that Libya’s riches would fund future terrorism.

The US government’s return-on-defense spending seems high. Libya produced about 1.6 million barrels a day in January, which is about 584 million barrels a year, which at \$100 / barrel is a bit over \$58 billion. A Tomahawk cruise missile is about \$1.5 million each, which means it would take firing almost 39,000 of them per year to break even, all things equal. (The discrete act of launching a missile from an existing ship by already salaried military technicians would seem to be of little or no cost. Michael Milken teaches that the true cost of a gallon of gas is already over \$14, when one factors in the cost of stabilizing drilling domains, protecting shipping lanes, etc.)

Are we being overly cynical in raising the idea that the decision to intervene into Libya’s civil uprising was based purely on some medieval model of invading, conquering and plundering resources? Maybe, but we would be equally naïve to think that foreign policy decisions are based solely on the need to prosthetize democratic principles. Give politicians a plurality of reasons to act and it is highly likely they will take action. We presume then that Operation Odyssey Dawn is just what it means – the beginning of a long period of control of Libya by the G7 (and we assume that France’s eagerness to intervene means it will be “hall monitor”?).

If we are to take political rhetoric at face value, then even if the West is taking control of energy producing states purely based on moral imperatives, we can assume that the G7 will not hand over control of oil fields to antagonistic parties or potentially antagonistic parties. We assume there will be *an understanding* in Libya, as we assume there has been in Iraq, Libya and Saudi Arabia for decades. We see military action in the region as tantamount to the West defending property already assumed to be its own.

Against this backdrop then, the US military has become increasingly active in resource-rich territories ever since large, formerly closed economies like Russia and China entered the global economy as trade partners. It has been seen as doing so in a benevolent fashion and in partnership (or with the tacit acceptance) of all nations including other military powers such as Russia and China. This should give us all a sense of comfort from a military perspective. Could it be possible that what we are witnessing is a relatively peaceful means of arranging for the future distribution global resources?

We would think the ultimate destination of Middle East energy will continue to be managed by the US and so most nations will continue to have incentive to remain or become friends with the US.

That the locals are now being priced out of their basic necessities and that this has led to domestic unrest is likely considered a transitory problem for Western politicians. We imagine the economic imperative for rebuilding the local economies into more stable, functioning ones would be to distribute domestic energy proceeds more equitably than their despots did in the past -- that, and the freedom to self-govern as long as others have access to their resources.

The point of this discussion is not to create conspiracy theories, give politicians more credit than their due, state the obvious or point an accusing finger; but to make the case that when push comes to shove the US controls the most valuable asset in the world today and that this implies the US and its allies will determine the next global monetary regime.

*Whether conspired or just dumb luck, it seems that what we are experiencing today is the centralization of power over global resources by the West so that it may control the global supply chain. Incentives suggest control over resources would be beneficial prior to a shift to a new monetary order, regardless of the manner in which wealth would be counted (dollars, seashells or gold). We apologize for any discomfort this analysis may bring readers, and we welcome comment.*

### Expectations

It does not matter whether natural incentives have lined up to endorse the continuation of American hegemony or there is an omnipotent set of global conspirators pulling all the strings, (we do not know or care which), the current system will fail and disparate wealth holders across all nations will use the US to preserve their wealth.

The most powerful financial principle is compounding<sup>10</sup> and the math behind it is tough to dispute. (We are reminded that Albert Einstein mused “the most powerful force in the universe is compound interest”.) No amount of confidence can overcome it over time. Widespread hope, marketing, political rhetoric, media compliance, or irrelevant market extrapolation can reverse the relationship that compels creditors to expect payment from borrowers. *Unfunded, highly levered economies have no way out except by retiring principal. No amount of revenue growth, tax increases or other fiscal measures can do this. Cutting \$4 trillion from budgets over ten or twelve years doesn't cut it.* Debt-based currencies and levered assets denominated in them must lose their purchasing power value.

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<sup>10</sup> Compound Interest formula:  $A = P \left(1 + \frac{r}{n}\right)^{nt}$  ; where:

P = principal amount (the initial amount you borrow or deposit

r = annual rate of interest (as a decimal)

t = number of years for which the amount is deposited or borrowed

A = amount of money accumulated after n years, including interest

n = number of times the interest is compounded per year

Ultimately we think global wealth holders, capital producers, militaries and governments will have aligned incentives. They will be drawn together to demand a global monetary system that stabilizes real value and produces popular confidence.

Possession of property will not shift but purchasing power will. *Relative purchasing power will be lost by those having held debt money and leveraged financial assets denominated in them. Relative purchasing power will be gained by those having held unleveraged currencies, scarce resources and true capital.* Whatever is negotiated to be the new global reserve monetary unit will, at least temporarily, have to be backed by a relatively scarce item. It will be an asset-backed currency and a store of quantifiable value unto itself.

#### The Dollar will Die. Long Live the Dollar.

After the dollar collapses and trade is suspended, after panic abates and property ownership is re-confirmed, after valuations of goods, services and assets find price-equilibriums at which buyers and sellers meet; we will doubtless look back and wonder what happened. We will likely spend a generation kicking ourselves, wondering how we could have been so stupid as to repeat the experience of those ninety years before us.

We suspect that although the world will adopt a new fixed-exchange monetary regime, Congress and parliaments across the world will not reverse the legality of fractional reserve lending. Basel 3, 4, and 5, (as global bank capital adequacy understandings are and will be known), will continue to set “reasonable” capital reserve ratios that allow lenders the “necessary flexibility” to administer credit to borrowers over and above their reserves. Our money may have hardened but fractional reserve lending will lay dormant, waiting for a time when banker “animal spirits” become irrepressible again. Banks will be able to inflate another day, and so they will tolerate the change.

In the meantime we will be relieved that our money will have become a store of value again so that we can save, and relieved that our workforces will have become globally competitive again. We will tell our children not to borrow, as our great grandparents told our grandparents. They may listen, but *their* kids may not, and we would guess *their* kids (like us) will certainly not. Eventually our successors will see the fixed exchange regime as stifling. They will have incentive to borrow and disincentive to save.

The same thing will happen again. Post-modern man a generation or two from now will conjure sophisticated ways to make money by just thinking of money. They will look at us as quaint, if they even care to study history. But, like us, they will only make money, like central bankers and Ponzi schemers. They will not produce capital. Our successors will lend more than they have to lend and borrow more than they can repay.

And so we see the current period as a space in time, highly predictable in its outcome. Our *economic Calvinism* rests on faith in man’s predisposition to want more now, and to always want more now, and faith in elected officials and bankers to figure out ways to appear to give it to them. This economic predestination has two ultimate terminals – boom and bust.

This paper has tried to define where we are in that long, secular cycle. It is what happens when two selfish professional system leveragers are driven by logic and fear from over-levered markets because they want to maintain and increase their own purchasing power. Maybe someday soon we will be able to return to socially acceptable capital markets and use socially acceptable strategies? Maybe someday soon the capital markets will again build and be comprised of capital?



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