REPO
CRISIS UPDATE

The Mother of All Crises
Nobody Will Discuss

By Martin Armstrong

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researching the past to predict the future

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The End of Keynesian Economics?

Perhaps the most overlooked aspect of the Repo Crisis is the fact that this is all about power and has nothing to do with Quantitative Easing. All the central banks are in the fight of their lives. Their authority under Keynesianism has been to control the short–term rates. The whole Quantitative Easing theory was an attempt to reduce long–term rates by buying in long–term government bonds and reducing the competition in hopes that the banks would start to lend long–term and thus "stimulate" the economy. The short–term rates are where their power resided under Keynesianism, whereby they raised or lowered rates to manipulate demand to manage the economy.

Therefore, this entire Repo Crisis is all about defending the Keynesian Economics lineage. This has nothing to do with "stimulating" the economy anymore. This is about defending the power of central banks. What is at stake here is the very existence of the theory of Keynesian Economics. In 1978, former Chairman of the Federal Reserve Paul Volcker made it clear that Keynesian Economics had already failed when the Recession of 1974–1976 unfolded and stagflation emerged, causing confusion in the economic world. In a publication of his Charles C. Moskowitz Memorial Lecture, Volcker explained:

Paul Adolph Volcker Jr.
(1927–2019)

"The Rediscovery of the Business Cycle – is a sign of the times. Not much more than a decade ago, in what now seems a more innocent age, the 'New Economics' had become orthodoxy. Its basic tenet, repeated in similar words in speech after speech, in article after article, was described by one of its leaders as 'the conviction that business cycles were not inevitable, that government policy could and should keep the economy close to a path of steady real growth at a constant target rate of unemployment.'

Of course, some minor fluctuations in economic activity were not ruled out. But the impression was conveyed that they were more the consequence of misguided political judgments, of practical men beguiled by the mythology of the old orthodoxy of balanced budgets, and of occasional errors in forecasting than of deficiency in our basic knowledge of how the economy worked, or in the adequacy of the tools of policy. The avant–garde of the profession began to look elsewhere – to problems of welfare economics and income distribution – for new challenges.

Of course, the handling of the economic consequences of the Vietnam War was an obvious blot on the record – but that, after all, reflected more political than economic judgments. By the early 1970s, the persistence of inflationary pressures, even in the face of mild recession, began to flash some danger signals; the responses of the economy to the twisting of the dials of monetary and fiscal policy no longer seemed quite so predictable. But it was not until the events of 1974 and 1975, when a recession sprung on an unsuspecting world with an intensity unmatched in the post–World War II period, that the lessons of the 'New Economics' were seriously challenged."

The New Classical school in economics emerged during the 1970s in response to the failure of Keynesian Economics to explain stagflation. Prices were rising, primarily because of the oil embargos that forced prices higher based on cost rather than demand. Therefore, like increases in taxes, it merely reduced the net disposable income despite the gross amount rising. They ended up calling this "stagflation," which refers to rising prices that do not result in economic growth. Under the Keynesian model, there was no such exception for that scenario because it was purely based upon a one-dimensional construct of the economy predicated entirely upon demand. Consequently, if prices rose the economy was also supposed to expand in growth based upon demand. Volcker realized back then that Keynesian Economics had failed, yet he still raised interest rates into 1981 based upon the Keynesian demand model, lacking any other tool or theory whatsoever. Volcker's actions were still entirely based upon Demand Economics presumptions.


Robert E. Lucas Jr.
(born 1937)

There emerged what became known as the New Classical Economic movement led by Robert Lucas Jr. (born 1937) and Monetarist Economic theory criticisms of Milton Friedman (1912–2006) respectively which forced the rethinking of Keynesian Economics.

Lucas argued that it was impossible to forecast economic changes based on previous relationships, such as Keynes' consumption function, because such aspects were not structural and could vary with respect to changes in government policy variables. This simply became known as the Lucas Critique which he claimed explained the paradigm shift that occurred during the 1970s. Lucas saw that in macroeconomic theory that it moved toward establishing micro-foundations, which are simply the microeconomic behavior of individual agents including business firms and households. He believed that the key underlying foundation of economic theory was human behavior.

Lucas' arguments called into question the entire Keynesian model and led to the proposition that all macro models should be based on microeconomics. Yet, this complicated approach was still based upon presumptions of human behavior without understanding the overall trend set in motion by herd instincts. Not every person acts rationally but will respond based upon what everyone else is doing at that moment.

Stanley Milgram's (1933-1984) experiments

There were shocking experiments conducted by Stanley Milgram (1933–1984) that demonstrated how normal people would inflict excruciating pain upon subjects if they could justify to themselves that some authority had instructed them to do so. This has become known as obedience to authority. Petty government officers will carry out rules because they were ordered to do so. This general hardwired tendency to simply follow government orders was responsible for killing millions of Jews in Germany, and between 20 and 40 million in Russia under Stalin. It is this same response that produced the Lost Decade in Japan. Newspapers report whatever the government says about anyone without independent thinking. All of this is similar to the collective response of people believing government statistics until it is too late.

In 1968, the social psychologists Stanley Milgram, Leonard Bickman, and Lawrence Berkowitz decided to test the herd instinct in humans by placing a single person on a street corner and having him look up at an empty sky for sixty seconds. A tiny fraction of the passing pedestrians stopped to see what the guy was looking at, but most just walked past. Next time around, the psychologists put five skyward gazing men on the corner. This time, four times as many people stopped to gaze at the empty sky. When the psychologists put fifteen men on the corner, 45% of all passersby stopped, and increasing the cohort of observers yet again made more than 80% of pedestrians tilt their heads and look up. This also pokes a hole in Lucas' view of behavioral economics.

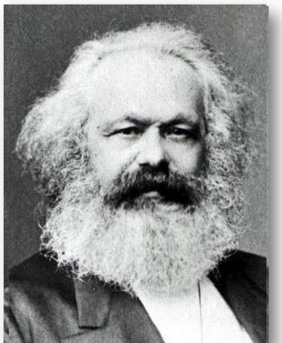
In the case of Milton Friedman, he is best known for reviving interest in the money supply as a major determinant of the nominal value of output. In other words, the Quantity Theory of Money. Monetarism has been what defines all this talk that we would see hyperinflation because of the Quantitative Easing by central banks. Here too, the failure has been its one-dimensional assumption. What is missing is the confidence of the people. Even increasing the supply of money has utterly failed to produce inflation when the people have no confidence in the future and thus the hoard their cash for a rainy day.

Milton Friedman
(1912 – November 16, 2006)

Roman Bronze Hoard
Late 4th Century to early 5th century

We even find hoards of debased Roman coins during a period of political instability. People will simply hoard money, even when debased, if they have no confidence in what comes tomorrow. This has led to the cries by various economists to cancel the currencies and move 100% to electronic currency to stop people from hoarding cash, which they recognize has defeated the Quantity Theory of Money. As always, instead of reviewing their theory and comprehending why it has failed, inevitably the solution they seek is to compel the economy and people comply with their ideas.

Now we face yet another change to the economic theories used to manipulate our lives. The new **Modern Monetary Theory** of money has emerged becausze they have witnessed the increase in the money supply with **Quantitative Easing** and concluded that they can just print money without restraint and there will be no inflation. They propose injecting Marxism whereby they raise taxes on the upper class to create a new economic Utopia where recessions and market crashes are forever extinguished from our daily lives. They fail to look closely at Europe or Japan and observe while there has been no inflation, they have created anemic economic growth at best. They ignore the fact that the rich create jobs through investment whereas government created jobs siphon off wealth reducing economic growth.



Karl Heinrich Marx
(1818-1883)

John Maynard Keynes
(1883-1946)

After the 1970s and the apparent failure of Keynesian Economics, the rise of these other theories emerged in an effort to explain the development of stagnation, which is a period of slow economic growth with relatively high unemployment that is accompanied by rising prices (inflation).

The development of these various economic theories all continued to be constructed upon the underlying proposition of John Maynard Keynes (1883–1946) that the government possessed the power to manage the economy, which was in truth following Karl Marx (1818– 1883). What emerged, has become known as the New Keynesian Model, which has been the merger of Keynesian Economics (demand) with the Monetarist view based on the Quantity Theory of Money. This merger has resulted in a major shift in the fundamental focus of how economic models have been viewed. There has been a move toward a monetary exchange economy perspective, as opposed to a barter economy. Hence, it became more about cash and credit controlled by central banks rather than the simple exchange of goods between individuals or businesses.

Therefore, under Keynesian Economics government bonds were the influential factor in long–term interest rates that led to the idea of buying in long–term government bonds by the central bank to lower long–term rates within the economy. The long–term rates are not established by a central bank, but are set by the free market. The economic focus, therefore, shifted to the central bank to control interest rates on the short–term in theory to control demand under Keynesian Economics. The central bank assumed the role of manager of inflation post–Great Depression. What has emerged recently post–September 2019 has been the assault on short–term rates within the free market. This forced the Federal Reserve to intervene to defend its own power which is now the Repo Crisis. The original design of the Fed in 1913 was simply to manage the capital flows between the regions within the domestic economy. Each branch acted independently to provide stability for the banking system. It was not the master of inflation.

Los Angeles Times
$2.75 DESIGNATED AREAS HIGHER © 2019 WST THURSDAY, AUGUST 1, 2019 latimes.com

MANUEL BALCE CENETA Associated Press

FEDERAL RESERVE Chairman Jerome H. Powell said political considerations had no bearing on the Fed's decision to cut the interest rate by a quarter-point.

Rate cut seen as preventive step to aid economy

Fed cites global uncertainty for the first such move since the Great Recession. Trump complains it doesn't go far enough.

How the Fed's move affects you

The interest-rate cut should lower costs for borrowers, but some with savings may see a drop in returns. **BUSINESS, C1**

By Don Lee

WASHINGTON — The Federal Reserve on Wednesday cut interest rates for the first time since the Great Recession in 2008, a risky move that clashes with its historical practice of taking such a step only when the economy is in real trouble.

The small, quarter-point reduction in its key rate is meant to be preventive medicine in the face of global economic uncertainties, such as the U.S. trade conflict with China and Britain's messy exit from the European Union.

In announcing its decision after a two-day meeting, the Fed highlighted elements of a solidly growing American economy but stated that it was acting "in light of the implications of global developments for the economic outlook as well as muted inflation pressures."

That strategy is a departure from the past when the central bank typically acted only after seeing actual evidence of an impending downturn.

The Fed statement Wednesday signaled that the central bank was prepared to cut rates further if needed, reiterating that it "will act as appropriate to sustain the expansion."

But financial markets and one of the Fed's most influential critics — President Trump — were disappointed. Stocks sold off upon release of the statement and kept sinking as Fed Chairman Jerome H. Powell addressed a news conference afterward.

Some investors were looking for a bigger half-point cut, and many others had been betting on the Fed to lower rates further in the next few months. But two of 10 policymakers voted against Wednesday's rate move, preferring to stand pat. And Powell spoke tentatively about future plans, and he pushed back against the idea that this was, as he put it, "the beginning of a

[See Fed, A1]

Debate emerges as Fed makes interest-rate cut

[**Fed,** from A1]

lengthy cutting cycle."

Trump has been hammering the Fed and Powell, whom the president nominated, to do more to stimulate the economy. Trump tweeted ahead of the policymakers' meeting that "a small rate cut is not enough." And he kept up the pressure Wednesday after the Fed's decision was announced.

"What the market wanted to hear from Jay Powell and the Federal Reserve was that this was the beginning of a lengthy and aggressive rate-cutting cycle which would keep pace with China, the European Union and other countries around the world," Trump tweeted. "As usual, Powell let us down."

Powell kept a stiff upper lip when asked by a reporter about Trump's influence, saying that political considerations had no bearing on the Fed's decision.

But some analysts were unconvinced. And Powell came under renewed criticism from the other side of the rate debate — economists, investors and others who have argued that the central bank has no business cutting rates when the economy is humming.

"The Fed's decision today is like in the days when doctors bled their patients to heal them," said Chris Rupkey, managing director at MUFG Bank in New York. "Fed officials made a very unwise decision today and buckled to the president's demands by manufacturing reasons to cut interest rates despite a strong economy with no recession signs apparent anywhere out on the horizon."

Powell defended Wednesday's decision as prudent risk management.

And he insisted that the small rate cut — and all the communications leading up to it that made it a sure thing — had boosted the economy.

Partly for that reason, the economic effect of Wednesday's drop in the Fed's benchmark rate to 2.25% from 2.5% will almost certainly be muted.

Mortgage rates and stock prices already have factored in a rate cut, most companies haven't had trouble accessing capital; and tweaking borrowing costs won't boost car sales, which have peaked after years of pent-up demand.

Credit isn't what his company needs, said Greg Danenhauer, an owner of Parker Boiler, a 65-employee manufacturing company in Los Angeles.

"We have money in the bank," he said, although he noted that cheaper loans could help his small-business customers, which include breweries and laundry firms.

Wednesday's Fed action also won't mean much for savers who have socked away money in certificates of deposits. The average interest rate on five-year CDs, for example, already has dropped to 1.31% from 1.52% in March in anticipation of the Fed cut, said Greg McBride of Bankrate.com.

But the bigger, long-term danger is that with interest rates already low, dropping them further not only nicks the Fed's firepower when a real downturn comes but also could add fuel to stocks and other assets that are at very high levels.

"That is clearly the risk: It fans some bubbles," said Ryan Sweet, an economist at Moody's Analytics.

In addition to lowering the Fed's main overnight lending rate, officials said Wednesday that the central bank would halt its run-off of asset holdings in August, two months earlier than scheduled. Some observers, including a very critical Trump, had viewed that reduction of the Fed balance sheet as having a tightening effect.

Besides jawboning from Trump, who fears that a slowdown could hurt his chances of winning reelection next year, the Fed will almost certainly face pressure to lower rates further from markets as well.

It won't be easy for Fed policymakers — who at times have given mixed or confusing communications — to manage Wall Street expectations.

Investors have been sensitive to every signal from the Fed, even if it involves just a small rate hike or cut. It reflects what analysts view as underlying insecurity in markets and an outsize reliance on the Fed to keep the party going.

The Fed in the past saw itself as a firefighter, but today it is more like a gardener that is expected to nurture an economy and keep it growing, said Dec Mullarkey, head of investment strategy at SLC Management, which manages $159 billion in assets.

And at the moment, the Fed is to trying to get ahead of a possible downturn as trade and other uncertainties have weighed on business sentiment and investments, he added.

"It's an ounce of prevention is worth a pound of cure kind of move," Mullarkey said.

He noted, however, that "it's a dangerous game because markets now keep second-guessing you, and there's quite a bit of feedback between markets and the Fed.... You want the Fed to be leading that conversation, not reacting to it. And it's complicated right now who's doing what."

Those pressures are, in part, of the Fed's own making.

The central bank raised rates four times last year as the economy was rolling along, in a bid to wean the financial system from cheap money and return rates to more normal levels amid strong growth. But then Powell made an abrupt shift early this year, first pausing the rate-hike campaign and later in spring pivoting fully to a rate-cut bias.

U.S. economic fundamentals have remained solid during that period. While growth has slowed from about 3% last year and through the first quarter, that was expected. Among other things, stimulus from the big tax cut that passed in late 2017 began to fade.

Even then, second-quarter growth was a healthy 2.1% and forecasters see the rest of the year performing about as well.

The latest data on consumer spending were strong, lifted by resilient job growth and solid income gains.

And inflation, which has been undershooting the Fed's 2% target and gave policymakers another reason to cut rates, is poised to inch higher.

The Fed noted that business investment has been "soft," and analysts attribute that partly to uncertainties stemming from the U.S.-China trade dispute and the multitude of tariffs imposed by each nation on the other. The two sides resumed negotiations this week but do not appear close to resolving their differences.

Some economists, however, say the falloff in business spending for equipment and buildings is part of a cyclical slowdown and not an underlying threat to growth. And they don't see the Fed having need to make further rate cuts after Wednesday.

In fact, the way things look now, the Fed could very well reverse course next year and push interest rates back up a notch, said Ken Matheny, an economist at Macroeconomic Advisers by IHS Markit, a leading forecasting firm in St. Louis.

Even though there is a case to be made for an "insurance cut" in rates, he said, financial conditions lately have become more favorable.

"We think it's a one-and-done," Matheny said of Wednesday's Fed action.

JUSTIN LANE EPA/Shutterstock

BECAUSE the Fed had been forecasting an interest-rate cut, the effect on the stock market was muted.

'The Fed's decision today is like in the days when doctors bled their patients to heal them. Fed officials made a very unwise decision today.'

— Chris Rupkey, managing director at MUFG Bank

RECESSION WARNING SENDS DOW TUMBLING

RICHARD DREW, ASSOCIATED PRESS

A board above the trading floor of the New York Stock Exchange shows the closing number for the Dow Jones industrial average on Wednesday.

BY DAMIAN PALETTA, THOMAS HEATH AND TAYLOR TELFORD
Washington Post

Recession signals intensified Wednesday in the United States and in some of the world's leading economies, as the damage from acrimonious trade wars is becoming increasingly apparent on multiple continents.

The U.S. stock market tumbled to its worst day of the year on Wednesday, after a reliable predictor of looming recessions flashed for the first time since the run-up to the 2008 financial crisis. The Dow Jones industrial average fell 800 points, or about 3%, and has lost close to 7% over the past three weeks.

Two of the world's largest economies, Germany and the United Kingdom, appear to be contracting even as the latter forges ahead with plans to leave the European Union. Growth also has slowed in China, which is in a bitter trade feud with the United States. Meanwhile, Argentina's stock market fell nearly 50% earlier this week after its incumbent president was defeated

Please see **RECESSION**, Page A8

While the Fed was considering lowering interest rates in the face of an inverted yield curve into August 2019, they were also being lobbied to help Europe and Japan who were pleading for the Fed to lower rates because they are trapped. Hence, faced with the pressing inverted yield curve as long–term rates were pressing lower as capital was fleeing from Europe in particular, the free market had other plans with the Repo Crisis emerging on September 17th, 2019. This forced the Fed to halt its policy to lower rates in sympathy.

The inverted yield–curve was being touted as a major indicator that a recession was upon us. This was why the Fed was lowering rates on August 1, 2019. On August 15, the St. Louis Post–Dispatch was printing the story written by the Washington Post, which was virtually cheering a recession to defeat Trump — their arch enemy.

We can see that the policy objectives of the Federal Reserve were viewing the inverted yield–curve as recessionary and therefore were lowering rates to accommodate Europe and Japan. Little did they understand that this was all being driven by capital inflows pouring into the dollar particularly from Europe. As the free markets showed, the fears rising from European banks set in motion the Repo Crisis by mid–September 2019.

A8 • ST. LOUIS POST-DISPATCH NEWS M 1 • THURSDAY • 08.15.2019

Recession

From A1

by a left-wing opponent.

Whether the events presage an economic calamity or just an alarming spasm are unclear. But unlike during the Great Recession, global leaders are not working in unison to confront mounting problems and arrest the slowdown. Instead, they are increasingly at each other's throats.

President Donald Trump has responded by both claiming the economy is still thriving while dramatically ramping up his attacks on Federal Reserve Chairman Jerome Powell, seeking to deflect blame.

Wednesday's sharp selloff was caused by an unusual development in the bond market, called an "inverted yield curve," that often foreshadows a recession.

For the first time since the run-up to the Great Recession, the yields — or returns — on two-year Treasury bonds eclipsed those of 10-year bonds. Normally, the government needs to pay out higher rates to attract investors for its long-term bonds. But with so many losing confidence in the near-term prospects of the economy and rushing to buy longer-term bonds, the U.S. government now is paying more to attract buyers to its two-year bond than its 10-year note.

This phenomenon, which suggests investor faith in the economy is faltering, has preceded every recession in the past 50 years.

"The stars are aligned across the curve that the economy is headed for a big fall," said Chris Rupkey, chief financial economist at MUFG Union Bank. "The yield curves are all crying timber that a recession is almost a reality, and investors are tripping over themselves to get out of the way."

It's the latest in a string of worrisome news about the U.S. economy. The government is expected to spend roughly $1 trillion more than it brings in through revenue this year, adding to a ballooning deficit. Business investment has begun to contract — largely due to the uncertainty surrounding Trump's trade war — and manufacturing hiring has receded. The big hiring and investment announcements that piled up at the beginning of the Trump administration have ceased, as have the announcements of bonuses and pay increases that came after a tax cut law was passed in 2017.

Several White House officials have become concerned that the economy is weakening faster than expected, but they are not working on proactive plans to try and change its course. The Treasury Department has had an exodus of senior advisers in recent months, and the White House just announced a replacement for its chairman of the Council of Economic Advisers.

Instead of rolling out new policies, Trump and other top aides have escalated their attacks on the Federal Reserve, trying to pin much of the U.S.'s problems on what Trump alleges is elevated interest rates that are strangling growth.

In a series of Twitter posts on Wednesday, Trump appeared to try and calm investors while also unloading vicious language aimed at Powell, whom he nominated in late 2017.

"China is not our problem, though Hong Kong is not helping," Trump wrote. "Our problem is with the Fed. Raised too much & too fast. Now too slow to cut.... Spread is way too much as other countries say THANK YOU to clueless Jay Powell and the Federal Reserve. Germany, and many others, are playing the game! CRAZY INVERTED YIELD CURVE! We should easily be reaping big Rewards & Gains, but the Fed is holding us back. We will Win!"

The Twitter posts reflected a growing anxiety within the White House about problems in the economy, which many advisers believe will determine whether the president wins reelection. A few hours earlier, Trump offered a contradictory assessment, saying the inverted yield curve was a good sign because there were "Tremendous amounts of money pouring into the United States. People want safety!"

In the past, Democrats and Republicans in control of the White House have scrambled when there were signs of an economic downturn, worried about the political fallout. They met and often consulted with Congress about ways to protect the economy or advance some kind of economic stimulus, either through tax cuts or spending increases.

But the Trump administration has already cut taxes and boosted spending, and there appears to be little political appetite to do more of either this year or next. White House officials have discussed a plan to make changes to the way capital gains taxes are levied, but that would only impact certain investors and has already faced criticism from Democrats as being a boon to the rich. Complicating matters, a number of investors and foreign leaders have blamed Trump's trade war for causing the contraction in business investment and forcing companies to pull back, an accusation that has caught White House advisers off guard.

The U.S. economy has shown signs of weakening in recent months, but high levels of consumer spending in the United States have helped enormously. Still, the escalating trade war between Trump and Chinese leaders has stopped many businesses from investing. And there are signs that the large tariffs he has placed on many Chinese imports is costing U.S. businesses and consumers billions of dollars.

In a rare admission of the economic consequences of his adversarial trade approach, Trump on Tuesday announced he was delaying many of the tariffs he had promised on cellphones and laptop computers until Dec. 15. That announcement brought the stock market up sharply higher on Tuesday, but all of those gains evaporated in minutes Wednesday amid fears about the inverted yield curve.

The Standard & Poor's 500-stock index, a broader measure of stocks, and the tech-heavy Nasdaq composite index both sank about 3%, matching the losses experienced by the Dow. Nearly all market sectors were in the red Wednesday, with energy, consumer staples and financial services leading the way.

Darkening skies overseas gave investors more to worry about. New data indicated Germany was slipping into recession with the country's economy shrinking 0.1% between April and June. If it experienced another contraction during this quarter, Germany officially would meet the definition of a recession. Officials blamed the drop-off on the U.S.-China trade war and the looming threat of a hard Brexit by the U.K.

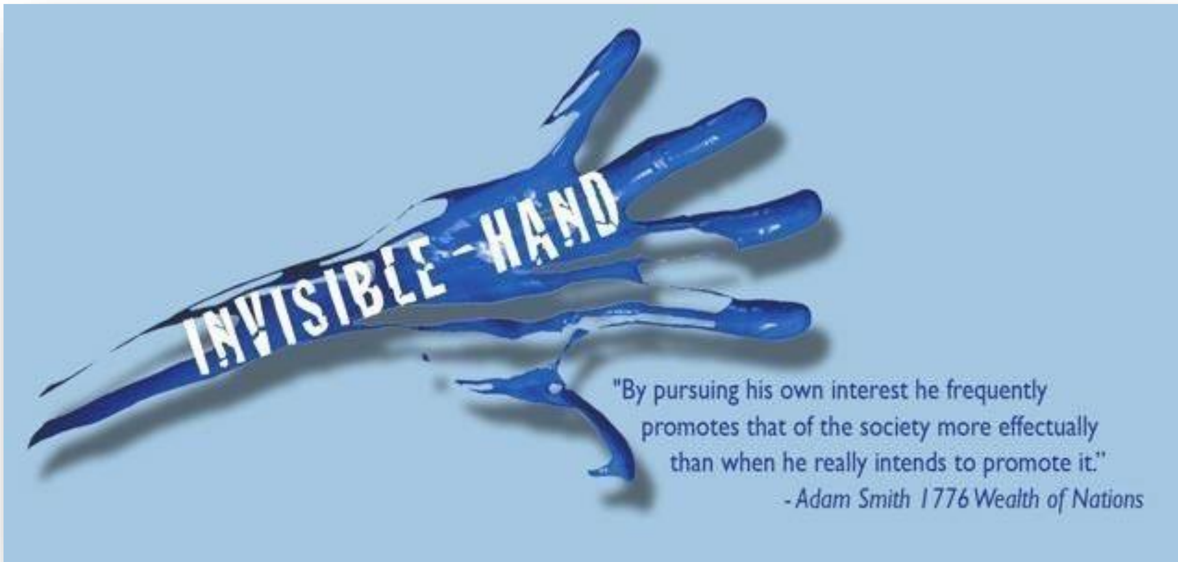
"The big concern is around trade," said Dan Ivascyn, group chief investment officer at Pimco. "The longer we remain in limbo, the more damage to the global economy. You already have a fragile global economy, and with this trade tension you are beginning to see people shift into safer assets with almost complete disregard for what they are earning on those assets."

RICHARD DREW, ASSOCIATED PRESS

From left, specialists Glenn Carell, John O'Hara and Robert Nelson gather at a trading post on the floor of the New York Stock Exchange on Wednesday. The Dow Jones Industrial Average sank 800 points amid warning signs of a possible recession.

St. Louis Post-Dispatch, St. Louis, Missouri - August 15, 2019, Thursday • Page A8

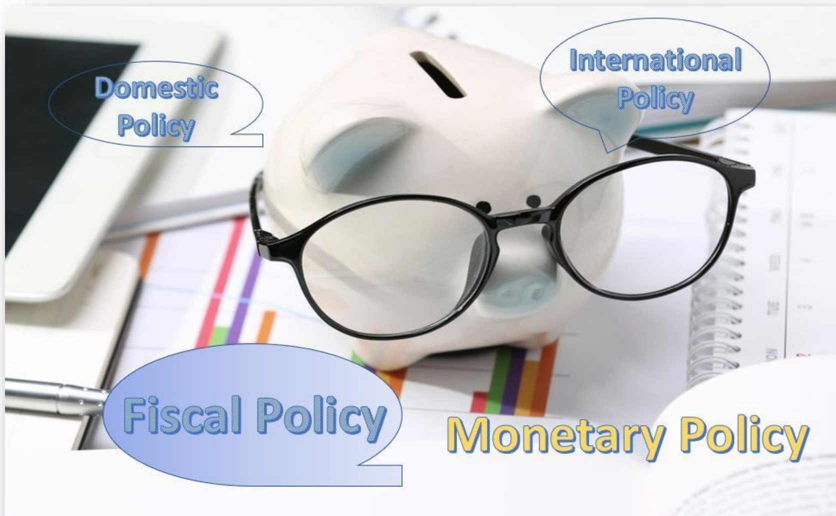
This shift in the focus of the role of the central bank post–Great Depression under Keynesian Economics to manage "demand" through the manipulation of interest rates has come to a climax. Negative interest rates have killed Keynesian Economics and encouraged domestic hoarding of cash and capital flight to other currencies. This also resulted in the free markets confronting that assumed power which has erupted into a Repo Crisis. Raising the interest rate is supposed to reduce demand for assets and result in the theory that "Cash is King."



Therefore, we have already seen a shift from using government bonds as the main economic indicator to short-term rates on money. Consequently, the Fed was forced to intervene in the repo market to maintain its only power over short-term rates. Its attempt to lower rates at the start of August resulted in a complete reversal of direction in September. Then the Fed funds rates were in jeopardy of rising by the invisible hand of the free market. The economy has shifted to very short-term central bank money which is precisely the crisis in the repo market. Consequently, the Federal Reserve cannot lower rates as long as there is a liquidity crisis in the repo market.

The New Keynesian Model has emerged as a model based on a monetary exchange economy in contrast to a barter economy based on transactions. The rate of interest is the rate of interest paid on central bank money, rather than on government bonds. The free markets are raising the interest rate on short-term money, which normally reflects a coming recession as the demand for cash rises against assets. However, we are witnessing a different version where there is a demand for US dollars in both cash and assets in contrast to the collapse in demand for the external currencies in Asia and Europe. Therefore, we have already seen the shift in the old theory of interest rates up and stocks down. That has simply failed in this new version of a financial crisis.

Fed's Changing Focus



Once upon a time, the Federal Reserve was simply created to secure the banking system. Post-Keynesian Economics, the Fed was charged with managing the demand within the economy to control inflation. It was theorized that the Fed could control the business cycle completely and manage the economy to eliminate depressions and recessions.

Suddenly, the Fed was charged with monetary policy rather than the overlord of the banking system, yet it had no control over the fiscal policy spending of politicians. Then the Fed began to be impacted by external factors with the advent of World War I and the movement of capital flows globally even before it opened its doors. It has still been trying to figure out how to deal with external factors it cannot possibly control – namely international policy and fiscal policy objectives.

While the Federal Reserve has injected tens of billions to calm the short-term lending markets known as the repo market, it is totally powerless to influence the international policies of negative interest rates in Europe or Japan. As public confidence is declining domestically, the fiscal policy carried out through the U.S. Treasury Department has only complicated the job of the Federal Reserve.

The Treasury must raise the money that politicians are spending, and it too has no control over the politicians. The Treasury Department must cope with higher spending by Congress, which is also creating large swings in the amount of money it has on deposit with the Federal Reserve. Some argue that this also undercuts the Fed's ability to keep bank reserves stable. Last year, there was a large shift in cash from the Treasury that drained liquidity from the banking system that some contend contributed to the Repo Crisis. Some maintain that this is putting greater strains on the Federal Reserve's management and funding markets. However, the deficits have not ballooned upward to warrant this as a cause.

The Treasury General Account at the Fed operates as the government's checking account. Money comes in when taxes are paid out of bank accounts of individuals and corporations, which drains bank reserves held at the New York Fed. Money goes out when the government pays its bills, but it does the opposite.

Treasury Disinformation

It appears that there is a disinformation campaign taking place to place blame on the rising deficits. Under the Obama administration, the Treasury back in 2015 maintained a policy of keeping at least 5 days' worth of cash on deposit, which was a minimum of $150 billion. By 2019, the balance has averaged $303 billion, versus about $240 billion in the prior four years. Some argue that the swings in the Treasury deposits between $450 billion to $112 billion are contributing to the Repo Crisis. I do not find any evidence that this is the source of the crisis.

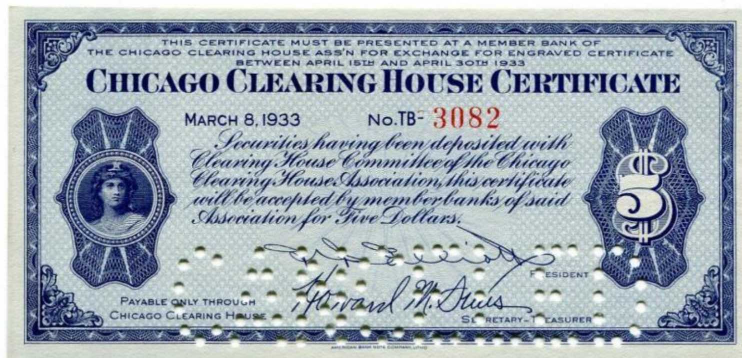
Some have even proposed that the Treasury could help by shifting its deposits to the big commercial banks instead of the Fed. This seems to be a really brain–dead idea for the Repo Crisis is all about the fact that private banks do not trust other private banks and prefer to deal with the Fed. Even Treasury Secretary Steven Mnuchin has suggested that it would only lead to even bigger financial stability problems. Then the Federal government would depend on a private bank, and obviously it would have to be bailed out or the government would fail and that includes Social Security checks. Fed Chairman Jerome Powell last December 2019 was forced to respond to such a stupid proposal. He said that the Fed officials had not discussed the topic with their Treasury counterparts.

Monetary Policy

Milton Friedman
(1912 – November 16, 2006)

Milton Freidman's (1912–2006) criticism of the Fed during the Great Depression was about their refusal to monetize gold inflows, thereby failing to expand the money supply. Freidman reasoned that the Great Depression was caused by the Federal Reserve allowing the sharp decline in the money supply that took place during the period 1929–1933. In other words, the Fed turned a normal recession into a depression by failing to implement an expansionary monetary policy in the early 1930s – i.e. austerity!

The Fed's austerity led to over 200 cities issuing their own money just to be able to conduct business. This became known as Depression Scrip. The fact that we find such a wealth of private currency being issued during the Great Depression does confirm Friedman's point.



New England and Midwest Join in Widespread Bank Holiday Move

South Dakota Gets on List

Florida Among Late Entrants

U.S. Banks-

Holiday Measure Recalls Bank Suspensions of 1907

Clearing House Certificates Circulated As Currency.

Holiday Fails To Excite City

Stores Report Trade Off Slightly.

Wires Limited

'All in Boat,' Is Reaction

Bluffs Little Disturbed by Holiday.

Gold Base Odds

Cash Is King For County

Polk Courthouse Goes on Cash Basis.

Des Moines Tribune, Des Moines, Iowa - March 4th, 1933, Saturday • Page 4

Again, the Monetarist focus was purely on the supply of money in the system, which no doubt contributed to the crisis of the Great Depression. However, the bank holiday of 1933 undermined the entire confidence in the economy and banking system. People hoarded their cash and would not spend it. There were some 9,000 banks that failed. That was not an inspiration of confidence.


"All the News That's Fit to Print."

The New York Times.

LATE CITY EDITION

ROOSEVELT ORDERS 4-DAY BANK HOLIDAY, PUTS EMBARGO ON GOLD, CALLS CONGRES

HITLER BLOC WINS A REICH MAJORITY; RULES IN PRUSSIA

JAPANESE PUSH ON IN FIERCE FIGHTING; CHINA CLOSES WALL

BANKS HERE ACT AT ONCE

City Scrip to Be Ready Today or Tomorrow to Replace Currency.

The President's Bank Proclamation

A Proclamation

President Takes Under Sweeping of War Time


DOLLAR DEALINGS HALTED IN EUROPE

London and Paris Suspend Exchange Quotations as Crisis Result.

By the Associated Press.

Dollar transactions were suspended in the European capitals as a result of the American bank holidays. Tourists unable to cash checks were accommodated by hotels, travel agencies and some banks.

London—All foreign exchange quotations were suspended, and there was no quotation on gold. Currency rates in Europe are based on the dollar and there was some talk of the possibility of adopting the French franc or some other currency backed by gold as basis for exchange rates. The foreign exchange policy for Monday was not certain. American branch banks were open, the bankers praised the declaration of bank holidays in the States as a move in the right direction. The stock market closed dull after a quiet session.

Paris—Foreign exchange quotations were suspended here also. There was no quotation on the dollar and the banks declined to cash checks drawn on American institutions affected by the holidays.

Berlin—The official dollar rate was fixed at 4.196 marks bid, 4.204 asked. Since 1930 private dealings in dollar exchange have been forbidden. German bankers felt no apprehension regarding the situation in America.

Rome—There were no dollar transactions. The cable quotation on the dollar was 19.35 lire as compared with the recent average of 19.51.

Madrid—Saturday is a full holiday in Madrid. The dollar was offered off the exchange at 11.86 pesetas, but the quotation slid to between 11 and 11¼. There were no official quotations.

Brussels and Amsterdam had no official dollar quotation. The unofficial rate in Amsterdam was 2.46½ guilders.

Berne—The American dollar was unquoted. The Swiss franc dropped 10 to 14 centimes.

Copenhagen—Here only the pound sterling was quoted. Banks withheld payment for the time being on American checks and bills.

Havana—American branch banks were open all day. The government forbade publication of news concerning bank holidays in the United States.

All the Canadian markets, including the Winnipeg Grain Exchange were open. Dollar quotations were suspended.

The Sunday Star March 5, 1933, • Page 3

The bank holiday was called following a month–long run on American banks based on rumors that Franklin Delano Roosevelt was going to confiscate gold, which he denied during the election. Roosevelt proclaimed a bank holiday, beginning March 6, 1933, which shut down the banking system and sent the US dollar into turmoil internationally.

The Justice Department even sought to prosecute people for hoarding gold. A New York attorney named Frederick Barber Campbell had on deposit at Chase National Bank of over 5,000 troy ounces (160 kg) of gold. When Campbell attempted to withdraw the gold, Chase refused, and Campbell sued Chase (*Campbell v. Chase Nat. Bank of City of New York, 5 F. Supp. 156 (S.D.N.Y. 1933)*).

A federal prosecutor then indicted Campbell on the following day (September 27, 1933) for failing to surrender his gold. This became the first attempt to criminally prosecute people for not turning over their gold. In the end, the prosecution of Campbell failed. Nevertheless, the authority of the federal government to seize gold was upheld, and Campbell's gold was confiscated. It stands as a warning about leaving your gold in any facility.

World War I & the Federal Reserve

On July 28, 1914, World War I began with Austria-Hungary's declaration of war against Serbia. Three days later, on July 31, the London Stock Exchange closed and this left New York Stock Exchange (NYSE) vulnerable. This forced the NYSE to close on the presumption that a panic would unfold in the financial markets because of European liquidation. Indeed, nearly all other world stock exchanges were already closed at that time. Eventually, the New York stock market was reopened on December 12, 1914.

It was clear that European investors prepared to liquidate their holdings of U.S. stocks and bonds to transfer gold to Europe to pay for the Great War. The Europeans had already taken $83 million in gold since May 1, 1914, which was the largest outflow of gold over any consecutive three-month period since the Panic of 1899 when the Bank of England doubled its interest rates to fight speculation. There was considerable concern that a stock market would crash as Europeans were in desperate need of cash. This would only increase the gold exports and result in a financial panic and economic collapse. Keeping the exchange closed was seen as essential to get the Federal Reserve up and going.

The coincidence of World War I taking place at the same time of the Federal Reserve launch certainly caused a structural problem. President Wilson and Treasury Secretary McAdoo wisely saw the stock market as a serious threat in the face of foreign liquidation, which would have jeopardized the facilitation of the birth of the Federal Reserve System. Interestingly, John Maynard Keynes emphasized the importance of gold in establishing financial credibility. He argued that London's position as the world's leading financial center would surely be jeopardized if Britain suspended gold payments. It was Keynes who advised the British government during this time period in his memorandum of August 3, 1914: "[T]he vital point is that we should not repudiate our external obligations to pay gold until it is physically impossible for us to fulfill them." Milton Friedman and Anna Schwartz wrote: "The Aldrich-Vreeland Act succeeded on the one occasion it was used, the outbreak of World War I." id/1963, p.441.

Indeed, on August 1, 1914, Germany declared war on Russia. France declared war on August 3, and Britain joined on August 4. Austria-Hungary also declared war on Russia and Japan declared war on Germany also during August 1914.

Great Britain and France declared war on Austria–Hungary on August 12. By August 25, Japan declared war on Austria–Hungary.

German Papiermark 1914

Germany abandoned the gold standard replacing the gold mark with the new German Papiermark as the official currency of Germany for World War I on August 4^{th}. On August 7^{th}, the Currency and Bank Notes Act in Great Britain gave wartime powers of banknote issue to the Treasury.

The Federal Reserve Act had only been signed into law on December 23, 1913, and it required that gold be held as backing for Federal Reserve Notes. Congressional hearings on President Wilson’s nominations to the Federal Reserve Board were still in progress when World War I began, and the regional Federal Reserve banks had not yet been organized. Eventually, Benjamin Strong (1872–1928) became the first Governor of the Federal Reserve Bank of New York in October 1914.

Benjamin Strong
(1872–1928)

In August 1914 the Wilson Administration demonstrated how to control a crisis without a central bank. Such financial crises frequently present a double threat: (1) a drain of funds from the banking system; and (2) capital flight from the country as a whole. The initial reaction was a capital withdrawal from the USA to fund the war in Europe, but then as tanks began rolling down the streets in

Europe, the capital turned to a flight back to the dollar.

ThomasWoodrow Wilson
(1856–1924)

The Wilson Administration in 1914 was in a difficult spot as World War I emerged. The USA could not afford to allow its gold reserves to be depleted when it was in the midst of a major structural shift in creating the Federal Reserve. If the gold reserves were lost, then the credibility of the Federal Reserve would have come into question.

The regional Federal Reserve banks did open on November 16th, 1914, almost a month before the reopening of the New York Stock Exchange. President Wilson and Treasury Secretary William Gibbs McAdoo (1863– 1941) invoked the Aldrich–Vreeland Act to justify lending freely. In order to stop the gold outflow, they shut down the New York Stock Exchange to prevent foreign liquidations which prevented any default of the gold standard, thereby maintaining American financial credibility. Hence, the Wilson Administration suspended the convertibility of the dollar to further maintain the integrity of the United States in the face of a global financial panic.

William Gibbs McAdoo Jr.
(October 31, 1863 – February 1, 1941)
46th US Secretary of the Treasury (March 6, 1913 – December 15, 1918)

Treasury Secretary McAdoo declared a financial crisis under the Aldrich–Vreeland Act, which provided the authority to issue emergency currency. This allowed the Federal Reserve to decide the timing and magnitude of securities to deposit as collateral for the issue of this additional currency. This measure was taken to address the liquidity crisis as people instantly began to hoard cash. It was this authority under the Aldrich–Vreeland Act that allowed for the success of this emergency issue of currency to ease the liquidity crisis.

When Congress created the Federal Reserve, a completely new currency came into existence. There were two types of currency issued under the Federal Reserve. The main system currency was simply known as the Federal Reserve notes. Then there were the Federal Reserve Bank notes that were issued by the independent branches.

Federal Reserve Notes of 1914

The Federal Reserve notes of 1914 were issued in all denominations from $5–$10,000. They were issued by the United States to the 12 Federal Reserve banks and through them to the member banks and the public. The notes were not issued by the banks themselves as were the Federal Reserve Bank notes (known as National Currency) and the obligation to pay the bearer was borne by the government and not by the banks. Hence these notes were not secured by the United States bonds or other securities.

Therefore, the Federal Reserve notes were the emergency issue that was not secured by any certified means of backing. The Federal Reserve notes simply stated: “United States of America will be paid to the bearer on demand.”

The first issue of early 1914 had red seals. Then as World War I broke out, red ink could no longer be imported, and the emergency issue appeared with blue ink seals. Notes with the red seals are rare and worth a lot more to collectors than the blue seal notes. This reflects the extent of the emergency note issue at this critical time of getting the Federal Reserve off and going.

Federal Reserve Bank Note - National Currency - Series 1915 Chicago Federal Reserve Branch

The Federal Reserve Bank notes are inscribed "National Currency." The first series to be issued by the independent lower–level branch banks of the Federal Reserve was dated Series of 1915 and consisted only of $5, $10, and $20 denominations. They were only issued by the Atlanta, Chicago, Kansas City, Dallas, and San Francisco.

How these notes different from a banking perspective compared to the emergency issue is very interesting. The obligation of this issue was to pay the bearer on demand only by that specific Federal Reserve branch. The 1915 series stated it was "secured by United States bonds deposited with the treasurer of the United States of America."

The next later issue of 1918 stated it was "secured by the United States bonds or the United States certificate of indebtedness or United States one year gold notes deposited with the treasury of the United States of America."

There were several important developments at this time as well such as on January 25, 1915 telephone service that began between New York and San Francisco for the first time, enabling faster domestic communication. Then later that year, the New York bankers granted a 500 million loan to Britain and France at 5% on October 15, 1915.

The following year, on September 8, 1916, Congress enacted the Emergency Revenue Act which doubled income tax rates. It also added the estate tax (death tax) and munitions profits tax because Americans were supplying Europe and that was perceived as profitable. They also established the Tariff Commission.

Wilson was re–elected as President on November 7, 1916. Then on February 3, 1917, the USS Housatonic was sailing from Galveston, Texas, on January 6, 1917, with a cargo of wheat and flour on its way to Liverpool. It was stopped by a German submarine and inspected. The German commander ordered the crew to abandon the ship, which they did, and they sunk it on the grounds that the vessel was carrying foodstuffs to an enemy belligerent. That was the excuse for the U.S. to break diplomatic relations with Germany.

On March 3, 1917, Wilson imposed the Special Preparedness Fund Act which provided for excess profit taxes and higher inheritance taxes. The next month on April 2, 1917, Wilson called a special session of Congress for a declaration of war against Germany.

Fiscal Policy

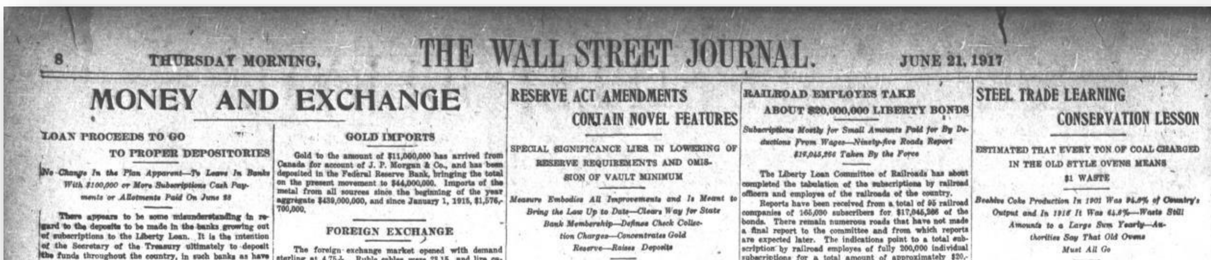

John Pierpont Morgan
(1837 - 1913)

The initial creation of the Federal Reserve was completely independent when it was enacted in 1913. Many conspiracy advocates point to the fact that the major banks are shareholders of the Fed. What they miss is that in 1913, the Fed was created to support the banking system. It was envisioned that the banks would become its shareholders who would fund any future bailouts as J.P. Morgan (1837–1913) had arranged during the Panic of 1907. It was Morgan who led a consortium of banks to lend to other banks in New York City to prevent a contagion bank run that would have brought them all down. It was Morgan's model upon which the Federal Reserve was organized.

The only manner in which the Federal Reserve would "stimulate" the economy was by purchasing short–term corporate paper to keep the economy stable when banks were unable or unwilling to lend. This enabled major corporations to find funding, so they did not have to lay off their workforces. With the passage of time and the changing economic theories, the structure and authority of the Federal Reserve continued to change with each passing financial panic.

Fed’s Changing Focus

World War I resulted in the first issue of government Liberty Bonds to fund the expense of “The Great War” on April 24, 1917. The entire allotment of the First Liberty Bond issue of $2 billion worth was sold in denominations of $50 to $10,000. The $50 and $100 denominations enabled lower–income groups to participate, while the higher denominations were purchased by high–income individuals, banks, and U.S. corporations to pay dividends to shareholders. For example, U.S. Steel purchased $125 million in Liberty Bonds and the interest received contributed to its own dividends.



8 THURSDAY MORNING, THE WALL STREET JOURNAL. JUNE 21, 1917

MONEY AND EXCHANGE

LOAN PROCEEDS TO GO TO PROPER DEPOSITORIES

No Change In the Plan Apparent—To Leave In Banks With $100,000 or More Subscriptions Cash Payments or Allotments Paid On June 28

There appears to be some misunderstanding in regard to the deposits to be made in the banks growing out of subscriptions to the Liberty Loan. It is the intention of the Secretary of the Treasury ultimately to deposit the funds throughout the country, in such banks as have

GOLD IMPORTS

Gold to the amount of $11,000,000 has arrived from Canada for account of J. P. Morgan & Co., and has been deposited in the Federal Reserve Bank, bringing the total on the present movement to $44,000,000. Imports of the metal from all sources since the beginning of the year aggregate $439,000,000, and since January 1, 1915, $1,576,-700,000.

FOREIGN EXCHANGE

The foreign exchange market opened with demand sterling at 4.75 1/4. Ruble cables were 28.15, and lire ca-

RESERVE ACT AMENDMENTS CONTAIN NOVEL FEATURES

SPECIAL SIGNIFICANCE LIES IN LOWERING OF RESERVE REQUIREMENTS AND OMISSION OF VAULT MINIMUM

Measure Embodies All Improvements and Is Meant to Bring the Law Up to Date—Clears Way for State Bank Membership—Defines Check Collection Charges—Concentrates Gold Reserve—Raises Deposits

RAILROAD EMPLOYES TAKE ABOUT $20,000,000 LIBERTY BONDS

Subscriptions Mostly for Small Amounts Paid for By Deductions From Wages—Ninety-five Roads Report $17,045,266 Taken By the Force

The Liberty Loan Committee of Railroads has about completed the tabulation of the subscriptions by railroad officers and employes of the railroads of the country.

Reports have been received from a total of 95 railroad companies of 165,030 subscribers for $17,045,266 of the bonds. There remain numerous roads that have not made a final report to the committee and from which reports are expected later. The indications point to a total subscription by railroad employes of fully 200,000 individual subscriptions for a total amount of approximately $20,-

STEEL TRADE LEARNING CONSERVATION LESSON

ESTIMATED THAT EVERY TON OF COAL CHARGED IN THE OLD STYLE OVENS MEANS $1 WASTE

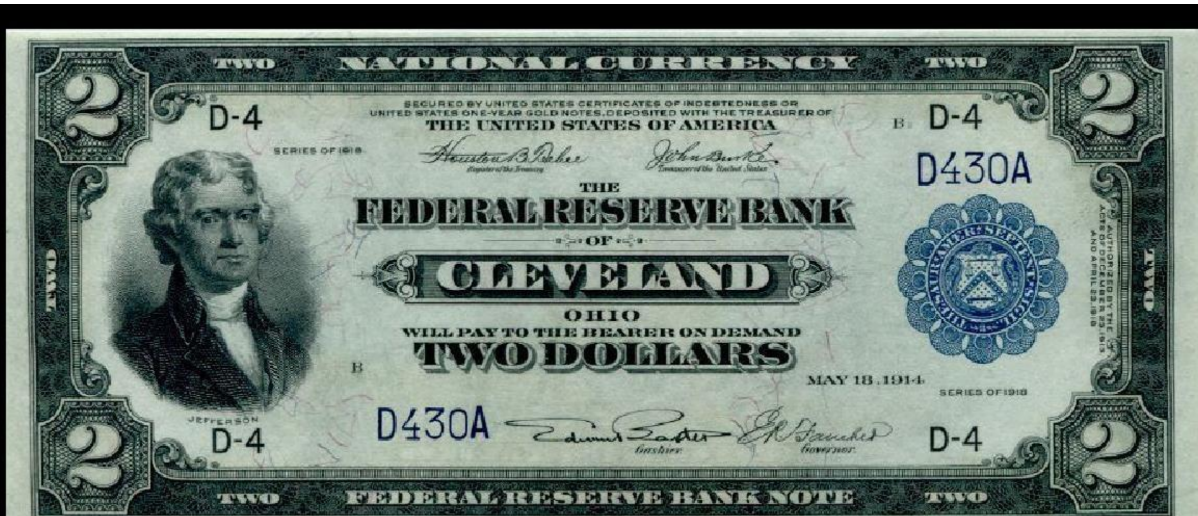
Beehive Coke Production In 1901 Was 94.8% of Country's Output and In 1916 It Was 64.6%—Waste Still Amounts to a Large Sum Yearly—Authorities Say That Old Ovens Must All Go

The Federal Reserve Act was amended on June 21, 1917. The Wall Street Journal reported: “Reserve Act Amendments Contain Novel Features.” Indeed, this change to the authority of the Federal Reserve directed the bank to establish branches by eliminating any confusion with respect to whether it was a discretionary or mandatory directive of Congress.

The Act of 1917 also clarified that any state bank that became a member bank of the Federal Reserve would retain its corporate powers under state law respecting the separation of powers.

U.S. gold certificates were to be counted as part of the gold reserves of the Federal Reserve Bank. However, this amended version of the Federal Reserve act of 1917 authorized the Federal Reserve to issue notes on the security of the 15–day notes of member banks secured by any eligible commercial paper or by bonds or notes of the United States. Therefore, the Federal Reserve Bank notes were allowed to be backed by private debt.

$1000 Federal Reserve Not Series 1918 "Will Pay to the Bearer on Demand"



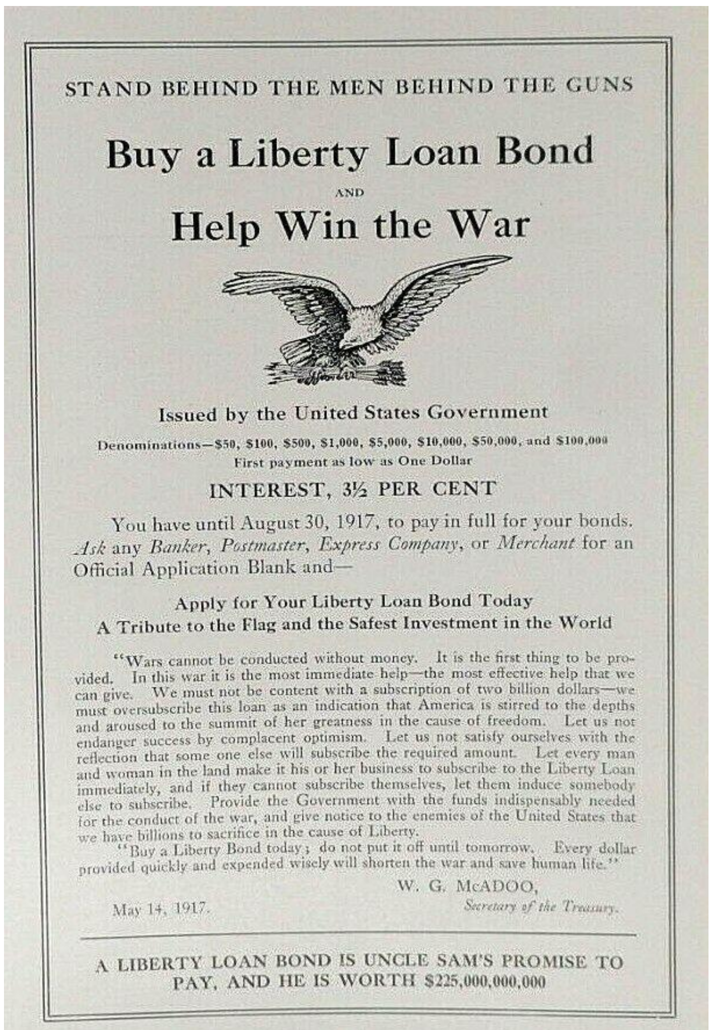
Federal Reserve Bank Note of Cleveland $2 Series of 1918

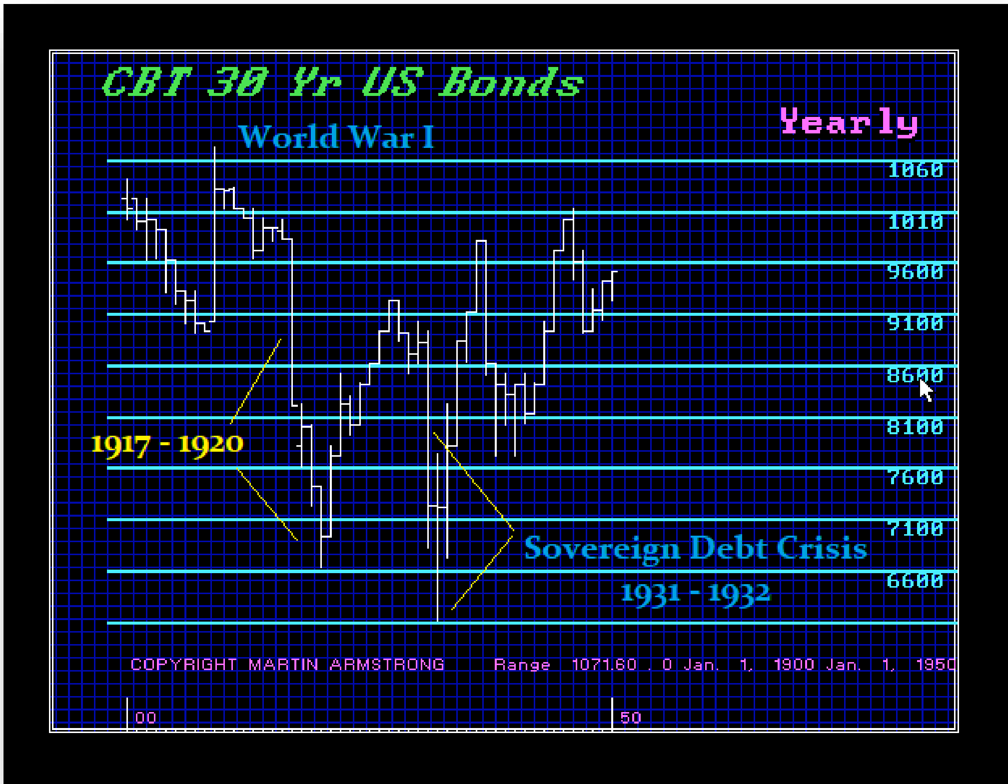
Secured by Uniyed States Certificates of Indeptedness or United States one-year Gold Notes, Deposited with the Treasurer of the United States of America

However, it also authorized the Federal Reserve to be able to have accounts in foreign countries as a correspondent bank. With respect to Federal Reserve notes, they were to be backed by gold or gold certificates issued by the U.S. Treasury, which was a distinct difference where they had no backing requirement whatsoever. Nevertheless, the 1918 series note makes no mention of such a change.

Section 17 of the Act was perhaps the most interesting. It repealed any provision of law requiring national banks to maintain a minimum deposit of bonds with the Treasurer of the United States. It also mandated that member banks had to then transfer all reserves to the Federal Reserve itself. Consequently, member banks were no longer allowed to maintain their reserves in their own faults. This was a major structural change.

Financing the war was greatly simplified by the Federal Reserve, which lent freely to banks at low interest rates. The banks, in turn, bought higher–yielding government bonds or lent to borrowers who then bought the bonds. In the end, about half of all American families bought war bonds, mostly between $5 and $100 worth, but half of the total sum sold were purchased by financial institutions for their own account in $10,000 increments.





Some complained that the interest rate of 3.5% was too low. This was the same as other government instruments, and the interest on these bonds was tax-exempt except for estate and inheritance taxes. Given the fact that with the maximum tax rate then of 67% a bond paying a 3.5% federally tax-free interest rate was equivalent to a risk-free taxable 10.6% yield.

The wartime economy surged, interest rates rose, and bond prices fell. The crash in government bonds persisted for 3 years between 1917 and 1920. There were four issues of Liberty Bonds:

- Apr 24, 1917: Emergency Loan Act issue of $5 billion in bonds at 3.5%
- Oct 1, 1917: Second Liberty Loan offers $3 billion in bonds at 4%
- Apr 5, 1918: Third Liberty Loan offers $3 billion in bonds at 4.5%
- Sep 28, 1918: Fourth Liberty Loan offers $6 billion in bonds at 4.25%

There was a total of four Liberty Loan Bond issues and one Victory Loan Bond issue. Of the $24 billion in total subscriptions offered, $21 billion dollars of bonds were issued. The average purchase of five issues was $445. Analyzing the denominations of the war bonds still outstanding as of June 30, 1920, only $3.9 billion or about 20 percent, were issued in the denominations of $50 and $100, representing average Americans with modest means who supported the war effort. As a point of comparison, the financial cost to the U.S. of WWI was approximately $32 billion, or approximately $500 billion in current dollars.

Because of the collapse in the value of the bonds, most of the first two issues of Liberty Bonds were redeemed or “converted” to higher rate issues. Those bonds converted were exchanged into the “First Liberty Bond Converted” or “Second Liberty Bond Converted” issues. The first two Liberty Loan Bond issues that were not redeemed or converted are among the rarest of the bonds issued. Many of these bonds have not survived the last nine decades because they were redeemed due to the need for money during the Great Depression of the 1930s.

With World War I, the Federal Reserve began to buy government paper rather than corporate. They never restored that fundamental structure which was critical to the economy to provide support to corporations when banks could not or would not lend. Moreover, each branch of the Federal Reserve maintained its own interest rate prior to 1935. Therefore, at least that structure remained intact until Roosevelt took power.

Federal Reserve August 1927
Discount Rate

Atlanta	4.0%
Boston	4.0%
Chicago	4.0%
Cleveland	4.0%
Dallas	4.0%
Kansas City	3.5%
Minneapolis	4.0%
New York	4.0%
Philadelphia	4.0%
Richmond	4.0%
St. Louis	4.0%
San Francisco	4.0%

ArmstrongEconomics.COM

In 1916, as a debt–to–GDP share of the economy, the debt accounted for just 2.7%. The surge in debt associated with World War I was financed largely by selling bonds to the U.S. public. By the time the U.S. entered the war, pretty much all the other major powers were already in it up to their necks, and thus, didn't have any money to lend.

In the aftermath of the war, Uncle Sam hit a new record high debt–to–GDP of about 33%, with more than $25 billion in debts. But with a combination of budget surpluses, expenditures aimed explicitly at paying off debt early, and payments from the losers of war, the U.S. made significant progress in paying down the debt. It fell by more than $9 billion by 1930, a reduction of more than a third.

June 16, Franklin D. Roosevelt
Signs Glass-Steagall (1933 Banking Act)

Clinton Repeals Glass Steagall Allowing 2007 Mortgage Crisis To Unfold
The Gramm–Leach–Bliley Act (the Financial Services Modernization Act of 1999)
(Pub.L. 106-102, 113 Stat. 1338, enacted November 12, 1999)

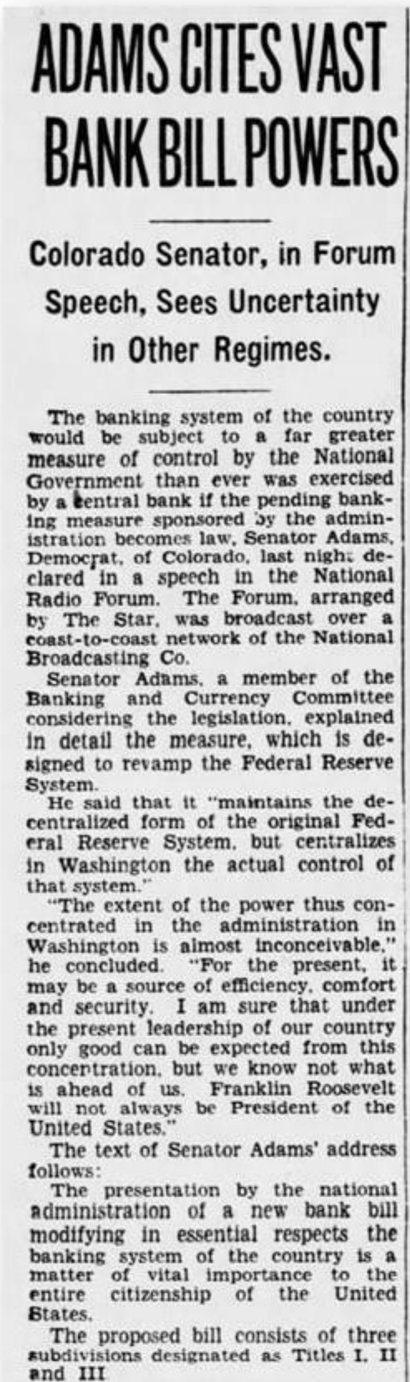
The 1933 Banking Act

The 1933 Banking Act established FDIC insurance. However, the most important aspect of this 1933 legislation was the separation of commercial and investment banking which became known as the Glass–Steagall Act. In 1999, Goldman Sachs led the charge to overrule Glass–Steagall which was successfully done under President Clinton who signed the Gramm–Leach–Bliley Act.

The 1933 Banking Act also established the Federal Open Market Committee (FOMC) which had a direct impact on the Federal Reserve. However, the 1933 FOMC did not include voting rights for the Federal Reserve Board, which was revised by the Banking Act of 1935 and amended again in 1942 to closely resemble the modern FOMC.

The 1935 Structural Change to the Federal Reserve

The entire design of the Federal Reserve was predicated upon the experience that although the United States was one political nation, it was not a single economy. Some regions were focused on commodity production and others on manufacture, while others were money centers for international finance. The very deliberate purpose of the frame of the Federal Reserve Act was to secure decentralized banking and currency control to prevent the centralization of banking and financial control in Washington or New York City.



ADAMS CITES VAST BANK BILL POWERS

Colorado Senator, in Forum Speech, Sees Uncertainty in Other Regimes.

The banking system of the country would be subject to a far greater measure of control by the National Government than ever was exercised by a central bank if the pending banking measure sponsored by the administration becomes law, Senator Adams, Democrat, of Colorado, last night declared in a speech in the National Radio Forum. The Forum, arranged by The Star, was broadcast over a coast-to-coast network of the National Broadcasting Co.

Senator Adams, a member of the Banking and Currency Committee considering the legislation, explained in detail the measure, which is designed to revamp the Federal Reserve System.

He said that it "maintains the decentralized form of the original Federal Reserve System, but centralizes in Washington the actual control of that system."

"The extent of the power thus concentrated in the administration in Washington is almost inconceivable," he concluded. "For the present, it may be a source of efficiency, comfort and security. I am sure that under the present leadership of our country only good can be expected from this concentration, but we know not what is ahead of us. Franklin Roosevelt will not always be President of the United States."

The text of Senator Adams' address follows:

The presentation by the national administration of a new bank bill modifying in essential respects the banking system of the country is a matter of vital importance to the entire citizenship of the United States.

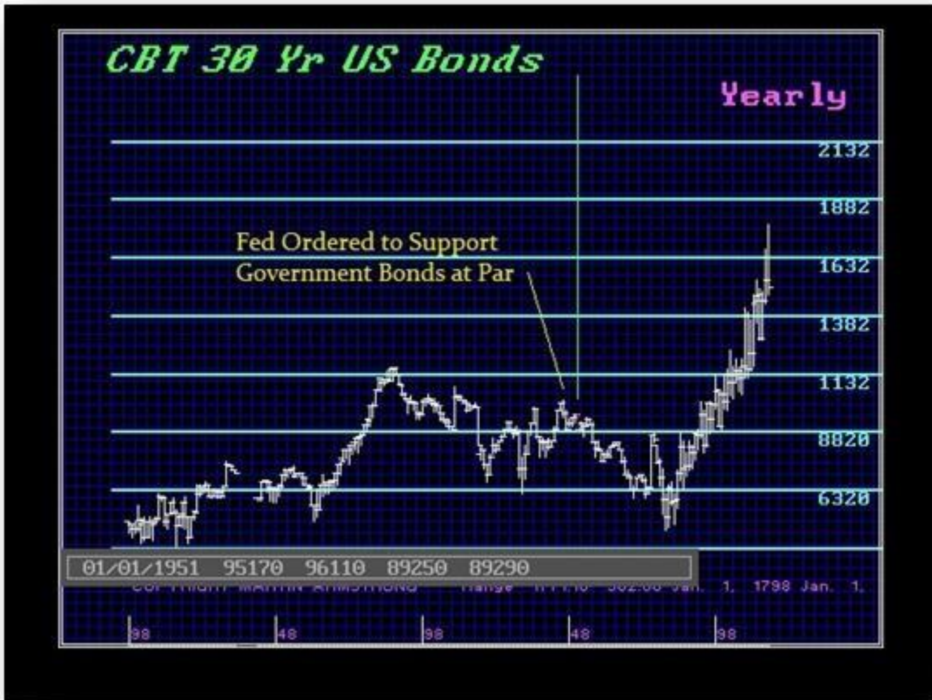
The proposed bill consists of three subdivisions designated as Titles I, II and III

Evening Star, Washington DC
April 2nd, 1935 • Page 30

Although a Democrat, Senator Alva B. Adams (1875–1941) who had represented Colorado in the United States Senate from 1923 until 1924 and again from 1933 to 1941 was a man of integrity. He was perhaps the only one who spoke out against Roosevelt in the grab for power that destroyed the very design of the Federal Reserve, transforming it to a centralized power ruled in Washington.

Alva B. Adams (1875–1941)
Senator for Colorado (1923-1924, 1933-1941)

The Banking Act of 1935 gave the Board of Governors control over other tools of monetary policy. The act authorized the board to set reserve requirements and interest rates for deposits at member banks. The act also provided the board with additional authority over discount rates in each Federal Reserve district. There was no more independence among the branches. It became one–size–fits–all.



It did not take long for Roosevelt to abuse the power he usurped in the 1935 Act. In 1942, the U.S. Treasury insisted that the Federal Reserve support the bond market during World War II. During April 1942, the Treasury requested that the Fed formally commit to maintaining a low-interest rate peg at 3/8% on short-term T-Bills to fund the war. The Fed complied and capped the rate at 2.5%.

At the time, in order for the Fed to maintain the peg, it was ordered to give up control of the size of its portfolio as well as the money stock. That is also what has happened today with Quantitative Easing among all central banks. Frankly, the Fed back then maintained the low interest rate by buying large amounts of government securities, which also increased the money supply domestically at the time. Because the Fed was committed to a specific rate by the peg, it was compelled to keep buying securities even if the members of the Federal Open Market Committee (FOMC) disagreed.

Everything exploded by February 1951. Inflation had soared reaching 21%. As the Korean War intensified, the Fed faced the possibility of having to monetize a substantial issuance of new government debt coming out to fund that war. This only intensified inflation. Nevertheless, Harry S. Truman became president in 1945 and it was his administration that continued to urge the Fed to maintain the peg agreement of 1945.

The conflict erupted in full view. The Fed revolted against the politicians. Shortly thereafter, the Fed informed the Treasury that as of February 19, 1951, it would no longer "maintain the existing situation." The Treasury was caught in a crisis for it needed to refund existing debt and issue new debt, a situation all governments are still in today. They never pay off debt, they simply roll forever.

The government had no choice but to negotiate a compromise under which the Fed would continue to support the price of five–year notes for a short time, but after that period the bond market would be on its own. It was on March 4, 1951, when the Treasury and the Fed issued a statement saying:

> "[We have] reached full accord with respect to debt management and monetary policies to be pursued in furthering their common purpose and to assure the successful financing of the government's requirements and, at the same time, to minimize monetization of the public debt."

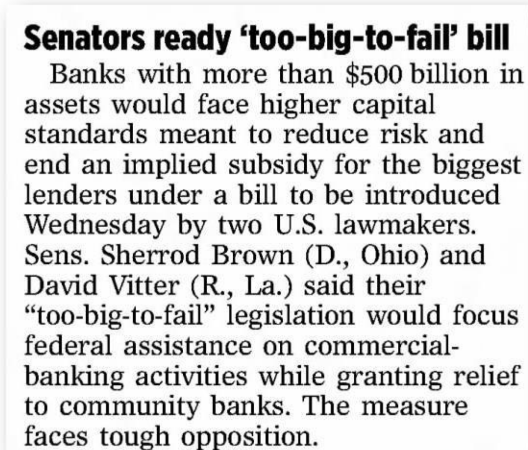
1985 Plaza Accord

From left are Gerhard Stoltenberg of West Germany, Pierre Bérégovoy of France, James A. Baker III of the United States, Nigel Lawson of Britain and Noboru Takeshita of Japan

If we look at the 1985 Plaza Accord, once again we see the U.S. Treasury interfere with the Federal Reserve. The entire move to great the Group of 5 (G5) was orchestrated by Secretary of the Treasury James Baker – not the Federal Reserve. Paul Volcker was in charge of the Fed at that time. He bowed to the wishes of James Baker.

Fed’s Changing Focus

With each crisis, the politicians have interfered with central banks and have distorted their very purpose. So, while many spin the conspiracies that the bankers are somehow in charge of the Fed, they fail to see that the bankers have zero power. The major directives are always coming from the politicians and they have constantly changed the focus of what the Federal Reserve is supposed to look at or even do within the economy.



Senators ready ‘too-big-to-fail’ bill

Banks with more than $500 billion in assets would face higher capital standards meant to reduce risk and end an implied subsidy for the biggest lenders under a bill to be introduced Wednesday by two U.S. lawmakers. Sens. Sherrod Brown (D., Ohio) and David Vitter (R., La.) said their “too-big-to-fail” legislation would focus federal assistance on commercial-banking activities while granting relief to community banks. The measure faces tough opposition.

The Philadelphia Inquirer, April 24, 2013 • Page A15

Then with 2007, the Federal Reserve was granted powers to bail out anything that was too big to fail. In 2015, after pressure from Congress to limit its power to prop up a troubled financial institution, the Federal Reserve adopted a new rule that would limit its ability to bail out failing financial institutions. The Fed announced that its board of governors approved a final rule for its “emergency lending” program, criticized as recognizing that there are some banks that are simply “too big to fail.”

Under the new rule, the Fed will no longer conduct “emergency lending” to specific companies. Instead, under the new rules, the Fed said that it will now only consider emergency lending for “broad–based” problems affecting larger market troubles. This is where the Repo Crisis emerged. The Fed is supporting the market to prevent a rise in interest rates rather than an individual institution.

The passage of the Dodd–Frank Act back in 2010, increased the Fed’s authority to provide “emergency lending” to a failing financial institution which was limited to programs and facilities with ″broad–based eligibility″ that have been established with the approval of the Secretary of the Treasury. Under the new rule, this definition of “broad–based” as an emergency lending program requires that “at least” five financial entities would be eligible to participate. Under the new Fed rules, if five financial entities aren’t concurrently failing, there are no bailouts. That means it will not bail out an individual bank. The crazy thing here is the fact that the very purposed of the Federal Reserve in 1913 was to secure stability in the banking system.

UNCLE SAM'S NEED OF AN ELASTIC CURRENCY

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

From the *Pioneer Press* (St. Paul)

Rules are not laws. This still leaves the Fed’s new rule open to future bailouts if we are still talking about a major money center bank that if allowed to fail would create a contagion among lesser smaller banks throughout the nation. The criticism that this leaves the door open for taxpayers to bail out banks, we must note, that the bank all repaid the $700 billion and the Fed has the authority to create elastic money which would not require raising taxes to bail out banks.

Clearly, “emergency lending” must as a practical perspective mean “discretionary lending.” If this were not true, then ironically the very original creation of the Federal Reserve would be destroyed. Yet, the Fed’s new rules also further prohibit bailouts to entities that are insolvent and cannot be rescued.

The Fed’s rule also incorporates the requirement in the Dodd–Frank Act that the Secretary of the Treasury must also approve all Fed emergency lending programs. It also made it clear that it must still find that ″unusual and exigent circumstances" exist as a pre–condition to authorizing emergency credit programs.

Indeed, once upon a time, the Federal Reserve was simply created to secure the banking system. Post–Keynesian Economics, the Fed was charged with managing the demand within the economy to control inflation. It was theorized that the Fed could control the business cycle completely and manage the economy, eliminating depressions and recessions. The very purpose of independence was killed by Roosevelt in 1935 and then we have a never–ending series of usurpations of powers and controls imposed on the Federal Reserve. The very idea that the president is not to intervene with the Fed decisions on interest rates is rather absurd. The Federal Reserve is no longer anything that it was designed to do.

The entire Marxists/Keynesian agenda has led to the usurpation of central banks and transformed them into merely another undefined branch of government.

The International v Domestic Perspective

When we look at markets, the most obvious realization from an international fund manager's perspective has always been the golden rule: Currency is everything! You will never be interested in participating in a country where there is country risk from a political perspective or one where the assets rise only in proportion to the decline in the value of that currency. All great speculative bubbles take place when both the assets and the currency are rising. Then international foreign investors will pour into that market when they can make money on both the asset and the currency.

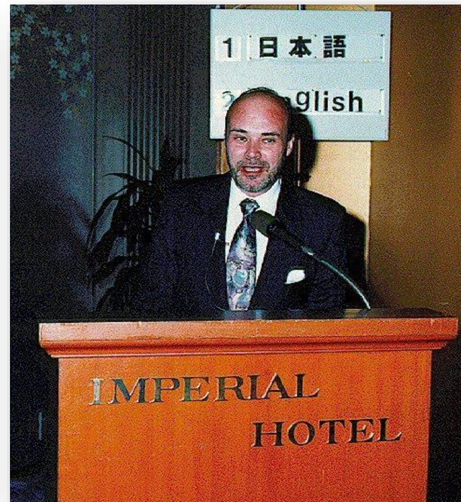
There are some exceptions which are major red flags. One of the famous forecasts we made was that the Japanese market would peak in December 1989 and that would be a major bubble top followed by a prolonged bear market for up to 26 years. I was often asked how I could make that forecast compared to other bubbles like 1987 or even the 2007 bubble? The Japanese bubble was unique. The price advance in yen was far greater than it was for foreign investors. The assets rose greater than the currency and that warned it was primarily a domestic bubble. This distinction warns of a more profound economic crisis unfolding.

Events such as the 2000 Dot.Com bubble benefitted foreign investors more than domestic. In dollars, the NASDAQ Composite rallied 190% during the final stage. In terms of euros, the rally was 253%. This is what I am talking about when the foreign investor benefits more from the currencies it reflects a global capital movement as compared to the Japanese bubble where the rally was greater in yen than in dollars.

We must understand that there is a significant difference in bubbles being international v domestic. All such domestic bubbles never end well and result in structural declines which may at times even lead to civil unrest. This is because the first sellers are based on currency rather than assets. In the case of Japan, the advance in yen sucked in everyone who ever thought of buying stocks in Japan domestically, which fundamentally destroyed the savings and fundamental capital formation. This is far more destructive just as a bond collapse wipes out more people than a stock market crash in normal markets where people have believed in their governments.

These subtle differences are extremely critical to the underlying foundation within an economy. Once that is undermined, it takes a very long period of time to rebuild that base. For example, with the Sovereign Debt Defaults of 1931 and over 9,000 bank failures, it took 25 years before the Dow finally exceeded the 1929 high in 1954. In the case of the Roaring 20s, the low in the U.S. share market came in 1932 in just under three years. However, it was the collapse in the bond markets which undermined the banking system and contributed to the defaults of 9,000 banks. That is what wiped out the capital formation, not the stock market decline.

In the case of Japan, it was a 19-year decline from the 1989 high with the low in the Nikkei finally unfolding in 2008. However, even 26 years later in 2015 the Nikkei still could only muster a rally back to 20952 or nearly 50% of the 1989 high.



I have often told the story of how a personal investor bribed his way into an institutional session at the Imperial Hotel. He apologized but said he just had to talk to me. He had invested $50 million and bought the market on the very day of the high. He said it was his first purchase ever and he was in his late 60s. He said brokers had called him every day for seven years and said the Nikkei rose 3%-5% every January. He watched for seven years and saw they were correct. He bought the very day of the high and watched it crash thereafter.

COUNTRY RISK

Most of the capital outflow from China has been its own people trying to get cash out. They were using Bitcoin to accomplish that. Country risk centers upon a stable and important rule of law, for without that capital will never be attracted to investment. Once the rule of law crumbles into bias and corruption, as we see today in the USA and Europe, this is part of the risk of investment that, with time, will destroy Western civilization.

GIBBON, Edward. **The History of the Decline and Fall of the Roman Empire.**
London: W. Strahan and T. Cadell, 1776-88. Six volumes. *Rare full first edition set*

Edward Gibbon wrote in his classic, 1776 Decline and Fall of the Roman Empire:

"…the intolerable weight of taxes, rendered still more oppressive by the intricate or arbitrary modes of collection; the obscurity of numerous and contradictory laws; the tedious and expensive forms of judicial proceedings; the partial administration of justice; and the universal corruption, which increased the influence of the rich, and aggravated the misfortunes of the poor. "

Book III, Chapter 34

Country risk is a critical part of international investment. In assisting international companies with decisions on where to locate plants or open up operations, the first criteria is always country risk, which is all about the stability of the rule of law. How can you invest in any country if there is no reliable legal system to secure contracts or property?

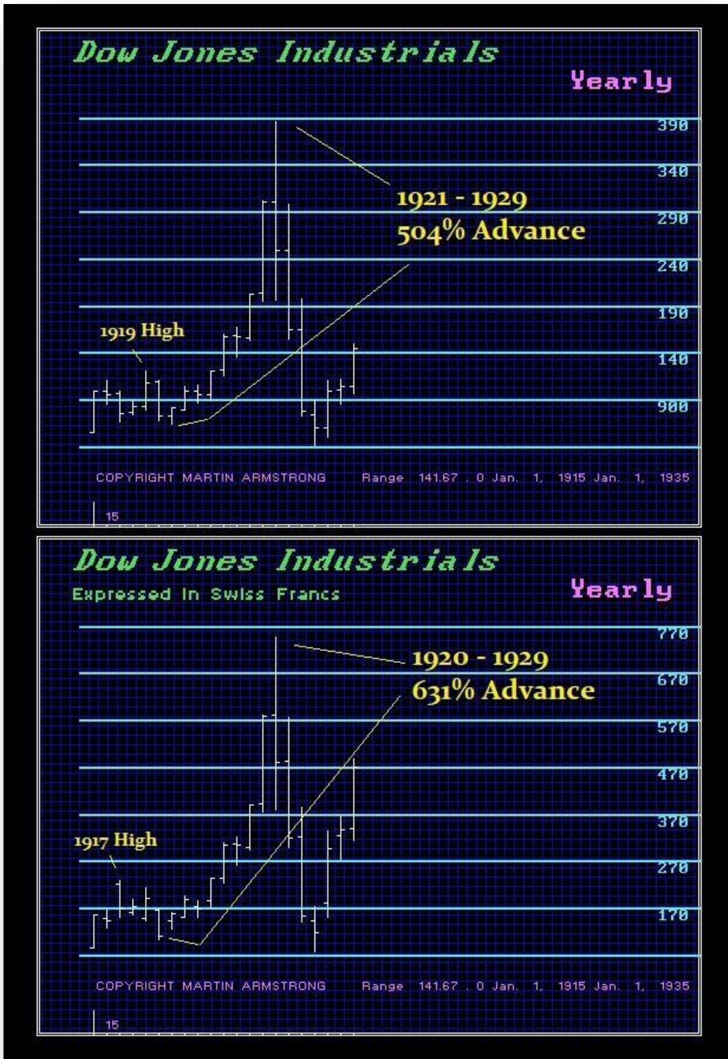

The Code of Hammurabi Black Basalt Stele - Louvre

Contract law began in Babylon. Hammurabi's legal code required all agreements to be written down. This put an end to false claims. When we talk about investing in Europe, we do not even consider country risk because it is assumed the rule of law is stable. That is gradually changing. The insane fines are part of the process of the decline and fall. In the USA, you cannot sue banks for manipulation in NYC. The conviction rate in the USA in Federal court is 98.5%+. They threaten and intimidate people and 98% take plea deals because jury trials are rigged for the government. This too is destroying the foundation of the American economy in a slow, gradual process.

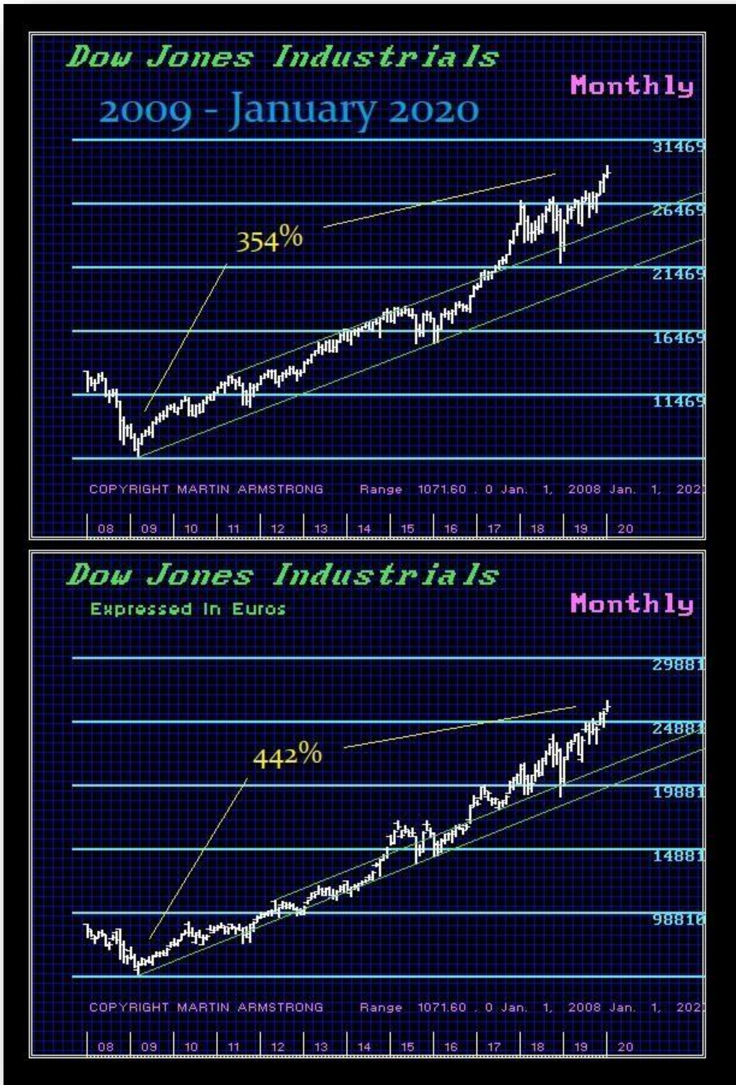
Consequently, China will surpass the United States and the West because our rule of law is collapsing. Courts rule in favor of government routinely and once that happens, no property is secure anymore. They are just confiscating cash presuming it is criminal in some way, be it taxes or otherwise, and they do not have to prove anything. This is demonstrating that the West will not be able to survive long–term without the security of property. Hence, you can see it coming. If China respects property rights, then capital will migrate to Asia and leave the West due to the lack of a rule of law.

Obviously, country risk is a factor that also determines the possibility of a bubble. Capital will simply not be attracted to a place where its capital is at risk. South Africa had created a Financial Rand all to prevent capital from moving out of the country. I was offered projects to advise on, but I would not be able to get the money out. Naturally, I declined.

After the Iranian Revolution, they simply nationalized the oil industry. American companies lost all their capital investment. As countries swing left, the country risk will rise. This will begin to impact markets where you see legislation that seeks to curtail foreign investment as it has been doing in real estate.



Looking at the Dow Jones Industrials during the 1920s, we can see that the highs and lows in terms of even Swiss francs differed greatly. In dollars, the high was 1919 with the commodity rally. In Swiss francs, the high was 1917 and the low was 1920 compared to the 1921 low in dollars. The rally in Swiss was 631% whereas the dollar rally was only 504%. International perspectives are critical to understanding the market timing. In this case, the country risk was Europe because of the war. Hence, the capital flight was from Europe to America. In this case, we have a stark difference between the U.S. bubble into the 1920s compared to the Japanese bubble of 1989.



Therefore, we must assess the correlation of a currency to a bubble as it is unfolding. In the current situation, we can see that the rally in dollar out of the 2009 low to the January 2020 high was 354%. When we plot this in euros, that same period produced a rally of 442%.

The rally this time around has been not only the **MOST HATED BULL MARKET** in history, but it has been entirely driven by capital inflows. This is why the Dow Jones Industrial Index has been the leader on the way up.

Certainly, we have had those blaming the Federal Reserve for the cheap interest rates. Yet, if the Fed responded as they did in 1927 and doubled the interest rates, then they will attract even more capital inflows. With interest rates at virtual 5,000–year lows outside the United States thanks to Quantitative Easing which has failed and trapped both the Bank of Japan and the European Central Bank, the Federal Reserve is in a position where domestic policy objectives have become hostage to international policy objectives.

The International v Domestic Perspective

The Federal Reserve has been focused on the problem of the negative interest rates in Europe and Japan. They have come to realize that there is a very serious crisis brewing outside of the United States which will totally eradicate their domestic policy objectives. The slightest uptick will be devastating to those economies, not to mention the losses on the outstanding long–term bonds which produce negative yields.

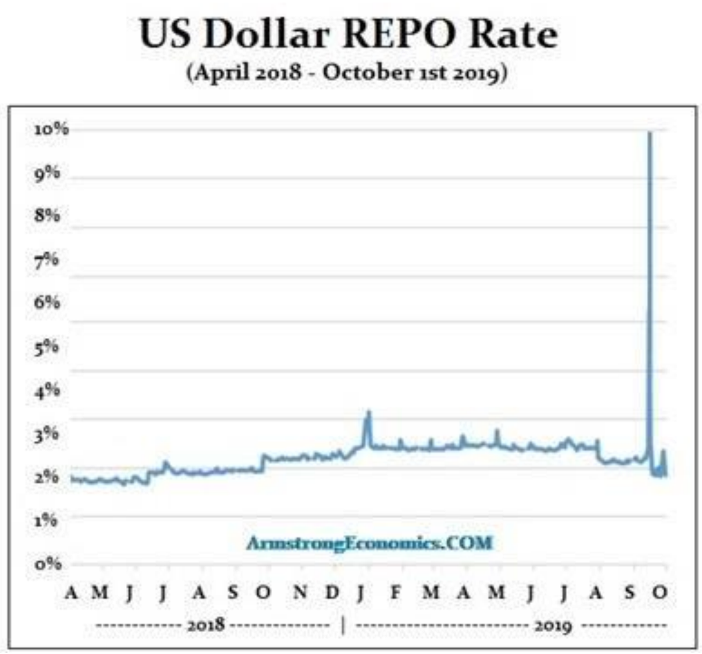
Therefore, to understand the crisis and the capital flows to the dollar, we must understand the country risk, the currency, and the movement of the assets. What it is creating is a future collapse in confidence with respect to the governments overseeing the economy. Therefore, I wrote the book, **"Manipulating the World Economy."** This is all coming to an end. We are looking at, not inflation, but a massive shift in investment strategy from public to private. The Fed cannot raise interest rates to prevent a rally without undermining the sovereign debt globally. The game has changed. The politicians will brow–beat the Fed because the Democrats are really Marxists and will scream at the Fed because their low rates are benefiting the rich. They are beyond brain–dead. The politicians are incapable of understanding the problem and they have become so confrontational that we can guarantee there will be no understanding reached because they are absorbed by this class warfare.

The Misconception of Who is in Control

A common misconception that prevails has been that central banks are actually in control of interest rates. Some do not understand how interest rates can rise when central banks are the only market maker. Others do not comprehend that if the debt crisis is outside the United States, then why is the Repo Crisis taking place within the United States? Some then wonder if there is an intense capital inflow into the USA, then why is that capital not financing repos in the United States?

These are interesting questions that are predicated upon the assumption that governments are all-powerful thanks to Marx and Keynes. Central banks do not control long-term rates. They set the short-term rate, such as Fed Funds, and the discount rate. That is what Quantitative Easing was all about. The central banks began to buy long-term debt in hopes of "influencing" the long-term rates by reducing the supply of government long-term debt. In theory, then the free market would have been willing to buy private long-term debt such as mortgages. That failed because banks had no confidence in the real estate market and were loaded to the gills with real estate debt which people were defaulting on.

The Repo Crisis has begun in the states because this is the only viable free market to speak of. Both Japan and Europe have destroyed the bond markets. The Repo Crisis is the manifestation of our forecast that we would enter a liquidity crisis by September 2019. We listed that as one of the major points to take home from the May 2019 Rome World Economic Conference.



The Repo Crisis is a liquidity crisis because of the collapse in confidence. Banks are unwilling to lend to each other because they are deeply concerned about a crisis in the international banking sector.

The Fed was lowering short-term rates because the yield curve inverted on the 10yr–2yr during the third quarter of 2019. Then the Repo Crisis hit on September 17. This forced the Fed to stop its intended policy to lower rates for the free market dictated otherwise.

The image that central banks are in control is an illusion. They too are subject to the free market. They are not in control of interest rates as they like to make everyone believe. If that were true, then there would have been no Repo Crisis to start with.

The Fed v ECB

The Federal Reserve does not need permission to create elastic money. It does have the authority to expand or contract its balance sheet. However, it cannot simply print money out of thin air. The European Central Bank (ECB) is the only institution that can authorize the printing of euro banknotes. The Federal Reserve must back the banknotes by purchasing U.S. government bonds. The Fed buys and sells U.S. government bonds to influence the money supply whereas the ECB influences the supply of euros in the market by directly controlling the number of euros available to eligible member banks. This structure was created because of Germany's obsession with its own hyperinflation of the 1920s.

Each member state retained its central bank and those central banks issue the banknotes –– not the ECB. Therefore, the ECB works with the central banks in each EU state to formulate monetary policy to help maintain stable prices and strengthen the euro. The ECB was created by the national central banks of the EU member states transferring their monetary policy function to the ECB, which in effect operates on a supervisory role.

There are four decision-making bodies of the ECB that are mandated to undertake the objectives of the institution. These bodies include the Governing Council, Executive Board, the General Council, and the Supervisory Board.

The Governing Council comprises six members of the Executive Board and Governors of the national central banks of the euro area member states. The Council members meet twice a month at the institution's offices in Germany. Its primary function is the formulation of monetary policy for the Eurozone area. That means it makes the decisions on monetary objectives, interest rates, and the supply of reserves in the Eurosystem.

The Executive Board comprises the President, Vice President, and four other executive members appointed by the European Council. The executive members serve for an eight-year non-renewable term. The role of the Executive Board is to implement the monetary policy as defined by the Governing Council and to manage the day-to-day operations of the ECB, alongside the Chief Services Officer. Also, the board prepares the Governing Council meetings and exercises power delegated to it by the Governing Council. It holds meetings every Tuesday.

The General Council is a transitional body that carries out responsibilities taken over from the European Monetary Institute (EMI). It comprises the President, Vice-President, and Governors of the national central banks of the EU member states. The body will continue to exist until all EU member states have adopted the euro. As of 2017, only 19 out of the 28 EU member states (now 27 post-Brexit) had taken up the euro as their single currency. This body is charged with fixing the exchange rates of currencies for countries preparing to join the Eurozone.

The ECB was granted a monopoly status on the issuing of banknotes in the Eurozone area. The ECB makes weekly announcements on the amount of money it wishes to supply and the minimum acceptable interest rate. Eligible banks that have provided collateral then place their bids for the ECB funds through an auction mechanism. Once the banks have obtained funds, they use them to advance loans to individuals and businesses all in theory.

The European Central Bank is also responsible for banking supervision in all the EU member states. The ECB carries out this function through the Single Supervisory Mechanism (SSM) that comprises the ECB and competent national authorities in the member countries. Therefore, the ECB has the power to grant and withdraw banking licenses, conduct supervisory reviews, and set higher capital requirements to counter financial risks. The ECB directly supervises 124 significant banks that hold 82% of the banking assets in the euro area.

Willem Frederik "Wim" Duisenberg
(1935–2005)
First President of the European Central Bank
(June 1, 1998 – November 1, 2003)

The tensions within Europe have never abated between members. The first President of the Bank was Willem Duisenberg (1935–2005), who was the former president of the Dutch central bank. The French objected and demanded that the ECB should be headed by a Frenchman, Jean-Claude Trichet, because the ECB was to be located in Germany. A gentleman's agreement was finally reached whereby Duisenberg would step down before the end of his mandate and Trichet would become the head of the ECB in November 2003. He was replaced by an Italian, Mario Draghi, who became the head of the ECB between 2011–2019. Now we have Christine Lagarde, who is French, taking over the ECB from Draghi.

Article 127

(ex Article 105 TEC)

1. The primary objective of the European System of Central Banks (hereinafter referred to as 'the ESCB') shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union as laid down in Article 3 of the Treaty on European Union. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119.

2. The basic tasks to be carried out through the ESCB shall be:

— to define and implement the monetary policy of the Union,

— to conduct foreign-exchange operations consistent with the provisions of Article 219,

— to hold and manage the official foreign reserves of the Member States,

— to promote the smooth operation of payment systems.

3. The third indent of paragraph 2 shall be without prejudice to the holding and management by the governments of Member States of foreign-exchange working balances.

4. The European Central Bank shall be consulted:

— on any proposed Union act in its fields of competence,

— by national authorities regarding any draft legislative provision in its fields of competence, but within the limits and under the conditions set out by the Council in accordance with the procedure laid down in Article 129(4).

The European Central Bank may submit opinions to the appropriate Union institutions, bodies, offices or agencies or to national authorities on matters in its fields of competence.

5. The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.

6. The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.

Authorization

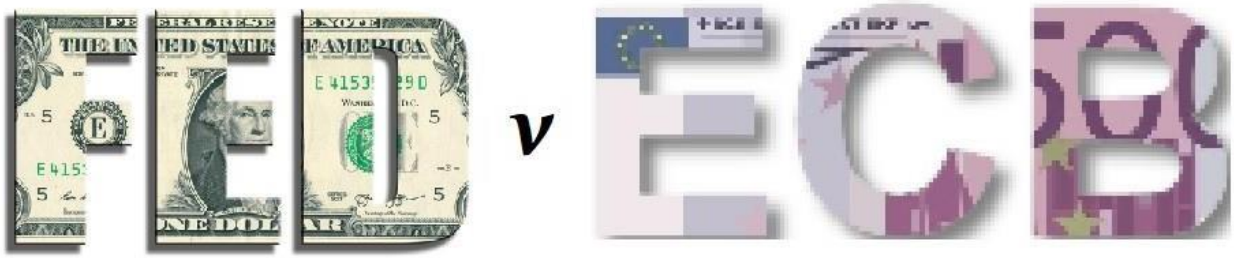
The primary objective of the European Central Bank was laid out in Article 127(1) of the Treaty on the Functioning of the European Union. That stated its authority was to maintain price stability within the Eurozone which is rather vague. The Governing Council in October 1998 took it upon themselves to define "price stability" as meaning inflation of under 2% on "a year–on–year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%." Therefore, the ECB was created differently from that of the Federal Reserve System which was intended to be simply an independent system where the banks were shareholders because that was a contribution to create the Fed outside of taxpayer money. Hence, the ECB has only one primary objective and it was envisioned as a division of the government. The "price stability" has never been defined in statutory law which leaves a very wide view of interpretation.

The Governing Council sought to confirm this definition of "price stability" in May 2003. They clarified that "in the pursuit of price stability, it aims to maintain inflation rates below, but close to, 2% over the medium term." Hence, all such lending to credit institutions had to be collateralized as required by Article 18 of the Statute of the ESCB. This so-called "clarification" is by no means a defined law. Therefore, this vague directive of maintaining "price stability" is further complicated because, under the Treaty, it also directs that "the ESCB shall support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union." This leaves the door wide open for the ECB under Legarde to suddenly declare that climate change must be a policy of the ECB. This clearly makes the ECB an arm of the EU Commission and not independent as is the case with the Federal Reserve.

Since November 4, 2014, the ECB has been responsible for specific tasks concerning policies relating to the prudential supervision of credit institutions within the framework of the Single Supervisory Mechanism. As a banking supervisor, the ECB also has an advisory role in assessing the resolution plans of credit institutions.

European Parliament & ECB

The ECB President reports to the European Parliament on monetary issues in a quarterly Monetary Dialogue. The ECB also prepares an annual report on monetary policy which is presented before Parliament. Parliament adopts a resolution on this annual report. The new supervisory responsibilities of the ECB are matched with additional accountability requirements as laid down in the SSM Regulation. The practical modalities are governed by an Interinstitutional Agreement (IIA) between Parliament and the ECB. The accountability arrangements include the appearance of the Chair of the Supervisory Board before the competent committee; answering questions asked by Parliament, and confidential oral discussions with the Chair and Vice Chair of the competent committee upon request. In addition, the ECB prepares an annual supervisory report, which is presented to Parliament by the Chair of the Supervisory Board.



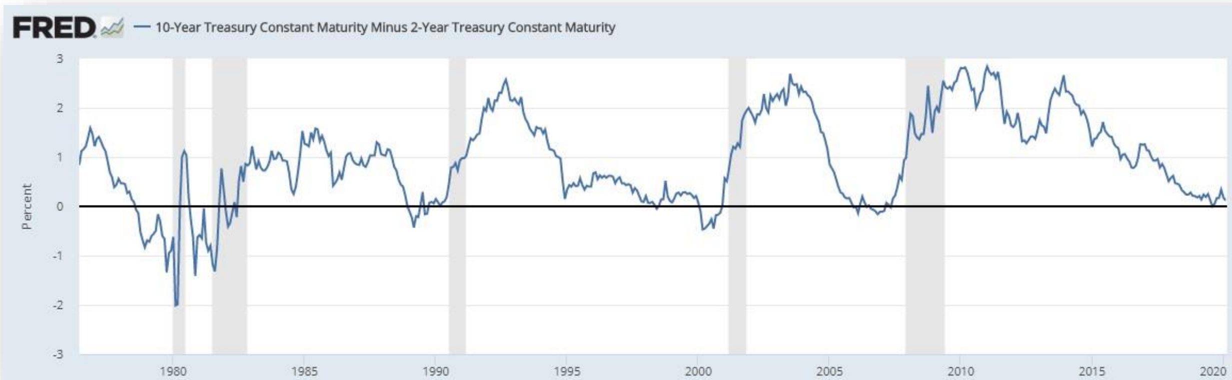
Structural Difference Between the Fed v ECB

The very structural design of the ECB v the Fed turns on the very fact that Europe rejected the basic idea of consolidating national debts from the outside. Therefore, the Fed buys government debt to back its currency, and in Quantitative Easing the Fed would buy federal government debt.

The ECB structure is substantially different whereby it simply creates money for there is no federal debt to back the currency. Therefore, the measures used by central banks to deal with such crises as we saw 2007–2009 vary significantly. These differences have never been looked at by the vast majority of analysts because they just assume that all central banks operate in the same manner with the same authority. The Federal Reserve and the European Central Bank (ECB) may appear on the surface to be similar because they both engaged in Quantitative Easing, however they followed distinctly different monetary policies that employed completely diverse financial controls to manage crises.

As explained, there has been an evolution in central banking post–Great Depression as politicians have divested themselves of responsibility for even inflation shifting that responsibility to the central bank. Consequently, central banks have inappropriately become the authority responsible for a country's monetary policy and the only issuer of printed bank notes and minted coins in an economy. The original purpose of the central bank to support the banking system has devolved from bailouts to bail–ins all to allow politicians to avoid responsibility.

Many regard the main purpose of a central bank today is to manage the stability of its currency and thereby controlling inflation through the supply of money in circulation. This, of course, has been the result of adopting Keynesian Economics but we are witnessing the failure of such models.



The structural flaw in baking is that the very design has been based upon the spread between short-term demand rates and long-term rates. The banks pay depositors the lower short-term rates and then lend out the money long-term and their profit is the spread. When an economy moves into recession, people need cash so they tend to save rather than spend and thus people borrow less so long-term rates begin to fall. If confidence is shaken, then there emerges a bank run with people demanding to withdraw their cash. This forces the banks to call in loans to meet the demand for the withdrawing. Banks get in trouble when we normally enter inverted-yield curves when they are purely a domestic occurrence.

If it is perceived that the bank is in trouble, that is when we see what is known as a bank run. People line up like a herd to withdraw their cash before the bank runs out and closes down. In some cases, the rumors can be unjustified. In 1931, a local bank had the name: Bank of United States. When people heard that the bank would not cash a check, they assumed this was like the central bank of the country and a real bank panic was born. Eventually, the bank closed. In the end, people recovered more than 90% of the money.

For this reason, when a crisis strikes and commercial banks cannot cover the shortage in supply of money, they turn to the country's central bank for additional funds. That was the original design of a central bank. The central bank must somehow provide these funds in order to keep the banking system from failing. That was the authority of the Federal Reserve to create Elastic Money allowing it to expand the money supply which would then contract when the crisis was over.

Buying v Lending

The primary difference between the Fed and the ECB is structural. During such periods of a financial crisis, the Fed buys U.S. government debt (treasuries) to inject cash into the system. The ECB is only authorized to lend money to governments and commercial banks within the Eurozone because there is no national European debt.

The Fed buys treasuries whereas the loans granted by the ECB were originally supposed to be short–term (up to three months) and were to be secured by collateral which turned out to be their own debt. When the loan period expires, the banks must pay the money back to the ECB. However, the ECB has admitted it cannot reduce its balance sheet and must roll the debt it has bought under its Quantitative Easing program. In other words, they are trapped eternally.

The Fed's Quantitative Easing

The Federal Reserve's main response to the 2007–2009 Financial Crisis was to increase liquidity in the market through large–scale asset purchases which became known as Quantitative Easing (QE). This QE program pumped cash into the marketplace by purchasing government bonds. After the main crisis was over, the Fed announced the tapering of its monetary policy in December 2013, and has been slowly reducing its monthly purchases on the back of improved economic performance.

Because there is a United States bond market that did not go to negative rates, the Fed has been able to allow its debt holding to mature. This is exactly the opposite of the position that the ECB finds itself in these days. The negative rates of the ECB have destroyed its bond market and that means there is no way to simply allow the debt holdings to mature, thereby shrinking its balance sheet. The crisis faced by the ECB is that it has surrendered all its power and now is unable to extract itself from its negative interest rates experiment. There are about $12 trillion of outstanding negative yield debt.

The ECB Extended Maturities of Bank Loans

The ECB's inability to extract itself from its negative interest rate experiment has forced it to maintain liquidity in a futile attempt to repair its lending system to commercial banks by extending the maturity of its outstanding loans. If the ECB called in its loans to member states, interest rates would explode.

The ECB was forced to change its monetary policy by increasing the maturity of its bank loans. What was intended to be three months eventually was extended to three years and even that has no hope of resolving the crisis. These loans have been made available on a full-allotment basis, meaning that banks have unlimited access to the liquidity of the central bank when providing adequate collateral. The definition of acceptable collateral has been eased in order to prevent a collapse of the entire financial system.

ECB's Securities Markets Programme

In 2010, when Greece was on the verge of collapse, the ECB introduced the Securities Markets Programme (SMP) and intervened in the markets by buying Greek bonds. When traders saw the crack in the European debt markets, they turned on Spain. The program had to be expanded to then also include purchases of Spanish and then Italian bonds up until its termination in September 2012. The ECB justified the creation of the SMP through the need to ensure financial stability in the Eurozone. It has used vague language in its authority to expand its powers.

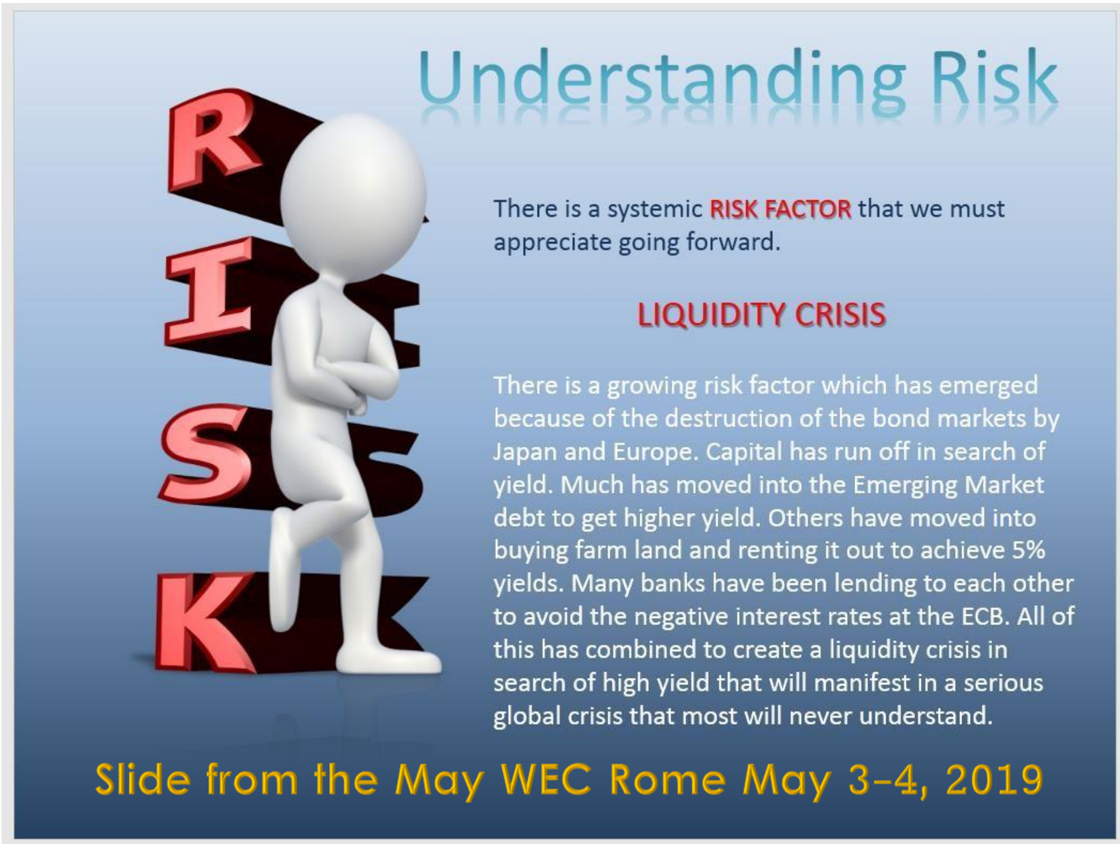
The EU rules prohibit the ECB from helping a country unless it has agreed to a rescue program of EU partners. Then, for example, the Euro-watchdogs could buy up Italian government bonds in order to contain a rise in yields. This provides for a monetary policy emergency tool adopted in 2012 called "OMT." However, this has never been used before. The ECB, behind the curtain, fears that if they try to use this mechanism and it fails, as our model warns, then the confidence in the entire EU system will collapse.

The European High Court ruled in 2015 that the ECB may buy government bonds of member states to rescue the euro. This is in direct contrast to the German Constitutional Court, which ruled that the ECB violated German sovereignty. "The program does not exceed the monetary powers of the ECB and is not contrary to the prohibition of monetary financing of Member States," said the European Court. However, this pitted the European High Court in direct conflict with the high court of Germany.

The ECB then started its own aggressive Quantitative Easing program. After launching the Banking Union, designed to coordinate monetary policy in a more cohesive way within the Eurozone, the ECB committed to buying €60 billion euros worth of member state government bonds per month. The European Central Bank also introduced negative interest rates in 2014 as a way to encourage banks to lend and boost the economy instead of keeping their cash stockpiled. That measure has completely failed, and in the process has trapped the ECB for it cannot now allow rates to rise.

There is no question that there are stark differences between the Fed and the ECB. The two banks are very different in nature and it remains to be seen whether the ECB will ever be able to escape its own madness.

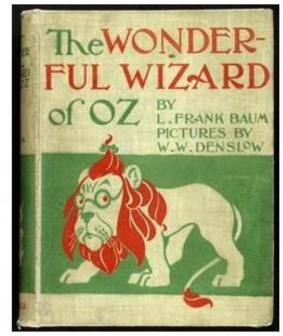
The Repo Crisis That Surprised Everyone



During the Rome World Economic Conference (WEC) held on May 3 and 4, 2019, we warned that a major Liquidity Crisis was developing as a direct consequence of the negative interest rates and the Quantitative Easing on the part of the European Central Bank (ECB), which was destroying the European bond market. It is quite shocking how those in power remain clueless as to how the global economy truly functions. All they have is the simplistic view of how to manipulate the masses with Keynesian Economics applied to their monetary policy of raising and lowering interest rates. They have entirely ignored the fiscal side of the books and disregarded the impact of taxes upon the people. They assume inflation will take place if you merely increase the quantity of money, but do not consider that the person on the street looks only at net disposable income after taxes. If he does not feel secure, he will hoard his cash and never spend.

During the Panic of 1893, long before Keynes, there was a major economic collapsed that inspired a march on Washington and also inspired the author of "The Wizard of Oz." The Tinman was industry, the Scarecrow was agriculture, and the Cowardly Lion was William Jennings Bryan. They followed the Yellow Brick Road which represented the austerity of the gold standard.

Lyman Frank Baum (1856–1919)



First Edition 1900

The Silver Democrats had sent the economy into nearly bankruptcy. It was at that time that President Grover Cleveland stood before a special session of Congress on August 8, 1893 and said:

Grover Cleveland (1837–1908)
only President of United States to serve two non consecutive terms (1885–1889 and 1893–1897)

"At times like the present, when the evils of unsound finance threaten us, the speculator may anticipate a harvest gathered from the misfortune of others, the capitalist may protect himself by hoarding or may even find profit in the fluctuations of values; but the wage earner – the first to be injured by a depreciated currency – is practically defenseless. He relies for work upon the ventures of confident and contented capital. This failing him, his condition is without alleviation, for he can neither prey on the misfortunes of others nor hoard his labour."

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Since we lean individually from our mistakes, many wrongly assume that the government knows what it is doing. Unfortunately, history repeats for the simple fact that collectively we never learn the lessons from the past. What applies to the individual does not apply collectively to society.

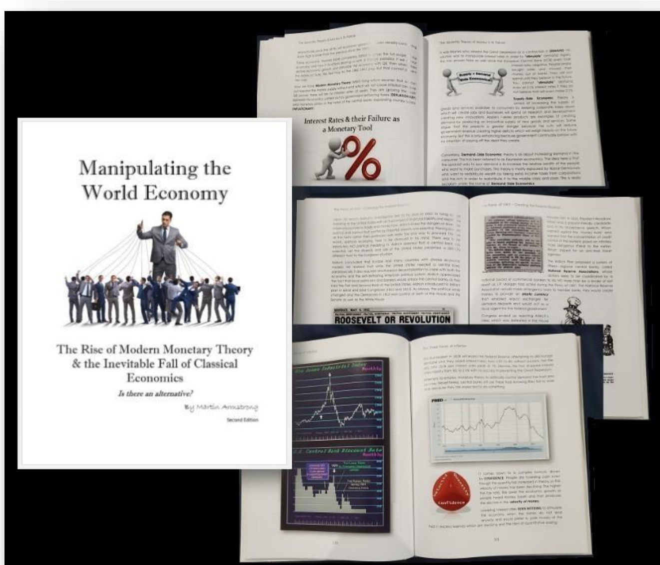
We have entered a serious Liquidity Crisis that most governments fail to understand. As a result, we have entered the "The Great Unknown" for we cannot ever learn from our past mistakes collectively as a society. Then there is the problem that those in power will never admit to a mistake, for they fear they will be voted out. Thus, society remains doomed, unable to advance from our mistakes that we deny making as a political society.

We are now entering a period of tremendous disparity between the artificial interest rates set by governments' central banks and those of the independent free market. What has been unfolding is a major clash between the real world and the artificial world which the ECB and the BOJ have attempted to create.

Traditionally, the central banks have controlled the short-term rates. The long-term rates have always been set by the free markets. When confidence collapses, that is when the yield curve inverts, and analysis warns of a recession

as they did during the summer of 2019. The very existence of the Repo Crisis is confirming that we have entered a new crisis, one where the central banks have lost the ability to manage the short-term rates. The Fed is trapped insofar as it cannot lower rates since they have become the market-maker in the repo market. If the Fed steps back, then the free market will send short-term rates higher which will blow up both the ECB and the BOJ.

In order to attempt to control the long end of the yield curve, the central banks engaged in Quantitative Easing where they bought in long-term debt in hopes of creating a shortage whereby they would bring those long-term rates down. Of course, the Federal Reserve was only buying government debt with no regard to credit risk. The academics where using their linear thinking applied to Keynesian economics with no real world experience.



The Fed never considered the fact that banks were also not lending because they distrusted the credit risk given the prospects of the future. People will not even borrow to invest if they do not trust the future.

The Repo Crisis is far more serious than most people understand. We are dealing with the last vestige of power that was once held by the central banks under Keynesian Economics. Ever since Karl Marx, there has been this idea that governments have the right, the knowledge, and the capacity to manipulate the world economy. While I put together the historical record of how governments have attempted to manipulate the world economy in my latest book, what we are facing is the clash of central banks desperately trying to remain relevant in the game.

The Fed has been compelled to intervene in the repo market in order to prevent short-term rates from rising. What is taking place is that the free markets are smelling risk ahead and that is being translated into greater caution in lending.

At the May 2019 WEC in Rome, we presented this slide. The #1 issue on our list of things to take home from the conference was the "Destruction of the Bond Markets & Liquidity Crisis" with a focus on both Europe and Japan. These 12 years of Quantitative Easing from both Europe and Japan have completely failed to stimulate and reverse the economic decline and unleashed a deflationary trend. In the process, by purchasing government bonds to influence long-term interest rates, the banks failed to lend to the private sector as (1) they did not trust the future, and (2) the consumer saw a bleak future.

This Quantitative Easing theory required these two factors. The refusal to bail out the banks left them holding non-performing loans that threatened their very existence. This is where academics' lack of real world experiences renders these theories completely bogus and impractical.

May 2019 WEC

At the May 2019 WEC, we warned the Liquidity Crisis was staring us in the face which meant the destruction of the government bond markets. That Liquidity Crisis first showed its teeth by capital flight to the dollar that drove the yield curve to an inverted position in 2019 (10yr–3month). As capital moved to buy 10-year U.S. treasuries with a positive yield compared to the European 10-year bonds, the warning signs were starting to appear. What was startling was the fact that not only did the central bankers fail to comprehend the trend, but the newspapers were all reporting this as a recession warning and cheering this would topple Trump.

On top of that, our banking clients in Europe were shipping cash to their U.S. branches who were then depositing that in the Excess Reserve Facility at the Federal Reserve. They were not stupid. The ECB wanted to charge them a negative rate to park funds in Europe, so they simply wired their funds to their U.S. branches and parked it at the Federal Reserve.

The second phase was that the repo rate started to rise reached a high of 10% by about 9 am on Tuesday, September 17, 2019, just before the stock market opened. The Fed Funds rate was testing the Fed's upper limit. The Fed was forced to intervene for the first time since the 2008 crisis. Had the Fed not intervened, then short-term rates would have exploded. This was now a battle for the very survival of central bank authority under Keynesian Economics.

Wednesday, September 18, 2019 • The Gazette 5B

BUSINESS 380

3 things to watch for from Federal Reserve

A rate cut and a focus on leadership will be discussion points

Associated Press

WASHINGTON — When it previously met in late July, the Federal Reserve cut its benchmark interest rate for the first time since America's financial system stood on the edge of collapse more than a decade ago.

The Fed today is widely expected to announce a second rate cut just before Chairman Jerome Powell holds a news conference. Its latest policy meeting comes against the backdrop of a solid if vulnerable U.S. economy now in its 11th year of expansion.

A global slowdown and economic threats posed by current trade conflicts have led the Fed to pursue rate cuts to try to prolong the ex-

Reuters

Federal Reserve Chairman Jerome Powell (center) speaks with Chicago Fed President Charles Evans (left) and St. Louis Fed President James Bullard at a conference June 4 on monetary policy at the Federal Reserve Bank of Chicago. Today, the Fed will releases its latest monetary policy statement.

Gander to close some stores

Future of Cedar Rapids store remains unclear

By Thomas Friestad, The Gazette

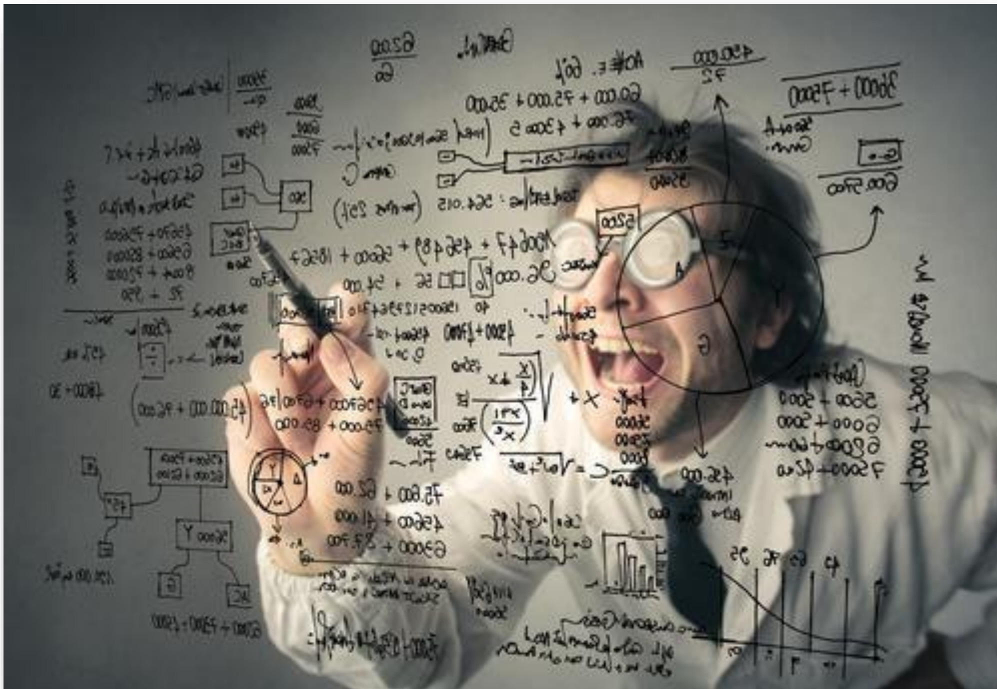
Camping World Holdings, Gander Outdoors' parent company, earlier this month announced plans to "strategically shift away" from locations where it cannot sell or service RVs.

Among the company's more than 200 Gander Outdoors stores nationwide, 165 locations meet that description, while an additional 37 — including the Cedar Rapids store at 2140 Edgewood Rd. SW — do not, and focus on outdoor lifestyle products.

Camping World Holdings currently expects to sell, repurpose, relocate or close between 27 and 37 stores, and forecasts most changes will take place by the end of the year, according to a Sept. 3

The Fed offered $75 billion through its facility and received $53 billion of demand from borrowers who swapped AAA Treasury holdings for cash at minimal rates. On Wednesday, the Fed again offered the same $75 billion facility and received $80 billion in bids. The press was still reporting on the 18th that the Federal Reserve was expected to cut rates. They completely failed to understand the real crisis behind the curtain.

Since the overnight financing (repo rate) was really the wholesale interest rate that formed a basic function within the economy, it seemed to go over the heads of the general media. Those who trade on leverage rely on the repo market (i.e. broker-dealers, hedge funds, and institutions). It is rarely written about for it is not generally seen by the public.



The events of September 17, 2019, were a clear warning sign of the brewing Liquidity Crisis unfolding on the horizon. The ECB and the BOJ are trapped and the insane theory of lowering interest rates to negative to compel people to spend and borrow was a complete utter failure. These mad scientists with no practical experience in the real world of finance succeeded in destroying their bond market. At the peak, more than \$15 trillion and perhaps up to \$17 trillion in negative–yielding bonds (\$1 trillion is corporate) had been issued as other fools rushed in to buy what no sane individual would ever do.

Prior to the 2007–2009 crisis, the repo rate was the only financial instrument that paid a rate of return that could become negative under normal market conditions. Negative repo rates could happen when there is a shortage of cash or particular collateral security, like negative–yielding bonds, are put up to borrow against. Therefore, trying to borrow against a negative–yielding bond can present a crisis. The standard repo contracts, such as the Global Master Repurchase Agreement (GMRA), have been drafted under the implicit assumption that general collateral (GC) repo rates would only ever be positive.

What transpired was that the buyers of these negative bonds have been simply traders. They have not bought this stuff to actually hold to maturity. They have been happy to trade them, assuming rates would continue lower so it would be a bond rally in price. What has been unleashed is the dogs of a financial war. We are looking at a serious crisis once again, but instead of the time bombs being mortgage–backed securities, this time it will be negative–yielding bonds. The bond markets have been converted into a child's game of musical chairs. When the music stops, someone will be left holding negative–yielding bonds that will only be salable at even deeper discounts of perhaps as great as 50% in a few years.

As the crisis mounted, about 30% of the bonds issued by governments outside the United States worldwide were trading at negative yields, which reached a peak of $17 trillion of outstanding debt (which has declined to about $12 trillion). This unprecedented reversal of normal practice has raised profound questions about the outlook for the bond markets long–term. This is seriously impacting core holdings for institutional investors. It has trapped the ECB and BOJ, disarming them of the vital tool of using interest rates under Keynesian Economics to steer their economies. The ECB and BOJ have committed suicide.

The Bank of Canada & the Repo Crisis

The Bank of Canada (BoC) states publicly that it is committed to providing liquidity in support of the efficient functioning of Canada's financial markets. It has continued to closely monitor financial market developments and has stated that it stands to provide liquidity as needed. During August 2019, the Bank of Canada responded to the growing liquidity crisis. At that time, the crisis was seen as merely an inverted yield curve in the United States with analysts calling for a recession.

The Bank of Canada is also fighting the free market rise in interest rates. They are expected to lower interest rates at least once in 2020. The interest rates rose sharply and peaked the week of November 13, 2019, in the aftermath of the Repo Crisis in the USA which hit September 17, 2019.

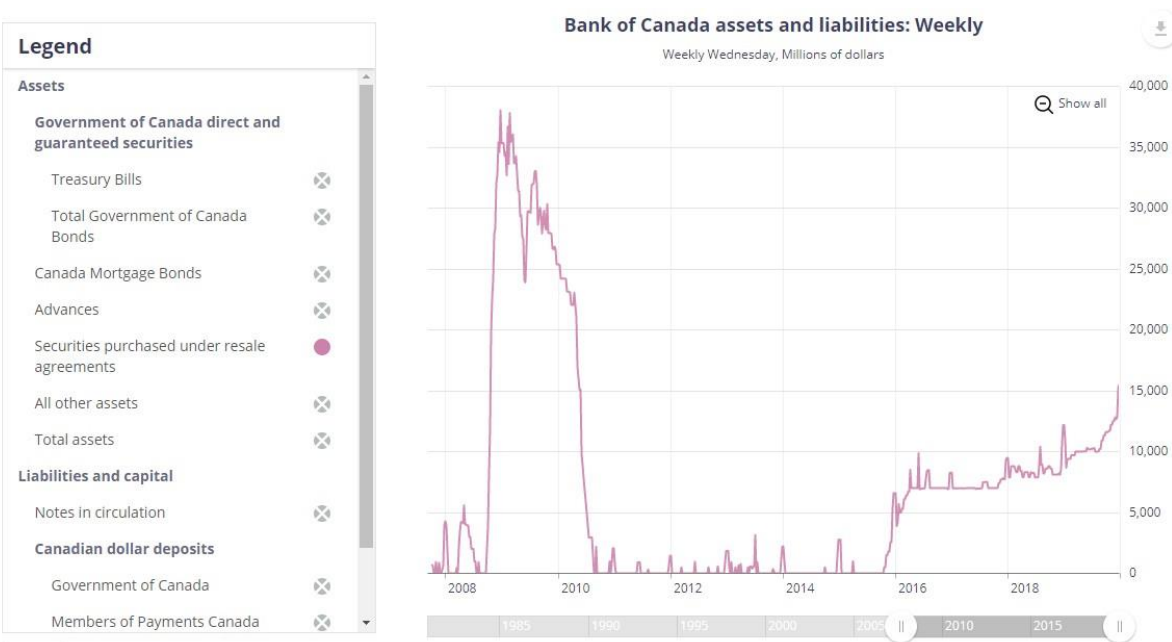
The Bank of Canada on August 15, 2019, announced that it was temporarily expanding the list of collateral that was eligible for use by market participants in its Special Purchase and Resale Agreements that are commonly known as SPRAs.

The BoC, which traditionally had only accepted Government of Canada securities as collateral for SPRAs, announced that the BoC would accept all securities that are already eligible as collateral for the bank's Standing Liquidity Facility (SLF) provided to participants in the Large Value Transfer System. Hence, they expanded the acceptable collateral as they saw the liquidity crisis coming down the road.

With respect to the margin requirements, the BoC announced that the same collateral used in SPRA transactions will be subject to the same margin requirements as those applicable in SLF transactions.

It further has acknowledged:

> "While money markets continue to experience difficulties, there has been significant progress in the functioning of the overnight market. Since 17 August, the overnight rate has been below the Bank of Canada's target rate and no Special Purchase and Resale Agreements (SPRAs) have been required. Against this background, effective 7 September, the Bank of Canada will restore the standard terms for SPRA, accepting only Government of Canada securities."



The Canadian Repo Crisis?

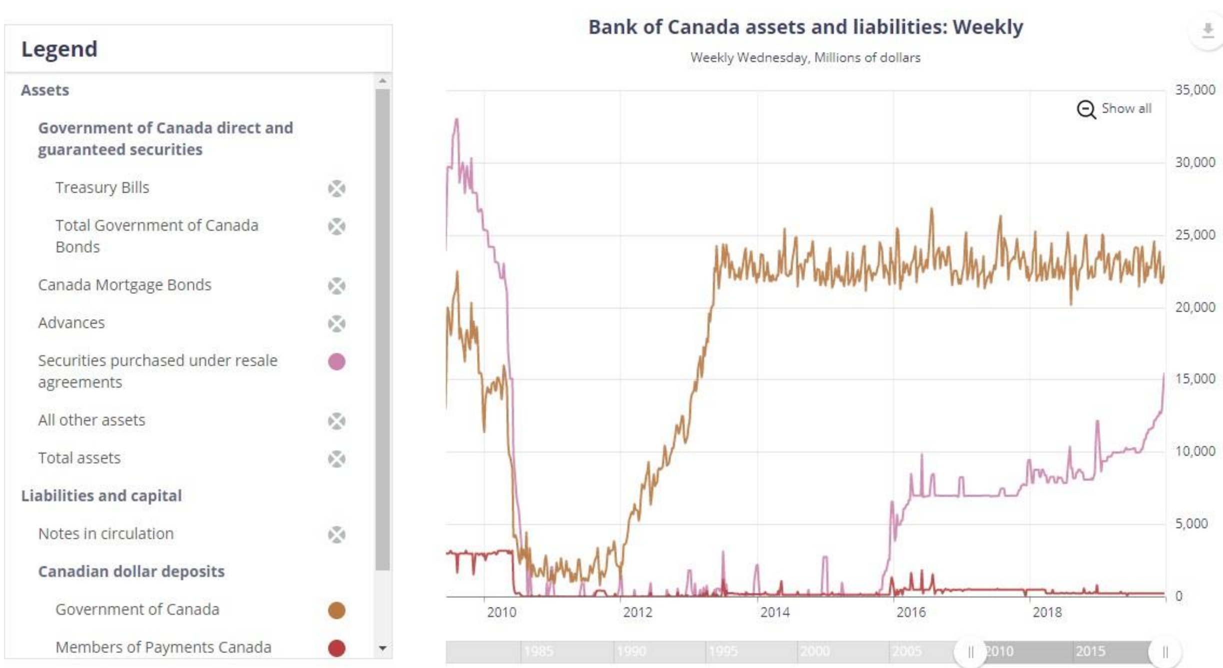
Many have been watching the Bank of Canada's balance sheet for signs that the Repo Crisis has spread to Canada. The concern has been over the BoC's balance sheet, which some interpreted as an indication that funding pressure was rising in Canada. A number of analysts viewed this as liquidity shortages spreading in the Canadian interbank market.

Turning to the BoC's chart illustrating the Securities Purchased Under Resale Agreements (SPRA), which are assets on their balance sheet, it notably began to rise during 2015 following the low made after the financial crisis high on December 31, 2008. Their holdings began to accelerate going into year-end 2015. They reached what seemed to be a plateau in 2016 through most of 2017. Then they began to make new highs in 2018 and spiked much higher during 2019. This certainly made it appear that the BoC was in fact also intervening in the financial markets in response to liquidity shortages.

In the case of the BoC, when it seeks to inject short-term liquidity into the market to prevent rates from rising, it purchases assets from a commercial bank in exchange for bank reserves. The assets it purchases from commercial banks are under a repurchase agreement (repo) whereby they purchase back the same assets from the BoC. These "repurchase agreements" are then known as SPRAs on the BoC's balance sheet. Despite the name, they are repos.

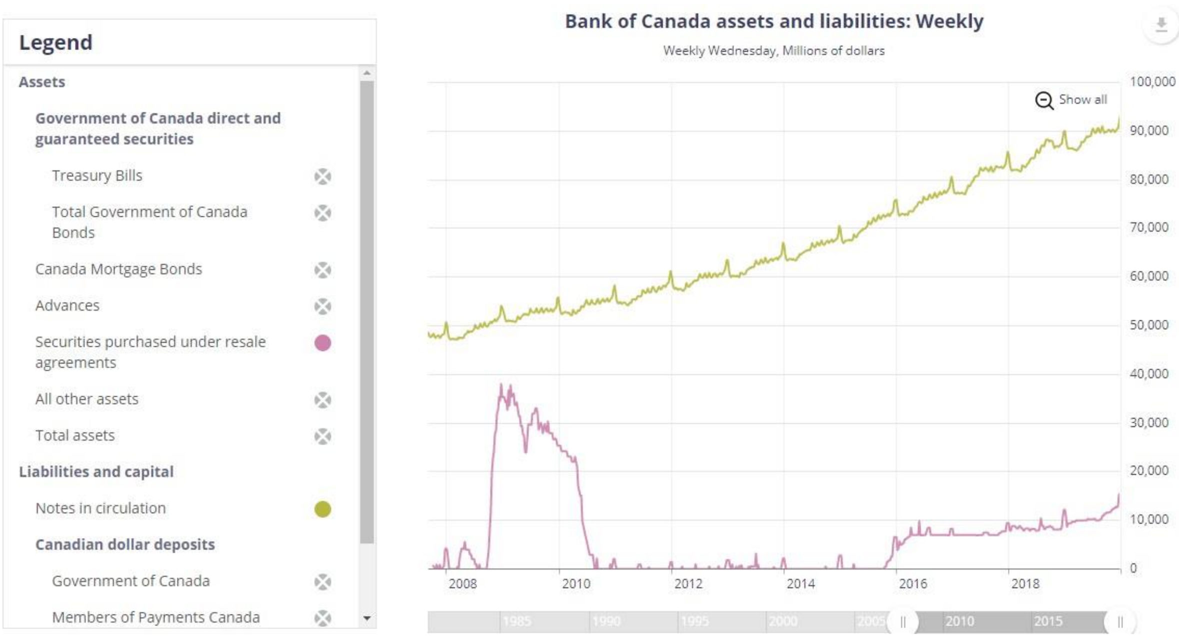
Like the Federal Reserve, the BoC uses these repo agreements to manage the overnight short-term interest rate. Therefore, if the overnight interest rate begins to rise above the BoC's set target for short-term rates, then the BoC will start to buy assets from commercial banks engaging in repos. This is how they seek to manage short-term interest rates.

We can easily ascertain that there has been a sharp rise in the BoC's SPRAs on their balance sheet, which implies that market interest rates have been under rising pressure. Thus, the BoC has been compelled to intervene in the short-term rate markets by purchasing a great share of assets. These purchases are made in order to maintain control over the short-term interest rates, which infers there is a rising shortage of liquidity in the interbank market even in Canada. This creates a continuous upwards bias on short-term interest rates, which is a direct assault on the BoC's power over the economy.



However, the data implies that the BoC has altered its management strategy away from government since it realized that government rates are now simply artificial. It is much more concerned about the free market.

Normally, if the BoC was simply intervening to keep short-term rates down, we would see more of an indication of this policy in its balance sheet. For example, intervening in repo would mean that they should have credited the accounts of commercial banks at the BoC. This should show up in the Canadian dollar deposits for "Members of Payments Canada," which does not reflect such an inflow. Commercial banks could be draining their reserves also by transferring the Government of Canada's deposits to the BoC. This should then result in "Members of Payments Canada" deposits remaining unchanged. However, then the Canadian dollar deposits for "Government of Canada" should reflect a corresponding amount of inflow. When we look at these components, both the government and commercial bank deposits have remained relatively flat while we see there has been a spike in the SPRAs. This suggests that the spike in repo purchases has nothing to do with traditional monetary policy.



The BoC has clearly shifted the strategy in how it is managing its balance sheet because it is diversifying away from holding its own government debt. The chart presented here from the BoC shows that they have been increasing the cash in circulation. As the BoC issues new bank notes, it has been, in effect, backing those notes with non-government debt.

Canadian bank notes become liabilities on the BoC's balance sheet, and therefore the BoC must offset these increasing "liabilities" by taking onto their balance sheet an offsetting asset. Historically, the BoC has bought government bonds, which in theory back the paper currency in circulation. Recently, the BoC, like some other central banks, has been striving to diversify its portfolio by reducing their support for the government bond markets in contrast to the European Central Bank.

The BoC has begun to diversify into non–government bond assets which they purchase via short–term repo transactions. This shortens the duration of its portfolio which allows it to unwind its portfolio in a crisis if cash is needed to be injected into the system. The short–term assets would be strategically useful during a financial crisis. Therefore, the BoC appears to be deeply concerned, not about an immediate liquidity crisis, but a major one in the event of rates rising beyond their control.

Therefore, the numbers clearly show that the BoC on the surface appears to be engaging in repo transactions to provide liquidity within the banking system in a more traditional role of managing the overnight short–term rate. However, it appears that the BoC itself is preparing for a new trend of rising interest rates. This trend was most likely set in motion by the free markets due to the failed experiment of negative interest rates by the European Central Bank and the Bank of Japan.

Can the Fed Exit the Repo Market?

It is stunning how after months of the persistent Repo Crisis the analysis on the repo market is still nowhere close to reality. It is hard to imagine that there is still no public analysis of the Repo Crisis and it seems to have become old news not worthy of a story. The popular explanation in September was repeated by the Wall Street Journal: "For one, Monday marked the deadline for companies to submit their quarterly federal tax payments."

This was standard analysis put out by the countless pundits the press relies upon and they must come up with some explanation and quick. Hence, the analysis put out in the press about the Repo Crisis was coming from people who have no real clients in the area and lack the expertise in the field to start with.

Not even the central banks understood what was going on because even they tend to be domestically oriented. Despite the obvious fact that we live in a global economy, all the economic theories, analysis, and experience have been domestically focused. Unless someone has been in the trenches globally, they will never see the wildcard coming from external sources.

The questions that are now dominating inquiries: "Can the Fed exit the repo market after being the dominant source of liquidity since September 2019? What will it take for the Federal Reserve to withdraw from its daily liquidity operations in this $2.2 trillion market for repurchase agreements (repos)?

All I am prepared to say publicly is that the solution is beyond the powers of all the central banks combined. The solution is not attainable without political concessions, which politically are just off the table. This is going to require a major reform that is unlikely to take place and will not even be recognized until the crisis erupts on a much larger scale.

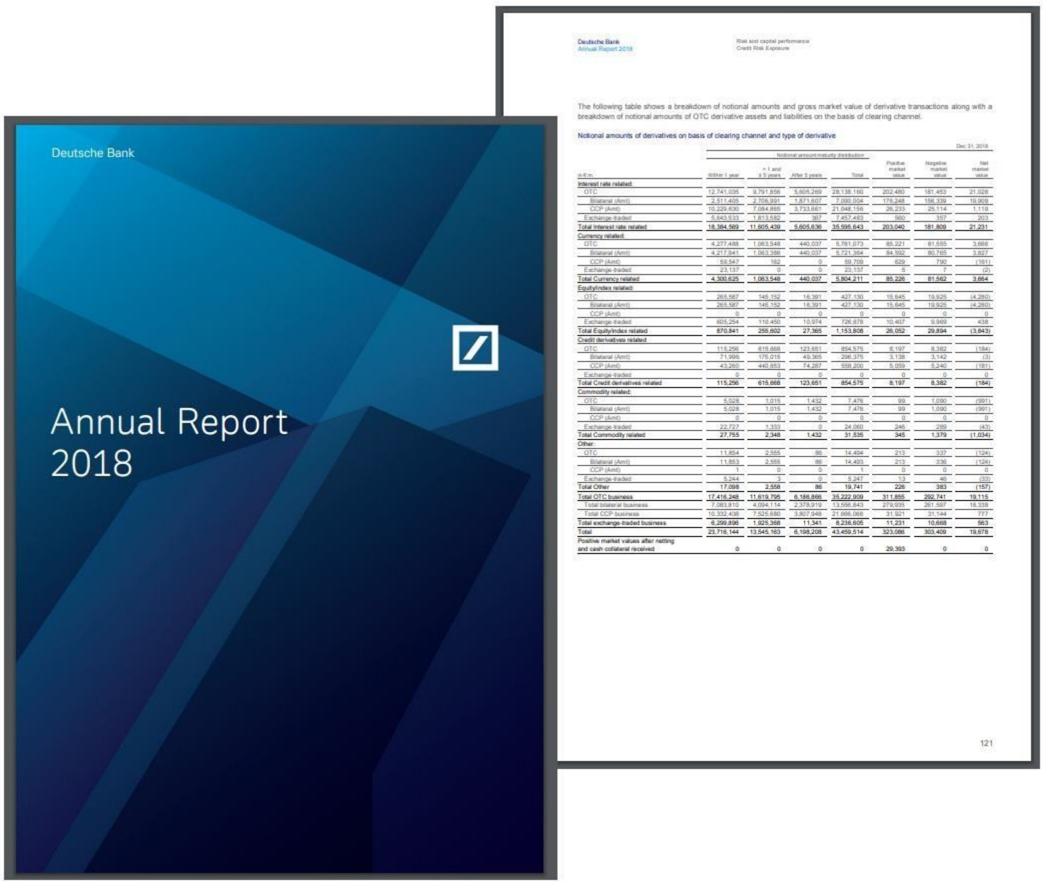
The repo operations are simply a band–aid, but the wound isn't healing. The New York Fed was compelled to inject billions of dollars of liquidity into the repo market, not simply to provide liquidity, but to maintain its own power over short–term interest rates.

The Fed will continue pumping tens of billions a day into the repo market without end simply because banks are unwilling to accept the counter–party risk post–2008 and that Lehman moment.

Some financial firms are urging the Fed to stay involved permanently through a standing repo facility, which would allow firms to trade Treasury holdings for cash. But Fed officials are still working out the details and plan to keep discussing the issue at future meetings. This would certainly mean that the Fed has no other choice if it seeks to maintain power over short–term rates.

Can the Fed exit the repo market? The answer appears to be no possible way.

Deutsche Bank & the Interest Rate Risk



Looking at just the outstanding negative-yielding debt and how that can collapse in street value by 40%-65% with rising interest rates, there is another aspect that presents a tremendous risk. If we look at the Annual Report for 2018 of Deutsche Bank, what we see is that its greatest exposure lies in the interest rates swap market. Banks have written derivatives on interest rates and the bias that was created by the European Central Bank (ECB) was that rates would only go down. This introduces some very different risk profiles with respect to interest rates exposure going forward.

The following table shows a breakdown of notional amounts and gross market value of derivative transactions along with a breakdown of notional amounts of OTC derivative assets and liabilities on the basis of clearing channel.

Notional amounts of derivatives on basis of clearing channel and type of derivative

							Dec 31, 2018
	Notional amount maturity distribution						
in € m.	Within 1 year	> 1 and ≤ 5 years	After 5 years	Total	Positive market value	Negative market value	Net market value
Interest rate related:							
OTC	12,741,035	9,791,856	5,605,269	28,138,160	202,480	181,453	21,028
Bilateral (Amt)	2,511,405	2,706,991	1,871,607	7,090,004	176,248	156,339	19,909
CCP (Amt)	10,229,630	7,084,865	3,733,661	21,048,156	26,233	25,114	1,119
Exchange-traded	5,643,533	1,813,582	367	7,457,483	560	357	203
Total Interest rate related	**18,384,569**	**11,605,439**	**5,605,636**	**35,595,643**	**203,040**	**181,809**	**21,231**
Currency related:							
OTC	4,277,488	1,063,548	440,037	5,781,073	85,221	81,555	3,666
Bilateral (Amt)	4,217,941	1,063,386	440,037	5,721,364	84,592	80,765	3,827
CCP (Amt)	59,547	162	0	59,709	629	790	(161)
Exchange-traded	23,137	0	0	23,137	5	7	(2)
Total Currency related	**4,300,625**	**1,063,548**	**440,037**	**5,804,211**	**85,226**	**81,562**	**3,664**
Equity/index related:							
OTC	265,587	145,152	16,391	427,130	15,645	19,925	(4,280)
Bilateral (Amt)	265,587	145,152	16,391	427,130	15,645	19,925	(4,280)
CCP (Amt)	0	0	0	0	0	0	0
Exchange-traded	605,254	110,450	10,974	726,678	10,407	9,969	438
Total Equity/index related	**870,841**	**255,602**	**27,365**	**1,153,808**	**26,052**	**29,894**	**(3,843)**
Credit derivatives related							
OTC	115,256	615,668	123,651	854,575	8,197	8,382	(184)
Bilateral (Amt)	71,996	175,015	49,365	296,375	3,138	3,142	(3)
CCP (Amt)	43,260	440,653	74,287	558,200	5,059	5,240	(181)
Exchange-traded	0	0	0	0	0	0	0
Total Credit derivatives related	**115,256**	**615,668**	**123,651**	**854,575**	**8,197**	**8,382**	**(184)**
Commodity related:							
OTC	5,028	1,015	1,432	7,476	99	1,090	(991)
Bilateral (Amt)	5,028	1,015	1,432	7,476	99	1,090	(991)
CCP (Amt)	0	0	0	0	0	0	0
Exchange-traded	22,727	1,333	0	24,060	246	289	(43)
Total Commodity related	**27,755**	**2,348**	**1,432**	**31,535**	**345**	**1,379**	**(1,034)**
Other:							
OTC	11,854	2,555	86	14,494	213	337	(124)
Bilateral (Amt)	11,853	2,555	86	14,493	213	336	(124)
CCP (Amt)	1	0	0	1	0	0	0
Exchange-traded	5,244	3	0	5,247	13	46	(33)
Total Other	**17,098**	**2,558**	**86**	**19,741**	**226**	**383**	**(157)**
Total OTC business	**17,416,248**	**11,619,795**	**6,186,866**	**35,222,909**	**311,855**	**292,741**	**19,115**
Total bilateral business	7,083,810	4,094,114	2,378,919	13,556,843	279,935	261,597	18,338
Total CCP business	10,332,438	7,525,680	3,807,948	21,666,066	31,921	31,144	777
Total exchange-traded business	**6,299,896**	**1,925,368**	**11,341**	**8,236,605**	**11,231**	**10,668**	**563**
Total	**23,716,144**	**13,545,163**	**6,198,208**	**43,459,514**	**323,086**	**303,409**	**19,678**
Positive market values after netting and cash collateral received	**0**	**0**	**0**	**0**	**29,393**	**0**	**0**

Deutsche Bank Derivative Book

Expressed in Trillions of Euros

Interest Rate Related ...	35,595,643
Currency Related	5,804,211
Equity/Index Related	1,153,808
Credit Derivatives	854,575
Commodity Related	31,535
Other	19,741
Total	43,459,514
Total CCP Business	21,666,066

Source: 2018 Annual Report

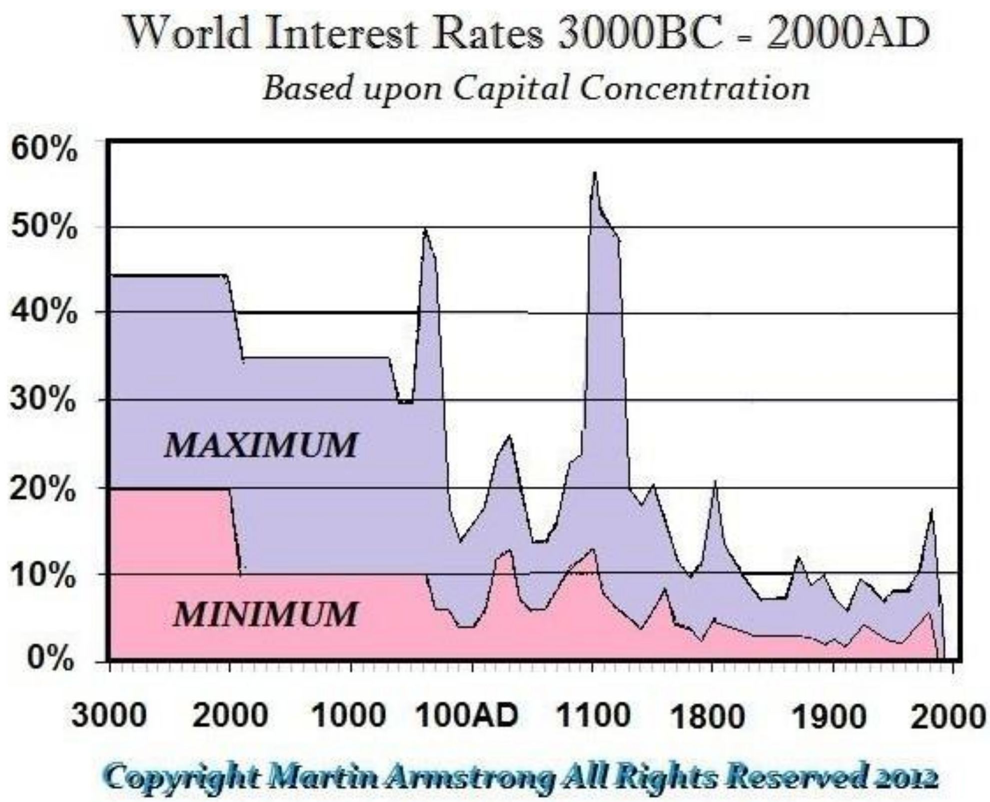
We can see that the derivatives with respect to interest rates far outpace those in all other areas. Even when we look at the fact that regulators following the 2007–2009 Financial Crisis created Central Counterparty Clearing Houses (CCPs), which were to perform two primary functions as the intermediary in a transaction. First, they were to be the clearing and settlement agent. As counterparties to the buyers and the sellers, CCPs guarantee the terms of a trade even if one party defaults on the agreement.

The problem with the way CCPs were created becomes obvious. Deutsche Bank is also a CCP. How can the clearing house be a party to a transaction which then guarantees itself? The CCP is supposed to be independent like a stock exchange. The exchange stands between the parties, it is not acting as a party on one side of the transaction.

In the event of interest rates rising, there are going to be serious losses in interest rates swaps. If any bank is also the CCP to their own transaction, this defeats the entire concept of a clearing house. This is again not a structure that is viable long-term.

in € m.	Within 1 year	> 1 and ≤ 5 years	After 5 years	Total	Positive market value	Negative market value	Net market value
Interest rate related:							
OTC	12,741,035	9,791,856	5,605,269	28,138,160	202,480	181,453	21,028
Bilateral (Amt)	2,511,405	2,706,991	1,871,607	7,090,004	176,248	156,339	19,909
CCP (Amt)	10,229,630	7,084,865	3,733,661	21,048,156	26,233	25,114	1,119
Exchange-traded	5,643,533	1,813,582	367	7,457,483	560	357	203
Total Interest rate related	18,384,569	11,605,439	5,605,636	35,595,643	203,040	181,809	21,231

The first argument against this will be that €18.3 trillion in interest rate instruments is less than one year. That leaves €11.8 trillion one year to five years in maturity with €5.6 trillion out for greater than five years. Granted, this the 2018 balance sheet. It really does not matter that 51% is one within one year. This large portion of the short–term is rolling, so it will not just move to zero.



A sharp rise in rates reflected in the Repo Crisis and the Bank of Japan's willingness to buy 100% of government debt to try to prevent interest rates from rising becomes possible because there has been such a manipulation of the free markets to desperately prevent interest rates from rising from an artificial 5,000–year low.

The derivatives added to the risk with interest rates because they have leveraged this entire game that is already leveraged to begin with. A mortgage for even five years is leveraging the system, for the price of a home rises in proportion to the amount of money that someone can muster to pay for a property. This is why FDR created the 30-year mortgage in 1935 to give people 30 years of future income to spend today. That is leverage.

Therefore, a simple uptick in interest rates will be far more devastating to the outstanding debt street value and the derivative losses can be far greater than suspected.

The Structural Risk of the Euro

There arrives a time when the sins of the past come to demand their retribution. The structural design of the euro has been a complete disaster. The refusal to consolidate the debts prohibits any possible bank bailout for that means that funds would flow from one member state to another. The Repo Crisis is emerging because of this structural design flaw that has placed the entire world at risk of a financial disaster beyond all proportions of the 2007–2009 Financial Crisis. This is only enhanced by the insanity of this experiment with negative interest rates. With nearly half the equivalent of the U.S. national debt outstanding in negative–yielding bonds, the potential losses are off the charts.

Due to this structural crisis in Europe, there is nothing external international central banks can do to prevent this crisis, no less manage the fallout. The best they can do will be to stand behind their own local banks who may suffer losses from any transactions with a European bank that the EU refuses to bail out.

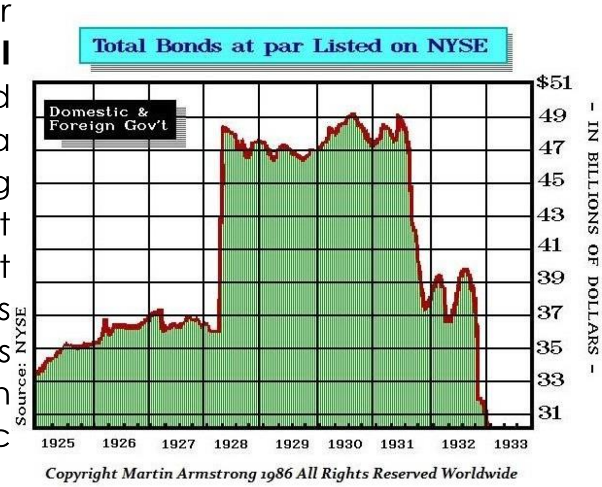
We face a global financial contagion never witnessed before in economic history. On top of that, we have fiscal irresponsibility clashing with the monetary policy of central banks and there is no referee standing between this clash of titans. Furthermore, we have absolutely the worst possible political catastrophe unfolding where people who have true qualifications to manage a financial crisis of this magnitude have no interest in even coming close to politics.

The analysis of this Repo Crisis has been the traditional domestic focus spun by people who have zero experience in international world capital flow analysis, economics, or basic comprehension of how the world economy operates.

Update for the Mother of all Financial Crises

(Making the Mortgage-Backed Securities Just a Trial Run)

There is about $12 trillion in outstanding negative–yielding bonds. As previously warned, this adds yet another dimension to this **Mother of all Financial Crises** beyond the Basel III regulations and the refusal to bail out European banks as a policy in the European Union. We are looking at a crisis similar to the events of the Great Depression when there was a Sovereign Debt Crisis. At that time, the bulk of countries permanently defaulted on their debts outside of the United States and then Roosevelt effectively defaulted on domestic bonds being repaid in gold.



Power to Regulate Gold Is Defended

WASHINGTON, Dec. 18. (UP) The power of congress to regulate the value of the dollar and to outlaw gold clauses in private and public contracts was advanced today before the Supreme court in defense of the government's action in its gold policies.

Attorney General Homer S. Cummings filed briefs disclosing the course the government will pursue January 8 when the gold cases face their acid test. It is estimated that public and private contracts bearing the gold clause affected by devaluation total approximately $100,000,000,000.

Miami Tribune, Miami, Florida, December 19, 1934, Page 5

While the USA did not default insofar as it did honor its debt, it changed the terms of that debt and effectively defaulted on repaying the debt in gold. The government repaid the debt in only paper dollars which had been devalued. Indeed, it was argued in the Supreme Court that the purchasing power of the money when given to the government for the bond was not the same upon redemption because of Roosevelt's devaluation.

It was further argued that the bondholder suffered a loss purchasing power and thus they were really entitled to a return of $1.69 per dollar due to the devaluation. The Supreme Court simply rejected that argument. It ruled: "We think that position is untenable."

> "Plaintiff seeks to make his case solely upon the theory that by reason of the change in the weight of the dollar he is entitled to $1.69 in the present currency for every dollar promised by the bond, regardless of any actual loss he has suffered with respect to any transaction in which his dollars may be used. We think that position is untenable.
>
> In the view that the facts alleged by the petition fail to show a cause of action for actual damages, the first question submitted by the Court of Claims is answered in the negative. It is not necessary to answer the second question."

PERRY v UNITED STATES, 294 U.S. 330 (1935)

Justice McReynolds dissented writing: "Obligations cannot be legally avoided by prohibiting the creditor from receiving the thing promised."

Suffice to say, these negative-yielding bonds are going to crash like something not witnessed since 1931. We must take into consideration that the crash need not even be in the form of a default. The prices will crash with just an uptick in interest rates. These bonds have been bought by punters who are just trading them back and forth. The likelihood of this sort of crisis will be felt perhaps in hedge funds and banks engaged in trading. With the first uptick in rates that the Fed cannot prevent, we are looking at a catastrophic collapse in the value of such bonds. The real problem will be that such an event will set in motion a contagion where people will be concerned about the debt issues.

The first knee-jerk reaction will be to flee to U.S. Treasuries where negative rates were never implemented. However, this is still likely to put pressure on the dollar and force it higher as was the case during the 1930s. This will unhinge the world monetary system and we are looking at the prospects of a currency reset. In the case of the 1930s, Roosevelt simply devalued the dollar but to accomplish that he confiscated the gold. This time around, the outstanding debt of the United States is not denominated in gold, which means the easy solution of a dollar devaluation will not be available as a solution this time around.

February 19th, 1935

Capital Gasps at Scathing Denunciation of New Deal Delivered by McReynolds

Tennesseean Speaking for Gold Opinion Dissenters, Says 'Constitution Is Gone,' Abrogation of Contracts Is 'Wickedness'

BINGHAMTON PRESS BUREAU
WASHINGTON, D. C., FEB. 19

Washington is buzzing today over the extemporaneous speech Associate Justice McReynolds made from the Supreme Court bench yesterday in behalf of the minority dissent on the 5-4 gold clause decision.

Buzzing and gasping. The gasps started right there in the staid old courtroom where the 73-year-old Tennessean, nodding his head for emphasis, made what amounted to a scathing denunciation of administration policies.

Not within the memory of the oldest observer of the United States Supreme Court has such language been employed by a justice on the bench. The allusion to Nero, the comment that the Constitution had been "swept away," reference to "wickedness" and expression of "shame and humiliation" would in themselves mark the occasion as

(Continued on Page Ten)

McReynolds--

(Continued From Page One)

unparalleled even though the subject under discussion was not of the outstanding importance of the gold decision.

It is rarely that the minority has anything to say about the majority in a Supreme Court decision. Usually the dissent stands on its own feet. But Justice McReynolds scoffed.

He scoffed, for instance, at the use of "mere generalities and a multitude of words" to distract the public mind. He scoffed at the idea that those who framed the Constitution would sanction repudiation of gold clause pledges which he said Congress had "swept away with a word." And even his fellow justices glanced at him with something of amazement evident in their faces when he said that while he did want to talk about the present situation there devolved upon a justice of the Supreme Court the responsibility "to reveal in all its nakedness just what has been done."

"It seems impossible," he said almost at the beginning of his discussion which followed the majority decision of Chief Justice Hughes and the criticism of the finding in the Perry issue by Justice Stone, "to overestimate the result of what has been done here today."

Then he alluded to the Constitution adding, it did not seem "too much to say that it is gone."

"The guarantees to which men and women heretofore have looked to protect their interests have been swept away," Justice McReynolds continued. "The powers of Congress have been enlarged, and we stand as a people today stripped of the very fundamentals."

He declared that the picture was not overdrawn, and that in the days to come when "the panorama was unfolded" the truth would be seen.

"The people expected these gold clauses to protect them against a debased currency," he exclaimed. "A debased currency is nothing new. Nero undertook to exercise that power. Six centuries ago in France it was regarded as a prerogative of the sovereign.

"Soon on the strength of these obligations, hundreds of millions of dollars were loaned to the great corporations of the country. Bonds were sold to men, women and children throughout the world."

But Congress, Justice McReynolds said, "may sweep away" the gold clauses "with a word, and in the face of the facts, declare it against public policy."

Discussing Liberty Bonds, he said that Congress "executed a solemn bond" to pay in gold.

"Billions and billions of dollars of these bonds were issued by this government with that solemn contract," he continued. "During the World war men stood on the street corners and said these bonds were the finest in the world, with the solemn promise of the government back of them. They told the people their country was in danger."

But in April, 1933, it had been decreed that all gold should come into the Treasury, and that there should be issued for that gold "any kind of money."

"For every dollar of gold we issued a depreciated currency," the justice remarked.

He remarked that Congress had given to the President the right to depreciate the gold content of the dollar up o 50 per cent. Congress, he continued, saw necessary to pass a law "to destroy every one of these contracts for the payment of obligations in gold."

Relating the steps taken in the currency program, he said:

"That's the state to which our government has come."

"This is not a thing I like to talk about," he remarked later. "God knows I wish I didn't have to. But there are some responsibilities attaching to a man on this bench to reveal to the bar, in all its nakedness, just what has been done.

"In one breath it is said that Congress has no power to repudiate a government obligation. In the next breath, it is said, it is true you have but 60 cents and you were promised a dollar, but Congress has made it unlawful for you to accept what you contracted for. Since it is unlawful for you to accept what you contracted for, you have not been damaged.

"The Treasury says, 'Here is the depreciated dollar. You must accept it for your contract.' The Treasury of a great nation says, 'Take this depreciated dollar. Congress made it unlawful for you to accept what is due you.' And since it is unlawful there is no damage."

Justice McReynolds remarked that he and the minority refused to use "mere generalities or a multitude of words to distract the mind" from the issues involved.

"No one denies that Congress had the right to adopt a monetary system, but it does not follow that it can adopt any monetary system," he continued.

It was not intended to give Congress power, under the law, to repudiate the obligations in question, he held.

"Here we have a monetary system—the extent, I almost said the wickedness—of which if almost beyond comprehension," the justice continued. "First, we give the President power to depreciate the dollar to 50 cents. Next, we destroy all these private obligations by statute. Not only private obligations but government obligations as well.

"And so, having put out $500,000,000 of gold clause bonds in May, Congress in July says all these contracts or promises to pay in gold are contrary to public policy. Having undertaken to destroy these gold clauses, the dollar is depreciated to 60 cents. Prices of commodities can now be estimated in the deflated dollar, and now instead of a dollar we have 60 cents.

"All mortgages of the railroads and the great corporations, all bank deposits, all insurance funds, everything the thrift of man has accumulated toward his old age is subject to this depreciation.

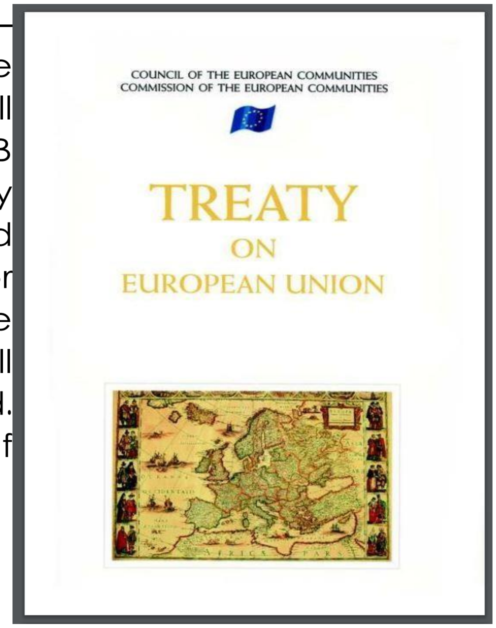
"No such power was ever granted by the framers of the Constitution. It was not there then. It was not there yesterday. It is not there today. We are confronted with a condition in which the dollar may be reduced to 50 cents today, 30 cents tomorrow, 10 cents the next day and 1 cent the day after.

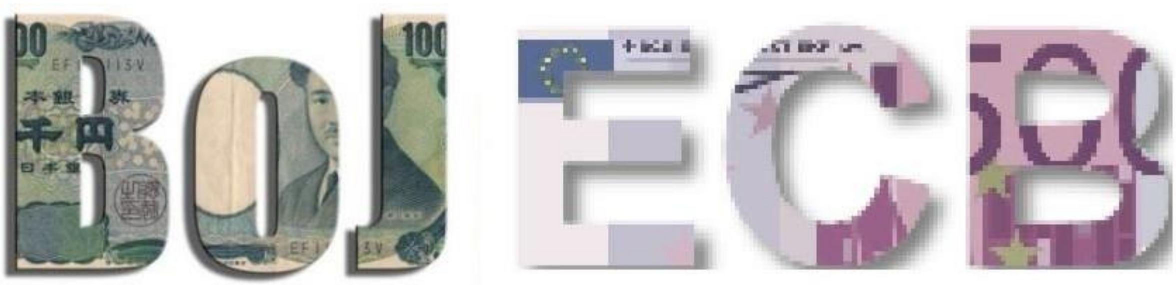
"We are told that the government has made out of this transaction the royal sum of $2,800,000,000 which now reposes in the Treasury."

On that basis, Justice McReynolds said, "you could depreciate the dollar to 10 cents or 5 cents and that would give you abundant capital to pay off the public debt and discharge the private obligations as well."

"That never was the law and it ought never to be the law," he declared.

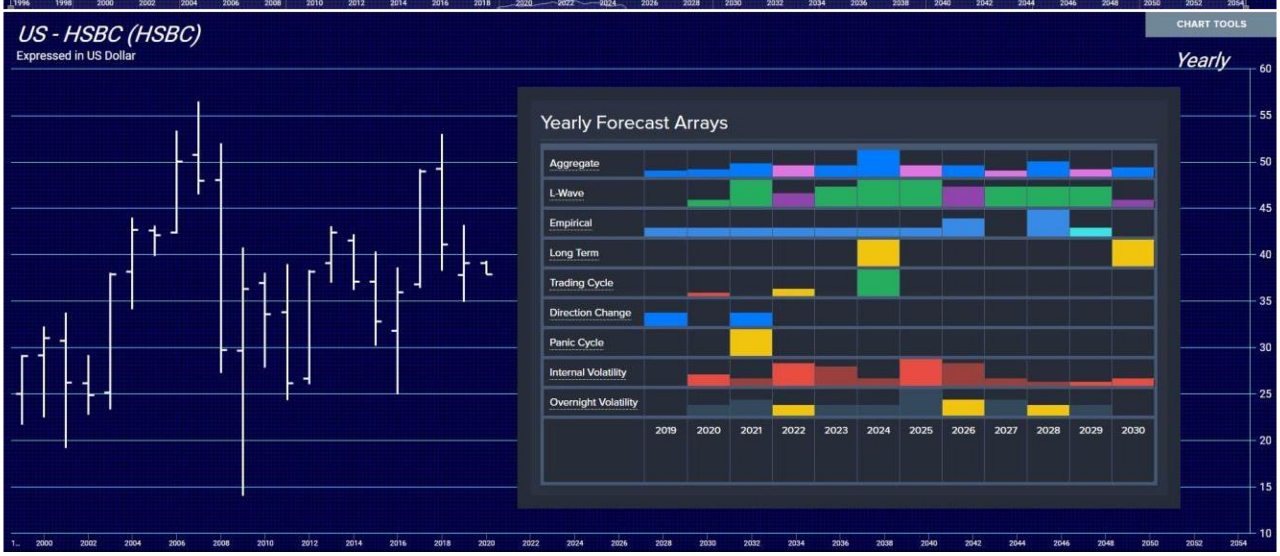
While Justice McReynolds delivered a scathing rebuke of the Roosevelt policy and the court's approval of altering all the outstanding debt contracts, even private, this stands as a warning that courts will distort the law to support the political desires of the government. Since these negative-yielding debt instruments will not require governments to default, they will be able to just point the finger at the private sector as being the problem – not them. However, it begs the question as to future issues of debt. These governments will be unable to sell such debt in the face of a major debt crisis. The ECB and the BOJ are most likely permanently trapped. They cannot allow rates to rise for it will create a huge bond crisis. It would also send fiscal budgets into major deficits. In the case of Europe, that will undermine the entire Maastricht Treaty. If governments cannot sell their debts, then the entire Eurozone will be impacted. The burning question will be simple: Will Germany itself exit the euro?





We are looking at a financial contagion that would unsettle the entire world economy all because of the ECB and BOJ cavalier experiment with negative–interest rates that they no cannot escape.

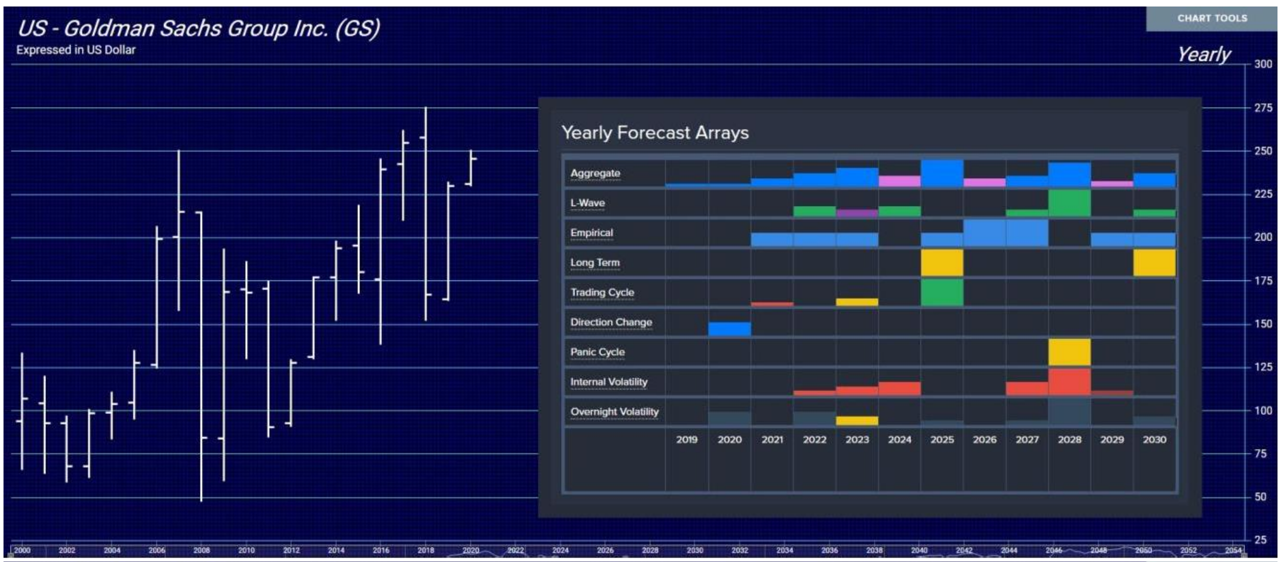
What Do the Bank Stocks Say?



When we look at the bank stocks to see if we can get a sense of timing in the years ahead, some interesting facts begin to emerge. People routinely ask why banks always create the problems. To set the record straight, it is the very structure of how banks have functioned that have historically led to their collapse.

The banks take demand deposits from customers, meaning you can ask for your funds back at any time (demand). They then lend that money out long–term, granting mortgages for example. Their profit has traditionally come from the fact that the long–term rates are normally higher than the short–term. The presumption is that 8% or less of the money on deposit in this demand category is sufficient to meet the normal business requirements. It is during panics when more than 8% of the people demand a return of their cash which creates the bank failure, for they have lent that money out long-term and cannot get their hands on that cash to meet the demands for immediate cash.

When the yield curve inverts, this they say is the precursor to recession because this is also when banks lose money, go bust, and stop lending which feeds into the recession.



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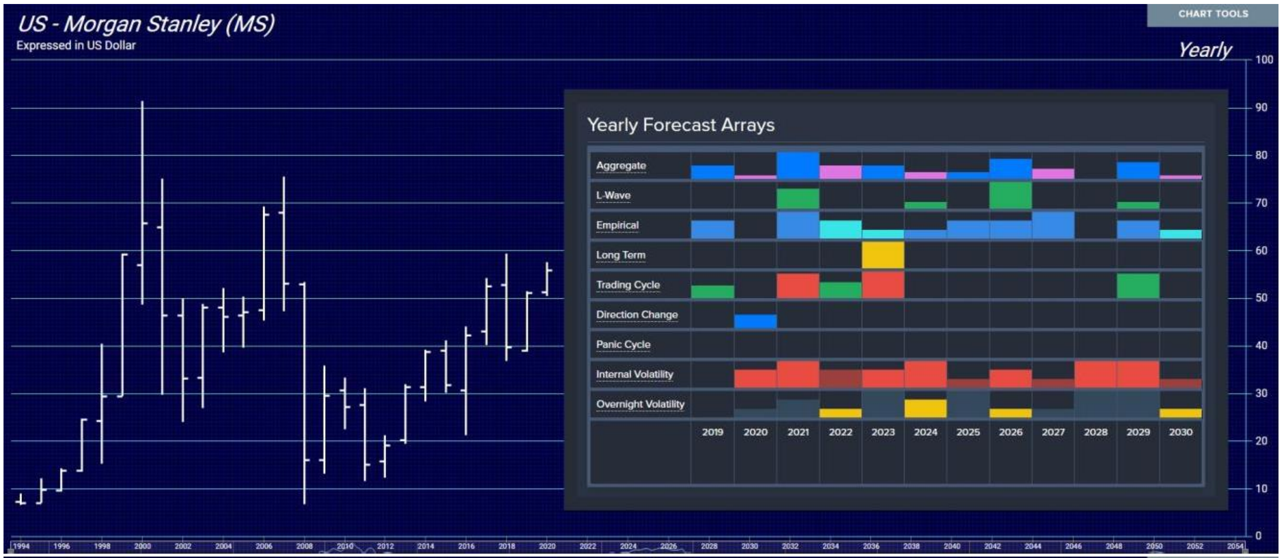

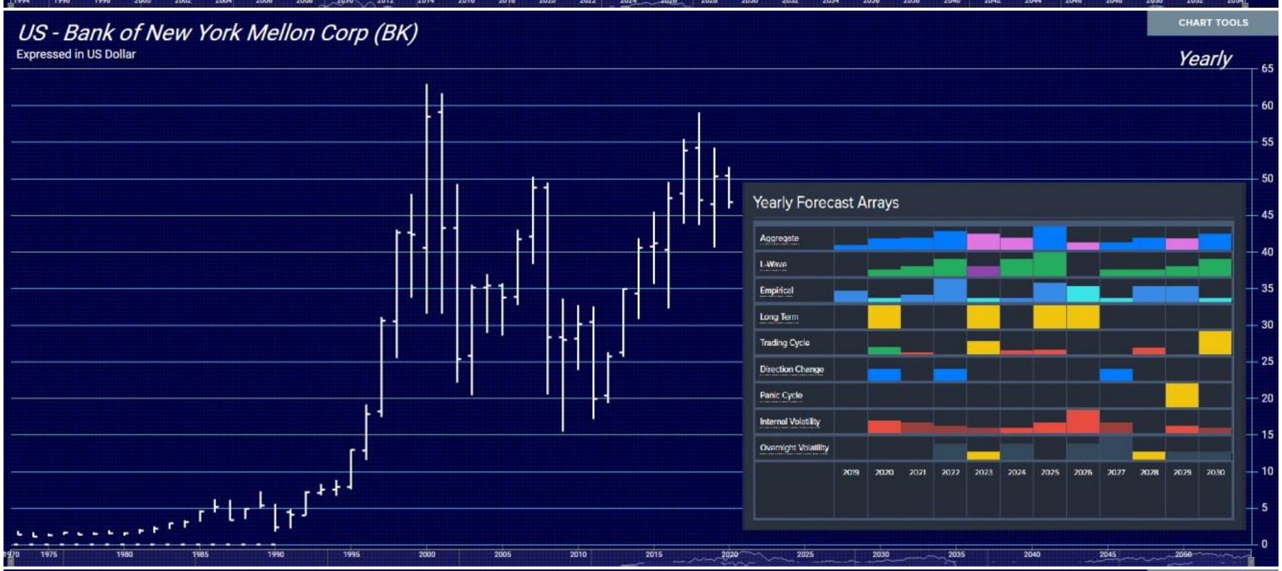

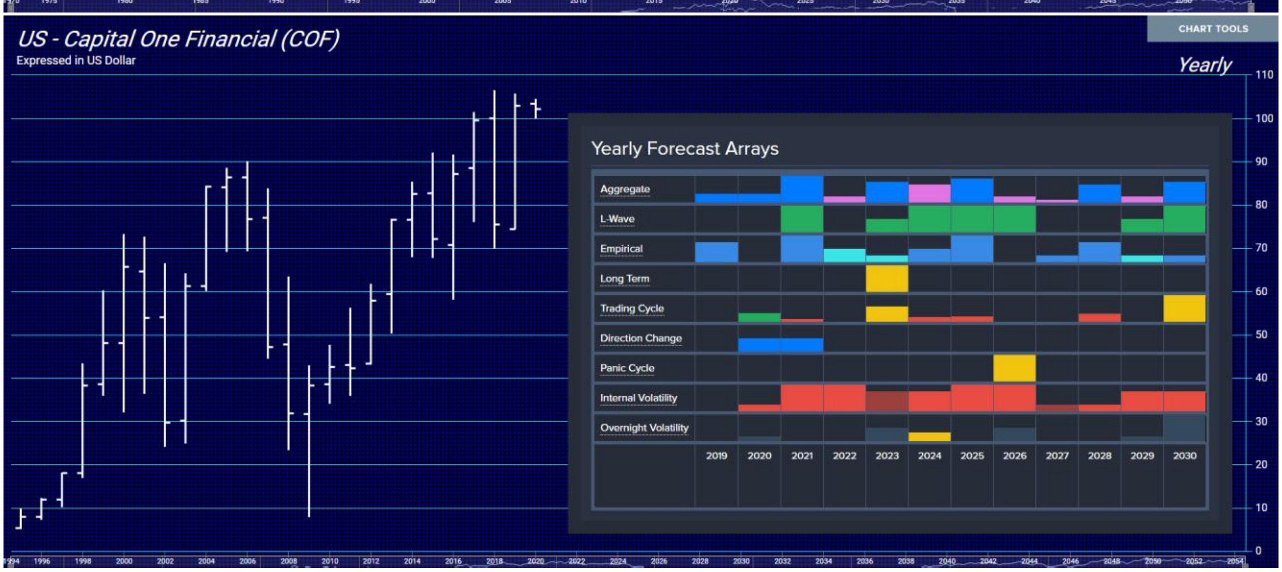

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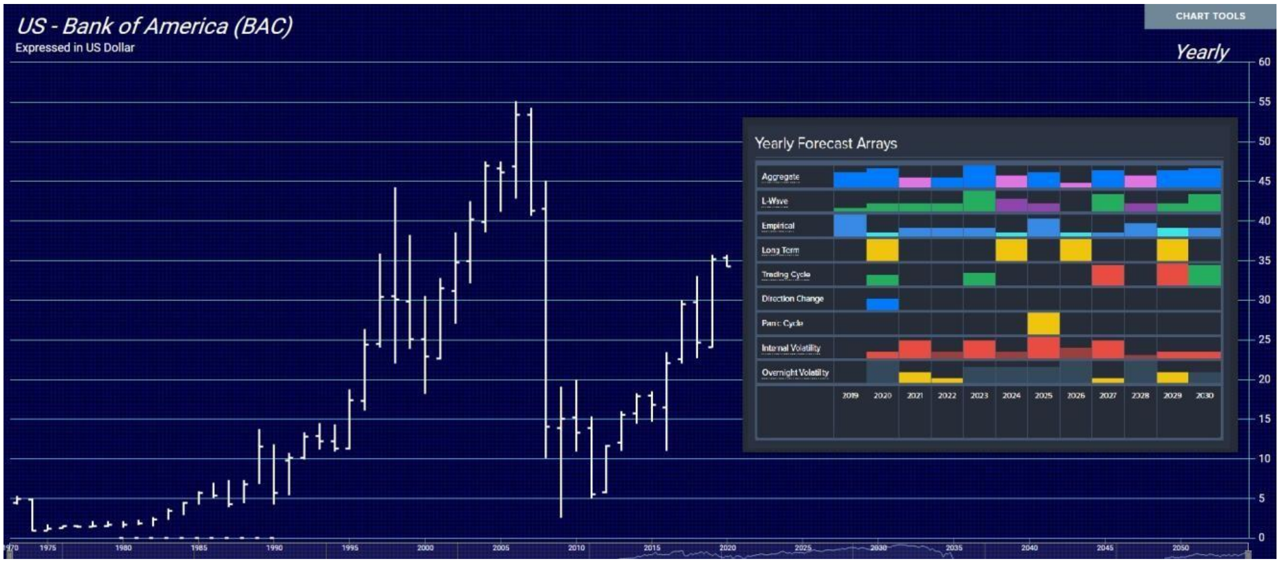
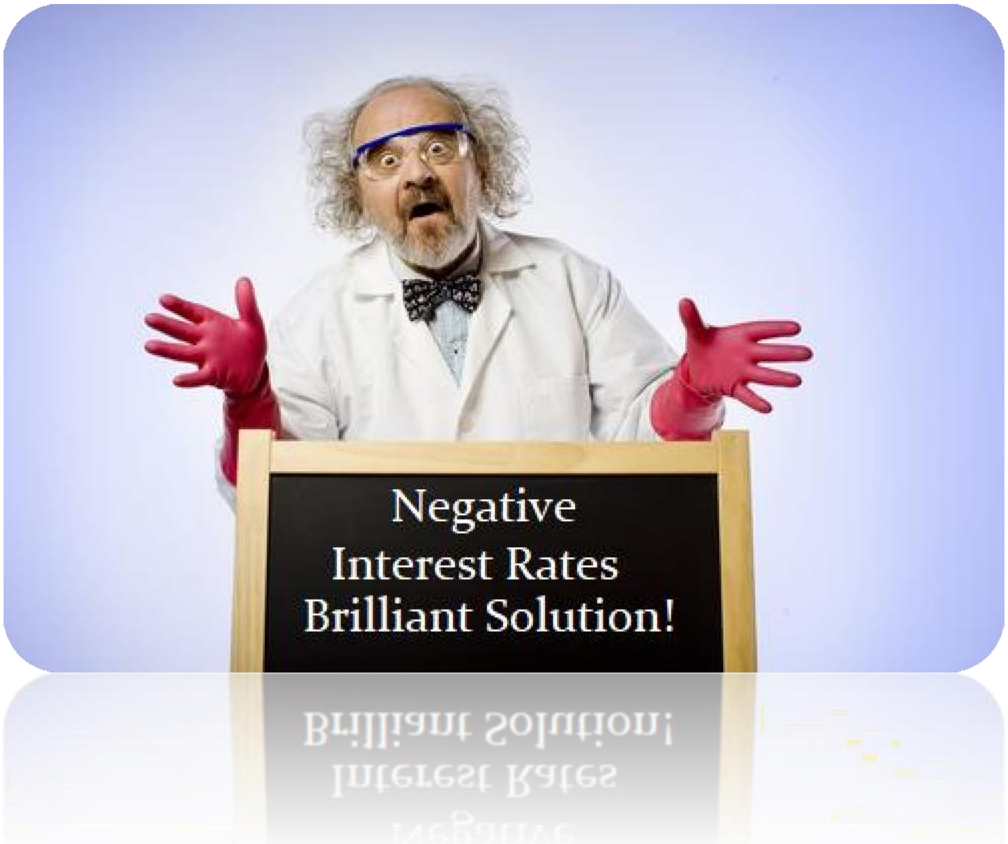


In many cases, we see 2020 as Directional Changes in many of these bank shares. We also see 2023 as an important turning point in the years ahead. When we look at the European banks, they tend to show the earliest turning points on a yearly basis, generally 2021/2022, with some New York banks showing up as 2023. We see the Royal Bank of Canada and Bank of Nova Scotia tend to have the longest forward targets lining up more with the commodity markets and the peak in the ECM come 2024/2025.

Conclusion



The Repo Crisis remains the precursor to the coming world Monetary Crisis Cycle. There is little doubt that we are facing a major debt crisis and this mad scientist experiment with negative-interest rates has unleashed the Mother of all Financial Crises from which there is no escape.

What remains at stake is the very power of central banks to control the short-term rates. They are in the fight of their lives and their very existence is now critical as we head into the profound turning point of 2032.

We have Directional Changes in most of these instruments every month until April. It appears that we are looking at a shift in the markets come May 2020.