The Macro-Metal News

Gold ignores the Federal Reserve, for now

February 29, 2020

METAL

Gold's more worried about the banks' drain than the Fed's faucet

- Since September 2019 the Federal Reserve has rapidly expanded the size of its balance sheet. Yet despite this seemingly dramatic increase in supply, the United States (US) dollar has appreciated in value.
- Ostensibly this suggests the market has a high level of faith in America's central bank. That is not the case.
- The reason gold and the dollar are not being propelled in opposite directions in reaction to the Federal Reserve is that the central bank is of relatively little importance to both. Though some central banks are central to their currencies, the Federal Reserve is not.
- Instead, both gold and the dollar are focused on the network of private financial institutions that create the vast majority of dollars used in global commerce. Presently, these institutions are shrinking, destroying credit and thus reducing the supply of dollars.
- One day America's central bank will wrest back control of the dollar. But until then gold will rise and fall on the vagaries of greed and fear while altogether ignoring the Federal Reserve's open market operations.

WILLY-NILLY MONEY MULTIPLICATION

IT IS A COMMON CONCEPTION THAT THE helter-skelter creation of currency is inflationary. Economist Milton Friedman put an academic imprimatur on this hypothesis in a 1970 speech during which he offered this axiom: "It follows from the propositions I have so far stated that inflation is always, and everywhere, a monetary phenomenon – in the sense that it is and can be produced only by a more rapid increase in the quantity of money, than in output."[1]

Today Friedman's truism is, seemingly, being disproved. Since September 2019, America's central bank, the Federal Reserve, has been expanding its balance sheet at the fastest pace this side of a financial emergency. Meanwhile the US dollar – instead of performing a reverse 4.5-somersault in the pike position off a 10-meter platform to the depths below – is appreciating in value! And gold? Well, relative to the pace of the Fed's open market operations, it is treading water (in US dollar terms).

Was Friedman wrong? Federal Reserve Governor Ben Bernanke did not think so in 2002. Then the would-be future Chairman of the Federal Reserve affirmed inflation was the output of a whirring printing press (emphasis added):

> Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is the equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.
>
> Of course, the U.S. government is not going to print money and distribute it **willy-nilly**...[2]

But that was almost two decades ago. Have we have entered a wonderous new age where central banks can print pell-mell, topsy-turvy or higgledy-piggledy without witnessing their currencies dematerialize? It depends.[a]

GRANT'S GOLD FORMULA

Financial journalist, author and wordsmith, James Grant, poetically formulated the price of gold as, "the reciprocal of faith in central banks." The validity of this Friedman-esque formula is routinely observed. Two recent examples, in which the circumstances were wholly opposite, come to mind.

In Turkey, throughout 2018, the illiberal – by Western standards at least – President Recep Tayyip Erdoğan publicly impugned the country's monetary authority, linking the nation's high rates of inflation to institutional incompetency.[3] In 2019, having lost his patience on the matter, Erdoğan removed the central bank governor from his post. The president's political opponents criticized[b] the dismissal claiming it endangered the institution's credibility: "Those who removed the central bank governor overnight have lost the right to demand confidence in the country's economy."[4] Thus, the viability of the central bank's independence was unsettled, the sustainability of the lira's purchasing power uncertain, confidence ebbed and the lira-price of gold surged.

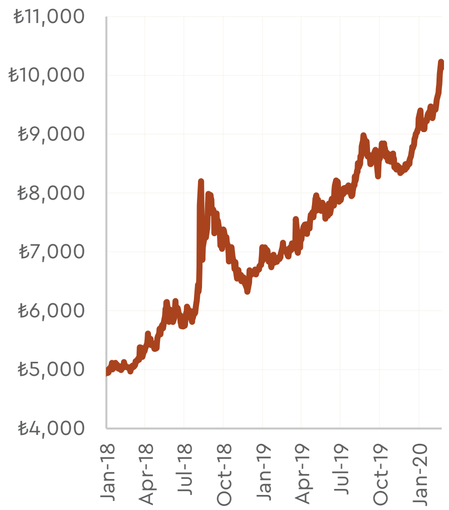
In Argentina, in early 2018, the nation's central bank began to implement policies that were decidedly supportive of the peso. In May, the internationally esteemed President Mauricio Macri called on reinforcements and – in lightning-quick fashion – secured by June a remarkable $50 billion US dollars from the International Monetary Fund; the largest credit line in the institution's 70-year history.[5] But did all this instill confidence? No it did not. The populace turned to the neighborhood arbolito[c] to exchange pesos for dollars as fast as possible. Gold soared in peso-terms.

In the first instance the national leader is illiberal, nationalist and conservative. In the second, the president was liberal, globalist and business friendly. One country's central bank is nominally independent, the other explicitly an arm of the government. One nation is left to flounder on its own, the other receives a credit line. So contradictory were the circumstances that *The Economist* wrote an article investigating, "Why Argentine orthodoxy has worked no better than Turkish iconoclasm".[6]

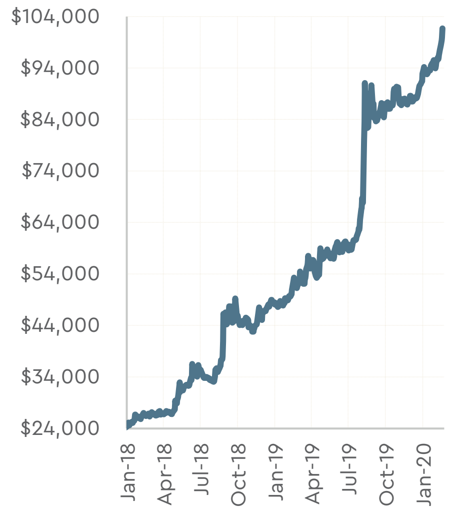
But Grant's formula cuts to the heart of the matter. Confidence – the lack of it – is what explains why gold sailed higher in those currencies.

[a] The older your blogger gets the more he realizes this answer – "it depends" – is simultaneously the least satisfying and most likely to be correct.
[b] This blogger has nothing useful to say about the political machinations of Turkey and only hopes to sketch the outlines of a monetary situation that appears uncertain. After all, Turkey's political intrigues are ancient, legendary and birthed the notion of "Byzantine" complexity. (Today's Istanbul was known as Constantinople during the Byzantine Empire, and in more ancient times was called Byzantium.)
[c] As per Reuters in early February: "On the streets of Buenos Aires, money changers known as 'arbolitos' or 'little trees' are taking advantage of Argentina's capital controls to take a slice of a booming black market trade in U.S. dollars."

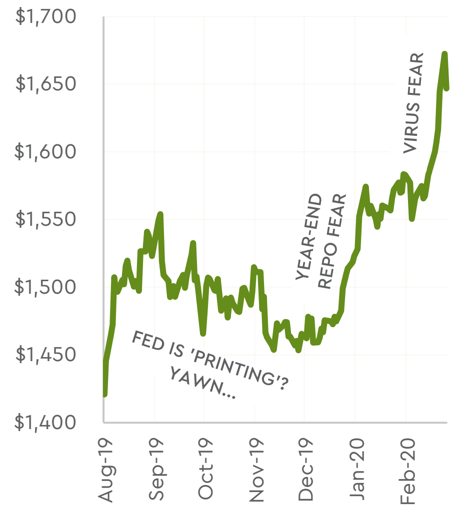
TURKISH GOLD
(GOLD, PRICE IN LIRA, DAILY)



ARGENTINIAN GOLD
(GOLD, PRICE IN PESOS, DAILY)



AMERICAN GOLD
(GOLD, PRICE IN DOLLARS, DAILY)



IF TRUE...

If Grant's formula is true, then it must mean confidence in the reserve-currency monetary authorities is high. But that is not actually the case. There is an implicit assumption made about reserve-currency central banks that this blogger wants to make explicit. It will explain why frequent market 'votes of no-confidence' are not rending the dollar, euro, yen or franc.

But first, please allow your writer to make the argument that the Federal Reserve, European Central Bank (ECB), Bank of Japan (BoJ) and Swiss National Bank (SNB) are as competently managed as the Türkiye Cumhuriyet Merkez Bankası and the Banco Central de la República Argentina.

Some readers will protest that these two groups are incomparable. That – with all due respect[a] – central banking is more 'civilized' in the halls of the Fed, ECB, BoJ and SNB. But are they really? Are these reserve-currency institutions more highly credentialed? Are they really apolitical? Are their policies so less radical? Has the implementation of their policies been that much more competent?

SAME PROCESS, DIFFERENT RESULTS

If Grant's formula holds, then why haven't reserve currencies fallen?

Is it because they have better credentials? Federico Sturzenegger, president of Argentina's central bank in 2018, has a PhD in economics from the Massachusetts Institute of Technology (MIT).[7] Raghuram Govind Rajan, former Governor of the Reserve Bank of India, also earned his PhD at MIT.[8] Yi Gang, Governor of the People's Bank of China, has an economics PhD from the University of Illinois.[9] The president of Brazil's central bank, Roberto Campos Neto, holds two masters degrees; one in economics from University of California, Los Angeles and another in applied mathematics from the California Institute for Technology.[10] The technocrats that head these, and other, monetary institutions are almost all highly educated and mentored by the world's most esteemed professors in the fields of finance, economics and mathematics.

Is it because these advanced economy institutions are apolitical? Monetary historian and Keeper of the Library of Mistakes, Russell Napier, in a recent essay brought to his readers' attention a statement made by Mario Draghi, in one of his final interviews as ECB President. Draghi said, "Opponents of the euro – the sovereigntists – have lost. They were defeated in the battle for the euro in the Greek crisis and they lost the political battle in the European Parliament elections this year."[11] As Napier rightly points out, "This is a remarkable statement because it is a comment by an unelected and supposedly independent central banker proclaiming a political victory."[12] A month before Draghi's interview, Bill Dudley, former president of the Federal Reserve Bank of New York, penned an article in which he said that "to remain apolitical" was "untenable":

> There's even an argument that the election itself falls within the Fed's purview. After all, Trump's reelection arguably presents a threat to the U.S. and global economy, to the Fed's independence and its ability to achieve its employment and inflation objectives. If the goal of monetary policy is to achieve the best long-term economic outcome, then Fed officials should consider how their decisions will affect the political outcome in 2020.[13]

Is it because these reserve-currency banks are not as radical? The SNB creates Swiss francs 'out of thin air', exchanges them into dollars, and then purchases stocks. As of December 31, 2019 it owned $74 million of Twitter, $61 million of Smuckers, $14 million of Grub Hub and $3 million of Shake Shack; plus $97 billion more in other holdings.[14b] The BoJ does the same. This time last year the central bank had already bought up 77% of all Japanese exchange traded funds.[15]

Is it because of greater levels of competency? Entering 2019 the Fed was adamant that the reduction of its balance sheet was "on automatic pilot".[16] It was a guaranteed, stone-cold, lead lock. By August they had stopped the reduction. By September they were growing the balance sheet. At first, just a couple of temporary open market operations to smooth over some 'unexpected' illiquidity. Then a few fortnight-

[a] This is your blogger's favorite cliché. As per Nigel Fountain, from his book *Clichés: Avoid Them Like the Plague!*: "Largely a euphemism for 'Please excuse me, but I am now going to contradict you,' the phrase uses 'due' in its sense of 'merited, appropriate: proper, right', the first printed reference to 'due respect' apparently dating from 1807. Today, useful substitutes for these words might easily include 'I am now patronizing you,' or, for those with a more timorous disposition, 'I am about to insult you - please do not hit me.' (There is also the subtext of 'I have not the least respect for you, but I am going through the motions.')"
[b] Which includes $101 million of Wheaton Precious Metals stock.

long "term" operations. Then a calendar bridging "turn" operation over year-end. Now the operations are slated to continue through the end of March. To readers predisposed to give the benefit of the doubt to the Fed this will be interpreted as, 'evolving with the circumstances.' To those who take a dim view of the past dozen years of emergency policies the sequence reads as, 'making it up as you go.' Your blogger is inclined to side with the latter interpretation.

HELIOCENTRIC BANK MODEL

If the characteristics and behaviors of central banking is not altogether different then what explains the different orbits these bodies take? Why does one bank that behaves in a certain way trace out a certain path while another bank with the same characteristics trace out a wholly different orbit?

It is because some central banks are central to their currencies but the Federal Reserve is not. Put another way, what the Federal Reserve does is less important to the US dollar than what the Bank of Argentina does to the peso. That is why the price of gold in US dollar terms is not flying away, there is a larger (dollar-)gravitational force to which gold is responding to.

Before Copernicus, Kepler and Galileo the paths trod by the Moon, Sun, planets and stars wound around Earth. It was a geocentric model of the Solar System and wider Universe. But curious eyes trained on the firmament above observed that some stars were oddballs (i.e. planets). These stars would over the course of weeks brighten and then dim. Seemingly approaching and then retreating from Earth! Also, these irregular stars would journey across the heavens, then slow, loiter for a while – perhaps gods attending a conclave? – and then reverse course (i.e. retrograde motion)!

To make observation match mathematics and retain the obvious centrality of Earth, intricate models were developed. Orbits within orbits (i.e. epicycles) were formulated. The results, when traced out on paper, were stunningly beautiful, intricate overlapping patterns that resembled the dahlia, or perhaps the lotus. Those readers without an eye for flowers (i.e. men) can imagine the patterns created by a Spirograph.

Then, between 1543 and 1632, the published works of Copernicus, Kepler and Galileo stripped the sky of its complexity and irregularity with a 'simple' swap of Earth and Sun. The orbits were revealed to be elliptical; the same rules could be applied to each body.

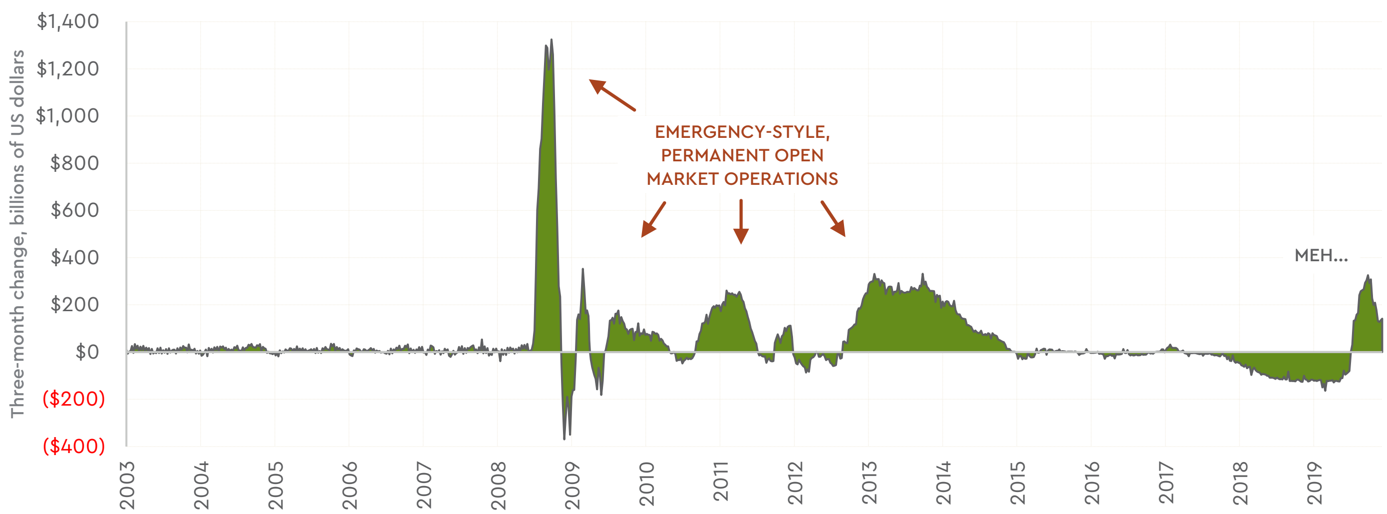
The same is true in our monetary constellation. Back to Grant for a second. Implicit in his financial haiku is that all central banks are central to their currency's money supply. The national bank in Buenos Aires is central to pesos. The national bank in Ankara is central to lira. If the national bank in Caracas creates bolívars, that means something. But for global reserve currencies that is not the case. These central banks are central in name only. Remove them from the center of their currency system and the orbits fall into a simple order.

To be more nuanced, it is not that the reserve-currency monetary authorities do not create money, they do, it is just that the amount they create compared to private, financial institutions is meager (emphasis added):[a]

> " The first [source of global instability] lies in the fact that **the process of creation of international liquidity** triggered by the U.S. balance-of-payments deficit **is** not only **due to** the increase in the amount of the dollar reserves in the hands of other central banks, but also to **the presence of an international banking system that multiplies U.S. liquid liabilities outside the control of any monetary authority**.
>
> The problem is old: it has been ten years since I first pointed to the need for some kind of regulation of the Euromarkets…
>
> The possibility of a repetition of the same sequence of events that followed the 1973 crisis has revived interest in Euromarket regulations.
>
> **But it is perhaps too late. The volume of the international liquidity denominated in dollars has reached levels that may no longer be controllable by any one authority**.
>
> Guido Carli,
> Former Governor of the Bank of Italy
> 1979[17]

RECENT OPERATIONS ARE "TEMPORARY", MERELY "TECHNICAL" ARCANA, SAYS THE FED

(UNITED STATES, FEDERAL RESERVE TOTAL ASSETS LESS ELIMINATIONS FROM CONSOLIDATION, WEDNESDAY LEVEL, WEEKLY)



[a] The following series of quotes is based in large part on the efforts and diligence of Jeffrey P. Snider of Alhambra Investments, as well as the presentation of his research in podcast form through a series of interviews ("Eurodollar University") conducted by Erik Townsend of Macro Voices.

Starting in the 1950s private banks began to take over from central banks in creating a credit-based international monetary order:

> The Eurodollar market was for years hidden from economists and other readers of the financial press by a remarkable conspiracy of silence. I stumbled on its existence by sheer accident in October 1959, and when I embarked on an enquiry about it in London banking circles several bankers emphatically asked me not to write about the new practice.
>
> Paul Einzig,
> Financial journalist
> 1964[18]

Because the world runs on bank ledger balances, and not physical notes or silver and gold bullion, the private bank can create credit-money[a] up to the limit of confidence (emphasis added):

> The Euro-dollar market is the latest example of the mystifying quality of money creation to even the most sophisticated bankers, let alone other businessmen. I heard a high official of an international financial organization discuss the Euro-dollar market before a collection of high-powered international bankers. He estimated that the Euro-dollar deposits totaled some $30 billion.
>
> ...**their major source is a bookkeeper's pen**.
>
> Milton Friedman,
> Economist
> 1969[19]

The modern, credit-based monetary system does not desire to create credit denominated in pesos, liras or bolívars. However, this network of financial institutions is very much interested in dollars, euros, francs and yen. So overwhelming is the size of the private network that it dwarfs the public money (emphasis added):

> Second, **with offshore markets able to create dollars**, reliance upon dollars generated within the United States to provide the world with a controlled supply of reserve currency (as a sort of governor of worldwide purchasing power) became impossible. **For from the early sixties onward there was virtually no control over the worldwide supply and use of dollars**.
>
> ...the enormous expansion in markets for U.S. dollars offshore, and **the new networks of interbank relations** that **made possible** the creation of **additional supplies of dollars** outside the United States and **beyond the control of the Federal Reserve**.
>
> Robert Roosa
> US Treasury
> 1984[20]

And that's why America's central bank is not central to dollars (emphasis added):

> The problem is that we cannot extract from our statistical database what is true money conceptually, either in the transactions mode or the store-of-value mode. One of the reasons, obviously, is that **the proliferation of products has been so extraordinary** that the true underlying mix of money in our money and near money data is continuously changing. As a consequence, while of necessity it must be the case at the end of the day that inflation has to be a monetary phenomenon, a decision to base policy on measures of money presupposes that we can locate money. And that has become an increasingly dubious proposition.
>
> Alan Greenspan,
> Federal Reserve Chairman
> 2000[21]

SHRINK TO GREATNESS

And how are these private, "networks of interbank relations" doing? They are shrinking, destroying credit and removing dollars, euros and francs out of the system.

In January of this year, Sergio Ermotti, the CEO of UBS, the Swiss financial multinational, chided other European banks for trying to, "shrink to greatness".[22] Ermotti was speaking to the press because, as *The Wall Street Journal* reported, "the banking giant missed its 2019 financial targets and lowered its goals to reflect tough market conditions."[23]

UBS reported its total assets ending 2019 were worth 939 billion Swiss francs, less than year-end 2018. Indeed, 2019's results were smaller than 2015's reported 943 billion Fr. Most shocking however is that UBS has fewer assets today than it did in 1998 when it reported 944 billion Fr. One of the world's most important banks is offering the wider global economy credit at 1998 levels. That's the level of economic activity it is willing to support.

Spain's banking giant Banco Santander announced poor results in January too, but they were celebrated as "better-than-expected".[24] Net profits for 2019 were "slash[ed]" by 17% but – good news – the fourth quarter's net profit jumped "helped by disposal gains".[25] Thus Europe's largest bank by market capitalization is 'growing' by disposing and slashing. From 1996 to 2008 Santander tripled in size, compounding at 20% a year. Last year? A 'better-than-expected' 4%.

This month, the British banking behemoth HSBC announced it would divest $100 billion in assets, step back from investment banking and cut 35,000 jobs over the next three years.[26]

This writer is not asking the reader to say a few words for bankers at prayer time but merely pointing out that the world's biggest creators of credit are 'shrinking to greatness'. And unfortunately, because the world's global monetary order is credit-based, that means there is less 'money' available for farming, fishing, mining, construction, manufacturing, power generation, trade, exploration and research.

CONCLUSION

Copernicus, Kepler and Galileo were not the first to deduce the heliocentric nature of the Solar System. That honor belongs to the Ancient Greek astronomer Aristarchus of Samos who predated our three Renaissance-era legends by 18 centuries.[27] But the knowledge was rejected as too improbable, too revolutionary to the established facts of the day and the theory was lost to time before

[a] In school we are taught that savers bring money to a bank, deposit it, and then the bank lends it out. That's not how it works. A bank creates money by journaling a ledger entry, assigning your account with an asset (dollars) and a liability (borrowing). On its own books it creates an asset (loan) and a liability (dollars). As long as you do not withdraw all of your loan and conduct your business solely in cash the system can lean heavily on just ledger balances serving as 'money'. Yes, there is enough spare cash in the system to allow a nominal proportion of people to operate on a cash basis. But most everyone conducts business via debit and credit cards, electronic fund transfers and wire payments. That is just adjusting one ledger balance down and assigning the journal entry to some other entity's ledger balance. Physical cash, gold or silver rarely enter the picture.

being rediscovered.

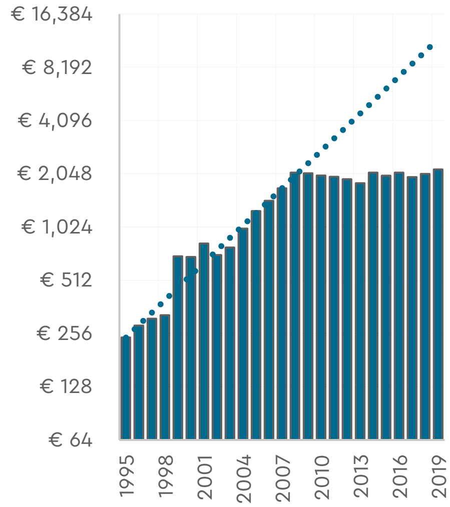
Likewise, the non-centrality of the Federal Reserve was once known as the above 'ancient' quotes demonstrate. But, likewise, it has been rejected as too improbable, too revolutionary to the established facts of the day. The idea is however making a comeback, 13 years of continuous emergency operations to generate sufficient liquidity have encouraged some to look about and ask questions. Most prominent perhaps has been the Bank of England:

> Most of the money in circulation is created, not by the printing presses of the Bank of England, but by the commercial banks themselves: banks create money whenever they lend to someone in the economy or buy an asset from consumers.
>
> Of the two types of broad money, bank deposits make up the vast majority – 97% of the amount currently in circulation. **And in the modern economy, those bank deposits are mostly created by commercial banks themselves**.[28]

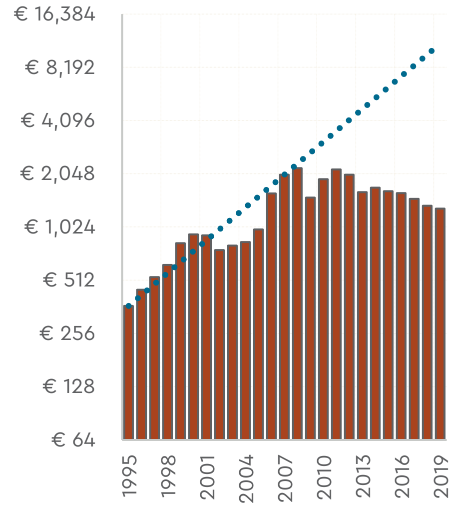
This post began with the Friedman proposition that, the more pell-mell the pecuniary proliferation, the greater the consequent currency debasement. That remains true. Though this writer believes central banks aren't central that does not mean they are powerless. The present trajectory of socioeconomic and geopolitical events suggests the world is transitioning out of the post-World War II era into a new one. Your writer does not know what this approaching epoch will look like, but he is optimistic. However, this writer, looking back on similar such transitions, believes such transitions are volatile. It is entirely reasonable to expect the federal government of the United States and the Federal Reserve to wrest back control of the dollar. That is a day that will produce, "a rapid increase in the quantity of money."

Until then gold will rise, or fall based on the vagaries of greed, fear, real interest rates and the value of the US dollar while altogether ignoring the Federal Reserve's open market operations.

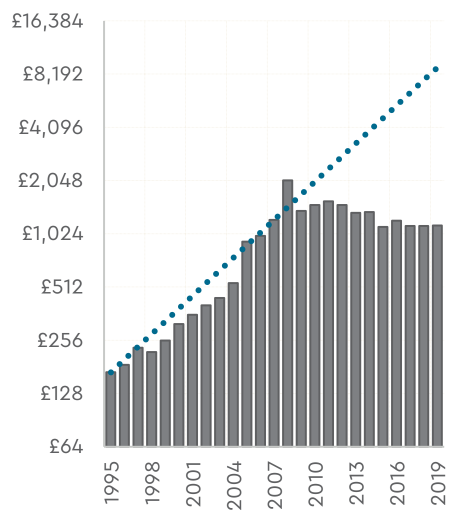
BNP PARIBAS SA
(TOTAL ASSETS, BILLIONS)



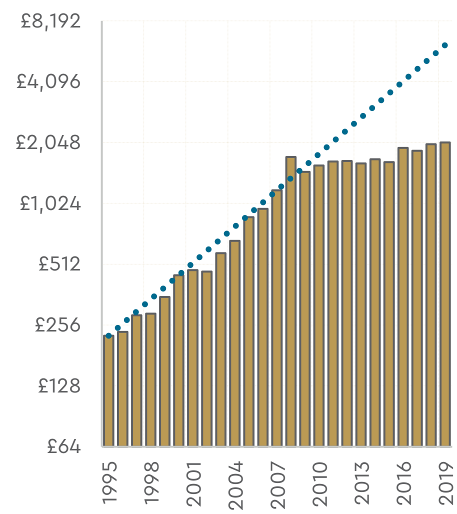
DEUTSCHE BANK AG
(TOTAL ASSETS, BILLIONS)



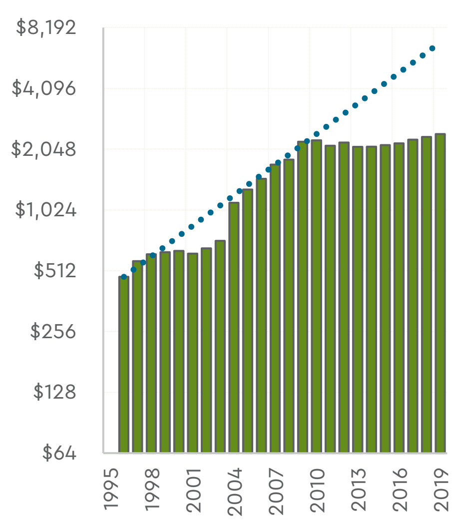
BARCLAYS PLC
(TOTAL ASSETS, BILLIONS)



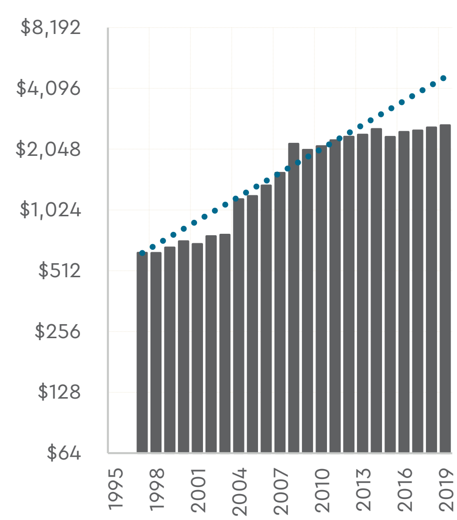
HSBC HOLDINGS PLC
(TOTAL ASSETS, BILLIONS)



BANK OF AMERICA CORP
(TOTAL ASSETS, BILLIONS)



JPMORGAN CHASE & CO
(TOTAL ASSETS, BILLIONS)



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