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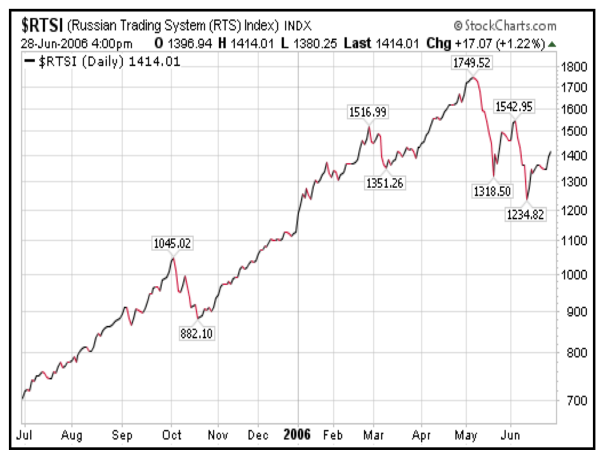
THE OMNIPOTENT FED: IF I EVER LOSE MY FAITH IN YOU

The sharp declines in various markets over the last several weeks have been attributed to investors' reactions to the Fed's concerns about inflation. Headlines such as "The Bernanke Panic", "Fed's Bernanke Faces Tough Choice", and "Bernanke's Inflation Message Deflates Wall Street", combined with the markets' reactions, shown below, suggests that inflation is a very real concern.



In the last few years, all of these markets have trended up together. In the last few weeks, they have all turned down together. As diligent investors, knowing that the markets always forecast the future, we must ask ourselves, "What is the market telling us now? Is this just a reprieve before the trend continues or has something changed?"

We suggest that something has, indeed, changed. Normally disparate markets have floated higher on a sea of liquidity. Recently, they have all turned lower. Could this be signaling a contraction in credit?

IN THIS ISSUE:

SPECIAL POINTS OF INTEREST:

- **Bernanke wreaks havoc**
- **The man behind the curtain**
- **Greenspan on the Great Depression**
- **Japan's Real Estate Bubble**
- **Putting Humpty Dumpty Together Again**

THE OMNIPOTENT FED

Our public discussion of the inflation-deflation debate began with our May 2004 newsletter, in which we offered two definitions, which bear repeating. Webster's defines *inflation* as "an increase in the volume of money and credit relative to available goods and services resulting in a continuing rise in the general price level," and Webster's defines *deflation* as "a contraction in the volume of available money or credit that results in a general decline in prices." Clearly, since we first wrote on this issue, the increase in the volume of credit has manifested itself in inflating asset prices the world over.

I have long found Robert Prechter's "all the same markets" hypothesis interesting. His line of reasoning, which he explains below, is not without merit.

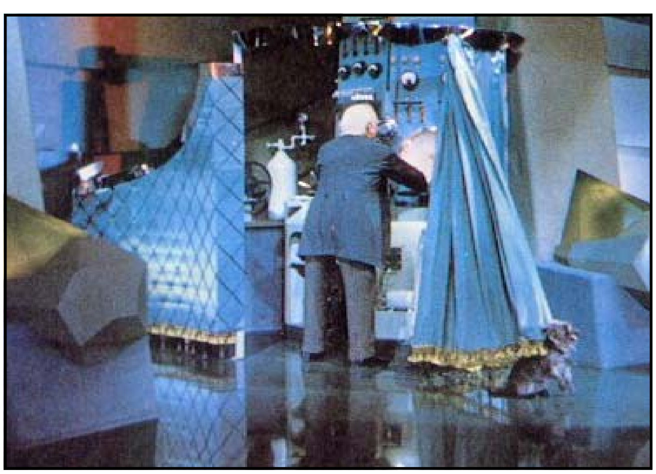
> "In 2004, Pete Kendall and I wrote an article for Barron's in which we argued that all investment markets had begun moving together, not contra-cyclically as they had in the past. We theorized that late in the credit and economic cycle, liquidity is the motor of all investment markets. We showed a graph of the major markets, including stocks, junk bonds and precious metals, and called them 'all the same market.' The flip side of markets going up together is that when the reversal comes they all go *down* together." [1]

So, the basic idea is that when an inordinate amount of credit is introduced to the system, it floods into normally divergent markets and forces all of them up together. For example, stocks and commodities do not usually trend together, yet they have been lately. Is it possible that cheap labor in the global marketplace, causing consumer prices to stay relatively low, would create an ideal environment for a rapid expansion of credit that would drive the vast majority of markets higher?"

Since we have so obviously been experiencing an inflationary environment over the last few years, and since we have seen rampant credit creation drive our markets up for the last couple decades, many assume the deflation argument lacks credibility. Let's talk through this. The foundation of contrarian investing is that the majority is usually wrong, and as such, contrarians endeavor to think opposite of the crowd. Now, if the vast majority of all bulls and bears think that varying degrees of inflation is the core problem, and if the majority of all bull and bear arguments are built upon the presupposition that the Fed's actions will dictate the ultimate outcome of various markets and economies, then, as contrarian, we feel compelled to explore the validity of these assumptions.

For the remainder of this piece, we will investigate why so many assume that the Fed has unfettered power to expand credit, and whether or not the Fed does have such power.

THE GREAT AND POWERFUL OZ



"Do not arouse the wrath of the great and powerful Oz...Pay no attention to that man behind the curtain."

The financial culture is obsessed with Fed watching – whether or not the Fed used the word "measured" in its most recent communiqué. To make this point, I decided to go to a search engine and type in "Bernanke comments" and see what havoc he has been creating lately. We read, "Bernanke comments send markets tumbling", "US stocks soar after Bernanke comments, banks rise", "Bernanke comments boost yuan", "Dollar Continues to Ride Off Of Bernanke Comments", "Bernanke comments Sink Tokyo Stocks", and "Bernanke comments may have triggered some short

IF I EVER LOSE MY FAITH IN YOU

covering." And, as if that's not enough, we now have to look for the hidden messages in what the Fed didn't say. For example, Jim Paulsen, chief investment strategist with Wells Capital remarked, "The reason it's (the market) up isn't so much that (Bernanke) said anything; it's what he didn't say."

Yet, when we understand the true predicament of the Fed, we realize that a more appropriate comparison would be the man behind the curtain in the Wizard of Oz or the cartoon version of the Dutch boy and the dike. You know – the one where new holes keep spouting water and the dike wall begins to crack while Daffy Duck looks like he's playing twister in an attempt to keep it all together until the inevitable happens.

Many will say, "But the Fed has steered our economy through high winds and heavy seas since 1913. How is it that you can even suggest that it has now powerless to help us at this time?" Obviously, I have some explaining to do.

Our hypothesis is that the Fed is perceived to possess power that it does not have because many attribute, a priori, our standard of living and wealth to the Fed's actions when, in fact, this has been the effect of changes in our monetary standards. We have all heard that Mark Twain once said, "History does not repeat itself, but it rhymes." I have always preferred one of his lesser known quips, "Truth is our most valuable commodity, so let us economize."

In this brief synopsis of our nation's monetary history, we are likely to realize the truth in both of Twain's statements. Even today, the Great Depression is one of the most poorly understood periods in our nation's monetary history. After the rampant credit creation of the 1920s, our nation fell into its Great Depression. England reneged on its gold exchange standard in 1931, leaving America as the sole industrialized nation to retain any form of a gold standard. Whether we look at Roosevelt's work programs or the mobilization of our nation to World War II, when the US came off of the gold standard, in 1932, this allowed our nation to inflate even more, and *that* is how we came out of the Great Depression.

Since the Federal Reserve is clearly the most revered voice in the US financial system, let me start our discussion of this era by quoting from our most recently retired, "Wizard." With countless articles and books written about him, there is no doubt that the US and perhaps the world sees Alan Greenspan as one of the leading authorities on money. In his 1966 comments on the Great Depression, this is what Greenspan had to say.

> "When business in the United States underwent a mild contraction in 1927, the Federal Reserve created more paper reserves in the hope of forestalling any possible bank reserve shortage. More disastrous, however, was the Federal Reserve's attempt to assist Great Britain who had been losing gold to us because the Bank of England refused to allow interest rates to rise when market forces dictated (it was politically unpalatable). The reasoning of the authorities involved was as follows: if the Federal Reserve pumped excessive paper reserves into American banks, interest rates in the United States would fall to a level comparable with those in Great Britain; this would act to stop Britain's gold loss and avoid the political embarrassment of having to raise interest rates. The "Fed" succeeded; it stopped the gold loss, but it nearly destroyed the economies of the world, in the process. The excess credit which the Fed pumped into the economy spilled over into the stock market – triggering a fantastic speculative boom. Belatedly, Federal Reserve officials attempted to sop up the excess reserves and finally succeeded in braking the boom. But it was too late: by 1929 the speculative imbalances had become so overwhelming that the attempt precipitated a sharp retrenching and a consequent demoralizing of business confidence. As a result, the American economy collapsed. Great Britain fared even worse, and rather than absorb the full consequences of her previous folly, she abandoned the gold standard completely in 1931, tearing asunder what remained of the fabric of confidence and inducing a world-wide series of bank failures. The world economies plunged into the Great Depression of the 1930's." [2]

THE OMNIPOTENT FED

Undoubtedly, most of us have heard a story that more closely follows what we are about to hear from Dr. Harvey Rosenblum. At a luncheon in 2004, I asked him, "What lessons has the Federal Reserve learned from the Great Depression?" As Head of Research for the Dallas Federal Reserve Bank, Dr. Rosenblum replied, "As we know today, the Federal Reserve did not step in and expand the money supply when it was most needed. But remember, we can't be too hard on them because they didn't have the benefit of Keynes' General Theory at that time."

So who is right, Greenspan or Rosenblum? Was the Great Depression a result of the Fed expanding credit too rapidly, triggering a speculative boom that eventually went bust, or was the Great Depression a result of the Fed not giving enough credit to the markets and the economy when the bust set in? Was the Great Depression caused by events set in motion many years prior to the Crash of '29 or was it caused by events just before the market topped? A closer look at the historical record will help us answer these questions.

If we are unfamiliar with Dr. Murray Rothbard, we are missing an important voice in our nation's financial history. His works, A History of Money and Banking in the United States, as well as America's Great Depression, among many others, are instrumental to understanding the events of this period. Notice how Rothbard's findings match those of Greenspan's 1966 comments. Notice also, the many similarities between Great Britain in the 1920s and 1930s and the U.S. today and how quickly the world's banking systems came unraveled.

The Great Depression was not only an American event; it was also a global one, and as such, the credit deluge and its repercussions were not limited to the U.S. and Great Britain. Other European banks cratered under the weight of the unsound credit practices of that day. Like today, the economies of the 1930s were globally interlinked. The following account of the events that surrounded that era suggest that today is not all that different from ages gone by, and as such, we should all seriously consider the very real probability of deflation.

In 1931, an important Austrian bank, the Boden-Kredit-Anstalt, was headed for liquidation, but, instead of allowing the bank to go under, a group of international financiers, attempted to bail the bank out. The Boden was merged with the largest commercial bank in Austria, the Österreichische-Kredit-Anstalt. In normal times the solution of merging a troubled bank with a larger one, along with the guarantee of the bank's assets by the Austrian government, would have stabilized the situation. However, the merger weakened the now-huge Kredit-Anstalt, and once a run on the bank began in May of 1931, not even the funding from the Bank of England, the Rothschild's of Vienna, and the newly created Bank of International Settlement could stop the collapse. Austria was forced to leave the gold standard and declare bankruptcy in 1931. [3]

By mid-July of 1931, less than 45 days later, the German banking system collapsed and went off of the gold standard. England, who was clinging to its reserve currency and superpower status, was continuing to deal with inflationary credit problems that had been building since World War I. In July of 1931, sterling redemptions in gold became so severe that the Bank of England lost $125 million in gold in nine days. Clearly, England's troubles were rapidly coming to a head. [4]

Great Britain, like other European nations, had removed their currency from the gold standard in order to expand their money supply to fund their military during World War I. As such, by February of 1920, the pound-sterling had depreciated 35 percent. Though Great Britain wanted to strengthen their currency to its prewar parity with gold, at the same time, they wanted to avoid the economic and social ramifications of a tight monetary policy. So, they continued to inflate. Rothbard notes:

IF I EVER LOSE MY FAITH IN YOU

> "Instead of repealing unemployment insurance, contracting credit, and/or going back to gold at a more realistic parity, Great Britain inflated her money supply to offset the loss of gold and turned to the United States for help. For if the United States government were to inflate *American* money, Great Britain would no longer lose gold to the United States. In short, the American public was nominated to suffer the burdens of inflation and subsequent collapse in order to maintain the British government and the British trade union movement in the style to which they insisted on becoming accustomed." [5]

As a result, Britain's gold reserves dwindled, as other nations, who saw Britain's debt as an ever-increasing risk, traded paper pounds for gold. In trying to keep Britain afloat and to help our own unsound banking system, the U.S. continued to expand liquidity. Rothbard continues:

> "July 1927 until December 1927 was another period of accelerated and heavy inflation, surpassing the peaks of latter 1922 and 1924. [There was] a very large increase in reserves, emanating from Bills Bought ($220 million), U.S. Government Securities ($225 million), and Bills Discounted ($140 million)." [6]

On Friday, September 18th of 1931, less than two months after the collapse of the German banking system, Dr. G. Vissering, head of the Netherlands Bank, phoned the head of the bank of England, Montagu Norman. With huge sterling deposits, Vissering was very concerned about the declining value of the sterling and was ready to withdraw. Norman assured Vissering that England would remain on the gold standard at all costs. Two days later England betrayed its word and came off the gold standard. The Netherlands Bank suffered severe losses, as did many banks around the world. As soon as England came off the gold standard, the pound fell 30 percent, and England lost its reserve currency status and was never again seen as the world's leading financial center. [7] The economist, Moritz J. Bonn, recorded the following.

> "September 20, 1931 was the end of an age. It was the last day of the age of economic liberalism in which Great Britain had been the leader of the world. Now the whole edifice had crashed. The slogan, "safe as the Bank of England" no longer had any meaning. For the first time in history a great creditor country had devalued its currency, and by doing so had inflicted heavy losses on all those who had trusted it." [8]

It is important to note that there is a point where the historical data disagrees with Greenspan's observations. In 1966, Greenspan asserted, "Federal Reserve officials attempted to sop up the excess reserves and finally succeeded in braking the boom. But it was too late." Though it is true that the Fed raised the rediscount rate in 1928 and 1929, Dr. Frank Shostak's numbers show that our Federal Reserve was quite aggressive in trying to expand the money supply after the stock market crashed in October of 1929. Shostak states:

> "Plainly, they intended to fight the forces of deflation. That fighting spirit continued throughout 1930 to 1933 as the amount of U.S. government securities the Fed held ballooned from $485 million to $2,432 million ($2.4 billion) - a 401% increase in 4 years." [9]

So, why didn't the money supply expand? Simple. In lowering the rediscount rate from 4.5 to 2 and purchasing $218 million in government securities in order to increase liquidity, their easy-money policies that had mounted throughout the 1920s resulted in loans that went belly up. [10]

> "The money supply, however, remained stable and did not increase, due to the bank failures of late 1930." [11]

THE OMNIPOTENT FED

Rothbard summarizes the oft-overlooked solution and the causes of the Great (global) Depression of the 1930s.

> "The depression, or what nowadays would be called the 'recession,' that struck the world economy in 1929 could have been met in the same way the U.S., Britain, and other countries had faced the previous sever contraction of 1920-21, and the way in which all countries met recessions under the classical gold standard. In short: they could have recognized the folly of the preceding inflationary boom and accepted the recession mechanism needed to return to an efficient free-market economy. They could have accepted the liquidation of unsound investments and the liquidation of egregiously unsound banks, and have accepted the concretionary deflation of money, credit, and prices. If they had done so, they would, as in the previous cases, have encountered a recession-adjustment period that would have been sharp, sever, but mercifully short. Recessions unhampered by government almost invariably work themselves into recovery within a year or 18 months.
>
> But the United States, Britain, and the rest of the world had been permanently seduced by the siren song of cheap money. If inflationary bank credit expansion had gotten the world into this mess, then more, more of the same would be the only way out. Pursuit of this inflationist, 'proto-Keynesian' folly, along with other massive government interventions to prevent price deflation, managed to convert what would have been a short, sharp recession into a chronic, permanent, stagnation with an unprecedented high unemployment that only ended with World War II.
>
> Great Britain tried to inflate its way out of the recession, as did the United States, despite the monetarist myth that the Federal Reserve deliberately contracted the money supply from 1929 to 1933. During the week of the great stock market crash-the final week of October 1929 – the Federal Reserve doubled its holding of government securities, and discounted $200 million for member banks. Secretary Mellon issued one of his traditionally optimistic pronouncements that there was 'plenty of credit available' and President Hoover hailed the nation's good fortune in possessing the splendid Federal Reserve System, which had succeeded in saving shaky banks, had restored confidence, and had made capital more abundant by reducing interest rates." 12

In an editorial in the *New York Journal of Commerce,* H. Parker Willis pointed out:

> "The easy-money policy of the Fed was actually bringing about the bank failures, because of the banks' 'inability to liquidate,' [and] noted that the country was suffering from frozen and wasteful malinvestments in plants, buildings, and other capital, and the depression could only be cured when these unsound credit positions were allowed to liquidate." 13

But someone will say, the world *did* recover from the Great Depression, and by my own admission, the means by which we came out of it, was inflation. And, that is true, but not before we experienced a painful deflationary period. At such hyper-inflated levels, our highly interdependent world has always been on the brink of a deflationary demise. Each time any country has tried to take the prudent course of deflating back to a stronger monetary system, the pain has proven too difficult to bear. So instead, we have changed the object that backs our increasingly-fiat currencies in order to proceed down the less painful route of another bout of inflation.

Yes, the world did recover from the Great Depression, and many believe this was because of the Fed's willingness to inflate us out, but the Fed has always been willing to inflate. Indeed, that is the only thing it has ever done. The problem has always come when the current monetary system can no longer support the needed growth in credit.

IF I EVER LOSE MY FAITH IN YOU

As these times, we invariably see the death of the existing monetary system and the birth of a new one that is fundamentally less sound. In the 1930s many European countries came off the gold exchange standard, meaning these central banks would no longer exchange gold, between each other, for their own currencies. In 1932, the U.S. came off the gold standard, no longer allowing its citizens to exchange dollars for gold. In 1945, with many countries on the verge of financial collapse because of the expenses they incurred in World War II, the Bretton Woods agreement was enacted. Now rather than operating on the promise that the pound-sterling was "as good as gold," central banks operated on the promise that the dollar was "as good as gold." In exchange, they were provided with U.S. dollars to inflate their way out of their debts. In 1971, France's decision to seek the actual gold that backed the promise of Bretton Woods was the straw that broke the camel's back. When the U.S. reneged and came off the gold exchange standard, yet one more era would come to a close. With the entire world now on fiat currencies, the consequence was mounting inflationary pressures. The U.S.'s solution was to broker a deal with Saudi Arabia to only accept U.S. dollars in exchange for oil. Thus, the monetary system was now backed by oil.

Lest we think that the sophistication of central bankers and our financial markets today has nullified the former limitations of central banks, we will look at Richard Koo's book, <u>Balance Sheet Recession</u>, which chronicles Japan's attempts, over the last fifteen years, to free itself from its deflationary quagmire. Yet, before we look at the attempted solutions, we would do well to look at the bubble that has caused Japan's long-standing recession. Like any good economist, Koo does not concern himself with the excesses, which preceded the fallout. For that bit of information, we turn to Edward Chancellor's book, <u>Devil Take the Hindmost</u>.

> "The bubble economy was first and foremost a property boom. Land holds a special position for the Japanese. Between 1956 and 1986, in only one year (1974) did land prices decline. Acting on the belief that land prices would never fall again, Japanese banks provided loans against the collateral of land rather than cash flows. Towards the end of the 1980s, they increased lending against property. The rising value of land became the engine for the creation of credit in the whole economy.
>
> By 1990, the total Japanese property market was valued at over ¥2,000 *trillion*, four times the real estate value of the entire United States. The grounds of the Imperial Palace in Tokyo were estimated to be worth more than the entire real estate value of California.
>
> As 1989 drew to a close, the Nikkei index was approaching the 40,000 mark, up 27 percent on the year, and nearly 500 percent on the decade. The Japanese stock market did not collapse with a sudden jolt. Instead, it gently let out air like a balloon left over from a Christmas party. By the end of January 1990, the Nikkei index had fallen two thousand points *(five percent)*. Its cause was a sharp tightening of monetary conditions. Governor Meino – who expressed a desire to see property prices fall by 20 percent – lifted interest rates a further five times until they reached 6 percent in August 1990. The stock market revived briefly in October 1990 and then continued sliding until it hit a low of 14,309 in August 1992, a decline of more than 60 percent from its peak.
>
> By late 1992 property prices in central Tokyo had fallen 60 percent from their peak. A banking crisis, caused by the banks excessive exposure to the falling property market, loomed. In August 1995, Japan experienced its first bank run of the postwar period.
>
> Speculation came to Japan in the 1980s. It burrowed so deep inside the Japanese system that when it departed, the system was in ruins. Officials tried to pick up the pieces and reconstruct the old order, but their efforts were in vain. This was the real legacy of the bubble economy." [14] (Italics mine)

THE OMNIPOTENT FED

As destructive as these things are, you'd think central bankers would spend more time trying to identify and dismantle these bombs, rather than just trying to deal with the nuclear fallout that follows. What was that saying? "An ounce of prevention is worth a pound of cure." I guess central bankers are way too smart for such counsel. In advising various government officials as they attempted to reconstruct the Japanese economy, Koo, Chief Economists of the largest securities house in Japan (Nomura Securities), picks up where Chancellor leaves off.

In a Balance Sheet Recession, which is a recession that comes about as people try to pay off their previous, excessive debts, Koo describes the Bank of Japan's various monetary policy attempts to stimulate inflation and kick-start the flagging Japanese economy. In short, Koo's conclusion is that Japan's central bank has been powerless to influence the economy because ultimately the ability to inflate an economy out of a recession is dependent upon the actions of the people, who have been more interested in paying off debt that assuming more of the same. Hence, John Maynard Keynes familiar phrase – "pushing on a string." First, Koo addresses how ineffective lowering interest rates has been in the Japanese economy.

> "Since I started my career as an economist for the Federal Reserve Bank of New York, I am reluctant to admit that the central bank [of Japan] is powerless. The Bank of Japan has reduced interest rates as low as possible, the lowest ever recorded in human history, in order to induce people to borrow and spend. Yet, in the situation in which Japan finds itself today, monetary policy is not effective. For monetary policy to be effective, there must be many people in the private sector who are induced to save less, to buy a home, or the invest in plant and equipment in response to the lowering of interest rates by the central bank. It is not lower rates *per se* that improve the economy. It is the people's reaction to lower interest rates (that is, borrowing money to spend or saving less) that improves the economy. It is only when the reduced savings or newly borrowed money is spent that income is generated for the next person and the economy moves forward.
>
> The fact that borrowers are not borrowing, while admitting that the banks are eager to lend, shows that the true bottleneck is on the demand side. If supply is not the bottleneck, no matter how far the supply problem is solved via monetary easing or the quick disposal of NPLs (non-performing loans), the economy will not turn around unless demand returns. The problem is on the demand side, not the supply side.
>
> The monetary tightening of the 1989 – 91 period was mobilized to crush the real estate bubble meant that the most important sector for monetary transmission in the economy was the first sector that was hit and destroyed. Even though most economists implicitly assume that the monetary transmission mechanism is always there, in the real world the transmission only goes through a limited number of interest-sensitive channels; when those channels are blocked or destroyed, the effectiveness of monetary policy drops off sharply. Of all the transmission mechanisms between the monetary authorities and the real economy, [as] the most interest-sensitive sector in any economy, the role of the construction and real estate sector is the most important. Furthermore, the construction and real estate sectors have huge spill-over effects to all other industries. After losing the real estate sector, therefore, there was not much left in the Japanese economy that the monetary authority could affect through the lowering of interest rates." [15]

IF I EVER LOSE MY FAITH IN YOU

Koo then goes on to explain how, and why, inflation targeting and quantitative easing have been useless in an environment where demand for borrowing is negative.

> "Since monetarists believe that *any* macroeconomic problem can be solved as long as the central bank's monetary policy is correct, they could never accept the argument that monetary policy is powerless in present-day Japan. According to their theory, such a situation could never happen.
>
> In order to counter the argument that there is nothing more the Bank of Japan can do they have come up with inflation targeting and quantitative easing as the means for the central bank to regain control of the economy. Inflation targeting means the central bank will target a level of inflation rate as its monetary policy target. Quantitative easing means the central bank continues to add liquidity to the banking system even if interest rates have no more room to go down. Because the value of money decreases in inflation, they claim that this policy would boost consumption and lead to an economic recovery. Professor Paul Krugman of Princeton University, for example, had strongly advocated 'quantitative easing' in order to attain an inflation target.
>
> Unfortunately, the real world is not so kind to Krugman. Though Krugman and others believe that the cause of Japan's recession is deflation, deflation is actually a result, rather than the cause of balance sheets recession. In 1993, when the Japanese economy fell into recession, Japan still had a positive inflation rate, but that did not prevent businesses and individuals from embarking on a massive effort the reduce borrowings and pay down debt. Hence, even if inflation is induced somehow, it will not be able to end the recession.
>
> Moreover, starting in 1999, the Bank of Japan, if only to prove the monetarists wrong, started a campaign of quantitative easing, and a massive amount of liquidity has been added as a result. However, absolutely nothing has happened, both in the real economy and the financial markets. Indeed, the economy continued to weaken, and share prices continued to fall, leaving those investors who bet on the monetarist argument with huge losses. Even Krugman admitted in his *New York Times* column, that there is no demand for funds in Japan and that ordinary monetary easing is not going to be effective." [16]

The reason that monetary easing and inflation targeting does not work, is the same reason that lowering interest rates does not work. The central bank is "pushing on a string." First, we consider the consumer.

> "Forcing the bank of Japan to adopt inflation targeting is meaningless under the present circumstances, because the central bank does not have any tools to achieve the target.
>
> The problem is that, although the Japanese people's morality might have declined somewhat during the past 10 years, it has not fallen anywhere near those levels that would make it possible for Krugman's idea to succeed. This is because those who are trying to clean up their balance sheets are behaving appropriately and responsibly. They are by no means behaving incorrectly. For those with debt overhang, improving their financial health by reducing debts is a very appropriate and responsible behaviour. To urge them to forget about their balance sheet problems is to urge them to take a very irresponsible action. Building an entire policy on the assumption that people will act irresponsibly is not realistic." [17]

THE OMNIPOTENT FED

Koo notes another problem that the central bank would encounter. For quantitative easing to work, the banking industry would need to perform a miracle.

> "In order to attain an inflation target, not only borrowers but also lending institutions (that is, banks) must change their behavior and lend more aggressively. After all, they are the first institutions to receive increased liquidity form the Bank of Japan's quantitative easing.
>
> Let us suppose that the Bank of Japan suddenly places a deposit of ¥ 1 trillion with your bank, [and] tells you that it expects no interest payment from your bank on this deposit. You lower lending standards to the lowest level that is acceptable to bank regulators, drop the basic lending rate to the level that is just enough to cover your operating costs, [and] then ask your loan officers to do everything humanely possible to unearth all possible loan demand in your region. After two weeks, your loan officers have come up with a figure of ¥100 billion-worth of possible new borrowers [but] this is the absolute maximum before going afoul of the bank regulators.
>
> What will be the increase in lending form your bank? The answer has to be ¥100 billion. For your bank to lend more its lending standards will have to be relaxed far beyond those that are minimally acceptable to the authorities, [and] you could be liable for criminal prosecution. Most banks today are trying desperately to reduce their NPLs in order to recover the trust of depositors and rating agencies. Asking them to make loans by drastically lowering their lending standards is an impossible proposition. Such a relaxation will also be unacceptable to shareholders and ratings agencies.
>
> If additional liquidity from quantitative easing is all bottled up within the banking system, there is no reason for inflation to accelerate. The money supply has no reason to expand no matter how much liquidity is provided by the central bank. Contrary to the belief of monetarists, therefore, monetary policy is *not* almighty." (Italics his) [18]

Clearly, Japan has been in the grip of a deflationary spiral that its central bank has been powerless to overcome.

The world is once again showing signs of credit saturation. Once again, this will lead us to a deflationary contraction in credit. Once again, this deflationary juggernaut will likely prove to be so painful that we will be willing to abandon our current monetary system and create a new one. As evidenced in our May 2006 newsletter, a new era is already being contemplated as revealed in William White's January 2006 working paper for the Bank of International Settlements. After accurately describing the world's increasingly debilitating debt deluge, White presents the idea of a "**new international monetary order**" as a possible solution to the storm that we will go through.

IF I EVER LOSE MY FAITH IN YOU

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Best Minds, Inc. is a registered investment advisor that looks to the best minds in the world of finance and economics to seek a direction for our clients. To be a true advocate, we have found it necessary to go well beyond the norms in financial planning today. We are avid readers. In our study of the markets, we research general history, financial and economic history, fundamental and technical analysis, and mass and individual psychology.

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Challenging one's thinking is the only way to come to firm conclusions.