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December 15, 2011

LEVERAGE, RISK AND GOLD

by Paul Nathan

In the June 2010 issue of GOLDVIEW ALERT, Paul Nathan gave his view on the gold standard. It was no call to re-establish it but it covered the moral case of for the gold standard as well as its practicality. The point was that, like freedom, Paul sees it as the ideal basis for a stable monetary policy. And like freedom, while achieving it may be a distant goal, moving toward it is always the direction we should be moving. I am happy to be able to present Paul's point of view as it is today.

Henk J. Krasenberg



In a free society where government is absent from the marketplace except to enforce laws against force and fraud—the individual must take responsibility for his livelihood and welfare. Conversely, the more the government enters the economy to help and “protect” individuals from the free market, the less responsibility individuals take for themselves as they instead hand that responsibility over to government.

The Consumer Protection Agency being established today is a perfect example of this. There was a time when we had one written law against fraud and the unwritten law called “Buyer Beware.” Today, dozens of agencies, thousands of regulators, and tens of thousands of rules and regulations have replaced those two simple axioms.

Social Security, unemployment insurance and food stamps all backstop the individual. The Fed, SEC, and the recent Dodd-Frank bill do the same for investors. The result is greater risk taking. Individuals needn't worry too much about their retirement, since the various government programs will look after them, investors take on more risk because the government claims it will protect them, and when there are market disruptions the Fed and other forms of government cavalry show up to save the day.

People tend to save less, spend more, and take on more debt and leverage as they fear the marketplace less and less. During the 19th Century, when government intervention into the economy was at a minimum—risk taking was low. The use of leverage was held down by the gold standard which required banks to hold large amounts of capital to convert their customer's deposits into gold on demand. Credit creation was extremely limited. ▶

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The establishment of the Federal Reserve System ended those requirements and freed up capital to be invested. Banks and individual investors increased their leverage and *risk*. Leveraged investments began to progressively rise after 1914. Margin buying was one of the main factors that led to the stock market boom of the 1920's and the crash of 1929. The de-leveraging of debt and the evaporation of money and credit were some of the primary causes of the deflationary depression of the thirties.

Flash forward to today. Once again the world must de-leverage debt—and there are conflicting theories on how to do it. Ben Bernanke, Chairman of the Fed, and a man who has studied monetary policy and written extensively on the Great Depression, chose to replace the capital lost in the banking system. Many believed this would set off a massive inflation. Yet, we have seen inflation average about 2% since 2008 when he began injecting funds into the system through "quantitative easing."

Europe is facing the same problem as the US but has decided not to increase the money supply. In fact they are allowing the money supply to decline and opted instead to cut government spending in attempts to stabilize debt and reduce it as a percentage of GDP. In some respects Europe has no choice. The European Central Bank doesn't have the authority to create money like the Fed. Because the Euro Zone decided against a unified bank of last resort, austerity is their only tool besides borrowing and taxing.

I see Europe destined for deflationary recession (or worse) because of their choice to not allow for a bank of last resort. An anti-deflationary monetary policy under the present EU structure is impossible. Again, where the Fed replaced failing debt with new capital, the ECB can only borrow or tax to do the same. So far they've only been able to raise about 700 billion dollars this way. But they will need *trillions* to impress the markets.

In the US, TARP was our "bazooka." Along with the Fed's multi-trillion dollar injection of funds, it amounted to an anti-deflationary move. As asset values fell or virtually disappeared, the government replaced them. TARP amounted to about a 700 billion dollar bridge loan which, while forced on the banks, has been mostly paid back now. And the Fed's injection of funds is sitting as reserves in banks as further protection against a run. When those funds are no longer needed they will be withdrawn or sterilized by the Fed to keep the increase in money supply stable.

The lesson the world will likely learn from these two different approaches is twofold: large amounts of money injected by governments into the banking system is not necessarily inflationary but increased taxes combined with austerity measures are most often deflationary and recessionary. Bernanke did what a banker of last resort is supposed to do. He helped prevent financial collapse and deflation from taking hold. The Fed didn't understand what they were doing during the crash of 1929 but they do now. I hope we've learned that a monetary policy designed to *prevent deflation* is not the same as a monetary policy designed to *create inflation*. This lesson has not been grasped by many of the world's so-called economic pundits. ►

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Does this mean we have learned how to avoid crises? The answer is emphatically no. But we have learned how to *temper* them. The market's fear is that Europe has not learned this lesson. Certainly Japan hasn't. The fear of a deflationary recession that could engulf the world is driving the panic we see today.

Increased debt, together with 40 to 1 leverage ratios just employed by MF Global, led to the eighth largest bankruptcy in US history. We have learned to ring fence our financial system. A large financial institution failed without panic and contagion. But Europe is far from that, and it is benign neglect and contagion that the markets fear.

The problem, according to economist David Malpass, is that Europe's banking system is four times larger than their GDP. They carry 40 trillion dollars worth of assets on their books where the US carries only 14 trillion. Under any rational monetary system this would be impossible.

One of the reasons I am for a gold standard is that this could never happen under such a system. A gold standard limits money and credit and it limits debt and leverage. Once you allow a central bank to control the money supply instead of the market, you tend to get more money, credit, and debt created than could be produced through the market process. Once you allow institutions to set leverage levels and not markets, you typically see more leverage, which of course means more risk. We certainly have that today.

The gold standard demands discipline from individuals, institutions, and governments. They must adhere to the rules of the marketplace or they will pay the price. Today governments, institutions, and individuals, are demanding that the market adhere to *their* rules. I have news for these people; *in all of history such demands have never been met.*

I am on record as saying that when a nation is on a fiat standard it needs a bank of last resort. It's necessary to prevent what might lead to systemic damage, which in turn might create a breakdown of the money system. If used properly a bank of last resort can prevent a collapse. It can prevent both deflation and inflation. The problem is that it also has the capacity to *create* these conditions. It is an unfortunate but necessary safeguard required of a fiat system which encourages unwarranted risks. The fiat standard is an inferior monetary system. It is run by individuals rather than markets – and individuals can make fatal mistakes.

Under a gold standard there is no need for a bank of last resort. As long as the market is free to operate under the rules of the gold standard, the conditions that lead to the kind of excessive leverage we have in today's world could never happen. Neither could the threat of a massive deflation or inflation, or the kind of credit and debt creation that plague us today. The gold standard cannot prevent monetary or economic crises but it prevents the kind of debt and leverage levels we see in today's world.

Between the two recent approaches, I think history will judge the actions taken by the US the least destructive. The US Treasury and the Fed backstop of our financial system ►

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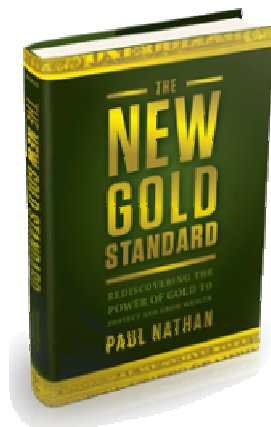
ended our financial contagion and stabilized the economy. The European approach of austerity, taxation, and emergency borrowing is leading Europe into recession. Unless they move to create a bank of last resort, deflation will be next.

The real lesson is that any monetary system that allows creation of leverage and debt based on the whims of human beings instead of the dictates of the marketplace is doomed to end up right where we are today. Moving back to the gold standard's principles of low leverage and high capital requirements is the best direction we and other nations can take.

Paul Nathan

"Paul Nathan is a brilliant investor with a great track record of making big calls at big turning points in markets. His analysis of what went wrong in the recent credit train wreck, and how to lift the world out of it, is sensible and incisive...both investors and policy makers should pay close attention to Paul Nathan's ideas."

—Donald L. Luskin Chief Investment Officer, Trend Macrolytics, LLC—



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Paul Nathan

Contact details:

paulnathan2010@gmail.com

www.paulnathan.biz



with the compliments of Henk J. Krasenberg

E U R O P E A N G O L D C E N T R E

e-mail: europeangoldcentre@gmail.com

website: www.europeangoldcentre.com