

Central bank cartel

The ultimate form of price control is the setting of interest rates by central banks

“Central banks have set interest rates to prevent prices falling, but this is to distort where the market perceives value”

BY BEN DAVIES

IN 284 AD the Roman Emperor Diocletian created inflation by placing too much money in circulation, and then fixed the maximum prices at which beef, grain, eggs, clothing and other articles could be sold, and prescribed the penalty of death for anyone who disposed of his wares at a higher figure.

The consequences according to Schuettinger and Butler, in a 1979 book called *40 centuries of wage and price control*, were that “the people brought provisions no more to markets, since they could not get a reasonable price for them and this increased the dearth so much that, at last after many had died by it, the law was set aside”.

Diocletian intuitively understood that by creating too much money, prices would rise and he thought he could control these with fixed lower prices.

Today central banks have set interest rates in the same vein of preventing prices falling, but this is to distort entirely where the market perceives value. It may well be those lower prices are it. People will borrow, if they require a product, because the market place has signalled fair price by true supply and demand.



Yoshihiko Noda, Japan's finance minister, left, and Masaaki Shirakawa, governor of the Bank of Japan

Photo: Bloomberg News

INTEREST RATES

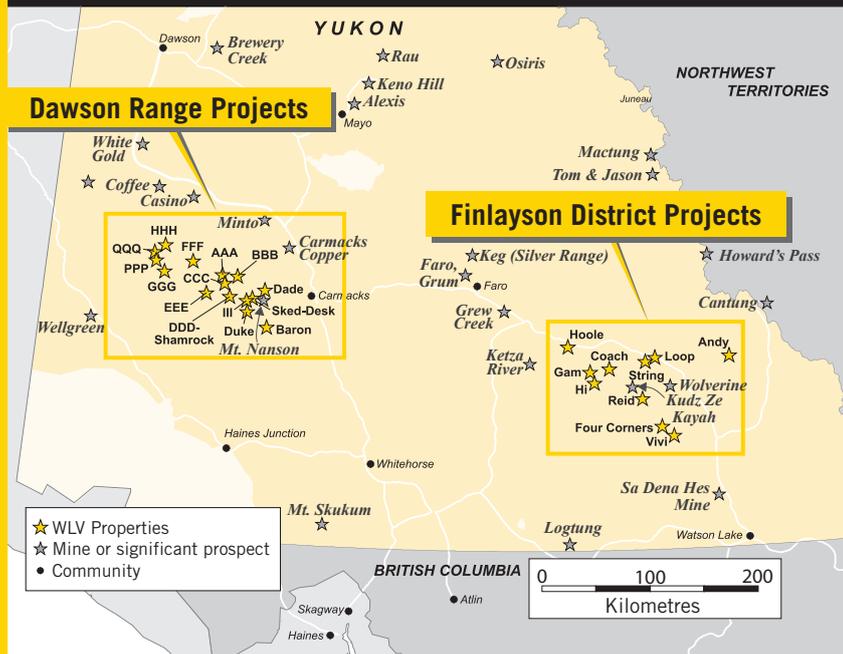
Liberal economists, more specifically Austrian economists, show that interest rates reflect a particular preference of human beings, namely time preference.

Humans prefer to have things now than in the future, and are prepared to borrow money at interest to get

them. When we lend something, we demand to be paid interest. This forms the basis of the theory of investment, production and use of capital.

The Austrian school of thought enables one to understand that economic decisions are inherently personal. Value does not exist in things, but in the minds

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of the individuals who value them. Trade occurs and prices emerge precisely because people value things differently. Markets steer goods to their most valued uses.

Private ownership is essential to achieving the best results. Intervention by governments and/or central banks will disrupt this highly complex market process, and invariably produce perverse results. Inflation is such a policy mistake brought about by trying to set interest rates too low.

Setting of interest rates at face value may appear to be an indirect manipulation of prices but, in reality, it is a price control extraordinaire. Like other economic goods, there is a supply of money and a demand for it, and money has its price (interest rate).

The price of money is expressed a little oddly – not in terms of the value of goods that will exchange for one unit of it (how many loaves of bread for a dollar), but the number of units of money that exchange for the other goods (how many dollars for a loaf); and we talk about its purchasing power rather than its price. Yet the purchasing power of money is a price like any other, decided by how people value it, through the pressures of supply and demand.

If you set the price of money too low, you are encouraging individuals and corporations to borrow as there is no perceived cost to them – the interest rate is so low right now it feels like free money to people and it, until it is used elsewhere.

A parallel universe of overinvestment and overconsumption occurs simultaneously, until such time as the rate of savings cannot support it. Simply put, one runs out of potential capital.

SUPPLY OF MONEY

This is exactly what central banks have achieved. They have lowered rates around the world below the market interest rate that would normally reflect consumer preferences. Public and private sector borrowing has been so egregious that they have run out of true savings and are reliant on creating infinite amounts of money (out of thin air) to replace this hard-earned savings. If the economy could thrive on such money, life would be very simple. In fact, if it was that simple, why would any of us ever work. It would all be play time.

This increase in the supply of money has set off an avalanche of price changes that has torn through markets, drawing resources first to one place, then another, creating real and destructive changes.

Money is not neutral.

Central Banks are a cartel. The US may own the reserve currency status but the fiat monetary order under Bretton Woods II has encouraged a collaboration on the fixing of money prices. This is an example of a public cartel.

The recent price intervention in the yen is an example of a crisis cartel. The acute shortage of yen, or rather perceived shortage of yen that would have transpired from repatriation of insurance monies, led to an infusion of yen by the G7 central banks. They ultimately fixed the price of yen at 79-80, for the time being at least.

YEN INTERVENTION

The Ministry of Finance (MoF) recently confirmed that there had been an intervention in foreign-exchange markets to the tune of ¥692.5 billion (US\$8.4 billion). This

was a joint intervention along with the other members of the G7, the first in over a decade.

On March 18, as the yen traded close to ¥76, the selling by the G7 began in earnest. This number does not reflect the true extent of yen intervention as this likely only captures Japan's efforts. Let's not forget that it was only last September that the Bank of Japan and the MoF sold ¥2,120 billion to combat the Chinese push of dollars onto them. This suggests that the yen sales were extensive.

In 1995, after the Kobe earthquake, the yen surged over 20% but this was more a function of the Plaza Accord, and dollar weakness, than repatriation needs of Japanese industry for reconstruction.

If we observe the real effective exchange rate (REER) of the yen we can see that relative to 1995, when we were last at the ¥80 level, in nominal terms the yen is weaker. Hence why Mr Yen, Eisuke Sakakibara, once the *enfant terrible* of the yen market, says the country can cope with a stronger yen at this stage.

Clearly, co-ordinated yen intervention has proven momentarily more successful than unilateral actions. Fear over a collapse of revenue for Japan's export economy appears to be the rationale.

Like all economies that run a large current account surplus, Japan has tremendous holdings outside the country. Indeed the Japan fiscal year ended on March 31, and we would typically see some yen sent home to balance corporate books.

As free market exponents, Hinde Capital says crisis controls can have catastrophic ramifications. Once the state pursues a policy of intervention it finds it all too easy to continue down the same old route.

This article was written by gold-fund manager Ben Davies, of Hinde Capital, and first published in the HindeSight Investment Letter



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