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Nothing New in Banking

Tally Sticks

In Medieval Europe which was predominately illiterate and constantly short of physical money, the split tally was a technique used to record bilateral exchange and debts. A stick (usually squared Hazelwood sticks were most common) was marked with a system of notches and then split lengthwise. This way the two halves both record the same notches and each party to the transaction received one half of the marked stick as proof. The technique was refined in various ways, one such way was to make the two halves of the stick of different length until it became virtually tamper proof. The longer part was called the stock and was given to the party which had advanced money. This is where “stockholder” derives from when we refer to modern day equity owners. The shorter half was called the foil and was retained by the party that had received the goods or funds as such that both parties had an identifiable and tamper proof record of the transaction.

In AD 1100, King Henry I came to the English throne and adopted the tally stick method of recording tax payments. By the time of Henry II, taxes were paid twice a year, and the tally sticks recording partial payment made at Easter soon began to circulate in a secondary discount market, being accepted as payment for goods and services at a discount since they could be later presented to the treasury as proof of taxes paid. It didn't take long for the King and his treasurer to realise that they could actually issue tally sticks in advance, in order to finance war and other royal spending. The selling of these claims to future tax revenue created the market for government debt-an essential part of today's fiat money system as well.

Goldsmith Bankers

Medieval England also saw the emergence of the goldsmith banker. Since no actual banks existed at this time, merchants and noblemen who had received gold specie in exchange for goods and services rendered, entrusted their wealth with a London goldsmith. In exchange for each deposit of precious metal, the goldsmiths issued paper receipts certifying the quantity and purity of the metal held on deposit. The goldsmith receipts like the tally sticks soon

began to circulate as a safe and convenient form of money backed by gold and silver in the goldsmiths' vaults. It didn't take long for the goldsmiths to realise that they could temporarily lend deposits out and collect interest on such loans. The temptation was too much and before long, they began issuing additional receipts for gold even if they were not backed by a deposit. This came to be known as ‘fractional reserves banking’ – lending out far more money than one actually has on deposit and the road to banking ruin was firmly in place.

The government and central bank of the day was still in the hands of the monarchy apart from a short Cromwellian experiment in the early 17th century. By 1660 Charles II was raising taxes although he did have to get parliaments permission. He immediately went to cash in the future tax receipts by selling tally sticks to the goldsmiths at a discount. The introduction of making debt payable to the bearer allowed the goldsmiths to sell it in the secondary market to raise funds for more lending to the King. In order to attract more funds higher interest rates were paid to the depositors. At that stage of the game the goldsmiths had a good thing going for them, since the King was the equivalent of a triple A rated sovereign borrower, who could always be relied upon to cover his debt with future tax receipts. Despite the fact that the vaults soon contained more wooden sticks than gold and the King meanwhile had begun to issue tally sticks as he pleased, no-one thought it problematic especially as this increase in wooden stick production had started a seemingly prosperous credit boom. The natural limit to debt expansion is when your creditors no longer are willing to lend you more money despite of higher rates. By 1671 the annual discount on the King's debt had reached 10% and new funds were barely enough to cover maturing loans. Time was running out. A plan was called for and with some legal advice the ‘discovery’ that usury was still illegal; all interest rates in excess of 6% were not permissible. All the recent loans were now declared illegal and payment was stopped. Overnight the Kings' tally sticks reverted back to their real worth –**firewood**. The Kings' creditors, the goldsmiths and their customers had “**drawn the short end of the stick**” (the origin of a still used expression).

What the tally stick system and its application by Charles II shows us is that a fiat money system can work for many years where worthless pieces of wood or paper are

deemed to have the same value as gold as long as there is complete faith in the government to not increase the supply of wood. Unfortunately in our history to date, no government has been able to resist the temptation to spend the future's productivity for today's consumption.

Fun in Florence

Since the beginning of time banking has made and lost fortunes for those involved in its activities. This has happened on a fairly regular basis for hundreds of years. One of the best examples was of the great Florentine banking dynasties of the middle ages. Established to assist in the new world of industry and growing cross border trading the great names of Medici, Bardi and Peruzzi to name a few, sprung up accepting deposits from wealthy nobleman and merchants which they lent to monarchs and the papacy to finance international and religious conflict.

Many of these were created as family businesses with unlimited liabilities and had numerous branches across Europe. Although the loans were often made to the AAA credit monarchs of the day, the doors of the Bardi and Peruzzi banks closed between 1343 and 1346. This was mainly due to the non repayment of gigantic loans by King Edward III of England which he had taken to finance The Hundred Years War with France. The Spinelli bank collapsed in 1456 as Pope Calixtus III reneged on his debts. Even the Medici bank, the largest and wealthiest in the 15th century credited with the financial innovation of the bill of exchange did not survive and folded in 1494. Many products created in the Middle Ages were to facilitate trade without carrying large quantities of gold specie and to avoid the receiving of interest usury still forbidden by most religions. The two belligerents of the English War of the Roses, The Lancastrians and the Yorkists who finally settled their differences at Bosworth Field nine years earlier were unable to repay their loans to the Medici bank which was the final nail in the coffin for the Citibank of the time.

As the economist J.K.Galbraith wrote in 1994, financial innovation is usually based on an extension of leverage.

As the medieval goldsmiths realised, the basis of Fractal Reserve banking is simplicity itself. You receive deposits for which you pay X % with which you make loans at X+ %. The difference in the maturity of the deposits and loans, the spread and the number of loans you make levered of the deposit base all factor into the equation of profitability. As does the correct analysis of risk and the diversification in determining the margin for potential defaults. Every bank failure in history has resulted from the incorrect analysis of the potential changes in these factors. While some seemingly conservative banks will fail at times as well as the more foolhardy; poor forecasting abilities are always at the fore front. In the pursuit of profits amid heavy competition, bankers find new ways and hopes to avoid natural business cycle events. Not all as stupid as others.

Northern Rock's aggressive lending practices in the buy-to-let market with U.K. house prices at over six times income, which had to be mostly financed with wholesale funding, set a new level in stupidity. Obviously these days there is more excuse to be imprudent as a banker rather than in 15th century Florence. Instead of the possibility of wiping out your entire family fortune and in some cases death, most reckless bankers of today receive millions as they lose their jobs and in some exceptionally ridiculous cases even get to keep both. Only the shareholders lose as the bankers can use the old politician's line "**everyone** has under estimated this current situation".

Of course that is not true, some people have fared better than others. UBS's spectacular fall from grace with its exceptional use of financial leverage is hard to beat although Royal Bank of Scotland's purchase of ABN Amro at the credit bubble zenith is a close contender. Unfortunately if you are too conservative all the time, your shareholders will punish you for not taking enough risk when all the others are coining it and won't remember you when you are still in business and the others have folded. It is a hard job to be very aggressive and make hay when the sun shines and scale down and keep your powder dry when the risk/reward is skewed against you. Not everyone can be John Paulson or Goldman Sachs after all. Some mere mortals will just ride the business cycle up and down. Unfortunately again like politicians they believe in their own "BS" on the up wave and cite market conditions on the down wave.

A Clue in the Yield Curve

While there are too many factors in this current banking saga to discuss at length in this letter, one is worth mentioning. The yield curve, the range of potential returns dependent on the maturity of the monies lent or borrowed might with all the benefit of hindsight has produced some warning as to the ongoing profitability of the banking system. Borrowing short term and lending longer term is the normal state of affairs in the banking business. Whether the actual government/credit curves show you a normal upward sloping yield curve or it is in a more implied way of paying low deposit rates while lending to risky lenders at higher longer term rates, it is all about the difference in the two and the management of the maturity spectrum. The steeper the curve and hence wider the spread the more profitable the enterprise. Obviously this makes perfect rational sense and as the chart 1 below suggests, the net interest margins have tended to rise as the yield curve has steepened and fallen as the yield curve has flattened. Banks' profits have to a great degree followed that pattern until the great progressive flattening as Saint Alan Greenspan raised the federal funds rate 17 times by 25bps a go from May 2004-June 2006. By the end of this mammoth task, the Federal rates had risen to 5.25% with 10 year rates still trading in the 4.50/5.00% range. There have been many discussions on this period with the massive foreign inflows into the longer end of the curve usually the concluding culprit to this excessive flattening. The fact remains that the curve was flat if not inverted and stayed that way until earlier this year before steepening rapidly again.

The fact that banks' profits continued to rise into the stratosphere despite no help at all from the yield curve was a clue. While at the time we might have believed that with new financial innovation, securitisation, wealth management divisions and insurance sidelines the banks were immune from the timeless yield curve. Of course now we know that Galbraith was right. For financial innovation, read more leverage and more risk. In the end good old fashioned poor risk management, little understanding of the business cycle and greed fuelled over leverage is bringing the house down.

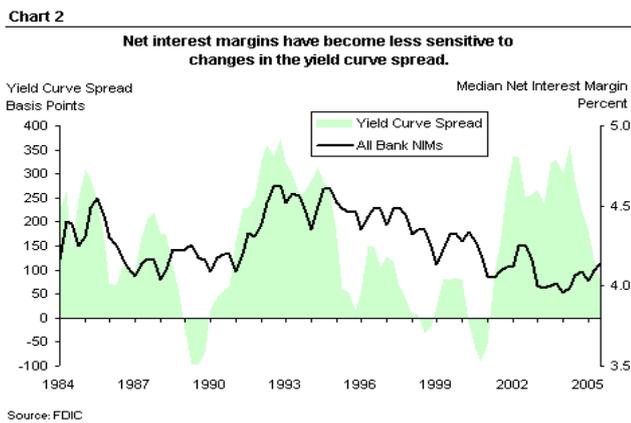


Chart 1: FDIC, 2008

The Future

How will the banks emerge from the current problems? From their 2006/2007 highs, most banks have lost at least 50% of their market capitalisations. Since the time of writing this piece, eleven US banks have folded including Lehman Bros and Merrill Lynch has been bought by Bank of America. AIG, the insurer to all, looks to be heading towards conservatorship. "Too big to fail."

While comparing banking crises of the past to a current situation will always raise a debate about how it is different this time but there are more similarities than differences in most cases. The Japanese banking crisis of the 1990s is the most recent comparison. In 1989 the great securities house of Nomura had a market capitalisation greater than all the US banks together at that time. Everyone looked to the East as the soon to be exposed ponzi scheme elevated property prices to extraordinary levels. Stories of the Imperial Palace garden real estate being worth more than California were read in amazement. Interrelated cross holdings fuelled by cheap money and financed by ever increasing property prices were all the rage. And then it stopped.

The charts below show stock prices of four large institutions since 1988.



Chart: Nomura Holdings Inc (Japan) Monthly 1988-2008
 Source: Bloomberg



Chart: Daiwa Securities Inc (Japan) Monthly 1988-2008
 Source: Bloomberg



Chart: Nippon Credit Bank Ltd (Japan) Monthly 1988-2008
 Source: Bloomberg

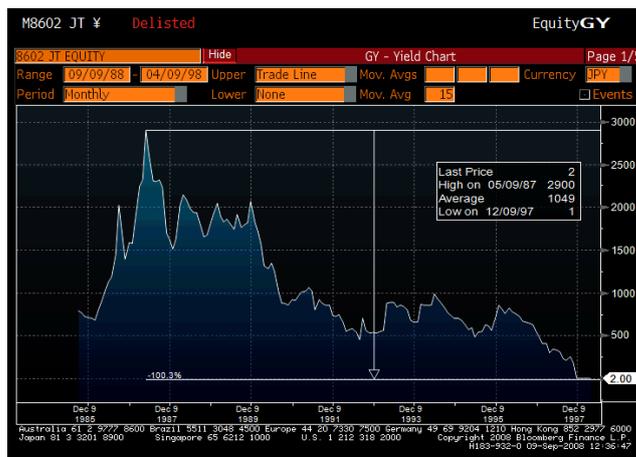


Chart: Yamaichi Securities Co Ltd Monthly 1988-2008
 Source: Bloomberg

Nomura and Daiwa share prices dropped by around 70% quickly and have gone nowhere in the last eighteen years. Yamaichi took eight years before going bankrupt while Nippon Credit Bank managed to merge in the same time. All the household bank names, Daiichi-Kangyo, Long Term

Credit, Fuji and numerous others only exist now in some merged form. Japanese historic cost accounting will be blamed for not realising losses quicker and a delayed response by the Bank of Japan cited as well for not doing enough fast enough.

How different is it today? I would argue that the losses are potentially larger and despite the complexities of some new product structures it is clearer that the residual values are easier to value at zero than Tokyo real estate was. It is all very debatable and not many people are fully aware of the facts. Certainly not the hordes of bank stock bottom pickers including sovereign wealth funds that have been very early to declare "great value".

I would imagine that many more small banks will fold, some larger players will merge and maybe another big name will close the doors. What seems most likely is that given the current climate and the foreseeable future, profits are going to be hard to make as we drip feed the mark to markets closer to the bid side (and trust me they aren't close at the moment) and the share prices will probably range trade for many years. It is very possible that the whole business plan is in jeopardy as the accessibility and cheapness of funds becomes yesterday's trade. The Irish and Spanish banks look particularly vulnerable given their property exposures but very few will escape more testing times ahead.

It must be said at this time that Ben Bernanke, the Federal Reserve chief has done what has to be done for the US banking industry to have a future by steepening the yield curve by 200bps and accepting any collateral whatsoever to provide on going liquidity. It will not be enough for many banks, nine failures in the US to date and might not be enough for the entire system if the brown stuff really hits the fan but he has stared into the abyss and he is doing everything he can. Jean-Claude Trichet of the ECB with the unenviable task of trying to manage a multitude of economies who are still on different business cycles acted quickly in delivering massive assistance to the money markets, more than \$100m in a single day. With a strict anti-inflation policy the recent interest rate rise was foreseen but will likely be reversed as growth falls.

A Special Case

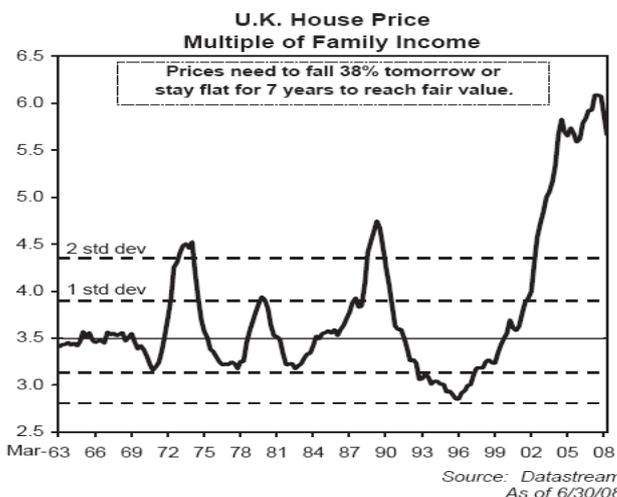
The U.K. MPC stands out as the most inept. Whether it is a case of "deer in the headlights", a moral hazard stand or just plain stupidity remains to be seen. With the most overvalued housing market, the most individually indebted population and an inverted yield curve, Mervyn King and his merry men have chosen to do very little and are still afraid to act in a decisive manner. The rate-raising hawk MPC member Tim Besley managed to have an article in "The Sun" newspaper (presumably no-one else wanted it) to talk to the normal people about the perils of inflation and why they should not ask for large wage increases for the good of the people. This seems rather like a pacifist's dilemma, refusing to kill to protect his wife and daughters from the invading hordes in wartime. Neither option is good but one is distinctly better than the other. "Inflate or die", Richard Russell of Dow Theory Letters used to say.

Mind The Gap

The chart below shows the gap between the normal ratio of income/house prices and our current level. This gap will be closed one way or another. Either house prices which are already dropping fall an additional 40% or the wage level will rise to close the gap or a combination of both. I'm sure Tim Besley's Sun readers would prefer to risk a wage price spiral than might cost jobs as profitability drops rather than to see their house price halve and be in negative equity for

years. It is too late for a good solution, you have missed the boat. Now is a time for crisis management.

U.K. House Prices Will Really Decline!



Cut Rates, issue a lot of long gilts to fund the soon to be huge deficit gap and steepen the yield curve. Let some wage inflation in which might help consumption, despite job losses and focus on closing the house/wage gap and how you can start over again. That happens with a more rigid monetary policy and credit controls.

The alternative is too horrible to contemplate. You can jump out of a 3rd story window or a 10th. Both are going to hurt and you might not survive either but one is a distinctly better option.

Another Dilemma

As in Tokyo fifteen years ago when the Mayor discovered that despite employing thousands of workers, the banking industry paid no taxes because of ongoing losses, Michael Bloomberg, New York's Mayor is well aware of the precarious situation facing the city's budget as banks are demanding a repayment of pre-paid taxes as they post record losses.

The U.K., as ever slow to the party seems blissfully unaware of the fiscal catastrophe steamrolling towards the governments' finances. The HMRC collected £410 billion in 2005/2006 and at least that if not 10% higher in 2006/2007. According to some estimates as much as 30% of all taxes collected, some £120 billion was paid by the banking industry either directly through corporate business tax or indirectly by banking and finance personnel. Last week's news story was that Merrill Lynch had posted some \$29 billion losses to their U.K. subsidiary and would not be paying any taxes for 60 years!!! As these business losses add up and job losses in the financial industry increase, Gordon Brown and his chums are going to be looking under every mattress to make up this huge hole. While it has been very fashionable to moan about huge city bonuses and non-dom privileges, the unfortunate fact has been that the financial industry has been paying 1/3 of the U.K. taxes for many years and that is now coming to an abrupt halt. Some very tough choices will have to be made by this government and the next as they join the individuals' struggles to manage their finances.

Modern Day Printing

This is a very emotive subject and many commentators refer to the “spigots” being turned on or the FED is “pumping” liquidity into system by “printing” money. We felt it was time to examine a simple idea yet complex mechanism.

The Mandrake Mechanism is a term coined by Edward Griffin in his book entitled *The Creature from Jekyll Island* - a second look at the Federal Reserve. Mandrake the Magician was a comic strip character from the 1940s. He had the ability to magically create things and, when appropriate, make them disappear. Thus, the Mandrake Mechanism was aptly named in his honour. (Excerpt from book below):

The *Mandrake Mechanism* is "the method by which the Federal Reserve creates money out of debt". It is how the government is able to create almost limitless money through the Monetization of debt via the manipulation of the reserve requirement amongst banks.

That's really all one needs to know about the operation of the banking cartel under the protection of the Federal Reserve. But it would be a shame to stop here without taking a look at the actual cogs, mirrors, and pulleys that make the magical mechanism work. It is a truly fascinating engine of mystery and deception. Let us, therefore, turn our attention to the actual process by which the magicians create the illusion of modern money. First we shall stand back for a general view to see the overall action. Then we shall move in closer and examine each component in detail.

The Mandrake Mechanism: an overview

The entire function of this machine is to convert debt into money. It's just that simple. First, the Fed takes all the government bonds which the public does not buy and writes a check to Congress in exchange for them. (It acquires other debt obligations as well, but government bonds comprise most of its inventory.) There is no money to back up this check. These fiat dollars are created on the spot for that purpose. By calling those bonds "reserves," the Fed then uses them as the base for creating 9 additional dollars for every dollar created for the bonds themselves. The money created for the bonds is spent by the government, whereas the money created on top of those bonds is the source of all the bank loans made to the nation's businesses and individuals. The result of this process is the same as creating money on a printing press, but the illusion is based on an accounting trick rather than a printing trick. The bottom line is that Congress and the banking cartel have entered into a partnership in which the cartel has the privilege of collecting interest on money which it creates out of nothing, a perpetual override on every American dollar that exists in the world. Congress, on the other hand, has access to unlimited funding without having to tell the voters their taxes are being raised through the process of inflation. If you understand this paragraph, you understand the Federal Reserve System.

Now for a more detailed view. There are three general ways in which the Federal Reserve creates fiat money out of debt. One is by making loans to the member banks through what is called the Discount Window. The second is by purchasing Treasury bonds and other certificates of debt through what is called the Open Market Committee. The third is by changing the so-called reserve ratio that member banks are required to hold. Each method is merely a different path to the same objective: taking IOUs and converting them into spendable money.

The Discount Window

The Discount Window is merely bankers' language for the loan window. When banks run short of money, the Federal Reserve stands ready as the "bankers' bank" to lend it. There are many reasons for them to need loans. Since they hold "reserves" of only about one or two per cent of their deposits in vault cash and eight or nine per cent in securities, their operating margin is extremely thin. It is common for them to experience temporary negative balances caused by unusual customer demand for cash or unusually large clusters of checks all clearing through other banks at the same time. Sometimes they make bad loans and, when these former "assets" are removed from their books, their "reserves" are also decreased and may, in fact, become negative. Finally, there is the profit motive. When banks borrow from the Federal Reserve at one interest rate and lend it out at a higher rate, there is an obvious advantage. But that is merely the beginning. When a bank borrows a dollar from the Fed, it becomes a one-dollar reserve. Since the banks are required to keep reserves of only about ten per cent, they actually can loan up to nine dollars for each dollar borrowed.

Let's take a look at the math. Assume the bank receives \$1 million from the Fed at a rate of 8%. The total annual cost, therefore, is \$80,000 ($.08 \times \$1,000,000$). The bank treats the loan as a cash deposit, which means it becomes the basis for manufacturing an additional \$9 million to be lent to its customers. If we assume that it lends that money at 11% interest, its gross return would be \$990,000 ($.11 \times \$9,000,000$). Subtract from this the bank's cost of \$80,000 plus an appropriate share of its overhead, and we have a net return of about \$900,000. In other words, the bank borrows a million and can almost double it in one year. That's leverage! But don't forget the source of that leverage: the manufacture of another \$9 million which is added to the nation's money supply.

The Open Market Operation

The most important method used by the Federal Reserve for the creation of fiat money is the purchase and sale of securities on the open market. But, before jumping into this, a word of warning. Don't expect what follows to make any sense. Just be prepared to know that this is how they do it.

The trick lies in the use of words and phrases which have technical meanings quite different from what they imply to the average citizen. So keep your eye on the words. They are not meant to explain but to deceive. In spite of first appearances, the process is not complicated. It is just absurd.

THE MANDRAKE MECHANISM: A DETAILED VIEW

Start with...

GOVERNMENT DEBT

The federal government adds ink to a piece of paper, creates impressive designs around the edges, and calls it a bond or Treasury note. It is merely a promise to pay a specified sum at a specified interest on a specified date. As we shall see in the following steps, this debt eventually becomes the foundation for almost the entire nation's money supply.¹³ In reality, the government has created cash, but it doesn't yet look like cash. To convert these IOUs into paper bills and check book money is the function of the Federal Reserve System. To bring about that transformation, the bond is given to the Fed where it is then classified as a...

SECURITIES ASSET

An instrument of government debt is considered an asset because it is assumed the government will keep its promise to pay. This is based upon its ability to obtain whatever money it needs through taxation. Thus, the strength of this asset is the power to take back that which it gives. So the Federal Reserve now has an "asset" which can be used to offset a liability. It then creates this liability by adding ink to yet another piece of paper and exchanging that with the government in return for the asset. That second piece of paper is a...

FEDERAL RESERVE CHECK

There is no money in any account to cover this check. Anyone else doing that would be sent to prison. It is legal for the Fed, however, because Congress wants the money, and this is the easiest way to get it. (To raise taxes would be political suicide; to depend on the public to buy all the bonds would not be realistic, especially if interest rates are set artificially low; and to print very large quantities of currency would be obvious and controversial.) This way, the process is mysteriously wrapped up in the banking system. The end result, however, is the same as turning on government printing presses and simply manufacturing fiat money (money created by the order of government with nothing of tangible value backing it) to pay government expenses. Yet, in accounting terms, the books are said to be "balanced" because the liability of the money is offset by the "asset" of the IOU. The Federal Reserve check received by the government then is endorsed and sent back to one of the Federal Reserve banks where it now becomes a...

GOVERNMENT DEPOSIT

Once the Federal Reserve check has been deposited into the government's account, it is used to pay government expenses and, thus, is transformed into many...

GOVERNMENT CHECKS

These checks become the means by which the first wave of fiat money floods into the economy. Recipients now deposit them into their own bank accounts where they become...

COMMERCIAL BANK DEPOSITS

Commercial bank deposits immediately take on a split personality. On the one hand, they are liabilities to the bank because they are owed back to the depositors. But, as long as they remain in the bank, they also are considered as assets because they are on hand. Once again, the books are balanced: the assets offset the liabilities. But the process does not stop there. Through the magic of fractional-reserve banking, the deposits are made to serve an additional and more lucrative purpose. To accomplish this, the on-hand deposits now become reclassified in the books and called...

BANK RESERVES

Reserves for what? Are these for paying off depositors should they want to close out of their accounts? No. That's the lowly function they served when they were classified as mere assets. Now that they have been given the name of "reserves," they become the magic wand to materialize even larger amounts of fiat money. This is where the real action is: at the level of the commercial banks. Here's how it works. The banks are permitted by the Fed to hold as little as 10% of their deposits in "reserve." That means, if they receive deposits of \$1 million from the first wave of fiat

money created by the Fed, they have \$900,000 more than they are required to keep on hand (\$1 million less 10% reserve). In bankers' language, that \$900,000 is called...

EXCESS RESERVES

The word "excess" is a tipoff that these so-called reserves have a special destiny. Now that they have been transmuted into an excess, they are considered as available for lending. And so in due course these excess reserves are converted into...

BANK LOANS

But wait a minute. How can this money be loaned out when it is owned by the original depositors who are still free to write checks and spend it any time they wish? The answer is that, when the new loans are made, they are not made with the same money at all. They are made with brand new money created out of thin air for that purpose. The nation's money supply simply increases by ninety per cent of the bank's deposits. Furthermore, this new money is far more interesting to the banks than the old. The old money, which they received from depositors, requires them to pay out interest or perform services for the privilege of using it. But, with the new money, the banks collect interest, instead, which is not too bad considering it cost them nothing to make. Nor is that the end of the process. When this second wave of fiat money moves into the economy, it comes right back into the banking system, just as the first wave did, in the form of...

MORE COMMERCIAL BANK DEPOSITS

The process now repeats but with slightly smaller numbers each time around. What was a "loan" on Friday comes back into the bank as a "deposit" on Monday. The deposit then is reclassified as a "reserve" and ninety per cent of that becomes an "excess" reserve which, once again, is available for a new "loan." Thus, the \$1 million of first wave fiat money gives birth to \$900,000 in the second wave, and that gives birth to \$810,000 in the third wave (\$900,000 less 10% reserve). It takes about twenty-eight times through the revolving door of deposits becoming loans becoming deposits becoming more loans until the process plays itself out to the maximum effect, which is...

BANK FIAT MONEY = UP TO 9 TIMES GOVERNMENT

The amount of fiat money created by the banking cartel is approximately nine times the amount of the original government debt which made the entire process possible. When the original debt itself is added to that figure, we finally have...

TOTAL FIAT MONEY = UP TO 10 TIMES GOVERNMENT

The total amount of fiat money created by the Federal Reserve and the commercial banks together is approximately ten times the amount of the underlying government debt. To the degree that this newly created money floods into the economy in excess of goods and services, it causes the purchasing power of all money, both old and new, to decline. Prices go up because the relative value of the money has gone down. The result is the same as if that purchasing power had been taken from us in taxes. The reality of this process, therefore, is that it is a...

HIDDEN TAX = UP TO 10 TIMES THE NATIONAL DEBT

Without realizing it, Americans have paid over the years, in addition to their federal income taxes and excise taxes, a completely hidden tax equal to many times the national

debt! And that still is not the end of the process. Since our money supply is purely an arbitrary entity with nothing behind it except debt, its quantity can go down as well as up. When people are going deeper into debt, the nation's money supply expands and prices go up, but when they pay off their debts and refuse to renew, the money supply contracts and prices tumble. That is exactly what happens in times of economic or political uncertainty. This alternation between period of expansion and contraction of the money supply is the underlying cause of...

BOOMS, BUSTS, AND DEPRESSIONS

Who benefits from all of this? Certainly not the average citizen. The only beneficiaries are the political scientists in Congress who enjoy the effect of unlimited revenue to perpetuate their power, and the monetary scientists within the banking cartel called the Federal Reserve System who have been able to harness the American people, without their knowing it, to the yoke of modern feudalism.

Reserve Ratios

The previous figures are based on a "reserve" ratio of 10% (a money-expansion ratio of 10-to-1). It must be remembered, however, that this is purely arbitrary. Since the money is fiat with no previous-metal backing, there is no real limitation except what the politicians and money managers decide is expedient for the moment. Altering this ratio is the third way in which the Federal Reserve can influence the nation's supply of money. The numbers, therefore, must be considered as transient. At any time there is a "need" for more money, the ratio can be increased to 20-to-1 or 50-to-1, or the pretence of a reserve can be dropped altogether. There is virtually no limit to the amount of fiat money that can be manufactured under the present system.

NATIONAL DEBT NOT NECESSARY FOR INFLATION

Because the Federal Reserve can be counted on to "monetize" (convert into money) virtually any amount of government debt, and because this process of expanding the money supply is the primary cause of inflation, it is tempting to jump to the conclusion that federal debt and inflation are but two aspects of the same phenomenon. This, however, is not necessarily true. It is quite possible to have either one without the other.

The banking cartel holds a monopoly in the manufacture of money. Consequently, money is created only when IOUs are "monetized" by the Fed or by commercial banks. When private individuals, corporations, or institutions purchase government bonds, they must use money they have previously earned and saved. In other words, no new money is created, because they are using funds that are already in existence. Therefore, the sale of government bonds to the banking system is inflationary, but when sold to the private sector, it is not. That is the primary reason the United States avoided massive inflation during the 1980s when the federal government was going into debt at a greater rate than ever before in its history. By keeping interest rates high, these bonds became attractive to private investors, including those in other countries.¹⁵ Very little new money was created, because most of the bonds were purchased with American dollars already in existence. This, of course, was a temporary fix at best. Today, those bonds are continually maturing and are being replaced by still more bonds to include the original debt plus accumulated interest. Eventually this process must come to an end and, when it does, the Fed will have no choice but to literally buy back all the debt of the '80s -- that is, to replace all of the formerly invested private money with

newly manufactured fiat money -- plus a great deal more to cover the interest. Then we will understand the meaning of inflation.

On the other side of the coin, the Federal Reserve has the option of manufacturing money even if the federal government does not go deeper into debt. For example, the huge expansion of the money supply leading up to the stock market crash in 1929 occurred at a time when the national debt was being paid off. In every year from 1920 through 1930, federal revenue exceeded expenses, and there were relatively few government bonds being offered. The massive inflation of the money supply was made possible by converting commercial bank loans into "reserves" at the Fed's discount window and by the Fed's purchase of banker's acceptances, which are commercial contracts for the purchase of goods.

Now the options are even greater. The Monetary Control Act of 1980 has made it possible for the Creature to monetize virtually any debt instrument, including IOUs from foreign governments. The apparent purpose of this legislation is to make it possible to bail out those governments which are having trouble paying the interest on their loans from American banks. When the Fed creates fiat American dollars to give foreign governments in exchange for their worthless bonds, the money path is slightly longer and more twisted, but the effect is similar to the purchase of U.S. Treasury Bonds. The newly created dollars go to the foreign governments, then to the American banks where they become cash reserves. Finally, they flow back into the U.S. money pool (multiplied by nine) in the form of additional loans. The cost of the operation once again is born by the American citizen through the loss of purchasing power. Expansion of the money supply, therefore, and the inflation that follows, no longer even require federal deficits. As long as someone is willing to borrow American dollars, the cartel will have the option of creating those dollars specifically to purchase their bonds and, by so doing, continue to expand the money supply.

We must not forget, however, that one of the reasons the Fed was created in the first place was to make it possible for Congress to spend without the public knowing it was being taxed. Americans have shown an amazing indifference to this fleecing, explained undoubtedly by their lack of understanding of how the Mandrake Mechanism works. Consequently, at the present time, this cosy contract between the banking cartel and the politicians is in little danger of being altered. As a practical matter, therefore, even though the Fed may also create fiat money in exchange for commercial debt and for bonds of foreign governments, its major concern likely will be to continue supplying Congress.

The implications of this fact are mind boggling. Since our money supply, at present at least, is tied to the national debt, to pay off that debt would cause money to disappear. Even to seriously reduce it would cripple the economy. Therefore, as long as the Federal Reserve exists, America will be, must be, in debt.

The purchase of bonds from other governments is accelerating in the present political climate of internationalism. Our own money supply increasingly is based upon their debt as well as ours, and they, too, will not be allowed to pay it off even if they are able.

EXPANSION LEADS TO CONTRACTION

While it is true that the Mandrake Mechanism is responsible for the expansion of the money supply, the process also works in reverse. Just as money is created when the

Federal Reserve purchases bonds or other debt instruments, it is extinguished by the sale of those same items. When they are sold, the money is given back to the System and disappears into the inkwell or computer chip from which it came. Then, the same secondary ripple effect that created money through the commercial banking system causes it to be withdrawn from the economy. Furthermore, even if the Federal Reserve does not deliberately contract the money supply, the same result can and often does occur when the public decides to resist the availability of credit and reduce its debt. A man can only be tempted to borrow; he cannot be forced to do so.

There are many psychological factors involved in a decision to go into debt that can offset the easy availability of money and a low interest rate: A downturn in the economy, the threat of civil disorder, the fear of pending war, an uncertain political climate, to name just a few. Even though the Fed may try to pump money into the economy by making it abundantly available, the public can thwart that move simply by saying no, thank you. When this happens, the old debts that are being paid off are not replaced by new ones to take their place, and the entire amount of consumer and business debt will shrink. That means the money supply also will shrink, because, in modern America, debt is money. And it is this very expansion and contraction of the monetary pool -- a phenomenon that could not occur if based upon the laws of supply and demand -- that is at the very core of practically every boom and bust that has plagued mankind throughout history.

In conclusion, it can be said that modern money is a grand illusion conjured by the magicians of finance in politics. We are living in an age of fiat money, and it is sobering to realize that every previous nation in history that has adopted such money eventually was economically destroyed by it. Furthermore, there is nothing in our present monetary structure that offers any assurances that we may be exempted from that morbid roll call.

Correction. There is one. It is still within the power of Congress to abolish the Federal Reserve System.

Summary

The American dollar (for example) has no intrinsic value. It is a classic example of fiat money with no limit to the quantity that can be produced. Its primary value lies in the willingness of people to accept it and, to that end, legal tender laws require them to do so. It is true that our money is created out of nothing, but it is more accurate to say that it is based upon debt. In one sense, therefore, our money is created out of less than nothing. The entire money supply would vanish into the bank vaults and computer chips if all debts were repaid. Under the present System, therefore, our leaders cannot allow a serious reduction in either the national or consumer debt. Charging interest on pretended loans is usury, and that has become institutionalized under the Federal Reserve System. The Mandrake Mechanism by which the Fed converts debt into money may seem complicated at first, but it is simple if one remembers that the process is not intended to be logical but to confuse and deceive. The end product of the Mechanism is artificial expansion of the money supply, which is the root cause of the hidden tax called inflation. This expansion then leads to contraction and, together, they produce the destructive boom-bust cycle that has plagued mankind throughout history wherever fiat money has existed.

When asset prices go up, with very few exceptions, nobody questions it. People feel richer and revel in their prosperity, often illusory. When markets fall and nominal prices rescind, people question, why? Few look at the causes just

the effect. In the fullness of time, time will perhaps become full. Maybe we have reached that critical moment in modern "economic history". It would appear that all is not New in Banking, as we flippantly title this piece. In reality the derivative monster the banking system has spawned is greater than anything in history and actually we are seeing centuries of fraudulent money systems come to a head. The systemic risk in global finance is REAL. We are right to be fearful. Governments are potentially fighting a losing battle by trying to drain risk out of the system by "opening the printing inks" and letting them flow. In reality we may well head to even more confiscation of freedom via a full scale nationalisation of the global economy.

As Ludwig von Mises wrote in *The Theory of Money and Credit* (1959)

A government that sets out to abolish market prices is inevitably driven toward the abolition of private property; it has to recognise that there is no middle way between the system of common ownership of the means of production, or socialism. It is gradually forced toward the compulsory production, universal obligation to labour, rationing of consumption, and, finally, official regulation of the whole of production and consumption.

Investment in Hinde Gold Fund through SIPP (UK)

Most SIPP providers have set up HGF as an investment security on their platforms and although some of our investors have used this tax efficient method for their investment we are trying to encourage more in the future. SIPPs have become far more standardised now than in the past and the government is encouraging these DIY pension plans in light of the real possibility of a shortage of state funding in our lifetime. They have become easy to set up and the charges of set up and maintenance are now very low in comparison to the big pension providers not to mention the increased transparency and on-line access for asset value and dealing.

A £50,000 cash amount can be paid into a SIPP which is deemed net of basic rate tax. The SIPP claims 6 weeks later or so £14,100 from HMRC ((50/0.78)-50) and now the total in the fund is £64,100. That is the gross amount so clients basic rate tax band is extended by that, and if they have earned say in excess of £100,000 they then get a tax rebate of 18% of the gross amount. A cheque or tax saving of £11,540 ((64.1kX 40%)-(14.1k rebated into SIPP) Note. Next week basic rate goes down to 20% which makes a difference on what gets added in tax direct from HMRC but not the net effect to investor.

Also many people who have worked in city or other institutions that have paid into a separate company pension scheme for many years can transfer all of these monies from each plan into one SIPP and manage it themselves accordingly. Again the costs of transfers have dropped dramatically recently making this a more compelling plan for everyone.

If you have any questions on these matters please call one of team at Hinde Capital Ltd. Our Website is www.hindecapital.com. All documentation on Fund and how to subscribe can be accessed there. Or alternatively please send all subscription requests to info@hindecapital.com