

# A View from the Trenches Toronto, Monday, September 21<sup>st</sup>, 2009

Good morning,

Today's is unfortunately a short letter, as I have had a very busy week and even busier weekend. Nevertheless, below I describe what I believe was and will be a very relevant theme during the last and coming weeks: Central banks coordination.

I've been trying unsuccessfully to edit a handwritten draft I wrote on this subject, but here is a main point:

In a global world with fiat money, if monetary policies are coordinated, it is perfectly possible to see a certain mathematical set, a certain path, of foreign exchange crosses compatible with increasing demand for consumption and investment goods. In formal notation:

$$\exists \quad (\text{usd/cad, usd/eur, usd/rmb, \dots, cad/nok, \dots, fx i/fx j}) \quad \text{where:} \quad \Delta (C + I) / \Delta t > 0$$

This is Bernanke & Friends' plan to get us out of this mess (For those interested in the details, this framework was first suggested by Patinkin, using a Walrasian model of a monetary economic system and including the net wealth effect). The key for this undetermined system (it is undetermined because multiple different foreign exchange crosses or price relationships can potentially satisfy this recovery process) to succeed is that there must not be a "deflator" for the main fiat policies. In statistics, a deflator is a value that allows data to be measured over time in terms of some base period usually through a price index in order to distinguish between changes in the money value of GNP which result from a change in prices and those which result from a change in physical output (<http://en.wikipedia.org/wiki/Deflator>). As such, it can also be used as a reserve asset. Gold therefore is a perfect deflator. Thus, if you believe my thesis, the key is that gold does not become a reserve asset.

This means that it is not possible to see multiple paths for  $\Delta (C + I) / \Delta t > 0$ , when people challenge central banks and change the set (usd/cad, usd/eur, usd/rmb, ..., cad/nok, ..., fx i/fx j) for the following set:

$$(\text{usd/Gold, cad/gold, gbp/gold, eur/gold, \dots, Fx i/gold})$$

For gold not to become a reserve asset, central banks have to coordinate a way to slowly debase their currencies in synchrony. This is what they are starting to do. China has been leading the way, followed by Canada. China started the process with its swaps of Agencies for Treasuries. Canada followed with the decision to issue USD4BN in federal government bonds, which were going to fund its capitalization portion in the IMF. But last week, we saw a firm confirmation of this process with the announcement by Germany.

Last week, Germany decided to issue a \$4 billion 3-year in the USD. This would be the first time it borrows in USD, since 2005. Other European nations have also approached the USD market (Spain, Belgium and Austria).

The excuse is that the cost of raising USD is lower than raising Euros. However, when governments can enforce fiat money upon its citizens but choose not to issue debt in their own currencies, they are not being efficient. In other words, these nations as well as Canada are giving up their right to seigniorage (<http://en.wikipedia.org/wiki/Seigniorage>). And there is no way you will ever convince me that a few bps differential between interest rates can make up for the cost of giving up this valuable right!

The real reason behind this that the political class of the world seeks to coordinate a global bid for the USD, to prevent gold from becoming a reserve currency. Politicians do not want the set: (usd/Gold, cad/gold, gbp/gold, eur/gold, ..., Fx i/gold) to become a reality. They do not want their deficits to be killed by the rigorous benchmark gold represents.

This is indeed going to be a long and tiresome war. Get ready!