

A View from the Trenches

Toronto, Friday, August 19th, 2011

Good morning,

In light of the events yesterday, which in our view were mainly driven by fears of US dollar funding problems in the Eurozone banks, we thought it would be appropriate to reproduce our comments from [June 4th, 2010](#), which anticipated a scenario like yesterday's. From the comments, it should be clear that the ongoing environment is and probably will continue to be highly supportive of gold and bearish of stocks. The only thing that could change things here is a strong, determined will to fiscally integrate ALL members of the Eurozone and the simultaneous announcement of Euro bonds (to understand how they would work, please refer our letter from [January 28th, 2011](#)). Below, our comments from June 4th, 2010:

"...At "A View from the Trenches" we were ahead of the curve, anticipating this "content problem" (refer: www.sibileau.com/martin/2010/05/10, "What to expect when you are expecting"), associated with secondary market purchases even before the announcement of the ECB's plan. Back then we wrote:

"...the ECB would tend to behave like a convertibility board, where sovereign debt is converted to Euros. Therefore, under scenario B, the supply of money would be determined by the growth rate of the EU's consolidated fiscal deficit! The ECB is not under control but is always "chasing the rabbit"... Governments puke debt and ECB comes after and cleans up buying in the secondary! Thus, what would be the exit strategy under scenario B? In the long run, the only way out for the ECB under scenario B is a consolidated fiscal surplus, which is totally out of ECB's hands. De facto, the ECB is denied an exit strategy..."

There is also another criticism that we think is unwarranted, namely, the short term nature of the existing currency swap contracts between the ECB and the Fed. It is maintained that because these contracts are renewed on a weekly basis, instead of a longer-term (i.e. 84 days), USD funding conditions remain "uncertain", which does not contribute to calm the markets. We believe the opposite is true. If the Fed validated the capital investments in the Euro-zone via currency swaps, which are nothing else but a hidden bailout of financial institutions, the Fed would be feeding the bullish trend in gold, at the expense of future higher USD inflation and of US taxpayers, and delaying an adjustment that would affect the ECB's balance sheet more violently.

The term mismatch in the currency swaps (1-week) and the 3-mo Libor-OIS benchmark, as well as the uncertainty over its renewal sends a clear signal to those yet surviving that they need to unwind and take losses. In 1965, M. Jacques Rueff (http://en.wikipedia.org/wiki/Jacques_Rueff) described a very similar situation occurring in the '20s with "currency swaps" between Britain and France, in this way:

"There is a very interesting document from this period, a letter from Sir Austen Chamberlain, who was then Foreign Secretary in London, to M. Poincaré, who was Prime Minister and Finance Minister in France; it must be of 1928. Sir Austen said, "We know that you are entitled to ask gold for your sterling, but in the frame of the close friendship between Britain and France we ask you, so as to avoid trouble for the City of London, not to do that." And we were, I must say, weak enough to comply with this request and not ask for gold. The fact that I had such important sterling deposits in London shows that we did not use this right to ask for gold. The adjustment, which would hardly have been felt if carried out on a day-to-day basis, was not made, and we had the fantastic boom of 1927, 1928, and 1929. This explains the depth of the collapse and of the depression, because the adjustment was so long delayed." (J. Rueff, "The Monetary Sin of the West", 1972)

Back in those days, as the Sterling and French Franc were backed by gold, the currency swap consisted in having Paris "lend" gold reserves to London, to address funding problems. The 2010 version of the same problem could read like this:

"There is a very interesting document from this period, a letter from M. Trichet, who was then the European Central Bank's President, to Mr. Bernanke, who was the Chairman of the U.S. Federal Reserve; it must be of 2011. M. Trichet said, "We know that you are entitled to ask dollars for your dollars, but in the frame of the close friendship between the European Union and the United States we ask you, so as to avoid trouble for the European Union, not to do that, and receive Euros instead." And we were, I must say, weak enough to comply with this request and not ask for dollars. The fact that I had such important U.S. dollar deposits in Frankfurt shows that we did not use this right to ask for U.S. dollars. The adjustment, which would hardly have been felt if carried out on a day-to-day basis, was not made, and we had the fantastic boom of 2009 and 2010. This explains the depth of the collapse and of the depression, because the adjustment was so long delayed."..."

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