

# A View from the Trenches

Toronto, Thursday, December 1<sup>st</sup>, 2011

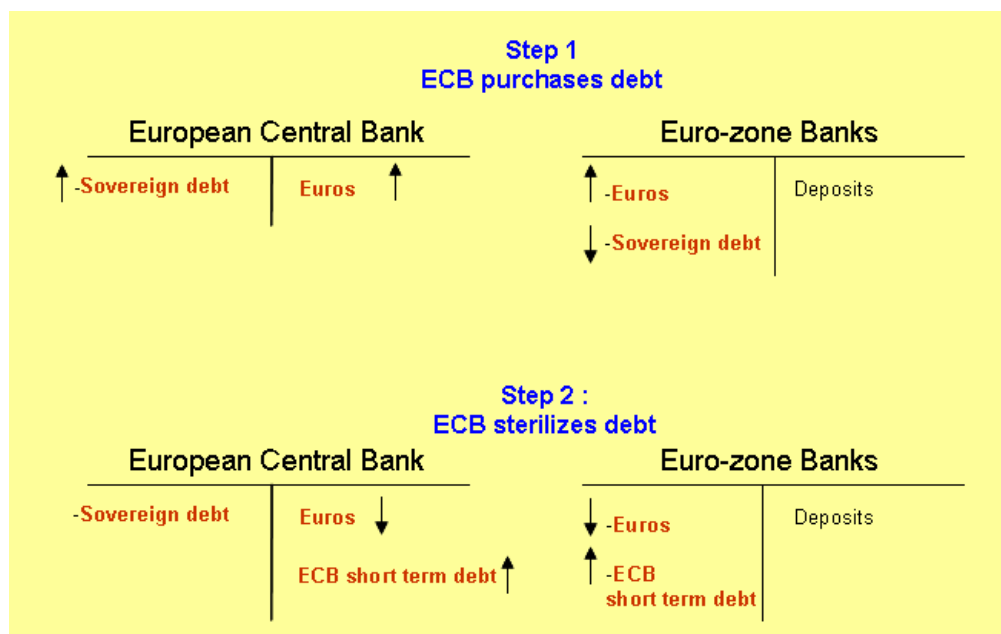
Good morning,

The coordinated action of central banks yesterday changed our short-term view. We had written in our last letter that we expected the fragile global financial system to collapse, with people taking matters into their own hands and, as Murray Rothbard once described: “...insisting upon a rigorous deflation (gauged by the increase of money in circulation)— and a rigorous testing of the country’s banking system in which they had placed their trust...”

Until Tuesday, we were certainly in that direction. But the announcement of cheaper US swaps from the Fed to the European Central Bank (“ECB”) has now lengthened the day of reckoning. What makes us think that we were right about the direction? Over the last two weeks, the Eurozone banks kept steadily increasing the utilization of liquidity lines provided by the ECB, the Euro/USD swap basis (i.e. the price that the Fed precisely wants to keep under control) continued to widen to 165bps, and lastly, on Tuesday, the ECB failed to sterilize all the money they printed to buy EU sovereign bonds.

Therefore, as we can see, the markets had become “inelastic” to prices, in their demand for liquidity. They kept bidding for it were it was supplied, they paid for it way above the “official” price (100bps was the “official” cost of a EU/USD swap and the LIBO rate did and does not represent the true cost of funding) and they did not find the price offered by the ECB good enough to let liquidity go back home (i.e the central bank). This last point, the failure to sterilize, is important.

As per the figure below, to keep the quantity of Euros printed to buy debt unchanged (Step 1), the ECB immediately issues short-term debt, which the banks, which had sold that toxic debt, buy. When they buy the short-term debt, they give their euros back to the ECB.



This worked well since May 2010, when it was first implemented, until last Tuesday. This week, the banks did not purchase all of the ECB debt. Why? Was the yield offered by the ECB not good enough? No. The problem is that you can't pay EU banks enough to let those hard earned Euros go. Why? Because these banks were already beginning to see deposit withdrawals. All these signals confirmed to us that the endgame was near and that it was the collapse of the Eurozone.

But yesterday's announcement of cheaper EUR/USD swaps starting December 5<sup>th</sup> kicks the proverbial can down the road...again! Now, at "A View from the Trenches", we have shown leadership in communicating to readers what a disgrace

Martin Sibileau

[martin@sibileau.com](mailto:martin@sibileau.com)

(647) 999-2055

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these swaps are. They transformed the recession of 1930 into the Great Depression, as Jacques Rueff documented in his book “The Monetary Sin of the West”.

With this move, Germany, who resisted the pressure to allow the ECB to monetize sovereign debt purchases, got the rest of the world to finance the deficits of the Eurozone. In particular, they got American taxpayers and everyone else in this planet who keeps his/her savings in US dollars, to finance them. Germany held the world hostage and Germany won!

Rather than liquidate those banks that were forced to hold sovereign debt (yes, forced!), generating a formidable credit crunch, the big global banks that had these unfortunate banks as counterparties, successfully lobbied the Fed to extend a blank cheque to them (i.e. the unfortunate banks), so that they do not go bankrupt. Was it for free? Or is there a commitment from the EU to also embark in monetization, in December? We don't know, but we suspect that the Fed would have not risked this move without some sort of compensation from the EU. Therefore, although money is not necessarily being created, the fact is that USD denominated assets that would have had to be sold by EU banks to shore liquidity, no longer need to be sold on the margin. This was a real transfer from Americans, who saw their purchasing power devalued immediately with the news, to the Eurozone banks, and the shareholders of those global banks who have them as counterparties.

The last aspect we want to remind the reader of is that through these swaps, the Fed is indirectly exposed to the future defaults in the Eurozone. Given their view on the problem, it is only logical to expect the Fed to push US dollar liquidity to extremes, as the root of the problem, the Euro deficits, remains in place. At the end of this much delayed story, the only winner will be gold. This monetary policy can never result in genuine growth but in inflation and we know that with inflation productivity falls.