UNDERSTANDING the Fed

How to protect yourself from the common and misleading myths about the U.S. Federal Reserve.

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Understanding the Fed:

How to Protect Yourself From the Common and Misleading Myths About the U.S. Federal Reserve

Excerpts taken from *Conquer the Crash* and *The Elliott Wave Theorist,*
both by Robert R. Prechter, Jr.

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Editor's Note: This ebook includes excerpts from Robert Prechter's book *Conquer the Crash* and his monthly letter *The Elliott Wave Theorist*. Subscribe to the *Theorist* for Bob's most up-to-date forecasts and analysis: www.elliottwave.com/wave/LatestTHE

Chapter 1

Money, Credit and the Federal Reserve Banking System

Excerpted from Conquer the Crash *— Chapter 10 — March 2002*

An argument for deflation is not to be offered lightly because, given the nature of today's money, certain aspects of money and credit creation cannot be forecast, only surmised. Before we can discuss these issues, we have to understand how money and credit come into being. This is a difficult chapter, but if you can assimilate what it says, you will have knowledge of the banking system that not one person in 10,000 has.

The Origin of Intangible Money

Originally, money was a *tangible good* freely chosen by society. For millennia, gold or silver provided this function, although sometimes other tangible goods (such as copper, brass and seashells) did. Originally, credit was the right to access that tangible money, whether by an ownership certificate or by borrowing.

Today, almost all money is *intangible*. It is not, nor does it even represent, a physical good. How it got that way is a long, complicated, disturbing story, which would take a full book to relate properly. It began about 300 years ago, when an English financier conceived the idea of a national central bank. Governments have often outlawed free-market determinations of what constitutes money and imposed their own versions upon society by law, but earlier schemes usually involved coinage. Under central banking, a government forces its citizens to accept its *debt* as the only form of legal tender. The Federal Reserve System assumed this monopoly role in the United States in 1913.

What Is a Dollar?

Originally, a dollar was defined as a certain amount of gold. Dollar bills and notes were promises to pay lawful money, which was gold. Anyone could present dollars to a bank and receive gold in exchange, and banks could get gold from the U.S. Treasury for dollar bills.

In 1933, President Roosevelt and Congress outlawed U.S. gold ownership and nullified and prohibited all domestic contracts denoted in gold, making Federal Reserve notes the legal tender of the land. In 1971, President Nixon halted gold payments from the U.S. Treasury to foreigners in exchange for dollars. Today, the Treasury will not give anyone anything tangible in exchange for a dollar. Even though Federal Reserve notes are defined as "obligations of the United States," they are not obligations to *do* anything. Although a dollar is labeled a "note," which means a debt contract, it is not a note *for* anything.

Congress claims that the dollar is "legally" 1/42.22 of an ounce of gold. Can you buy gold for $42.22 an ounce? No. This definition is bogus, and everyone knows it. If you bring a dollar to the U.S. Treasury, you will not collect any tangible good, much less 1/42.22 of an ounce of gold. You will be sent home.

Some authorities were quietly amazed that when the government progressively removed the tangible backing for the dollar, the currency continued to function. If you bring a dollar to the marketplace, you can still buy goods with it because the government says (by "fiat") that it is money and because its long history of use has lulled people into accepting it as such. The volume of goods you can buy with it fluctuates according to the total volume of dollars — in both cash and credit — and their holders' level of confidence that those values will remain intact.

Exactly what a dollar is and what *backs* it are difficult questions to answer because no official entity will provide a satisfying answer. It has *no simultaneous actuality and definition*. It may be defined as 1/42.22 of an ounce of gold, but it is not *actually* that. Whatever it actually is (if anything) may not be definable. To the extent that its physical backing, if any, may be officially definable in actuality, no one is talking.

Let's attempt to define what gives the dollar objective value. As we will see in the next section, the dollar is "backed" primarily by government bonds, which are promises to pay dollars. So today, *the dollar is a promise backed by a promise to pay an identical promise*. What is the nature of each promise? If the Treasury will not give you anything tangible for your dollar, then the dollar is a promise to pay *nothing*. The Treasury should have no trouble keeping this promise.

In Chapter 9, I called the dollar "money." By the definition given there, it is. I used that definition and explanation because it makes the whole picture comprehensible. But the truth is that since the dollar is backed by *debt*, it is actually a *credit*, not money. It is a credit against what the government owes, denoted in dollars and backed by nothing. So although we may use the term "money" in referring to dollars, there is no longer any real money in the U.S. financial system; there is nothing but credit and debt.

As you can see, defining the dollar, and therefore the terms money, credit, inflation and deflation, today is a challenge, to say the least. Despite that challenge, we can still use these terms because people's minds have conferred meaning and value upon these ethereal concepts. Understanding this fact, we will now proceed with a discussion of how money and credit expand in today's financial system.

How the Federal Reserve System Manufactures Money

Over the years, the Federal Reserve Bank has transferred purchasing power from all other dollar holders primarily to the U.S. Treasury by a complex series of machinations. The U.S. Treasury borrows money by selling bonds in the open market. The Fed is said to "buy" the Treasury's bonds from banks and other financial institutions, but in actuality, it is allowed by law simply to fabricate a new checking account for the seller in exchange for the bonds. It holds the Treasury's bonds as assets against — as "backing" for — that new money. Now the seller is whole (he was just a middleman), the Fed has the bonds, and the Treasury has the new money. This transactional train is a long route to a simple alchemy (called "monetizing" the debt) in which the Fed turns government bonds into money. The net result is as if the government had simply fabricated its own checking account, although it pays the Fed a portion of the bonds' interest for providing the service surreptitiously. To date, the Fed has monetized about $600 billion worth of Treasury obligations. This process expands the supply of *money*.

In 1980, Congress gave the Fed the legal authority to monetize any agency's debt. In other words, it can exchange the bonds of a government, bank or other institution for a checking account denominated in dollars. This mechanism gives the President, through the Treasury, a mechanism for "bailing out" debt-troubled governments, banks or other institutions that can no longer get financing anywhere else. Such decisions are made for political reasons, and the Fed can go along or refuse, at least as the relationship currently stands. Today, the Fed has about $36 billion worth of foreign debt on its books. The power to grant or refuse such largesse is unprecedented.

Each new Fed account denominated in dollars is new money, but contrary to common inference, it is not new value. The new account *has* value, but that value comes from a *reduction* in the value of all other outstanding accounts denominated in dollars. That reduction takes place as the favored institution spends the newly credited dollars, driving up the dollar-denominated demand for goods and thus their prices. All other dollar holders still hold the same *number* of dollars, but now there are more dollars in circulation, and each one purchases less in the way of goods and services. The old dollars *lose* value to the extent that the new account *gains* value. The net result is a transfer of value to the receiver's account from those of all other dollar holders. This fact is not readily obvious because the *unit of account* throughout the financial system does not change even though its *value* changes.

It is important to understand exactly what the Fed has the power to do in this context: It has legal permission to transfer wealth from dollar savers to certain debtors *without the permission of the savers*. The effect on the money supply is exactly the same as if the money had been counterfeited and slipped into circulation.

In the old days, governments would inflate the money supply by diluting their coins with base metal or printing notes directly. Now the same old game is much less obvious. On the other hand, there is also far more to it. This section has described the Fed's *secondary* role. The Fed's main occupation is not creating money but *facilitating credit*. This crucial difference will eventually bring us to why deflation is possible.

How the Federal Reserve Has Encouraged the Growth of Credit

Congress authorized the Fed not only to create money for the government but also to "smooth out" the economy by manipulating credit (which also happens to be a re-election tool for incumbents). Politics being what they are, this manipulation has been almost exclusively in the direction of making credit easy to obtain. The Fed used to make more credit available to the banking system by monetizing federal debt, that is, by creating money. Under the structure of our "fractional reserve" system, banks were authorized to employ that new money as "reserves" against which they could make new loans. Thus, new money meant new credit.

It meant a lot of new credit because banks were allowed by regulation to lend out 90 percent of their deposits, which meant that banks had to keep 10 percent of deposits on hand ("in reserve") to cover withdrawals. When the Fed increased a bank's reserves, that bank could lend 90 percent of *those* new dollars. Those dollars, in turn, would make their way to other banks as new deposits. Those other banks could lend 90 percent of *those* deposits, and so on. The expansion of reserves and deposits throughout the banking system this way is called the "multiplier effect." This process expanded the supply of *credit* well beyond the supply of money.

Because of competition from money market funds, banks began using fancy financial manipulation to get around reserve requirements. In the early 1990s, the Federal Reserve Board under Chairman Alan Greenspan took a controversial step and removed banks' reserve requirements almost entirely. To do so, it first lowered to zero the reserve requirement on all accounts other than checking accounts. Then it let banks pretend that they have almost no checking account balances by allowing them to "sweep" those deposits into various savings accounts and money market funds at the end of each business day. Magically, when monitors check the banks' balances at night, they find the value of checking accounts artificially understated by hundreds of billions of dollars. The net result is that banks today conveniently meet their nominally required reserves (currently about $45b.) with the cash in their vaults that they need to hold for everyday transactions anyway.

By this change in regulation, the Fed essentially removed itself from the businesses of requiring banks to hold reserves and of manipulating the level of those reserves. This move took place during a recession and while S&P earnings per share were undergoing their biggest drop since the 1940s. The temporary cure for that economic contraction was the ultimate in "easy money."

We still have a fractional reserve system on the books, but we do not have one in actuality. Now banks can lend out virtually all of their deposits. In fact, they can lend out *more* than all of their deposits, because banks' parent companies can issue stock, bonds, commercial paper or any financial instrument and lend the proceeds to their subsidiary banks, upon which assets the banks can make new loans. In other words, to a limited degree, banks can arrange to create their own new money for lending purposes. Today, U.S. banks have extended 25 percent more total credit than they have in total deposits ($5.4 trillion vs. $4.3 trillion). Since all banks do not engage in this practice, others must be quite aggressive at it. For more on this theme, see Chapter 19.

Recall that when banks lend money, it gets deposited in other banks, which can lend it out again. Without a reserve requirement, the multiplier effect is no longer restricted to ten times deposits; it is virtually unlimited. Every new dollar deposited can be lent over and over throughout the system: A deposit becomes a loan becomes a deposit becomes a loan, and so on.

As you can see, the fiat money system has encouraged inflation via both money creation and the expansion of credit. This dual growth has been the monetary engine of the historic uptrend of stock prices in wave (V) from 1932. The stupendous growth in bank credit since 1975 (see graphs in Chapter 11) has provided the monetary fuel for its final advance, wave V. The effective elimination of reserve requirements a decade ago extended that trend to one of historic proportion.

The Net Effect of Monetization

Although the Fed has almost wholly withdrawn from the role of holding book-entry reserves for banks, it has not retired its holdings of Treasury bonds. Because the Fed is legally bound to back its notes (greenback currency) with government securities, today almost all of the Fed's Treasury bond assets are held as reserves against a nearly equal dollar value of Federal Reserve notes in circulation around the world. Thus, the net result of the Fed's 89 years of money inflating is that the Fed has turned $600 billion worth of U.S. Treasury and foreign obligations into Federal Reserve notes.

Today the Fed's production of currency is passive, in response to orders from domestic and foreign banks, which in turn respond to demand from the public. Under current policy, banks must pay for that currency with any remaining reserve balances. If they don't have any, they borrow to cover the cost and pay back that loan as they collect interest on their own loans. Thus, as things stand, the Fed no longer considers itself in the business of "printing money" for the government. Rather, it facilitates the expansion of credit to satisfy the lending policies of government and banks.

If banks and the Treasury were to become strapped for cash in a monetary crisis, policies could change. The unencumbered production of banknotes could become deliberate Fed or government policy, as we have seen happen in other countries throughout history. At this point, there is no indication that the Fed has entertained any such policy. Nevertheless, Chapters 13 and 22 address this possibility.

For Information

There is much information available on the Fed's activities, but nowhere have I found a concise summary such as presented in this chapter. If you would like to learn more, I can start you off on your search. For a positive spin on the Fed's value, contact the Fed itself or any conventional economist. For a less rosy view, contact the Foundation for the Advancement of Monetary Education or join the Ludwig von Mises Institute and order a copy of their 150-page paperback, *The Case Against the Fed*, by Murray N. Rothbard, which is just $5 plus shipping from www.mises.org/catalog.asp. The most knowledgeable source that I have found with respect to the workings of the Federal Reserve System is Lou Crandall of Wrightson Associates, publisher of *The Money Market Observer*, a service for traders. Contact information is as follows:

The Money Market Observer

Wrightson Associates

Website: www.wrightson.com

Email: sales@wrightson.com

Address: 560 Washington St., New York, NY 10014

Phone: 212-815-6540

Fax: 212-341-9253

Editor: Lou Crandall

Federal Reserve

Website: www.federalreserve.gov

Phone: 202-452-3819

Ludwig von Mises Institute

Website: www.mises.org

Email: mail@mises.org

Address: 518 West Magnolia Avenue, Auburn, AL 36832

Phone: 334-321-2100

Fax: 334-321-2119

Book catalog: www.mises.org/catalog.asp

Foundation for the Advancement of Monetary Education

Website: www.fame.org

Email: info@fame.org

Address: Box 625, FDR Station., New York, NY 10150

Phone: (212)818-1206

Fax: (212) 818-1197

Chapter 2

What Makes Deflation Likely Today?

Excerpted from Conquer the Crash *— Chapter 11 — March 2002*

Following the Great Depression, the Fed and the U.S. government embarked on a program, sometimes consciously and sometimes not, both of increasing the creation of new money and credit and of fostering the confidence of lenders and borrowers so as to facilitate the expansion of credit. These policies both accommodated and encouraged the expansionary trend of the 'Teens and 1920s, which ended in bust, and the far larger expansionary trend that began in 1932 and which has accelerated over the past half-century.

Other governments and central banks have followed similar policies. The International Monetary Fund, the World Bank and similar institutions, funded mostly by the U.S. taxpayer, have extended immense credit around the globe. Their policies have supported nearly continuous worldwide inflation, particularly over the past thirty years. As a result, the global financial system is gorged with non-self-liquidating credit.

Conventional economists excuse and praise this system under the erroneous belief that expanding money and credit promotes economic growth, which is terribly false. It appears to do so for a while, but in the long run, the swollen mass of debt collapses of its own weight, which is deflation, and destroys the economy. Only the Austrian school understands this fact. A devastated economy, moreover, encourages radical politics, which is even worse. We will address this topic in Chapter 26.

A House of (Credit) Cards

The value of credit that has been extended worldwide is unprecedented. *At the Crest of the Tidal Wave* reported in 1995 that United States entities of all types owed a total of $17.1 trillion dollars. I thought it was a big number. That figure has soared to $29.5 trillion at the end of 2001, so it should be $30 trillion by the time this book is printed. That figure represents three times the annual Gross Domestic Product, the highest ratio ever.

Worse, most of this debt is the non-self-liquidating type. Much of it comprises loans to governments, investment loans for buying stock and real estate, and loans for everyday consumer items and services, none of which has any production tied to it. Even a lot of corporate debt is non-self-liquidating, since so much of corporate activity these days is related to finance rather than production. The Fed's aggressive easy-money policy of recent months has cruelly enticed even more marginal borrowers into the ring, particularly in the area of mortgages.

This $30 trillion figure, moreover, does not include government guarantees such as bank deposit insurance, unfunded Social Security obligations, and so on, which could add another $20 trillion or so to that figure, depending upon what estimates we accept. It also does not take into account U.S. banks' holdings of $50 trillion worth of derivatives at representative value (equaling five full years' worth of U.S. GDP), which could turn into IOUs for more money than their issuers imagine. Then there is the problem of major coporations' unfunded pension plan liabilities. Companies have promised billions of dollars in fixed-income pensions, but their plan assets will fall so much in value that they will have to fund those pensions from their operating budgets. How much of those liabilities will turn into debt is unknown, but the risk is large and real. Is it not appropriate that you are now reading Chapter 11?

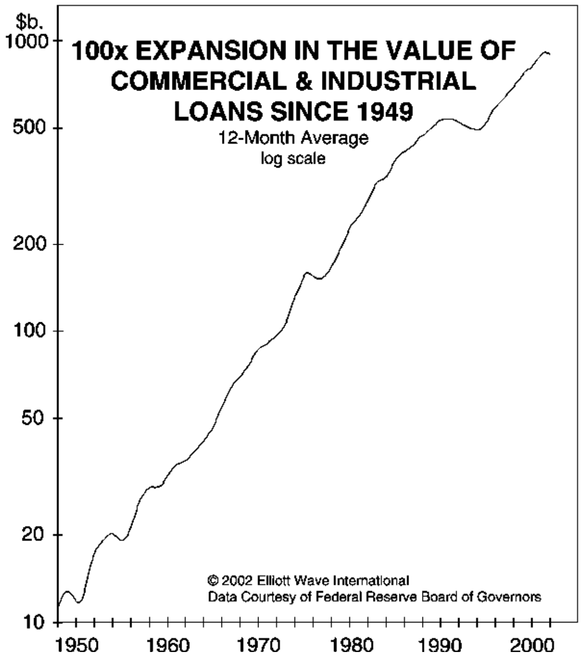

Figure 11-1

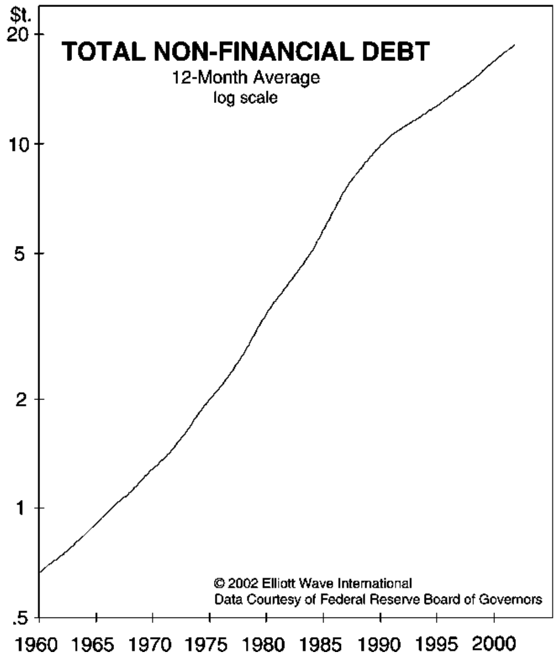

Figure 11-2

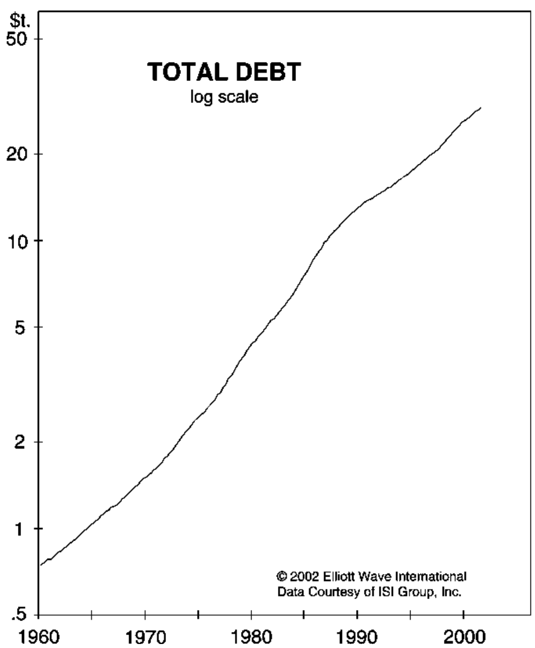

Figure 11-3

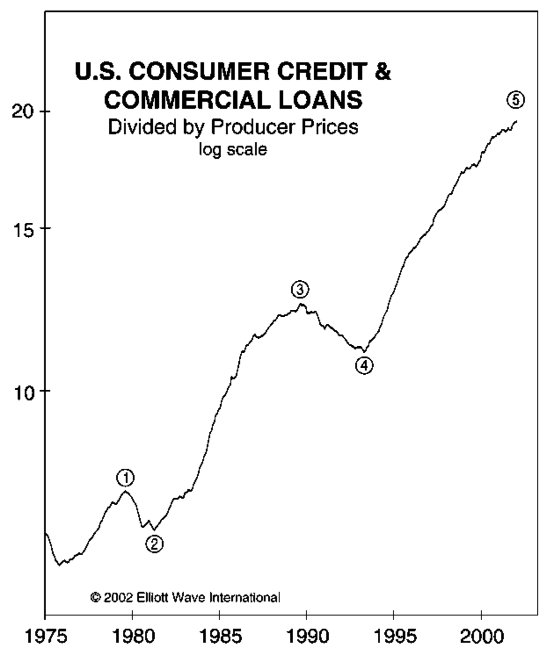

Figure 11-4

Figures 11-1 through 11-4, along with Figure 7-6, show some aspects of both the amazing *growth* in credit — as much as 100 fold since 1949 — and the astonishing *extent* of indebtedness today among corporations, governments and the public, both in terms of total dollars' worth and as a percent of GDP. There are so many measures revealing how extended debtors have become that I could dedicate a whole book to that topic alone.

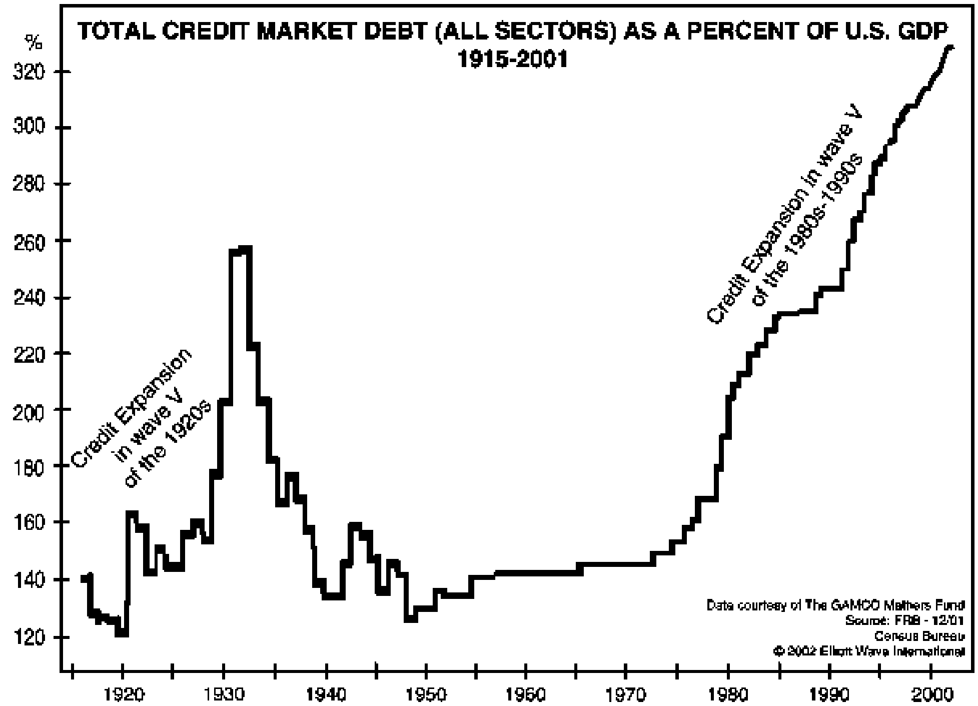

Figure 11-5

Runaway credit expansion is a characteristic of major fifth waves. Waxing optimism supports not only the investment boom but also a credit expansion, which in turn fuels the investment boom. Figure 11-5 is a stunning picture of the credit expansion of wave V of the 1920s (beginning the year that Congress authorized the Fed), which ended in a bust, and of wave V in the 1980s-1990s, which is even bigger.

I have heard economists understate the debt risk of the United States by focusing on the level of its net debt to foreigners, which is just above $2 trillion, as if all other debt we just "owe to ourselves." But every loan involves a creditor and a debtor, who are separate entities. No one owes a debt to himself. Creditors in other countries who have lent trillions to the U.S. and their own fellow citizens have added to the ocean of worldwide debt, not reduced it. So not only has there been an expansion of credit, but it has been the biggest credit expansion in history by a huge margin. Coextensively, not only is there a threat of deflation, but there is also the threat of the biggest deflation in history by a huge margin.

Broader Ideas of Money

It is a good thing that deflation is defined as a reduction in the relative volume of money and credit, so we are not forced to distinguish too specifically between the two things in today's world. Exactly what paper and which book entries should be designated as "money" in a fiat-enforced debt-based paper currency system with an overwhelming volume of credit is open to debate.

Many people believe that when they hold stock certificates or someone's IOUs (in the form of bills, notes and bonds), they still have money. "I have my money in the stock market" or "in municipal bonds" are common phrases. In truth, they own not money but financial assets, in the form of corporate shares or repayment contracts. As we will see in Chapter 19, even "money in the bank" in the modern system is nothing but a call on the bank's loans, which means that it is an IOU.

There is no universally accepted definition of what constitutes "the money supply," just an array of arguments over where to draw the line. The most conservative definition limits money to the value of circulating cash currency and checking accounts. As we have seen, though, even they have an origin in debt. Broader definitions of money include the short-term debt of strong issuers. They earn the description "money equivalents" and are often available in "money market funds." Today, there are several accepted definitions of the "money supply," each with its own designation, such as M1, M2 and M3.

The mental quality of modern money extends the limits of what people *think* is money. For example, a futures contract is an IOU for goods at a certain price. Is that money? Many companies use stock options as payment for services. Is that money? Over the past fifteen years, a vast portion of the population has come to believe the oft-repeated phrase, "Owning shares of a stock fund is just like having money in the bank, only better." They have put their life's savings into stock funds under the assumption that they have the equivalent of a money account *on deposit* there. But is it money? The answer to all these questions is no, but people have come to think of such things as money. They spend their actual money and take on debt in accordance with that belief. Because the idea of money is so highly psychological today, the line between what is money and what is not has become blurred, at least in people's minds, and that is where it matters when it comes to understanding the psychology of deflation. Today the vast volume of what people consider to be money has ballooned the psychological potential for deflation far beyond even the immense monetary potential for deflation implied in Figures 11-1 through 11-5.

A Reversal in the Making

No tree grows to the sky. No shared mental state, including confidence, holds forever. The exceptional volume of credit extended throughout the world has been precarious for some time. As Bolton observed, though, such conditions can maintain for years. If the trend toward increasing confidence were to reverse, the supply of credit, and therefore the supply of money, would shrink, producing deflation. Of course, that is a big "if," because for half a century, those wary of credit growth in the U.S. have sounded warnings of collapse, and it has not happened. This is where wave analysis comes in.

Recall that two things are required to produce an expansionary trend in credit. The first is expansionary psychology, and the second is the ability to pay interest. Chapter 4 of this book makes the case that after nearly seven decades of a positive trend, *confidence* has probably reached its limit. Chapter 1 demonstrates a multi-decade deceleration in the U.S. economy that will soon stress debtors' *ability to pay*. These dual forces should serve to usher in a credit contraction very soon.

Wave analysis can also be useful when applied directly to the realm of credit growth. Figure 11-4 is a plot of consumer credit and commercial loans divided by the Producer Price Index to reflect loan values in constant dollars. It shows that the uptrend in real credit value extended to consumers and businesses has traced out five waves since the major bottom of 1974. This is nearly the same picture that we see in stock market margin debt (Figure 7-4). Plots of the credit expansion's rate of change show that the growth in credit is running out of steam at multiple degrees of trend, which is what the analysis in Chapter 1 reveals about the economy. The downturn, it appears, is imminent if not already upon us.

If borrowers begin paying back enough of their debt relative to the amount of new loans issued, or if borrowers default on enough of their loans, or if the economy cannot support the aggregate cost of interest payments and the promise to return principal, or if enough banks and investors become sufficiently reluctant to lend, the "multiplier effect" will go into reverse. Total *credit* will contract, so bank deposits will contract, so the supply of *money* will contract, *all with the same degree of leverage with which they were initially expanded*. The immense reverse credit leverage of zero-reserve (actually *negative*-reserve) banking, then, is the primary fuel for a deflationary crash.

Japan's deflation and its march into depression began in 1990. Southeast Asia's began in 1997. Argentina's has just made headlines. The U.S. and the rest of the nations that have so far escaped are next in line. When the lines in Figures 11-1 through 11-5 turn down (the first one may already have done so), the game will be up.

How Big a Deflation?

Today, under what is left of bank reserves, there are $11 billion on reserve at the Fed plus $44 billion in cash on hand in banks' vaults. This $55 billion total covers the entire stock of bank credit issued in the United States. This amount equates to 1/100 of M2, valued today at $5.5 trillion, and 1/550 of all U.S. debt outstanding, valued today at $30 trillion. If we generously designate the U.S. money supply to include all Federal Reserve notes worldwide, totaling just under $600 billion, these ratios are 1/10 and 1/55.

Of course, since the dollar itself is just a credit, there is no tangible commodity backing the debt that is outstanding today. Real collateral underlies many loans, but its total value may be as little as a few cents on the dollar, euro or yen of total credit. I say "real" collateral because although one can borrow against the value of stocks, for example, they are just paper certificates, inflated well beyond the liquidating value of the underlying company's assets. One can also borrow against the value of bonds, which is an amazing trick: using debt to finance debt. As a result of widespread loans made on such bases, the discrepancy between the value of total debt outstanding and the value of its real underlying collateral is huge. It is anyone's guess how much of that gap ultimately will have to close to satisfy the credit markets in a deflationary depression. For our purposes, it is enough to say that the gap itself, and therefore the deflationary potential, is historically large.

Although the United States is the world leader in fiat money and credit creation, a version of the story told in this and the preceding chapter has happened in every country in the world with a central bank. As a result, we risk overwhelming deflation in every corner of the globe.

Chapter 3

Can the Fed Stop Deflation?

Excerpted from Conquer the Crash *— Chapter 13 — March 2002*

Consensus Opinion Concerning Deflation

Seventy years of nearly continuous inflation have made most people utterly confident of its permanence. If the majority of economists have any monetary fear at all, it is fear of inflation, which is the opposite of deflation. Two of the world's most renowned economists have reiterated this fear in recent months in *The Wall Street Journal*, predicting an immediate acceleration of inflation.

As for the very idea of deflation, one economist a few years ago told a national newspaper that deflation had a "1 in 10,000" chance of occurring. The Chairman of Carnegie Mellon's business school calls the notion of deflation "utter nonsense." A professor of economics at Pepperdine University states flatly, "Rising stock prices will inevitably lead to rising prices in the rest of the economy." The publication of an economic think-tank insists, "Anyone who asserts that deflation is imminent or already underway ignores the rationale for fiat currency — that is, to facilitate the manipulation of economic activity." A financial writer explains, "Deflation…is totally a function of the Federal Reserve's management of monetary policy. It has nothing to do with the business cycle, productivity, taxes, booms and busts or anything else." Concurring, an adviser writes in a national magazine, "U.S. deflation would be simple to stop today. The Federal Reserve could just print more money, ending the price slide in its tracks." Yet another sneers, "Get real," and likens anyone concerned about deflation to "small children." One maverick economist whose model accommodates deflation and who actually expects a period of deflation is nevertheless convinced that it will be a "good deflation" and "nothing to fear." On financial television, another analyst (who apparently defines deflation as falling prices) quips, "Don't worry about deflation. All it does is pad profits." A banker calls any episode of falling oil prices "a positive catalyst [that] will put more money in consumers' pockets. It will benefit companies that are powered by energy and oil, and it will benefit the overall economy." Others excitedly welcome recently falling commodity prices as an economic stimulus "equivalent to a massive tax cut." A national business magazine guarantees, "That's not deflation ahead, just slower inflation. Put your deflation worries away." The senior economist with Deutsche Bank in New York estimates, "The chance of deflation is at most one in 50" (apparently up from the 1 in 10,000 of a couple of years ago). The President of the San Francisco Fed says, "The idea that we are launching into a prolonged period of declining prices I don't think has substance." A former government economist jokes that deflation is "57th on my list of worries, right after the 56th — fear of being eaten by piranhas." These comments about deflation represent entrenched professional opinion.

As you can see, anyone challenging virtually the entire army of financial and economic thinkers, from academic to professional, from liberal to conservative, from Keynesian socialist to Objectivist free-market, from Monetarist technocratic even to many vocal proponents of the Austrian school, must respond to their belief that inflation is virtually inevitable and deflation impossible.

"Potent Directors"

The primary basis for today's belief in perpetual prosperity and inflation with *perhaps* an occasional recession is what I call the "potent directors" fallacy. It is nearly impossible to find a treatise on macroeconomics today that does not assert or assume that the Federal Reserve Board has learned to control both our money and our economy. Many believe that it also possesses immense power to manipulate the stock market.

The very idea that it *can* do these things is false. Last October, before the House and Senate Joint Economic committee, Chairman Alan Greenspan himself called the idea that the Fed could prevent recessions a "puzzling" notion, chalking up such events to exactly what causes them: "human psychology." In August 1999, he even more specifically described the stock market as being driven by "waves of optimism and pessimism." He's right on this point, but no one is listening.

The Chairman also expresses the view that the Fed has the power to temper economic swings for the better. Is that what it does? Politicians and most economists assert that a central bank is necessary for maximum growth. Is that the case?

This is not the place for a treatise on the subject, but a brief dose of reality should serve. Real economic growth in the U.S. was greater in the nineteenth century without a central bank than it has been in the twentieth century with one. Real economic growth in Hong Kong during the latter half of the twentieth century outstripped that of every other country in the entire world, and it had no central bank. Anyone who advocates a causal connection between central banking and economic performance must conclude that a central bank is harmful to economic growth. For recent examples of the failure of the idea of efficacious economic directors, just look around. Since Japan's boom ended in 1990, its regulators have been using every presumed macroeconomic "tool" to get the Land of the Sinking Sun rising again, as yet to no avail. The World Bank, the IMF, local central banks and government officials were "wisely managing" Southeast Asia's boom until it collapsed spectacularly in 1997. Prevent the bust? They expressed profound dismay that it even happened. As I write this paragraph, Argentina's economy has just crashed despite the machinations of its own presumed "potent directors." I say "despite," but the truth is that directors, whether they are Argentina's, Japan's or America's, *cannot* make things better and have *always* made things worse. It is a principle that meddling in the free market can only disable it. People think that the Fed has "managed" the economy brilliantly in the 1980s and 1990s. Most financial professionals believe that the only potential culprit of a deviation from the path to ever greater prosperity would be current-time central bank actions so flagrantly stupid as to be beyond the realm of possibility. But the deep flaws in the Fed's manipulation of the banking system to induce and facilitate the extension of credit will bear bitter fruit in the next depression. Economists who do not believe that a prolonged expansionary credit policy has consequences will soon be blasting the Fed for "mistakes" in the present, whereas the errors that matter most reside in the past. Regardless of whether this truth comes to light, the populace will disrespect the Fed and other central banks mightily by the time the depression is over. For many people, the single biggest financial shock and surprise over the next decade will be the revelation that the Fed has never really known what on earth it was doing. The spectacle of U.S. officials in recent weeks lecturing Japan on how to contain deflation will be revealed as the grossest hubris. Make sure that you avoid the disillusion and financial devastation that will afflict those who harbor a misguided faith in the world's central bankers and the idea that they can manage our money, our credit or our economy.

The Fed's Final Card

The Fed used to have two sources of power to expand the total amount of bank credit: It could lower reserve requirements or lower the discount rate, the rate at which it lends money to banks. In shepherding reserve requirements down to zero, it has expended all the power of the first source. In 2001, the Fed lowered its discount rate from 6 percent to 1.25 percent, an unprecedented amount in such a short time. By doing so, it has expended much of the power residing in the second source. What will it do if the economy resumes its contraction, lower interest rates to zero? *Then what?*

Why the Fed Cannot Stop Deflation

Countless people say that deflation is impossible because the Federal Reserve Bank can just *print money* to stave off deflation. If the Fed's main jobs were simply establishing new checking accounts and grinding out banknotes, that's what it might do. But in terms of *volume*, that has not been the Fed's primary function, which for 89 years has been in fact to foster the *expansion of credit*. Printed fiat currency depends almost entirely upon the whims of the issuer, but credit is another matter entirely.

What the Fed does is to set or influence certain very short-term interbank loan rates. It sets the discount rate, which is the Fed's nominal near-term lending rate to banks. This action is primarily a "signal" of the Fed's posture because banks almost never borrow from the Fed, as doing so implies desperation. (Whether they will do so more in coming years under duress is another question.) More actively, the Fed buys and sells overnight "repurchase agreements," which are collateralized loans among banks and dealers, to defend its chosen rate, called the "federal funds" rate. In stable times, the lower the rate at which banks can borrow short-term funds, the lower the rate at which they can offer long-term loans to the public. Thus, though the Fed undertakes its operations to influence bank borrowing, its ultimate goal is to influence public borrowing from banks. Observe that the Fed makes bank credit more available or less available to two sets of *willing borrowers*.

During social-mood uptrends, this strategy appears to work, because the borrowers — i.e., banks and their customers — are confident, eager participants in the process. During monetary crises, the Fed's attempts to target interest rates don't appear to work because in such environments, the demands of creditors overwhelm the Fed's desires. In the inflationary 1970s to early 1980s, rates of interest soared to 16 percent, and the Fed was forced to follow, not because it wanted that interest rate but because debt investors demanded it.

Regardless of the federal funds rate, banks set their own lending rates to customers. During economic contractions, banks can become fearful to make long-term loans even with cheap short-term money. In that case, they raise their loan rates to make up for the perceived risk of loss. In particularly scary times, banks have been known virtually to cease new commercial and consumer lending altogether. Thus, the ultimate success of the Fed's attempts to influence the total amount of credit outstanding depends not only upon willing borrowers but also upon the banks as *willing creditors.*

Economists hint at the Fed's occasional impotence in fostering credit expansion when they describe an ineffective monetary strategy, i.e., a drop in the Fed's target rates that does not stimulate borrowing, as "pushing on a string." At such times, low Fed-influenced rates cannot overcome creditors' disinclination to lend and/or customers' unwillingness or inability to borrow. That's what has been happening in Japan for over a decade, where rates have fallen effectively to zero but the volume of credit is still contracting. Unfortunately for would-be credit manipulators, the leeway in interest-rate manipulation stops at zero percent. When prices for goods fall rapidly during deflation, the value of money rises, so even a zero interest rate imposes a heavy real cost on borrowers, who are obligated to return more valuable dollars at a later date. No one with money wants to pay someone else to borrow it, so interest rates cannot go negative. (Some people have proposed various pay-to-borrow schemes for central banks to employ in combating deflation, but it is doubtful that the real world would accommodate any of them.)

When banks and investors are reluctant to lend, then only *higher* interest rates can induce them to do so. In deflationary times, the market accommodates this pressure with falling bond prices and higher lending rates for all but the most pristine debtors. But wait; it's not that simple, because higher interest rates do not serve only to *attract* capital; they can also make it flee. Once again, the determinant of the difference is market psychology: Creditors in a defensive frame of mind can perceive a borrower's willingness to pay high rates as desperation, in which case, the higher the offer, the more repelled is the creditor. In a deflationary crash, rising interest rates on bonds mean that creditors fear default.

A defensive credit market can scuttle the Fed's efforts to get lenders and borrowers to agree to transact at all, much less at some desired target rate. If people and corporations are unwilling to borrow or unable to finance debt, and if banks and investors are disinclined to lend, central banks cannot force them to do so. During deflation, they cannot even induce them to do so with a zero interest rate.

Thus, regardless of assertions to the contrary, the Fed's purported "control" of borrowing, lending and interest rates ultimately depends upon an accommodating market psychology and cannot be set by decree. So ultimately, the Fed does not control either interest rates or the total supply of credit; the market does.

There is an invisible group of lenders in the money game: *complacent depositors*, who — thanks to the FDIC (see Chapter 19) and general obliviousness — have been letting banks engage in whatever lending activities they like. Under pressure, bankers have occasionally testified that depositors might become highly skittish (if not horrified) if they knew how their money is being handled. During emotional times, the Fed will also have to try to maintain bank depositors' confidence by refraining from actions that appear to indicate panic. This balancing act will temper the Fed's potency and put it on the defensive yet further.

In contrast to the assumptions of conventional macroeconomic models, people are not machines. They get emotional. People become depressed, fearful, cautious and angry during depressions; that's essentially what causes them. A change in the population's mental state from a desire to expand to a desire to conserve is key to understanding why central bank machinations cannot avert deflation.

When ebullience makes people expansive, they often act on impulse, without full regard to reason. That's why, for example, consumers, corporations and governments can allow themselves to take on huge masses of debt, which they later regret. It is why creditors can be comfortable lending to weak borrowers, which they later regret. It is also why stocks can reach unprecedented valuations.

Conversely, when fear makes people defensive, they again often act on impulse, without full regard to reason. One example of action impelled by defensive psychology is governments' recurring drive toward protectionism during deflationary periods. Protectionism is correctly recognized among economists of all stripes as destructive, yet there is always a call for it when people's mental state changes to a defensive psychology. Voting blocs, whether corporate, union or regional, demand import tariffs and bans, and politicians provide them in order to get re-elected. If one country does not adopt protectionism, its trading partners will. Either way, the inevitable dampening effect on trade is inescapable. You will be reading about tariff wars in the newspapers before this cycle is over. Another example of defensive psychology is the increasing conservatism of bankers during a credit contraction. When lending officers become afraid, they call in loans and slow or stop their lending no matter how good their clients' credit may be in actuality. Instead of seeing opportunity, they see only danger. Ironically, much of the actual danger appears as a consequence of the reckless, impulsive decisions that they made in the preceding uptrend. In an environment of pessimism, corporations likewise reduce borrowing for expansion and acquisition, fearing the burden more than they believe in the opportunity. Consumers adopt a defensive strategy at such times by opting to save and conserve rather than to borrow, invest and spend. Anything the Fed does in such a climate will be seen through the lens of cynicism and fear. In such a mental state, people will interpret Fed actions differently from the way that they did when they were inclined toward confidence and hope.

With these thoughts in mind, let's return to the idea that the Fed could just print banknotes to stave off bank failures. One can imagine a scenario in which the Fed, beginning soon after the onset of deflation, trades banknotes for portfolios of bad loans, replacing a sea of bad debt with an equal ocean of banknotes, thus smoothly monetizing all defaults in the system without a ripple of protest, reaction or deflation. There are two problems with this scenario. One is that the Fed is a bank, and it would have no desire to go broke buying up worthless portfolios, debasing its own reserves to nothing. Only a government mandate triggered by crisis could compel such an action, which would come only after deflation had ravaged the system. Even in 1933, when the Fed agreed to monetize some banks' loans, it offered cash in exchange for only the very best loans in the banks' portfolios, not the precarious ones. Second, the smooth reflation scenario is an ivory-tower concoction that sounds plausible only by omitting human beings from it. While the Fed could embark on an aggressive plan to liquefy the banking system with cash in response to a developing credit crisis, that action itself ironically could serve to aggravate deflation, not relieve it. In a defensive emotional environment, evidence that the Fed or the government had decided to adopt a deliberate policy of inflating the currency could give bondholders an excuse, justified or not, to panic. It could be taken as evidence that the crisis is worse than they thought, which would make them fear defaults among weak borrowers, or that hyperinflation lay ahead, which could make them fear the depreciation of all dollar-denominated debt. Nervous holders of suspect debt that was near expiration could simply decline to exercise their option to repurchase it once the current holding term ran out. Fearful holders of suspect long-term debt far from expiration could dump their notes and bonds on the market, making prices collapse. If this were to happen, the net result of an attempt at inflating would be a system-wide reduction in the purchasing power of dollar-denominated debt, in other words, a drop in the dollar value of total credit extended, which is deflation.

The myth of Fed omnipotence has three main counter-vailing forces: the bond market, the gold market and the currency market. With today's full disclosure of central banks' activities, governments and central banks cannot hide their monetary decisions. Indications that the Fed had adopted an unwelcome policy would spread immediately around the world, and markets would adjust accordingly. Downward adjustments in bond prices could not only negate but also *outrun* the Fed's attempts at undesired money or credit expansion.

The problems that the Fed faces are due to the fact that the world is not so much awash in money as it is awash in credit. Because today the amount of outstanding credit dwarfs the quantity of money, debt investors, who always have the option to sell bonds in large quantities, are in the driver's seat with respect to interest rates, currency values and the total quantity of credit, which means that they, not the Fed, are now in charge of the prospects for inflation and deflation. The Fed has become a slave to trends that it has already fostered for seventy years, to events that have already transpired. For the Fed, the mass of credit that it has nursed into the world is like having raised King Kong from babyhood as a pet. He might behave, but only if you can figure out what he wants and keep him satisfied.

In the context of our discussion, the Fed has four relevant tasks: to keep the banking system liquid, to maintain the public's confidence in banks, to maintain the market's faith in the value of Treasury securities, which constitute its own reserves, and to maintain the integrity of the dollar relative to other currencies, since dollars are the basis of the Fed's power. In a system-wide financial crisis, these goals will conflict. If the Fed chooses to favor any one of these goals, the others will be at least compromised, possibly doomed.

The Fed may have taken its steps to eliminate reserve requirements with these conflicts in mind, because whether by unintended consequence or design, that regulatory change transferred the full moral responsibility for depositors' money onto the banks. The Fed has thus excused itself from responsibility in a system-wide banking crisis, giving itself the option of defending the dollar or the Treasury's debt rather than your bank deposits. Indeed, from 1928 to 1933, the Fed raised its holdings of Treasury securities from 10.8 percent of its credit portfolio to 91.5 percent, effectively fleeing to "quality" right along with the rest of the market. What actual path the Fed will take under pressure is unknown, but it is important to know that it is under no *obligation* to save the banks, print money or pursue any other rescue. Its primary legal obligation is to provide backing for the nation's currency, which it could quite merrily fulfill no matter what happens to the banking system.

Local Inflation by Repatriation?

Other countries hold Treasury securities in their central banks as reserves, and their citizens keep dollar bills as a store of value and medium of exchange. In fact, foreigners hold 45 percent of Treasury securities in the marketplace and 75 percent of all $100 bills. Repatriation of those instruments, it has been proposed, could cause a dramatic local inflation. If in fact investors around the world were to panic over the quality of the Treasury's debt, it would cause a price collapse in Treasury securities, which would be deflationary. As for currency repatriation, if overall money and credit were deflating in dollar terms, dollar bills would be rising in value. Foreigners would want to hold onto those remaining dollar bills with both hands. Even if foreigners did return their dollars, the Fed, as required by law, would offset returned dollar currency with sales of Treasury bonds, thus neutralizing the monetary effect.

Can Fiscal Policy Halt Deflation?

Can the government spend our way out of deflation and depression? Governments sometimes employ aspects of "fiscal policy," i.e., altering spending or taxing policies, to "pump up" demand for goods and services. Raising taxes for any reason would be harmful. Increasing government spending (with or without raising taxes) simply transfers wealth from savers to spenders, substituting a short-run stimulus for long-run financial deterioration. Japan has used this approach for twelve years, and it hasn't worked. Slashing taxes absent government spending cuts would be useless because the government would have to borrow the difference. Cutting government spending is a good thing, but politics will prevent its happening prior to a crisis.

Understand further that even the government's "tools" of macroeconomic manipulation are hardly mechanical levers on a machine; they are subject to psychology. Have you noticed the government's increasing fiscal conservatism over the past decade? Even Democrats have been voicing the virtues of a balanced budget! This is a sea change in *thinking*, and that is what ultimately causes trends such as inflation and deflation.

Endgame

The lack of solutions to the deflation problem is due to the fact that the problem results from prior excesses. Like the discomfort of drug addiction withdrawal, the discomfort of credit addiction withdrawal cannot be avoided. The time to have thought about avoiding a system-wide deflation was years ago. Now it's too late.

It does not matter how it happens; in the right psychological environment, *deflation will win*, at least initially. People today, raised in the benign, expansive environment of Supercycle wave (V), love to quote the conventional wisdom, "Don't fight the Fed." Now that the environment is about to change, I think that the cry of the truly wise should be, *"Don't fight the waves."*

Currency Hyperinflation

While I can discern no obvious forces that would counteract deflation, *after* deflation is another matter. At the bottom, when there is little credit left to destroy, currency inflation, perhaps even hyperinflation, could well come into play. In fact, I think this outcome has a fairly high probability in the next Kondratieff cycle.

When a government embarks on a policy of currency hyperinflation, such as the Confederate States did in the 1860s, Germany did in the early 1920s or France did after World War II, the monetary path is utterly different from that of deflation, but ironically, the end result is about the same as that of a deflationary crash. At the end of hyperinflation, total bank accounts denominated in the hyperinflated currency are worth far less than they were, sometimes nothing at all. Total debts have shrunk or disappeared because the notes were denominated in depreciated money. In the severest cases, even the money disappears. In this sense, even with hyperinflation, the end result is the destruction of money and credit, which is deflation.

The Markets Will Signal Inflation

Despite my thoughts on the matter, I recognize that international money flows are massive, central bankers can be ingenious, and politics can be volatile. Perhaps there is some way that inflation, whether globally or locally, could accelerate in the immediate future. How can you tell if my conclusion about deflation is wrong and that inflation or hyperinflation is taking place *instead* of deflation?

There are two sensitive barometers of major monetary trends. One is the currency market. If the price of the dollar against other currencies begins to plummet, it *might* mean that the market fears dollar inflation, but it might simply mean that credit denominated in other currencies is deflating faster than that denominated in dollars. The other monetary barometer, which is more important, is the gold market. If gold begins to soar in dollar terms, then the market almost surely fears inflation. The bond market will not make the best barometer of inflation because much of it will fall under either scenario. I hope to recommend gold at lower prices near the bottom of the deflationary trend, but if gold were to move above $400 per ounce, I would probably be convinced that a major low had passed. The ideas in Chapters 18 and 22 will show you how to protect yourself simultaneously against deflation and a collapse in dollar value.

A High Degree of Complexity

Stocks are not registering a Supercycle top like that of 1929 but a Grand Supercycle top, per CTC Figure 4-1. This means that the ultimate — if not the immediate — consequences will be more severe and more confounding than the consequences of the 1929-1932 crash. As Chapter 5 of *At the Crest of the Tidal Wave* explains, the entirety of Grand Supercycle wave Ⅳ should last a century and comprise two or three major bear markets with one or two intervening bull markets. This book addresses primarily the first bear market, although the two preceding sections attempt to outline some of the longer-term risks. Because in some ways the financial world is in uncharted waters, this book may not have all the answers.

Chapter 4

Jaguar Inflation

Excerpted from The Elliott Wave Theorist — *February 2004*

I am tired of hearing people insist that the Fed can expand credit all it wants. Sometimes an analogy clarifies a subject, so let's try one.

It may sound crazy, but suppose the government were to decide that the health of the nation depends upon producing Jaguar automobiles and providing them to as many people as possible. To facilitate that goal, it begins operating Jaguar plants all over the country, subsidizing production with tax money. To everyone's delight, it offers these luxury cars for sale at 50 percent off the old price. People flock to the showrooms and buy. Later, sales slow down, so the government cuts the price in half again. More people rush in and buy. Sales again slow, so it lowers the price to $900 each. People return to the stores to buy two or three, or half a dozen. Why not? Look how cheap they are! Buyers give Jaguars to their kids and park an extra one on the lawn. Finally, the country is awash in Jaguars. Alas, sales slow again, and the government panics. It must move more Jaguars, or, according to its theory — ironically now made fact — the economy will recede. People are working three days a week just to pay their taxes so the government can keep producing more Jaguars. If Jaguars stop moving, the economy will stop. So the government begins *giving Jaguars away*. A few more cars move out of the showrooms, but then it ends. *Nobody wants any more Jaguars. They don't care if they're free. They can't find a use for them*. Production of Jaguars ceases. It takes years to work through the overhanging supply of Jaguars. Tax collections collapse, the factories close, and unemployment soars. The economy is wrecked. People can't afford to buy gasoline, so many of the Jaguars rust away to worthlessness. The number of Jaguars — at best — returns to the level it was before the program began.

The same thing can happen with credit.

It may sound crazy, but suppose the government were to decide that the health of the nation depends upon producing credit and providing it to as many people as possible. To facilitate that goal, it begins operating credit-production plants all over the country, called Federal Reserve Banks. To everyone's delight, these banks offer the credit for sale at below market rates. People flock to the banks and buy. Later, sales slow down, so the banks cut the price again. More people rush in and buy. Sales again slow, so they lower the price to one percent. People return to the banks to buy even more credit. Why not? Look how cheap it is! Borrowers use credit to buy houses, boats and an extra Jaguar to park out on the lawn. Finally, the country is awash in credit. Alas, sales slow again, and the banks panic. They must move more credit, or, according to its theory — ironically now made fact — the economy will recede. People are working three days a week just to pay the interest on their debt to the banks so the banks can keep offering more credit. If credit stops moving, the economy will stop. So the banks begin *giving credit away*, at zero percent interest. A few more loans move through the tellers' windows, but then it ends. *Nobody wants any more credit. They don't care if it's free. They can't find a use for it*. Production of credit ceases. It takes years to work through the overhanging supply of credit. Interest payments collapse, banks close, and unemployment soars. The economy is wrecked. People can't afford to pay interest on their debts, so many bonds deteriorate to worthlessness. The value of credit — at best — returns to the level it was before the program began.

See how it works?

Is the analogy perfect? No. The idea of pushing credit on people is far more dangerous than the idea of pushing Jaguars on them. In the credit scenario, debtors and even most creditors lose everything in the end. In the Jaguar scenario, at least everyone ends up with a garage full of cars. Of course, the Jaguar scenario is impossible, because the government can't *produce* value. It can, however, *reduce* values. A government that imposes a central bank monopoly, for example, can reduce the incremental value of credit. A monopoly credit system also allows for fraud and theft on a far bigger scale. Instead of government appropriating citizens' labor openly by having them produce cars, a monopoly banking system does so clandestinely by stealing stored labor from citizens' bank accounts by inflating the supply of credit, thereby reducing the value of their savings.

I hate to challenge mainstream 20th century macroeconomic theory, but the idea that a growing economy needs easy credit is a false theory. Credit should be supplied by the free market, in which case it will almost always be offered intelligently, primarily to producers, not consumers. Would lower levels of credit availability mean that fewer people would own a house or a car? Quite the opposite. Only the timeline would be different. Initially it would take a few years longer for the same number of people to own houses and cars – *actually* own them, not rent them from banks. Because banks would not be appropriating so much of everyone's labor and wealth, the economy would grow much faster. Eventually, the extent of home and car ownership – *actual* ownership – would eclipse that in an easy-credit society. Moreover, people would *keep* their homes and cars because banks would not be foreclosing on them. As a bonus, there would be no devastating across-the-board collapse of the banking system, which, as history has repeatedly demonstrated, is inevitable under a central bank's fiat-credit monopoly.

Jaguars, anyone?

Chapter 5

Can't Buy Enough…of That Junky Stuff, or, Why the Fed Will Not Stop Deflation

Excerpted from The Elliott Wave Theorist — *September 2007*

We hear it every day: "What about the Fed?" The vast majority of investors and commentators seems confident that the Fed's machinations make a stock market collapse impossible. Every hour or so one can read or hear another comment along these lines: "the Fed will provide liquidity," "the Fed is injecting money into the system," "the Fed will be forced to bail out homeowners, homebuilders, mortgage companies and banks," "the Fed has no choice but to inflate," "the government cannot allow deflation," "the Fed will print money to stave off deflation" and any number of like statements. None of them is true. The Fed is not forced to do anything; the Fed has not been injecting money; the Fed does have choices; the government does not control deflationary forces; and the Fed will not print money unless and until it changes its long-standing policies and decides to destroy itself.

A perfect example of one of these fallacies recently exposed is the widespread report in August that the Fed had "injected" billions of dollars worth of "money" into the "system" by "buying" "sub-prime mortgages." In fact, all it did was offer to stave off the immediate illegality of many banks' operations by ***lending*** money against the collateral of ***guaranteed*** mortgages but only ***temporarily*** under contracts that oblige the banks to buy them back within 1 to 30 days. The typical duration is 3 days. Observe three important things:

(1) The Fed did not give out ***money***; it offered a temporary, collateralized ***loan***.

(2) The Fed did not ***inject*** liquidity; it offered it.

(3) The Fed did not lend against worthless sub-prime mortgages; it lent against ***valuable*** mortgages issued by Fannie Mae (the Federal National Mortgage Association), Ginnie Mae (the Government National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation). The New York Fed is also accepting "investment quality" commercial paper, which means highly liquid, valuable IOUs, not junk.

As a result:

(1) The Fed took almost no risk in the transactions.

(2) The net liquidity it provided—after the repo agreements close—is zero.

(3) The financial system is still choking on bad loans.

(4) Banks and other lending institutions must sell other assets to raise cash to buy back their mortgages from the Fed.

These points are crucial to a proper understanding of the situation. The Fed is doing nothing akin to what most of the media claims; like McDonald's, it is selling not so much sustenance as time, in this case time for banks to divest themselves of some assets. But in the Fed's case, that's all it's selling; you don't get any food in the bargain.

As I have said before, the Federal Reserve may be large and complex, but it is a bank. It has private owners: member banks, whose shareholders can be anyone. (For an excellent primer, see http://www.libertyunbound.com/archive/2004_10/woolsey-fed.html.) The Fed's stockholders exploit the banking system through access to easy loans and the Fed's 6%-guaranteed stock dividends. Member banks do not want to see their nurturing enterprise destroyed. Although Bernanke probably received distress calls from mortgage lenders, he probably also got calls from prospering member banks saying, "Don't you ***dare*** buy any of that crap and put it in the long-term portfolio." Nor is it likely to do so. Member banks may make mortgages and lend to consumers, but the Fed doesn't; comparatively, it's highly conservative.

In the early 1930s, as markets fell and the economy collapsed, the Fed offered loans only on the most pristine debt. Its standards have fallen a bit, but not by much. Today it will still lend only on ***highly reliable*** IOUs, not junk. And it doesn't even want to own most of those; it takes them on only temporarily as part of a short-term repurchase agreement.

The Fed's power derives from the value of its holdings, which are primarily Treasury bonds, which provide backing for the value of the Fed's notes. What would a Federal Reserve Note be worth if it were backed by sub-prime mortgages? The real value of U.S. Treasury debt is precarious enough as it is, but at least it has the taxing power of the government behind it. But if the Fed bought up the entire supply of sub-prime mortgages, its notes would lose value accordingly. So will the Fed bail out mortgage companies, as the optimists seem to think? No, it won't. Those who think the Fed will buy up junk with cash delivered by helicopter are dreaming. (***Editor's Note:*** *Robert Prechter addresses this statement in the next excerpt from the September 2008* Theorist.)

Ironically, of course, the Federal Reserve System and the federal government — both directly and via creations such as privileged mortgage companies and the FDIC — have ***fostered*** all the lending and the junk debt that resulted. But these entities want only to benefit from the process, not suffer from it. As we will see throughout the bear market and into the depression, the Fed is self-interested and will not brook losses in its portfolio. Those who own the bad loans, and perhaps some foolish government entities that try to "save" them, will take losses, but the Fed won't.

One might imagine various schemes by which the government would guarantee such mortgages, but if it did, the mortgages would in effect become Treasury bonds. The problem, as others have pointed out, is that government guarantees on bad debt would simply encourage more of it. Unless the government decides to freeze the mortgage lending industry, which would have its own devastating repercussions, it cannot pull off a bailout scheme.

What must the banks do with their "grace period" of a few days that the Fed's repo agreements provide? They have to ***raise the cash to buy back the IOUs that the Fed agreed to hold for them***. How does a bank raise money? By selling assets. Thus begins the downward spiral: Contracting credit causes asset sales, which cause collateral values to fall, which causes lenders to curtail lending, thus contracting overall credit, which causes assets sales, and so it goes. Thus, the Fed is not staving off deflation; at best, it may have helped — momentarily — to make it more orderly. But the selling of assets has begun regardless.

One of the Fed's just-accessed "tools" is its authority to suspend various lending restrictions. As Fortune (August 24) just reported, a week ago the Fed, in an unprecedented move suggesting growing panic, suspended the limit on the percentage of capital that Citigroup and Bank of America can lend to their affiliated brokerage firms. With that permission, these banks immediately raised their loans from the previous maximum of 10 percent of their total capital to an enormous 30 percent, and they have permission to go higher if they want. Observe that the Fed did not lend to the brokers. It merely authorized these banks to do it. The banks, though obviously desperate to shore up their brokerage divisions, just as necessarily believe that their loans will be paid back, which means that they are bullish on the stock market and most other financial markets. But what will happen when markets fall further and the banks' depositors get wind of the fact that their money has been lent to speculators with leveraged market positions? The Fed, which greased the loan scheme by financing the loan to these banks (not the brokers) through its discount window, now has a claim on these banks' assets. It will be utterly fascinating to see what the Fed decides to do when these big banks finally call the Fed and say that if it calls in its loans, they will go bankrupt. I'm betting that the Fed, perhaps after a few more frantic calls to other creditors for help, will eventually call in the loans anyway.

Does the Fed have secret tools to stave off deflation? Yes, to the same extent that Hitler, hiding in a bunker in 1945, had secret weapons to stave off the Allies. The Fed has only one tool: to offer credit, and its arsenal is depleted because it will offer credit ***only on terms good to itself***. And borrowers will borrow only if they think they can pay back the debt after selling assets. You can bet that the Fed is lending only to banks that it believes have the necessary assets to survive its loans' repayment provisions. If not, well, it will be the FDIC's problem. The Fed is not engineering a system-wide bailout; it is just re-arranging deck chairs.

Interest rates are higher than they were in 2002. Many people say that the Fed therefore has lots of room to bring rates down and keep the economy inflated. Do lower interest rates cause recovery? No, they simply reflect a crashing market for credit. The market makes interest rates rise and fall, and the Fed's rates typically just follow suit. Sometimes central banks force the issue, as when the Fed in the final months of 2002 lowered its discount rate to 0.75 percent, staying a bit ahead of the decline in T-bill yields. But its systematic rate drops didn't stop the S&P from losing ***half its value in 31 months.*** When the Japanese central bank lowered rates virtually to zero in the 1990s, doing so likewise did not prevent Japanese real estate prices from imploding and the Nikkei from proceeding through its ***biggest bear market ever*** by a huge margin. Rates near zero, then, did not constitute a magic potion. Zero was simply the price of loans at the time; nobody wanted them. So the "room" the Fed presumably has may or may not matter. If the market decides to take rates to zero or below, the Fed will simply follow and then have no power.

The Fed does not "inject" liquidity; it only offers it. If nobody wants it, the inflation game is over. The determinant of that matter is the market. When bull markets turn to bear, confidence turns to fear, and fearful people do not lend or borrow at the same rates as confident ones. The ultimate drivers of inflation and deflation are human mental states that the Fed cannot manipulate. The pattern of the stock market's waves determines the ebb and flow of these mental states, and now that a bear market has begun, nothing will stop the trend toward falling confidence and thus falling asset prices, credit deflation and economic depression.

The truth is that the Fed's supposed tools of adding liquidity, such as the limit suspension just granted to the big New York banks, are formulas for total disaster. The terrible secret is that every one of the Fed's tools is nothing but a mechanism to make matters ***worse***. Just because it has taken 74 years to get to the point at which this fact is once again about to become obvious does not mean that it wasn't true all along. The Fed is short-sighted, and its schemes to foster liquidity for short term crises have served, and are continuing to serve, to insure the ultimate collapse of most of the nation's banking system. The storm clouds are getting dark, so that time may have arrived.

The market is certainly poised for a panic. Confidence has held sway for 2½ decades, during which time investors have become utterly unconcerned with risk. They hold a number of misconceptions that foster such complacency. The day the Fed lowers one of its rates or engineers a major temporary loan and the stock market goes down anyway is the day that investors will become utterly uncertain of what they believe about market causality, and panic will have no bridle. Sadly, Ben Bernanke will be blamed for the debacle, when all he will have been guilty of is serving an immoral monopoly, bad timing and failing to understand the forces at work. The third item pertains to almost everyone.

The Fed Is Not Smart Enough To Stop Deflation, Even If It Could

The dab of grease on the gears in the form of the recent discount-rate cut did not come as part of the Fed's normal policy. According to a Bloomberg article of August 17, the surprise discount rate cut was "an extraordinary policy shift." In other words, ***the Fed did not know what the hell was going on.*** It was caught off guard and had to react. In fact, right through July the Fed's spokespeople were all saying that the number one threat to the economy was inflation! Like virtually all futurists, the Fed's economists extrapolate trends to derive forecasts. They never look at underlying indications of coming trend ***change***. That's fine; it helps those of us who at least try to do so. But the idea that the Fed comprises a group of masterminds who "get it" at some deep level and can thereby control things is miles off the mark. For more on this theme, see the "Potent Directors Fallacy" discussion in ***The Wave Principle of Human Social Behavior***.

Chapter 6

The Fed's "Uncle" Point Is In View

Excerpted from The Elliott Wave Theorist — *September 2008*

Chapter 13 of *Conquer the Crash* is titled, "Can the Fed Stop Deflation?" The answer given there was an emphatic *no*. In barely a year the faith — and that's what it was — in the Fed's inflating power has pretty much died. CTC quoted *The Wizard of Oz*, and now anyone can see that there is no magic: just a man yanking on levers and blowing smoke. Back in 1929, consortiums of big banks, using their depositors' money, tried to save the debt-laden stock market. They failed. This time, the new consortium was bigger: the Federal Reserve. But CTC anticipated the end of that game, too: "The bankers' pools of 1929 gave up on this strategy, *and so will the Fed if it tries it*." It is finally becoming obvious to everyone that the Fed is failing in extending its bag of tricks to stop deflation. The Fed's balance sheet now contains more than 50 percent mortgage and other bank debt. Perhaps the Fed is willing to blow the rest of its AAA assets in the form of Treasury bonds, but somewhere between now and then is the Fed's uncle point. The markets, however, are not so dumb as to wait for it. They can already see the end of that road, and they are moving now, ahead of it.

The Last Bastion against Deflation: The Federal Government

Now that the downward portion of the credit cycle is firmly in force, further inflation is impossible. But there is one entity left that can try to stave off deflation: the federal government.

The ultimate source of all the bad credit in the U.S. financial system is Congress. Congress created the Federal Reserve System and many privileged lending corporations: Fannie Mae, Freddie Mac, Ginnie Mae, Sallie Mae, the Federal Housing Administration and the Federal Home Loan Banks, to name a few. The August issue cited our estimate that the mortgage-encouraging entities that Congress created account for 75 percent of all U.S. debt creation with respect to housing. For investors in mortgage (in)securities, the ratio is even greater. Recent reports show that these agencies, which have been stealing people blind by taking interest for nothing, account for a stunning 82 percent of all securitized mortgage debt. Roughly speaking, the government directly encouraged the indebtedness of four out of five home-related borrowers. As noted in the August issue, it indirectly encouraged the rest through the Fed's lending to banks and the FDIC's guarantee of bank deposits. These policies allowed borrowers to drive up house prices to absurd levels, making them unaffordable to people who wanted to buy them with actual money. Proof that these mortgages are artificial and the product of something other than a free market is the fact that while Germany, for example, has issued mortgage-backed securities with a value equal to 0.2 percent of its annual GDP, the U.S. has issued them so ferociously that their value has reached 49.6 percent of annual GDP, a multiple of 250 times Germany's rate, and that is not in total value but only in value relative to the U.S.'s much larger GDP. (Statistics courtesy of the British Treasury.)

Well, the ultimate source of this seemingly risk-free credit still exists, at least for now. When Bernanke & Co. met in the back rooms of the White House in recent weekends, he must have said this: "Boys, we're nearly out of ammo. We have $400b. of credit left to lend, and we have two percentage points lower to go in interest rates. The only way to stave off deflation is for you to *guarantee* all the bad debts in the system." So far, government has leapt to oblige. One of its representatives strode to the podium to declare that it would pledge the future production of the American taxpayer in order to trade, in essence, all the bad IOUs held by speculators in Fannie and Freddie's mortgages for gilt-edged, freshly stamped U.S. Treasury bonds.

Now, what exactly does that mean for deflation? This latest extension of the decades-long debt-creation scheme has essentially exchanged bad IOUs for T-bonds. This move does not create inflation, but it is an attempt to stop deflation. Instead of becoming worthless wallpaper and 20-cents-on-the-dollar pieces of paper, these IOUs have, through the flap of a jaw, maintained their *full, 100 percent* liability. This means that the credit supply attending all these mortgages, which was in the process of collapsing, has ballooned right back up to its former level.

You might think this shift of liability is a magic potion to stave off deflation. But it's not.

Believers in perpetual inflation will ask, "What's to stop the U.S. government from simply adopting all bad debts, keeping the credit bubble inflated?" Answer: The U.S. government's IOUs have a price, an interest rate and a safety rating. Just as mortgage prices, rates and safety ratings were under investors' control, so they are for Treasuries. Remember when Bill Clinton became outraged when he found out that "a bunch of bond traders," not politicians, determined the price of T-bonds and the interest rates that the government must charge? If investors begin to fear the government's ability to pay interest and principal, they will move out of Treasuries the way they moved out of mortgages. The American financial system is too soaked with bad debt for a government bailout to work, and the market won't let politicians get away with assuming all the bad debts. It may take some time for the market to figure out what to do about it, but as always, there is no such thing as a free lunch. The only question is who pays for it.

The Fed is nearly out of the picture, so the consortium of last resort, the federal government, is assuming the job of propping up the debt bubble. It is multiples bigger than any such entity that went before, because it can draw on the liquidity of American taxpayers and clandestinely steal value from American savers. So the question comes down to this: Will the public put up with more financial exploitation? To date, that's exactly what it has done, but social mood has entered wave **c** of a Supercycle-degree decline, and voters are likely to become far less complacent, and more belligerent, than they have been for the past 76 years.

An early hint of the public's reaction comes in the form of news reports. In my lifetime, I can hardly remember times when the media questioned benevolent-sounding actions of the government. Articles were always about who the action would "help." But many commentators have more accurately reported on the latest bailout. *USA Today*'s headline reads, "Taxpayers take on trillions of risk." (9/8) This headline is stunning because of its accuracy. When the government bailed out Chrysler, no newspaper ran an equally accurate headline saying, "Congress assures long-run bankruptcy for GM and Ford." They all talked about why it was a good thing. This time, realism and skepticism (at a later stage of the cycle it will be cynicism and outrage) attend the bailout. The Wall Street Journal's "Market Watch" reports an overwhelmingly negative response among emailers. Local newspapers' "Letters" sections publish comments of dismay and even outrage. CNBC's Mark Haines, in an interview on 9/8 with MSNBC, began by saying ironically, "Isn't socialism great?" This breadth of disgust is *new*, and it's a reflection of emerging negative social mood.

Social mood trends arise from mental states and lead to social actions and events. Deflation is a social event. Ultimately, social mood will determine whether deflation occurs or not. When voters become angry enough, Congressmen will stop flinging pork at all comers. Now the automakers want a bailout. Voters have remained complacent about it so far, but this benign attitude won't last. The day the government capitulates and announces that it can't bail out everyone is the day deflationary psychology will have won out.

Chapter 7

Government Thrashing

Excerpted from The Elliott Wave Theorist — *March 2009*

This quarter is the 9-year anniversary of the peak of wave V in the Dow. So, based on our projections, the bear market is more than halfway done in time. It is less than halfway done in price, however, as the steepest portions of the decline lie ahead. How far along is it in terms of bear-market politics?

I could write an entire issue detailing the injustice of recent actions by the Federal government and the Fed to take or pledge money from taxpayers and give it to bankers and governments (including foreign banks and governments), whether directly or through intermediaries such as AIG. I could note the hypocrisy of Congressmen, who, without checking anything, sanctioned the spending of trillions of dollars worth of "bailout" money and then pillory a guy who came out of retirement to work for $1 a year to try to fix what is now *their* company, AIG. I could point out that the fools who bought the lousy debt that AIG insured are as dumb as the people who sold it were corrupt, so they do not deserve to be bailed out. I could note that the amount of money that the government threw at AIG ($183b.) is *one thousand times* as much as the amount of the bonuses they are screaming about ($165m.), none of which went to the people who ruined AIG (they are long gone). I could say that the current Congressional hearings are a sideshow compared to the massive money-grab engineered by Congress and the Treasury against the American taxpayer. I could point out that the chairman of the Senate's own banking panel (Chris Dodd, D-Conn.) "inserted language in a recently passed stimulus bill that shielded bonuses." (USA 3/20, p.6A) I could predict that the House's passage of a bill to tax employees of companies who accepted bailout money at a rate of 100% (90% plus local taxes) of their pay beyond $250,000 will simply cause the most talented employees to defect to competitors, gutting the companies that the government bought. I could observe that anyone who does business with the government makes a pact with the devil; as James Bianco observes, they can't get out: "Bank of America said it wants to pay back its $45 billion in TARP funds by the end of the year, [but] as the rules are currently written, they cannot write a check for $45 billion. They have to raise $45 billion in new capital. The prospects of doing this are impossible." In other words, BOA, along with AIG, Citigroup, JPMorgan Chase, Wells Fargo, GM, Morgan Stanley, Goldman Sachs, PNC Financial, U.S. Bancorp and Chrysler, all have their feet stuck in the tar pit. I could suggest that Ben Bernanke is on the road to destroying the Fed by loading it up with trillions of dollars worth of garbage loans. I could wonder about the proposal to create a "bad bank," given that we already have one: It's called *the Fed*. And there is so much more to say! But frankly the thing that matters more to me is whether any of these circus acts will turn around the economy. They most surely will not; they will make it worse. Keynesianism did not "work" in the 1930s-1960s; the uptrend in social mood simply disguised its poisonous effect. Now the main trend is down, and all that will come of this historic government and central-bank intervention is misery. Such actions are perfectly compatible with socionomics, which posits that a trend toward negative mood manifests in all kinds of socially self-destructive behavior.

Regulators completely missed Bernie Madoff's historic Ponzi scheme, but no need to fear, as they are back on the ball. They have announced that they will soon move to protect investors by curbing short selling (again). Have you noticed that regulators never forbid *buyers* from "piling on," entering orders on continually higher prices, tick after tick? Such selective rule-making is discriminatory. Regulators do not care if buyers bankrupt a short seller by running over his position. Tough break for him. Anyway, to give the appearance of helping hapless investors, they plan to reinstate the "uptick rule," under which a speculator is barred from selling short except at a price higher than that of the previous trade. There is every historical indication that short-selling curbs have no effect on the market beyond causing about 1-3 days of short-covering. Such actions, in other words, are incapable of slowing down a bear market. Of course, laws and regulations usually bring about the opposite of the stated goal, and this is no exception. To the extent that curbs are successful in reducing short selling, they force panicked bulls to sell to nervous bulls instead of to eager buyers who must cover shorts. In this manner such regulations make all investors' experience in the bear market worse.

The point of this section is to assure you that despite the massive intervention from government and the Fed, it won't change the trends of markets or the effectiveness of market analysis. If the Fed were truly running the show, the Dow, for example, would not be going down, much less while adhering so nicely to trend channels. The conclusions that people draw from authorities' announcements and actions typically cause them to do the wrong thing with their investment capital. Stay focused on the markets themselves and you will be able to see through the fog better than someone who continually reacts to news.

Chapter 8

The Coming Deflationary Pressure on the Government

Excerpted from The Elliott Wave Theorist — *December 2009*

The federal government is the last borrower and debt guarantor in the system, and it has been going berserk in playing these roles. Its breakneck pace of writing new mortgages and of guaranteeing bad debt has replaced private-market mechanisms over the past year. Despite the government's breathtaking spending and unprecedented level of debt, it is still considered a "good" borrower because it can tax its citizens. Fed Chairman Bernanke's greatest achievement was not the measly $1.25t. of debt that he arranged to have the Fed monetize; it was convincing the government to shift the burden of debt default from the speculators and creditors to taxpayers. Let's see how these programs are faring:

> Treasury Secretary Timothy Geithner said today the government is unlikely to recoup its investments in insurer American International Group Inc. or the automakers General Motors Co. and Chrysler Group LLC. The Government Accountability Office yesterday said that U.S. taxpayers will lose $30.4 billion from the auto-industry bailout [and another] $30.4 billion in AIG. (Bloomberg, 12/10)

The Secretary calls these schemes "investments," which is absurd. No one, including taxpayers, made an "investment." Congress simply bought auto-workers' votes with taxpayer money. Had all of these companies gone bust without the bailout, the creditors and stockholders, people who took risks to make profits, would have liquidated the companies' assets and taken the losses themselves. Other companies would have bought the assets and continued employing people — though likely fewer of them — to make cars and sell insurance. But, instead, taxpayers are out $60.8 billion. *Congress does not care*. It got what it wanted. But *at some point*, probably late in wave 3 down, voters will get mad enough start demanding that Congress stop spending their money at such a pace.

Raising Margin Requirements Is Deflationary

An EWT reader recently received this notice from his broker:

> Dear Valued Client,
>
> We want to let you know that effective December 1, 2009, the Financial Industry Regulatory Authority (FINRA) is implementing increased customer margin requirements for leveraged Exchange Traded Funds (ETFs). FINRA believes these higher margin levels are necessary in view of the increased volatility of leveraged ETFs compared with their non-leveraged counterparts. We will change our margin requirements [from 30%] to 60% for double-leveraged ETFs and 90% for triple-leveraged ETFs.

One may debate about the advisability of various margin levels, but it is clear that raising margin requirements reduces the leverage in the financial system, and that's deflationary. This change is an expression of increasing *caution*, which is borne of a trend toward negative social mood.

Congress Will Soon Hamper the Fed

Everyone talks about how the Fed can just "print money" at will, as if no one will ever get in the way. It has indeed been monetizing a lot of debt recently to bail out its buddies in the banking industry. But at some point actual human beings — the ones who participate in social mood trends — get involved and muddy the waters. Bloomberg (10/30) reports that an angry Congressman, who happens to be "the ranking member of the House Oversight and Government Reform Committee," has sent letters to the New York Fed and AIG demanding to see all of their correspondence regarding the Fed's payoff on AIG's credit-default contracts, which amounted to using $62 billion to cover 100 percent of all of the bad bets placed by "Goldman Sachs Group Inc., Societe Generale SA and Deutsche Bank AG" *over the objections of AIG*, which wanted to negotiate a lower payout. Spokesmen for the New York Fed and AIG "declined to comment." The negative trend of social mood that produced the Watergate scandal of 1974 is at work once again. Political actions such as this will hamper the Fed's ability to bail out the biggest gamblers among its friends, a.k.a. "to provide liquidity to distressed institutions."

Another Bloomberg report tells of more mischief to come:

> Frank, a Massachusetts Democrat and the committee chairman, said in an Oct. 7 interview he wants to review the "whole governance structure" of the Fed next year. In April, Dodd and Shelby won passage, by a 96-2 vote, of a non-binding resolution calling in part for an "evaluation of the appropriate number and the associated costs" of Fed district banks. Representative Ron Paul, a Texas Republican who has called for abolishing the Fed, has gained 307 co-sponsors for legislation to require an audit of the central bank. (Bloomberg, 10/30)

Since then, the audit-the-Fed bill has morphed into an amendment to the massive bill to regulate the financial industry that is making its way through Congress. Obviously, the Fed today has a lot more than a pack of neo-Austrian economists to worry about. It has *Congress* to worry about, and there is no more destructive body on the face of the earth.

The Fed Will Soon Hamper Itself

The market for "securitized debt" is as dead as an armadillo on a Texas state highway. So why is the market holding on?

Here is one reason: "Through TALF, the Federal Reserve lends cheap money to investors such as hedge funds as long as they use it to buy securities backed by credit card, car loans and other sectors earmarked for support…. 70 per cent of the $134bn of new deals this year [are] backed by TALF." (FT, 12/9) But when the consumer debt begins to implode again, even hedge funds will not want it, and either they will try to sell the stuff, which won't work, or they will go bust, with IOUs to the Fed on their books. At some point, the Fed will have to stop this particular shenanigan.

A bigger reason why debt securities haven't crashed is that the Fed all year has been swapping its direct loans to institutions for securitized mortgages. (See Figure 3.) Why is it taking this unprecedented step? Last year, the Fed

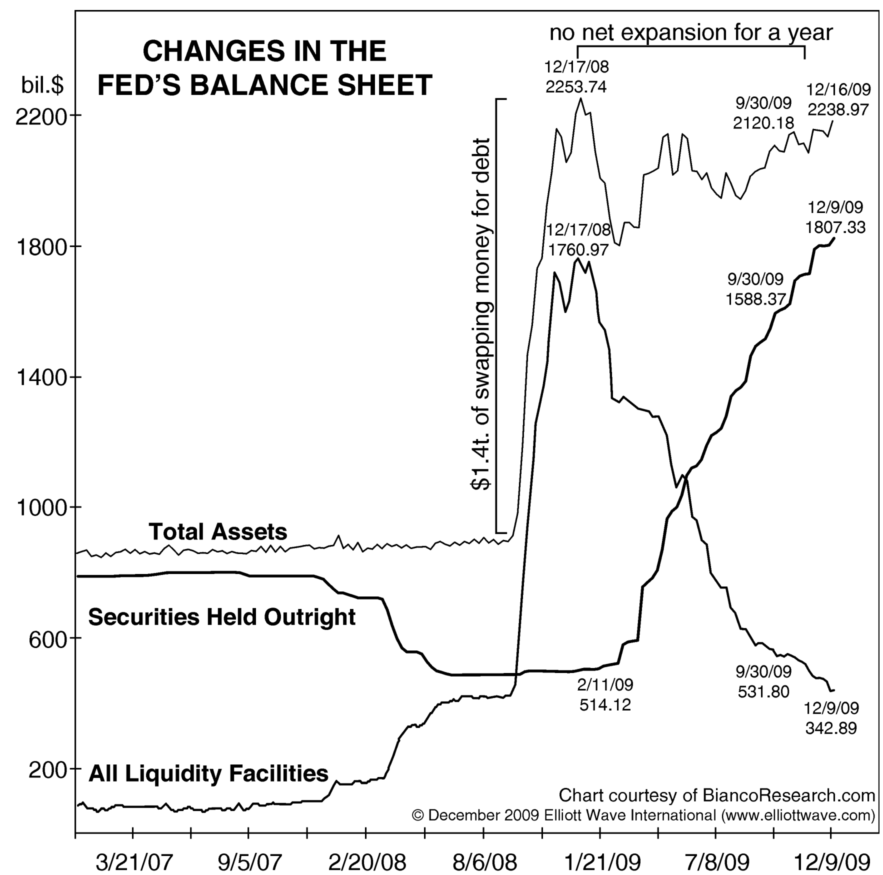

Figure 3

held mostly IOUs from financial institutions, and those IOUs were backed by whatever the institutions had in their portfolios. This strategy didn't work too well. A recent report sheds some light on the poor quality of some of these assets:

> A $29 billion trail from the Federal Reserve's bailout of Wall Street investment bank Bear Stearns ends in a partially deserted shopping center on a bleak spot on the south side of Oklahoma City. The Fed now owns the Crossroads Mall, a sprawling shopping complex at the junction of Interstate highways 244 and 35, complete with an oil well pumping crude in the parking lot — except the Fed does not own the mineral rights. The Fed finds itself in the unusual situation of being an Oklahoma City landlord after it lent JPMorgan Chase $29 billion to buy Bear Stearns last year. That money was secured by a portfolio of Bear assets. Crossroads Mall is the only bricks and mortar acquired through bailout. The remaining billions are tied up in invisible securities spread across hundreds, if not thousands, of properties. It is hard to be precise because the Fed has not published specifics on what it now owns. The only reason that Crossroads Mall has surfaced is that it went into foreclosure in April.
>
> The value of the [Fed's] commercial loan holdings has already been written down to $4.4 billion. In part, this decline in value is because two other pieces of the Bear Stearns collateral — Extended Stay Hotels, and the Grand-Stay Residential Suites Hotels in Oxnard, California — have sought court bankruptcy protection.
>
> Losses are potentially at taxpayer's expense because the Fed generally makes a fat annual profit running the country's payments system and other operations, and any losses reduce how much it can pay out to the U.S. Treasury, and hence taxpayers. (Reuters, 10/21)

Perhaps reacting to such developments, the Fed switched its strategy to the outright buying of securitized debt, comprising mostly government-guaranteed mortgages. During 2009, it exchanged $1 trillion worth of direct loans to financial institutions — which were backed by those institutions' assets — for an equivalent amount of outright-owned debt securities. The intent of this program is to sop up mortgages from the market and to keep interest rates on mortgages low so that private borrowers can get low rates from banks. But in buying up mortgages, the Fed may have done something stupid. Holding IOUs from financial firms seems to be a safer way to go, because the Fed could always have written the loans with highly favorable terms to itself, so that it could require the institution to sell enough assets to make good on the loan. During crunch time, the Fed could have chosen to extend the maturities of such loans while expanding the institutions' obligations behind them. But the Fed's new policy of providing liquidity by accumulating a portfolio of owned securities has put the central bank in the same position as any other doofus whose portfolio is full of dubious IOUs, which is to say: at the mercy of the marketplace. True, it is currently making a nice 4% annualized profit on these holdings. But any downward adjustment in asset prices will directly affect the value of the Fed's portfolio.

There is another twist to the situation. James Bianco informs us, "banks are required to cover Federal Reserve losses," which means that any losses it incurs "will hit the entire banking system." (Bianco Research, 12/3) So with its asset-buying scheme, the Fed is juggling fire with both hands: It is gambling with its own health and that of the entire banking system. It always amazes me that people think the Fed can make losses disappear. The Fed hopes that a mere recession has ended and that recovery will improve the value and liquidity of the debt it owns. But this is a *depression*, and the bill for lunch will end up on the table for someone to pay. That someone may turn out to be the Fed, and if so, ultimately the very banks that the Fed is trying to help.

This situation is deflationary, because the Fed's experience in owning mortgages should have the effect of making members of the Fed *more conservative*. Some Fed governors already dislike the new portfolio that the Fed is holding: "Federal Reserve Bank of Philadelphia President Charles Plosser said the central bank should limit the securities on its balance sheet to Treasuries." (Bloomberg, 10/21). Plosser, a former professor, is "among the strong internal critics of the Fed's efforts." He worries, quite accurately, that the Fed may have trouble exiting its mortgage-backed securities, whether because of market pricing, politics or both. The Fed might have been comfortable lending more money to institutions if they had recourses for payment. But if the Fed incurs losses, it is doubtful that the Board will approve many more trillion-dollar acquisitions of mortgage debt. Such investments, if allowed to continue, will ruin the Fed. By following this aggressive policy move during 2009, the Fed has set itself up to do in 2010 just what the big bankers did in 1929: holler "uncle."

I would not be surprised if by the end of the bear market the Fed owns more Treasuries than anything else, just as it did throughout the collapse of 1929-1932. It's an interesting conundrum. If the Fed keeps buying mortgages, it will commit suicide. If it doesn't, the politicians will probably kill it for having been self-interested.

The Fed's Presumed Inflation Since 2008 Is Mostly a Mirage

Many commentators talk about inflationary forces running rampant. We all know that the Fed created $1.4 trillion new dollars in 2008. It has told the world that it will inflate to save the monetary system. So that is the news that most people hear.

But the Fed's dramatic money creation in 2008 only *seems* to force inflation because people focus on only one side of the Fed's action. Even though the Fed created a lot of new money, it did not affect the total amount of money-plus-credit one bit, because the other side of the action is equally deflationary. When the Fed buys a Treasury bond, net inflation occurs, because it simply monetizes the government's brand-new IOU. But in 2008, in order for the Fed to add $1.4 trillion new dollars to the monetary system, it *removed* exactly the same value of IOU-dollars from the market. It has since retired some of this money, leaving a net of about $1.3 trillion. So *investors*, who previously held $1.3t. worth of IOUs for dollars, now hold $1.3t. worth of dollars. They are no longer debt investors but money holders. The net change in the money-plus-credit supply is zero. The Fed simply *retired* (temporarily, it hopes) a certain amount of debt and replaced it with money. In fact, if the Fed is to be believed, it desperately wants to sell the rest of these (in)securities and retire the new money. I doubt it will happen, but it doesn't much matter to inflation either way.

In currency-based monetary systems, the creation of new banknotes causes — indeed forces —i nflation. Likewise, the monetization of new government debt creates permanent inflation practically speaking. (Theoretically, the government could retire its debt, but it never does.) But when the Fed simply swaps money for previously existing debt, there is no net change in the amount of dollar-based "purchasing power" on the planet.

The theory among monetarists is that these new dollars are hot money that creditors can now re-lend. Thus, it will multiply throughout the banking system. At first it might seem that new money in banks' hands should be more powerful for creating inflation than the previously-held FNM mortgages. But this is not the case, because the main thing for which the Fed wants banks to lend out the new dollars is *new mortgages*. Today, bankers and other creditors are afraid of mortgages, and they don't want new mortgages any more than they want the old ones. In the mortgage-intoxicated, pre-2008 world, there would have been little significant difference in the paper, because banks were creating new dollars any time they wanted by taking on new mortgages. In the mortgage-repelled, post-2008 world, guess what: there is still little significant difference in the paper, because virtually the only thing banks can use it for is to fund mortgages! The only other outlet for the Fed's new money is to fund market speculation, which is one reason why the stock and commodity markets rose.

What is *very* different — as predicted in *Conquer the Crash* — is the desire of lenders to lend and of borrowers to borrow, which has shriveled dramatically. This abrupt change resulted from the *change in the trend of social mood* at Supercycle degree that took place between 2005 and 2008, when real estate, stocks and commodities peaked along with the ability of the banking system to write one more mortgage without choking to death.

Evidence for this case is in Figure 4. Even though the Fed has swapped over a trillion dollars of new money for old debt, the banks aren't lending it. Primary wave 2 allowed the money multiplier to rally to zero, but that trend ended around August, when the real Dow (Dow/gold) peaked out. The money multiplier is back in negative territory, which means that there is more debt being retired than there is new money being created. In other words, deflation is winning.

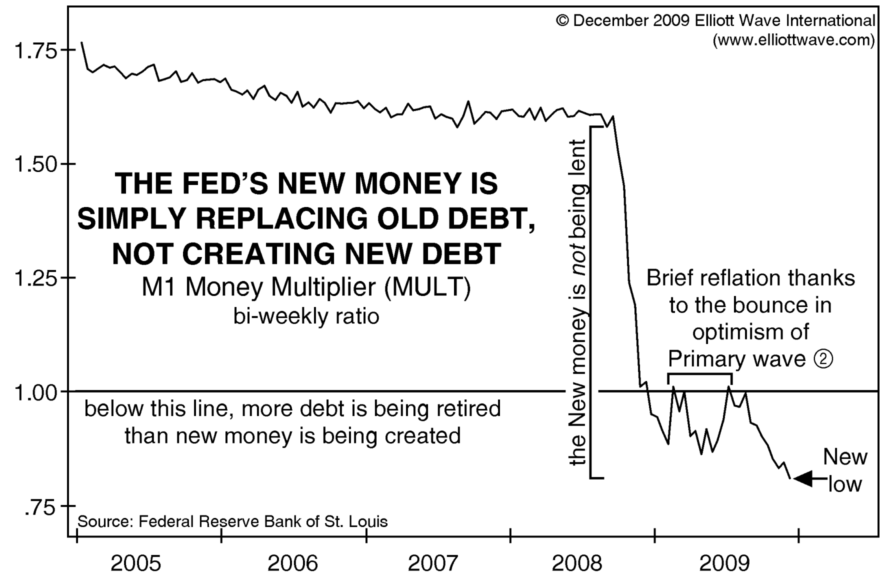

Figure 4

The bottom line is that the Fed hasn't created much inflation over the past two years. The only reason that markets have been rallying recently is that the *Elliott wave form required a rally*. In other words, in March 2009 pessimism had reached a Primary-degree extreme, and it was time for a Primary-degree respite. The change in attitude from that time forward has, for a time, allowed credit to expand again. But the Fed and the government didn't force the change. They merely accommodated it, as they always have. They offered unlimited credit through the first quarter of 2009, and no one wanted it. In March, the social mood changed enough so that some people once again became willing to take these lenders up on their offer.

When credit collapses again during the wave 3 downtrend, we at Elliott Wave International will no longer have to keep "making the case" that the Fed is impotent. It will be clear once again, just as it was in 2008. When Primary wave 4 causes the market to rebound from a much lower level, pundits will undoubtedly tell us once again that the Fed has succeeded in causing a turnaround. The reason that most people's reasoning on such matters keeps changing is that their thought processes with regard to financial markets never do change. They continually rationalize the stock market's actions based on changes in their mood and their mental default to exogenous cause.

EWI eBook

Understanding the Fed:

How to Protect Yourself From the Common and Misleading Myths About the U.S. Federal Reserve

Excerpts taken from *Conquer the Crash* and *The Elliott Wave Theorist,* both by Robert R. Prechter, Jr.

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Post Office Box 1618

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