

## The Multiplication of Money

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**By John Mauldin**

The economy grew in the fourth quarter by 5.9%, the most in years. The adjusted monetary base is exploding. Bank reserves are literally through the roof. The Fed is flooding money into the system in an effort to get banks to lend. An historically normal response by banks (to increase lending) would have been massively inflationary, causing the Fed to stomp on the brakes. Despite raising the almost meaningless discount rate (as who uses it?), this week Ben Bernanke assured Congress of an easy monetary policy, with rates remaining low for a long time. Many ask, how can this not be inflationary?

This week we look at some fundamentals of money supply and the economy. If you understand this, you won't get misled by people selling investments, telling you to buy this or that based on some chart that shows whatever they are selling to be what you absolutely have to have to protect your portfolio and/or make massive profits. And we touch on a few odds and ends. And yes, I can't resist, a few more thoughts on Greece. It will make for an interesting letter, as I'm writing on a plane to San Jose. And it will print a bit longer than usual, because there are a lot of charts.

Before we get into the meat of the letter, I want to give you a chance to register for my 7th (where do the years go?!) annual Strategic Investment Conference, cosponsored with my friends at Altegris Investments. The conference will be held April 22-24 and, as always, in La Jolla, California. The speaker lineup is powerful. Already committed are Dr. Gary Shilling, David Rosenberg, Dr. Lacy Hunt, Dr. Niall Ferguson, and George Friedman, as well as your humble analyst. We are talking with several other equally exciting speakers and expect those to firm up shortly.

Look at that lineup. These are the guys who got the calls right over the past few years. They called the housing crisis, the credit bubble, and the recession. And, in my opinion, these are some of the best in the world at giving us ideas about where we are headed.

Comments from those who attend the annual affair generally run along the lines of, "This is the best conference we have ever been to." And each year it seems to get better. This year we are going to focus on "The End Game," that is, on the paths the various nations are likely to take as they try to solve their various deficit problems, and how that will affect the world and local economies and our investments. We make sure you have access to our speakers and get your questions answered, and you'll come away with excellent, practical investment ideas.

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This conference sells out every year, and it looks like it will do so this year. You do not want to miss it. There is a physical limit to the space. Every year I have to tell people, including good friends, that there is no more room. Don't wait to sign up. There is still an early-registration discount. And while it pains me to say it, you must be an accredited investor to attend the conference, as there are regulations we must follow in order to offer specific advice and ideas. Click on the link and sign up now. <https://hedge-fund-conference.com/2010/invitation.aspx?ref=mauldin>

### Where Is All that Greek Gold?

Last week I mentioned the (what seemed to me and much of the world) odd incident of Greek politicians talking about the need for Germany to pay its debts to Greece. I got this response from a Greek reader. Comments afterward.

“Dear Mr. Mauldin,

I am an avid reader and I just wanted to correct you about a comment in one of your articles, “The Pain in Spain”, specifically:

*‘Somehow they forgot about the German government paying 115 million deutschmarks in 1960 -- not a small sum back then.’*

This repayment of 1960 is undeniable. but the total amount owed was \$10 billion (\$3.5 billion for the return of the gold stolen and the repayment of the war loans Greece was forced into giving Germany, and \$7 billion in war reparations awarded to Greece in 1946). As the DM/\$ parity was then four for one, this means they gave Greece \$29 million out of the \$10 billion owed.

Germany also proclaims that they have given Greece over the years, in one form or another, €16.5 billion. But the fact of the matter is that despite these alleged payments, the issue of the war loans and gold is still not settled.

Greece has never stopped asking for the money to be paid back ... it is estimated that this sum owed now totals \$70 billion [I assume the Greeks want interest – JM]. So even taking into account the €16.5 billion, more than \$50 billion is still owed.

Helmut Kohl refused to even discuss the repayment, presenting as an excuse that this amount was owed by the whole of Germany and until Germany is unified the issue could not be discussed.

Guess what, Germany is unified....

Best Regards,

Anthony Kioussopoulos

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P.S. Do not take my e-mail as a refusal to acknowledge the fault of successive Greek governments in creating this mess; just take it as a correction for a specific issue.”

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The point here is not that Anthony is 100% right, though his statements have the ring of authenticity. The point is that the Greeks believe it. And thus my lack of surprise last week when I noted that leading Greek politicians of both the conservative and liberal parties were talking the same line. This is an issue that runs across the Greek political spectrum. And that makes the situation all the more intractable, as emotional responses are not the stuff of rational debates.

(I should note that if the US demanded payment from Europe of all the money we loaned them after the war, at full interest, our national balance would be a lot better. But I doubt that ever gets brought up, nor should it at a remove of 65 years.)

This week saw riots and a national strike as Greek unions demonstrated against budget cuts. Yet polls seem to indicate a majority of Greeks recognize the need for rather serious austerity measures. As I have documented, they really have no good choices, only very bad and disastrous choices. The austerity measures that will be forced on them by market realities if they default will be far worse than those they can self-impose over time. In fact, yesterday EU inspectors visiting Athens told authorities they see a deeper than expected recession.

Two very condensed reports from European media:

1. After the German magazine *Focus* ran an issue with a Photoshopped picture of Venus de Milo giving the middle finger to “Greek con artists” (referring to the fraud the Greeks perpetrated when they joined the EU by hiding debt), street protests demanding the boycott of German goods were organized in Athens and endorsed by the Greek administration. There was also name calling by the Greek administration, blaming Germany for all of Greece’s economic and financial problems because the Nazis stole all of Greece’s gold in World War II. In general, the Greek public believes that all this is just excuse-making on the part of the Government, but a boycott is loudly supported by members of all the public workers’ unions. (Reuters report)

The situation is exacerbated by news today that Greece needs to refinance \$27bn of bonds in March, vs. the statements JUST TWO DAYS AGO that only half that amount was coming due, and then not until April and May.

2. *Financial Times Deutschland* reported the results of a poll of German banks that was conducted yesterday. No German bank polled said it would make any further investments in Greek sovereign debt. The following banks and building societies are at risk of collapse due to excessive Greek bond holdings: Hypo Real Estate (\$13 billion exposure), Commerzbank (\$7 billion exposure, and the bank was bailed out last year by the German government), LBBW (\$4 billion), Bayern Landesbank (\$2.2 billion). It should be pointed out that Greece is a small country, with 11 million people and a GDP of \$313 billion that is running a trade deficit of \$11bn. Banking experts generally stated that any private purchases of Greek bonds are now completely out of the question. Any

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future aid will have to be government to government, and that will exclude Germany, as Angela Merkel stated earlier in the week. Within the eurozone, there are no other countries outside of Germany that have, or can raise, any capital to invest in Greece. (Hat tip to Steve Stough for the above points.)

For what it's worth, I do not see Germany bailing out Greece in the current climate. If Germany were to force Greece to undertake the severe measures they would be required to take for a bailout, the streets of Greece would be full of demonstrators denouncing Germany. I just don't see it happening.

If not Germany, who? France? Spain? Italy? They all have their own very real problems. Everyone else is too small. The US will not. Neither will China.

My guess is that at the end of the day (which will come soon) the IMF is going to have to step in. It will be a blow to European pride, but what else is there?

### The Euro and a Conspiracy of Hedge Funds

The lead story in this morning's *Wall Street Journal* is that hedge funds are holding "idea meetings" and deciding that shorting the euro is a good bet. *Der Spiegel* called them "secret meetings," as if somehow a cabal of hedge funds is conspiring to push the euro down. A few points for the writers of *Der Spiegel*:

1. There is no secret about the problems with the euro. Let's see, when the head of Germany's leading debt-management agency warned this week that the euro would collapse if any member defaulted on its debt, was he part of a secret conspiracy? If he is right, do you want to bet that Greece will behave, and go long the euro?
2. The currency market is a \$2 trillion dollar a DAY market. That's over \$50 trillion a month. Even with 20:1 leverage, \$50 billion in hedge funds shorting the euro is a drop in the bucket, and I seriously doubt anywhere close to that much is at risk. George Soros won his bet against the pound sterling because the pound was fundamentally flawed and overvalued, and he put his money where his mouth was.
3. If a hedge fund is betting against the euro, someone has to be on the other side of that trade. Are those guys (on the other side) conspiring in secret to drive the euro up and the dollar down? Are they in "secret" meetings to take advantage of the poor, dumb, misinformed hedge funds? Who are they? The world needs to know who is conspiring against the dollar and other currencies! Whatever. One side will be wrong. Fundamentals will out.
4. I get invited to "idea dinners" from time to time. They are indeed private, but they don't rise to the level of "secret." I do very little trading, but these meetings help to hone my ideas, and I hope that helps make this letter a better source for you.

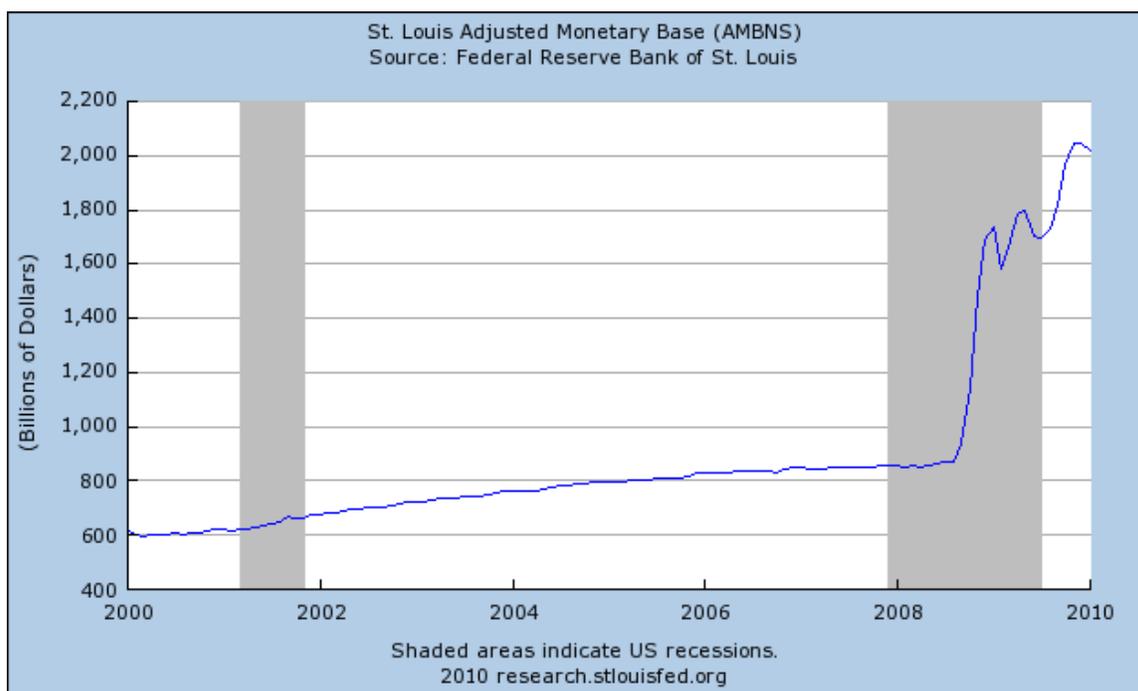
The *Journal* wrote that these hedge-fund managers expect the euro to go to parity with the dollar, as if that is some novel idea. I made that prediction in 2002 when the euro was at \$.88, suggesting that it would rise to \$1.50 and then fall back to parity by the

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middle of the next decade. Maybe it will get there a little faster than I thought. Stay tuned, and I do NOT suggest making 20:1 bets on currency moves. A lot of those hedge funds will lose a lot of money if the market moves against them.

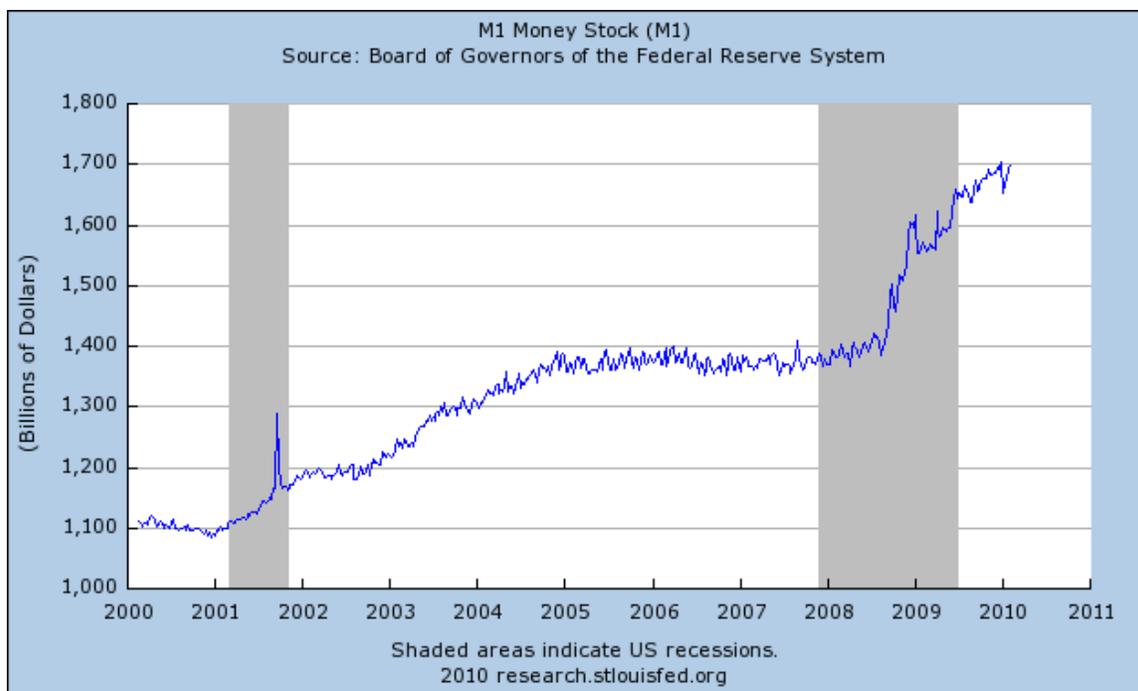
### So Where's the Inflation?

Now for a series of graphs. First, let's look at the Adjusted Monetary Base (or M0). This is the one monetary aggregate that the Federal Reserve actually controls. Notice that it exploded in the middle of 2008, as the Fed started quantitative easing and pushed rates to zero. They were desperate to try and thaw out the credit markets that had frozen.

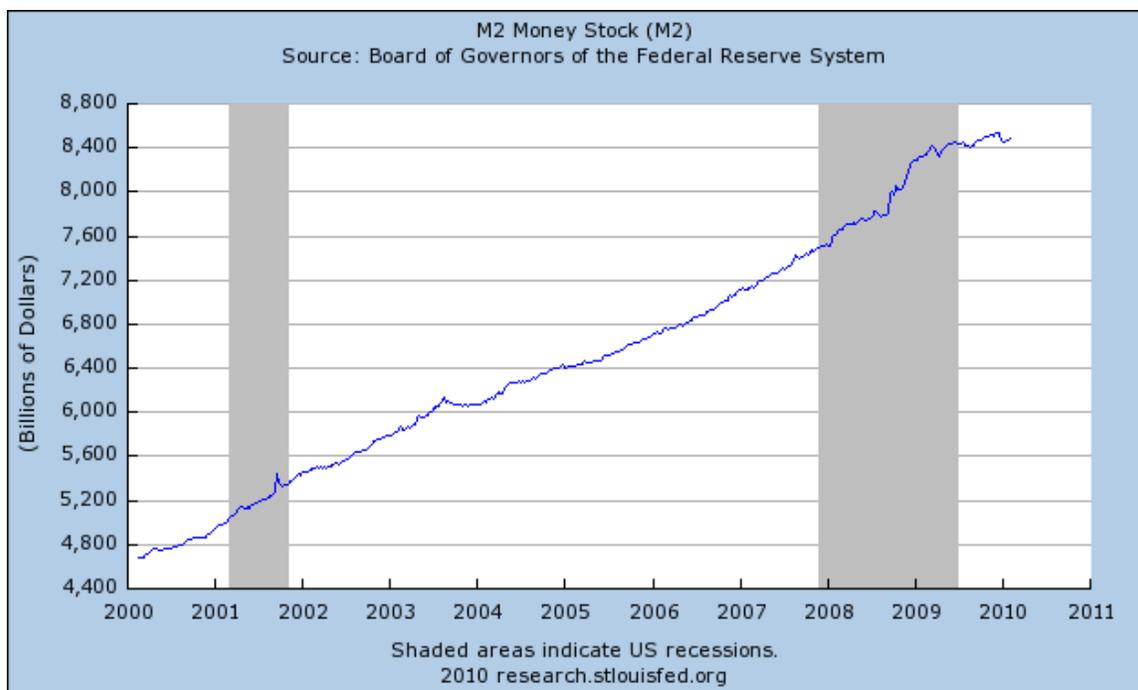


That in turn caused M1 to increase.

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But the broader measure on money that is M2 rose into 2009 and has then gone sideways. Normally the stimulus of such raw money growth in M0 would have M2 exploding upward, as you get a money multiplier effect.

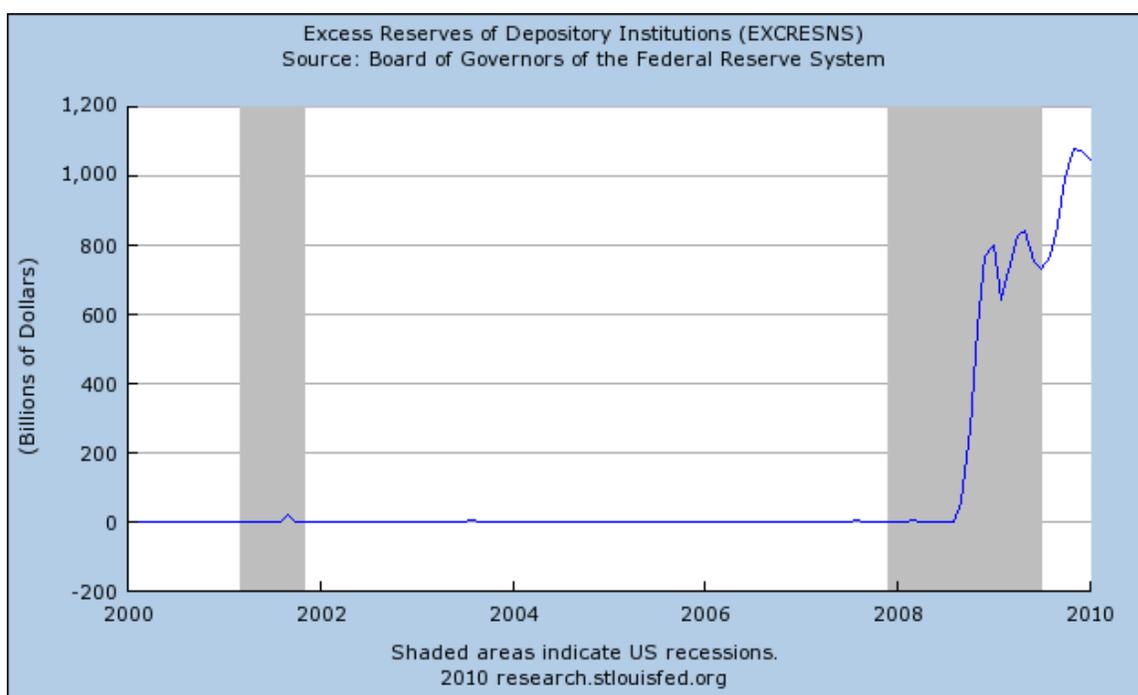


We all know that a US bank can lend out about nine times the deposits it has on hand. When the Fed puts money into the system, it can be multiplied rather quickly if banks choose to lend. This is called the money multiplier.

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“Restated, increases in central bank money may not result in commercial bank money because the money is not *required* to be lent out – it may instead result in a growth of unlent reserves (excess reserves). This situation is referred to as ‘pushing on a string’: withdrawal of central bank money *compels* commercial banks to curtail lending (one can *pull* money via this mechanism), but input of central bank money does not compel commercial banks to lend (one cannot *push* via this mechanism).” (Wikipedia)

This described growth in excess reserves has indeed occurred in the financial crisis of 2007–2010, with US bank excess reserves growing over 500-fold, from under \$2 billion in August 2008 to over \$1,000 billion recently. Look at the chart below. This is what has all the gold bugs salivating: Where else has this happened without hyperinflation?



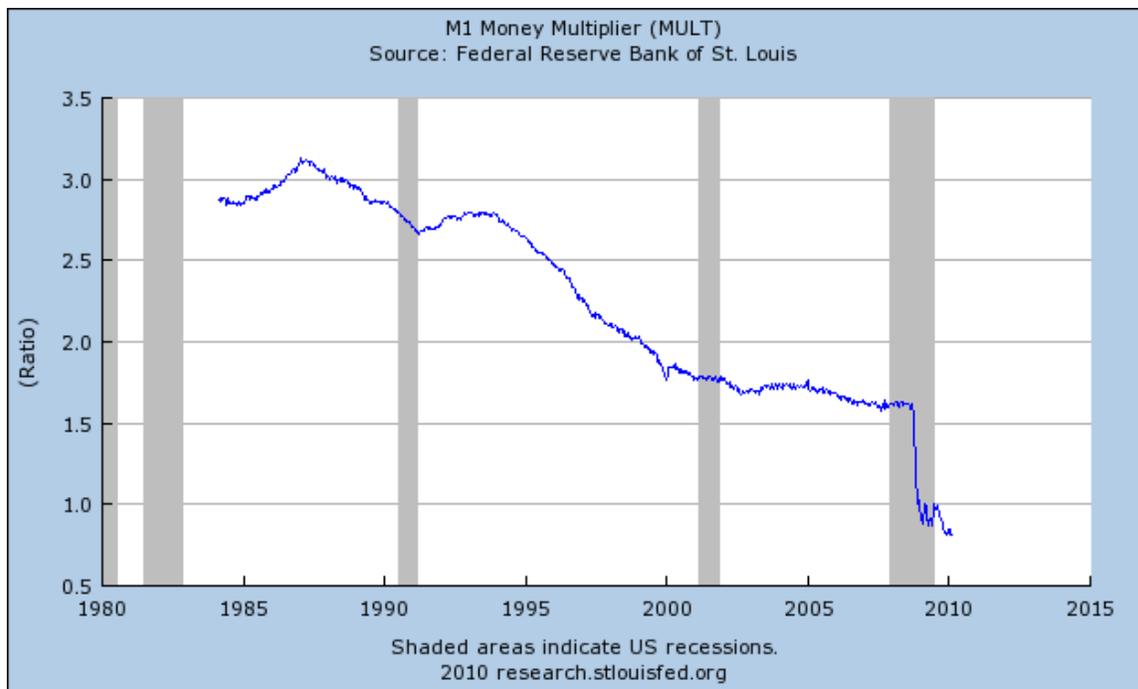
Now let’s turn to our old friend Paul Samuelson and his textbook that we all read in Econ 101 to learn about the money multiplier:

“By increasing the volume of their government securities and loans and by lowering Member Bank legal reserve requirements, the Reserve Banks can encourage an increase in the supply of money and bank deposits. They can encourage but, without taking drastic action, they cannot *compel*. For in the middle of a deep depression just when we want Reserve policy to be most effective, the Member Banks are likely to be timid about buying new investments or making loans. If the Reserve authorities buy government bonds in the open market and thereby swell bank reserves, the banks will not put these funds to work but will simply hold reserves. Result: no 5 for 1, ‘no nothing,’ simply a substitution on the bank’s balance sheet of idle cash for old government bonds.”

– (Samuelson 1948, pp. 353–354)

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And that is what has happened. And all those mortgage bonds and other assets the Federal Reserve has purchased? They have been put right back into the Fed by the banks. There has been no money multiplier. In fact, the money multiplier, as measured by the ratio of M2 to M1 growth is at its lowest level ever. Look at the graph below:



What this graph shows, astonishingly, is that a dollar added to the monetary base now has a **NEGATIVE** multiplier effect. Without showing yet another chart, bank lending has fallen percentagewise the most in 67 years. The actual amount of bank loans is falling each and every quarter, with no signs of a bottom. Consumers are reducing their debt and leverage. Bank loans are being written off at staggering rates. Over 700 banks (I think that is the figure I saw) are officially on watch by the FDIC, with more banks being closed each week.

There is at least \$300-400 billion in losses on commercial real estate waiting to be written down. Housing foreclosures are rising and hundreds of billions have yet to be written off. As more families fall into unemployment or underemployment, there will be more writedowns. Is it any wonder that banks are having to shore up their balance sheets and make fewer loans?

With capacity utilization just off all-time lows, why should we expect businesses to borrow to increase capacity? Inventory levels are much lower than two years ago. Businesses no longer need to finance as much inventory. They simply need less.

Dennis Gartman writes:

“Effectively the Fed had become a cash machine rather than a monetary expansion machine. At the end of last year, the multiplier had actually fallen to less than

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1.0 and the trend remains downward. If anyone had told us five years ago that the money multiplier would be down to 1.0 we would have laughed. The laugh, however, would have been upon us, for it is there and it is still falling. Hard it shall be to sponsor strong economic growth when no one really wants to take a loan or when few banks want to make a loan. The “game” of banking has been turned upon its head, and the strength of the economy suffers while inflationary pressures (at least for now) remain virtually non-existent.”

Next week (or within a few weeks) we will review the velocity of money, as the normal, accustomed relationships about money supply and inflation are proving to be wrong. We live in extraordinary times. We are coming to the End Game of the debt supercycle that has lasted for 70 years. Everything is changing in front of our eyes. It compels us to understand the basics of how economies function, and what is both different and not different about the times we are in.

### No Help for Homebuilders

Before we close, this note from Mark Hanson about the home-building market:

“In January, builders sold a whopping 1000 houses per day nationally. During the same month, Foreclosures rang up at 4300 and Notice-of-Defaults at 5100 per day nationally. What a mess. I really thought earlier in the year with massive mortgage rate and tax stimuli -- and the purposeful lack of distressed inventory due to HAMP and other mortgage mod and foreclosure prevention initiatives -- that builders had a shot at some volume.

**“But their window of opportunity has now passed.** With HAFA coming on line and foreclosures, short sales and deeds-in-lieu about to dump significantly more distressed inventory on the market throughout 2010, the odds that of any meaningful pickup in builder output or sales is significantly decreasing daily.”

### The Singularity, San Antonio, Home, and Addictions

It is time to hit the send button. In order to have some mercy on you, gentle reader, I am saving the last 8 pages of this letter for another time. All things in moderation.

As noted above, I am on a plane to San Jose, where I will take a short ride to NASA Ames to spend the next 9 days listening to experts talk about how various technologies will change over the next 10 years, and how that will impact business, society – well, everything. I am really pumped about it. 12 hours a day of lectures and some local tours, with a small group that appears to include some very bright attendees (from their bios). Your humble analyst will speak for just an hour on the future of the world economy. Sadly, my assessment will not be as optimistic as theirs, at least with regard to the next 5 years. If I am allowed, I am going to publish my abbreviated notes in next week’s letter, assuming I can take notes and keep up at the same time.

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Then I must miss the final day, as I fly to San Antonio for a speech on Saturday morning to the top level of Cambridge brokers, then back home for a month! A whole month! Maybe I can catch up on my writing and emails.

I met with George Friedman of Stratfor this Tuesday. (Tiffani went with me, her first trip away from my granddaughter Lively. Ryan got to play Mr. Mom.) I was sitting in George's office at the end of the day, waiting for everyone else to show up so we could go to dinner. I had been busy trying to coordinate meetings and keep up with my reading and research, emails, and phone calls.

"George, I have a problem. I feel like I am drinking information through a fire hose. I am addicted to information. It is beginning to interfere with my productivity, as I get so much high-quality material from the best sources that I feel I need to absorb. Each bit of information becomes a clue to the larger puzzle. But I have to write more. I am going to have to start randomly deleting things every now and then if I am going to stay on top of it all, and get some of these books that are in me done."

I am determined to have a life outside of work (family and friends are important), and am for the most part successful at that, but I am not getting done all that I wish I could do when I'm at work. And there are books piled on my desk that simply scream for attention.

I thought George would understand. He has some 90 analysts all over the world feeding him up-to-the-minute analysis on country and issue situations. Surely, he must have an idea for me on how to handle the "download" problem.

"John," he replied quietly, sighing heavily, "I know what you mean. But if I started randomly deleting, I'd be afraid I would miss something important. What else can you do but keep at it?"

It is the conundrum of our age. I hope, gentle reader, that I help you in some ways to keep up and stay informed without overloading you! Have a great week, and learn something new!

Your really ready to think about the future analyst,

John Mauldin