THINGS THAT MAKE YOU GO
Hmmm...
A walk around the fringes of finance

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"History never repeats itself, but it often rhymes"
– MARK TWAIN

"Sanctions and negotiations can be very ineffective, and indeed foolish, unless the people you are talking with and negotiating with and trying to reach agreements with are people who can be trusted to keep their word"
– Casper Weinberger

"The four most dangerous words in investing are 'This time it's different.'"
– Sir John Templeton

It's funny how things turn out sometimes.

Today, January 20th, is my 45th birthday and I find myself in a hotel room in Dubai tapping away at my computer keyboard while I have some spare time in the hope of getting something written, assembled and distributed before the craziness of the next week descends on me.

To get here from Singapore I flew seven hours on an Emirates 777 and, as we approached the UAE the Captain informed us that, should we look out of the right side of the plane, we would see the Straits of Hormuz.

Sadly, I was trapped in the middle row next to a Chinese lady of undeterminable age who, on a 7-hour flight that began at 9:35am Singapore time, polished off six cans of Heineken and two glasses of red wine, so I couldn't get a decent view of the Straits below us, but it brought my mind back to where it has been a fair bit recently, namely Iran and the price of crude oil and gold.

Oddly enough, on this very day in 1981 (my 24th birthday - sigh!), literally minutes after the inauguration of the first US President named Ron, 52 American citizens walked free from a 444-day hostage ordeal in the US Embassy in Tehran which had begun on November 4, 1979 when a group of irate Iranian students seized the embassy in protest at the US decision to allow the deposed Shah of Iran to travel to New York to receive medical treatment.

The stand-off, the disastrous rescue attempt - Operation Eagle Claw - and the seeming impotence of the United States in the face of such a challenge to its sovereignty all combined to help unseat Jimmy Carter in the 1980 Presidential elections and hand the US Presidency to the first Ron - Ronald Reagan.

A little over a year before he was unceremoniously ousted from the Oval Office, on November 14, 1979, Carter had put Presidential pen to Presidential paper and signed Executive Order 12170:

> *Pursuant to the authority vested in me as President by the Constitution and laws of the United States including the International Emergency Economic Powers Act, 50 U.S.C.A. sec. 1701 et seq., the National Emergencies Act, 50 U.S.C. sec. 1601 et seq., and 3 U.S.C. sec. 301.*
>
> *I, JIMMY CARTER, President of the United States, find that the situation in Iran constitutes an unusual and extraordinary threat to the national security, foreign policy and economy of the United States and hereby declare a national emergency to deal with that threat.*
>
> *I hereby order blocked all property and interests in property of the Government of Iran, its instrumentalities and controlled entities and the Central Bank of Iran which are or become subject to the jurisdiction of the United States or which are in or come within the possession or control of persons subject to the jurisdiction of the United States.*
>
> *The Secretary of the Treasury is authorized to employ all powers granted to me by the International Emergency Economic Powers Act to carry out the provisions of this order.*
>
> *This order is effective immediately and shall be transmitted to the Congress and published in the Federal Register.*
>
> *The White House,*
>
> *November 14, 1979* *Jimmy Carter*

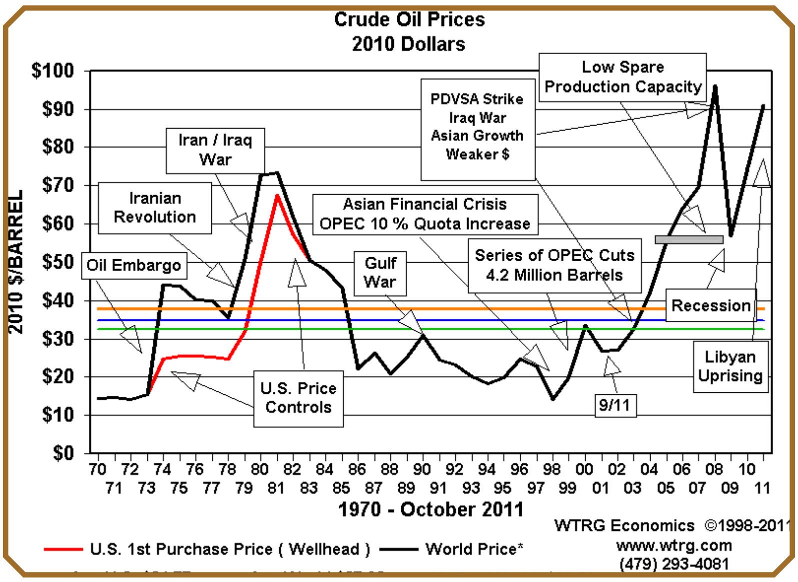
Thus, with a stroke of Carter's pen, began thirty years of sanctions against Iran that have once again become the focal point in a potentially deadly game of chicken as the increasingly bellicose Iranian regime of Mohammed Ahmadinejad stand their ground in an ever-more fractious face-off with the West.

The original sanctions against Iran froze a total of roughly $12 billion of assets including bank deposits, gold and other properties but, perhaps more importantly in history's eyes, weakened the country to such an extent that, on September 22, 1980, Saddam Hussein was emboldened to invade Iran (with the notable support of the United States and Kuwait amongst others). Every action has an equal and opposite reaction.

No sooner had Hussein invaded Iran than the US *increased* sanctions, doing so again in 1984, when sanctions were approved that prohibited weapons sales and all U.S. assistance to Iran. The United States also opposed all loans to Iran from international financial institutions. In October 1987, President Reagan issued Executive Order 12613 prohibiting the importation and exportation of any goods or services from Iran.

Things got worse in the 1990s when Presidents Rafsanjani and Khatami fell foul of Bill Clinton who signed Executive Orders 12957 and 12959 prohibiting US trade with Iran's oil industry and all US trade with Iran respectively.

Then came Ahmadinejad.



CLICK TO ENLARGE

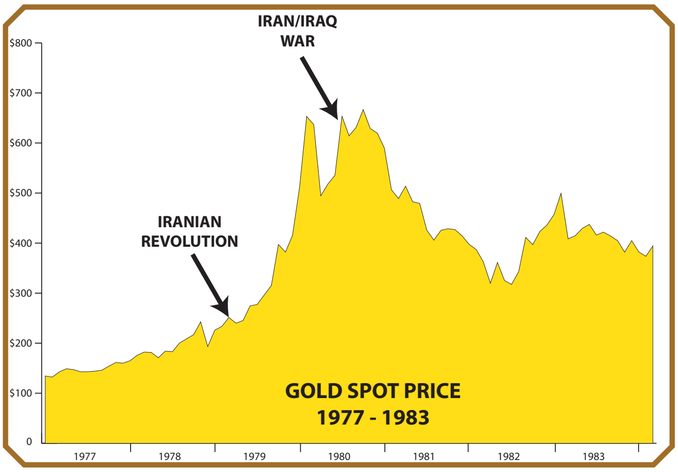
SOURCE: WTRG ECONOMICS

After his election in 2005, Ahmadinejad set about lifting the suspension on Iranian uranium (try saying THAT five times quickly) enrichment and that brought him into direct conflict with the UN who adopted a whole bunch of resolutions, and George W. Bush who signed yet another Executive Order (13382 for those keeping score) freezing yet more Iranian assets.

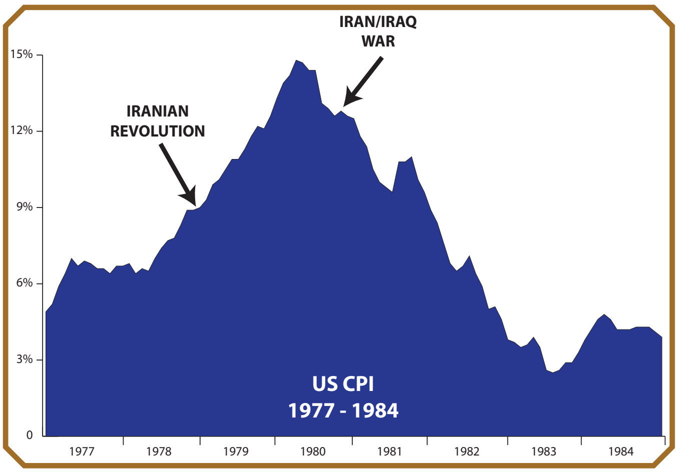
Finally, on June 24, 2010, the US decided that the whole Executive Order thing was getting out of hand and so Barack Obama signed into law the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010 (CISADA) which, amongst other things, enhanced restrictions on the import from Iran of rugs, pistachio nuts and caviar.

But from the outset of sanctions against Iran in 1979, it was crude oil and gold that were affected the most. The chart, above, shows the oil price which, having begun to recover from the 1973 Arab embargo, spiked viciously as first the Iranian revolution that deposed the Shah then the stand-off with the US and finally the onset of the war with Iraq combined to send the price from a (then) already high $38 to a previously inconceivable $70.

Around the same time, gold was attracting a safe-haven bid as the unrest in the Middle East pushed the price of crude higher and the spectre of a major conflict in the region with the US being drawn



SOURCE: BLOOMBERG/TTYMGH



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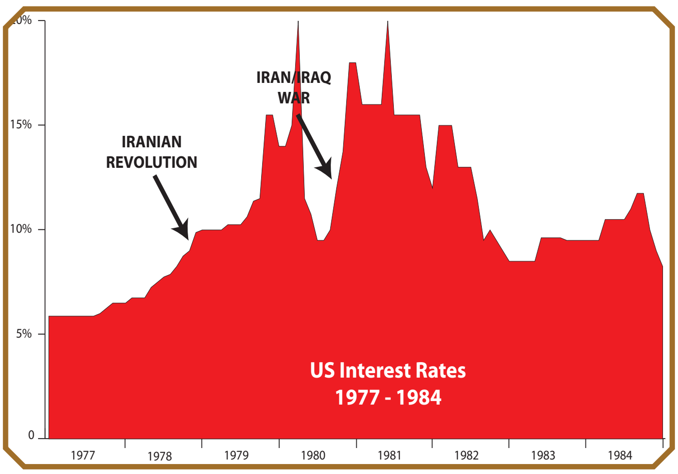


SOURCE: BLOOMBERG/TTYMGH

into the fray occupied the thoughts of investors across the globe. Inflation was on everybody's mind as prices of just about everything rose in lockstep.

Sound familiar?

A look at a chart of gold (chart, left) around the same time illustrates a very recognizable curve indeed:

This period also coincided with Russia's invasion of Afghanistan which began on Christmas Eve 1979 and, naturally with oil rising so spectacularly, runaway inflation in the US (represented here by the US CPI, chart, left, middle).

As the 1970s gave way to the 1980s, the world was a pretty dangerous place to be.

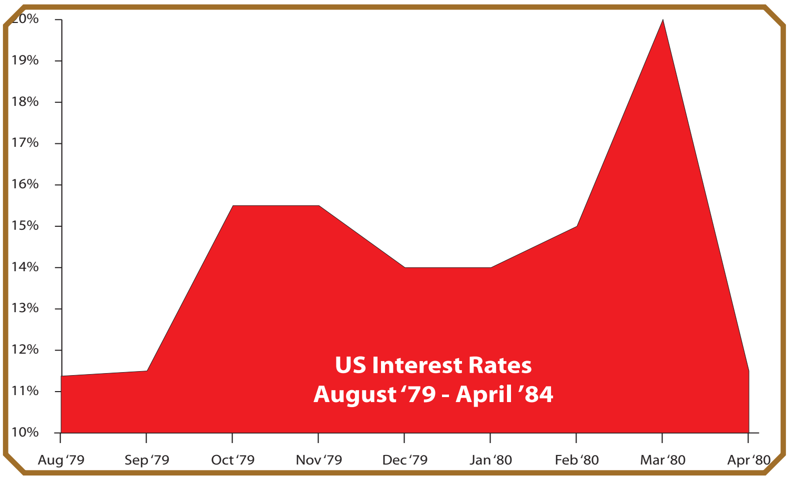
The arrival of Paul Volcker as Chairman of the Federal Reserve in August of 1979 was the beginning of a concerted effort to check the runaway inflation that had crippled the US in the wake of soaring oil prices and, even though US interest rates were at what today would not only be the inconceivable level of 10%, but a level that would mean certain bankruptcy for the United States as every penny of tax revenue (and then some) would be needed to pay the interest on their debt, Volcker set about virtually doubling them. Austerity? I've got your austerity right here.

The table (right) and the chart on the following page (top) demonstrate just how serious Volcker was about raising rates as he set about crushing inflation:

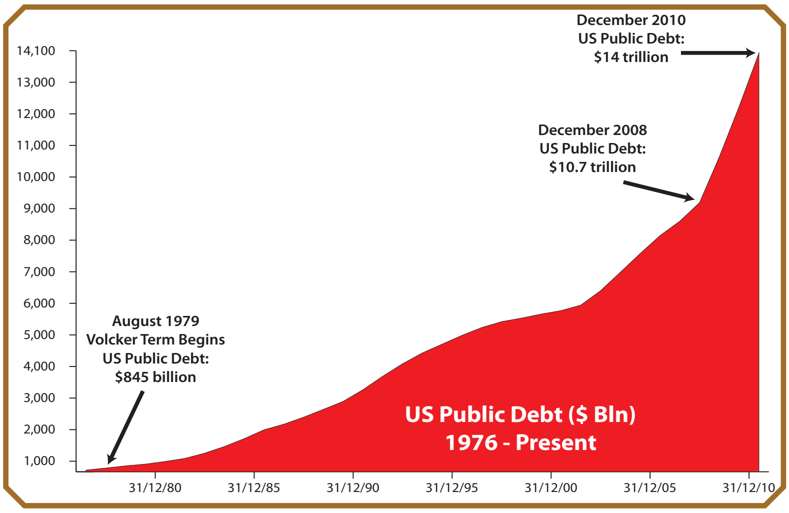
DATE	RATE
Aug '79	11.375%
Sep '79	11.50%
Oct '79	15.50%
Nov '79	15.50%
Dec '79	14.00%
Jan '80	14.00%
Feb '80	15.00%
Mar '80	20.00%
Apr '80	11.50%

In October 1979, Volcker raised interest rates 3.5% in one clip. In March of 1980 he hiked then 5% - that's FIVE PERCENT. The following month, as the effects of those higher rates became clear, he immediately reacted, slashing them by 8.5%.

The US wasn't out of the woods yet by any means - in fact interest rates would again touch 20% briefly in May of 1981, but Volcker was able to move aggressively in both directions when he needed to.



SOURCE: BLOOMBERG/TTYMGH



SOURCE: BLOOMBERG/TTYMGH

The Bernanke Fed does not have that luxury.

When Volcker began his term as chairman of the Federal Reserve, US public debt was $845 billion (chart, bottom left) which afforded him a degree of latitude in his policy application (although back then, $845 billion WAS real money), he also inherited higher interest rates at which that level of debt was at least sustainable which gave him even more flexibility in the setting of those rates. Today, with a suffocating $14 TRILLION of public debt (an amount that has increased almost 40% since December 2008), and interest rates at zero, Ben Bernanke's room to maneuver is a source of mirth to battery hens everywhere.

The US currently has to borrow approximately 40c of every dollar it spends and, according to JPMorgan, every 65bps increase in those rates adds $100bln in interest payments to the United States' bill. Maybe not checkmate just yet - but it's close...

Any *meaningful* move upwards in interest rates from here will very quickly alter the US' debt dynamic to the point of outright insolvency. Currently, the US' average maturity is 62.5 months and their average interest rate (not including TIPS) is a staggeringly low 2.274% (down from 6.66% in 2000). That level is clearly unsustainable in the long term, particularly with the massive inflation of the Fed's balance sheet that has taken place since 2008, but the US has the luxury of, as Jim Puplava likes to say, being the best house in a bad neighbourhood.

Once Europe reaches its inevitable denouement - and I suspect we are rapidly approaching that point; think March - all eyes will look for the next crumbling edifice and there are plenty of them to choose from.

(Incidentally, while reports of an agreed 70% write-down on all Greek debt may well boost markets, I suspect there will be a very long way to travel over inhospitable terrain before any agreement is free of legal challenges either from bond holders or CDS holders:

> *(NYTimes): Hedge funds have been known to use hardball tactics to make money. Now they have come up with a new one: suing Greece in a human rights court to make good on its bond payments.*
>
> *The novel approach would have the funds arguing in the European Court of Human Rights that Greece had violated bondholder rights, though that could be a multiyear project with no guarantee of a payoff. And it would not be likely to produce sympathy for these funds, which many blame for the lack of progress so far in the negotiations over restructuring Greece's debts.*

The tactic has emerged in conversations with lawyers and hedge funds as it became clear that Greece was considering passing legislation to force all private bondholders to take losses, while exempting the European Central Bank, which is the largest institutional holder of Greek bonds with 50 billion euros or so.

Legal experts suggest that the investors may have a case because if Greece changes the terms of its bonds so that investors receive less than they are owed, that could be viewed as a property rights violation — and in Europe, property rights are human rights.

According to one senior government official involved in the negotiations, Greece will present an offer to creditors this week that includes an interest rate or coupon on new bonds received in exchange for the old bonds that is less than the 4 percent private creditors have been pushing for — and they will be forced to accept it whether they like it or not.

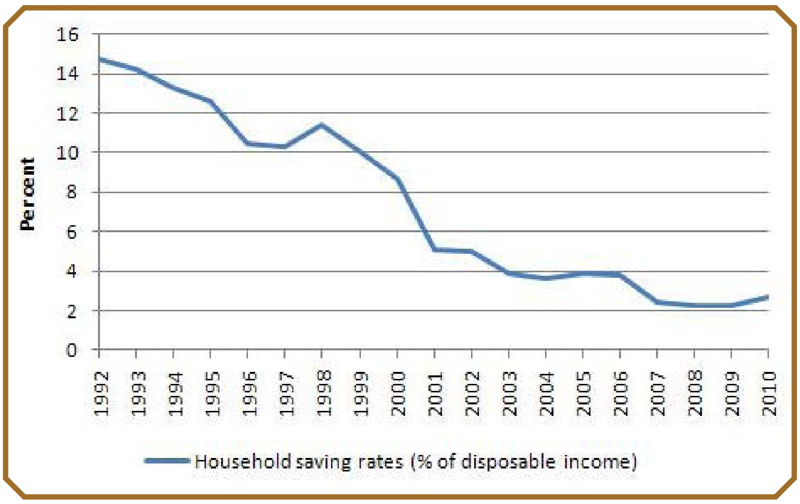
"This is crunch time for us. The time for niceties has expired," said the person, who was not authorized to talk publicly. "These guys will have to accept everything.")

The UK, Japan and the US are ALL facing the same intractable debt dynamics and you can be sure that, one-by-one, they will all have their feet held to the fire. Even mighty Germany is not immune as this week the spiky Egan Jones agency gave warning when putting Europe's economic boiler-room on watch for possible downgrade:

(Egan Jones): Germany maintains its position as the European Union's top economy. However, Germany has been shouldering the burdens of other EU countries via its exposure to the EFSF and indirectly via the ECB's hefty exposure to the weaker banks and the weaker sovereign credits. The country's debt to GDP of 83% as of 2010 (expect near 86% for 2011) and a deficit to GDP of 4.6% is weak (and getting weaker) for a top-tier country. On the positive side, unemployment was only 6.8% but will probably increase as many EU countries implement austerity measures. Other positives were the positive (EUR133B) balance of trade and the positive (EUR193B) current account as of the end of 2010.

Inflation has been fairly moderate at 2%, but we expect an increase as a result of the decline in the euro relative to the dollar. German chancellor Angela Merkel continues to create tension with EU member states by pushing for ratification of changes to the Lisbon Treaty. The government insists that private investors bear more of the costs of further European bailouts. Note, the cost of the bailouts is likely to be absorbed via increased support for the EFSF, the ESM, the ECB and a rise in the number of euros. The fallout from a likely Greek default needs to be monitored.

My best guess is that Japan comes into focus first as the sheer amount of chatter surrounding it has increased markedly of late and that can only mean that more people are looking more closely at the country whose ability to finance their preposterous debt levels domestically has quite literally been the only thing stopping them from defaulting for many years. The fact that, since 1992, Japan's domestic savings rate (left) has



SOURCE: OECD

fallen from 15% to 2.7% is an alarm bell of deafening proportions. When Japan finally DOES succumb to the inevitable, it will NOT be a pretty sight and, like Hemingway famously said, it will go broke two ways; slowly then all at once. I think it's fair to say that twenty years could be classified as slowly.

Japan may yet be beaten to the punch by the UK, whose fiscal situation is comparably dire (but a topic for another day), but either way, they will both face their day of reckoning. Once those days have come and gone, all eyes will turn to the US.

It's no secret that the US is completely unable to withstand higher interest rates and so, to maintain low rates, they have chosen to go down the path of Quantitative Easing or, to use the vernacular, moneyprinting. As a consequence, there are multiple trillions of dollars of freshly-printed money currently waiting to be unleashed into the wild ($1.6 trln alone just sitting on deposit at the Fed in return for 0.25% interest).

What happens when that pent-up cash is released is anybody's guess and the cornerstone of the inflation/deflation debate that rages constantly. My own belief is that the debate is largely a moot one as any bout of deflation will be attacked with highly inflationary measures ensuring that, even if we have a brief period of deflation, ultimately, with the cure for the one ill being a healthy dose of the other, you can rest assured that we will end up with inflation either way.

In the late 70s/early 80s, the world faced a situation remarkably similar to that it faces today in many ways but many believe there will somehow be a different outcome. As Sir John Templeton said, the four most dangerous words in investing are 'this time is different', but as my good and wise friend Brian P likes to say "This time isn't different. This time is NEVER different". In fact, if there IS one difference, it's that level of debt which only serves to make this time WORSE, not better than last time.

	70s/80s	**Today**
Tension in the Middle East:	✓	✓
High Oil Price:	✓	✓
High Gold Price:	✓	✓
Runaway Inflation:	✓	✗
Rapidly Rising Rates:	✓	✗

Looking at the checklist above, it seems as though we are only missing two crucial ingredients and, though many people in positions of influence over such things as Fed or ECB policy like to believe they have the necessary control over all aspects of what they are doing to address the world's current problems, they are wrong. Dead wrong.

At some point, inflation WILL kick in and rates WILL rise as what Bill Fleckenstein likes to call 'the funding crisis' begins and that perception of control will be shattered.

When that happens, the current 'high' prices of oil and gold will seem like nothing of the sort.

This week's edition of Things That Make You Go Hmmm..... begins in Portugal, where Ambrose Evans-Pritchard sees a looming disaster before heading to Greece to see how the haircut negotiations are going (hint: not so well), New York City where taxicab medallions may be the next bubble to burst and, of course, to Italy where ordinary Italians are getting fed up with Germany. It was only a matter of time, frankly. We end up back with Ambrose Evans-Pritchard - this time in the UK where 'austerity' would appear to be having little effect (though, uncharacteristically, there is a hint of bullishness about the US in Ambrose's article).

Alf Field explains why the gold correction is over (and there aren't many who know more about the subject than Alf), John Mauldin offers Greeks a disaster menu and tells them to take their pick, Satyajit Das bemoans the death of trust and the Chairman of China's Banking Regulatory Commission discusses the challenges he sees heading his way in 2012.

Michael Pettis ponders when we might see a reversal in trade, the Economist examines the debt hangover crippling the world and we have charts of plummeting personal income, proof (positive?) of shenanigans in the London bullion markets and Richard Ross is back with the kind of idiosyncratic look at Europe that only he can provide.

The FDIC are back in business as the first three banks of 2012 hit the wall while in our interviews section, the great Marc Faber holds court on bond markets and lost wagers, Andrew Lilico comes to similar conclusions as I have on the timetable of a Greek default and, if you have time, you can listen to me chatting with Jim Puplava about a wide range of topics starting in China and moving via several other locales to the US.

That's about it for another week. I will be absent from your inboxes again next week I'm afraid as I'll be traveling back to Singapore so I'll see you all back here in a fortnight.

Before I go, just a reminder that I will be taking on my first speaking engagement next month at the Cambridge House California Investment Conference in Palm Springs. The conference runs over the weekend of the 11th and 12th of February so if any readers are in the area and would like to stop by, I would love to see you there.

The line-up this year is fantastic with John Embry, Greg Weldon, Brent Cook, Bill Murphy and Chris Powell of GATA and my friend, Al Korelin just a few of the many speakers in attendance.

It should be a lot of fun and, personally, I'm looking forward to having the chance to meet and listen to insights from some of the sharpest financial minds around.

For details, please click on the link HERE

Contents

23 January 2012

The Gonnie, Gonnie Banks

#	Bank	Assets ($m)	Deposits ($m)	Cost ($m)
1	Central Florida State Bank, Belleview, FL	79.1	77.7	24.4
2	First State Bank, Stockbridge, GA	536.9	527.5	216.2
3	American Eagle Savings Bank, Boothwyn, PA	19.6	17.7	3.2
	Total Cost to FDIC Deposit Insurance Fund			**243.8**

Portugal's borrowing costs have jumped to record highs and are tracking the moves seen in the culminating phase of Greece's debt crisis, dashing hopes that the country will be able to stave off contagion by embracing drastic austerity.

Yields on Portugal's 10-year bonds climbed to 14.39pc on Thursday. Credit default swaps measuring bond risk have reached 1270 points, pricing a two-thirds chance of default over the next five years.

While some of the latest damage reflects forced selling of Portuguese debt after Standard & Poor's cut the country's credit rating to junk status last Friday, there are deeper worries that sharp fiscal cuts by the free-market government of Pedro Passos Coelho may prove self-defeating.

> "... confidence in Portugal's democracy has fallen to the lowest since the end of the Salazar dictatorship. Barely more than half retain faith in the system and 15pc pine for "authoritarian" rule."

Mr Passos Coelho has been praised by EU leaders and the International Monetary Fund for delivering on austerity, but the risk is that severe tightening - without offsetting monetary and exchange stimulus - will push Portugal into the same downward spiral that has already engulfed Greece.

Jurgen Michels, Europe economist at Citigroup, said Portugal's economy will contract by a further 5.8pc this year and by 3.7pc in 2013, a far sharper decline than official forecasts. The peak-to-trough collapse would be 13pc, a full-fledged depression.

"As this gets worse it is going to be extremely difficult to go ahead with more austerity measures: political contagion will start to come through," he said.

Portugal has so far reacted calmly. It has avoided the sorts of riots seen in Greece, but patience is wearing thin. The CGTP labour federation held a protest march in Lisbon this week, vowing to resist "forced labour".

A new study by the Barometer for Democracy shows that confidence in Portugal's democracy has fallen to the lowest since the end of the Salazar dictatorship. Barely more than half retain faith in the system and 15pc pine for "authoritarian" rule.

While Portugal's public debt of 113pc of GDP is lower than Greece's, the private sector has much larger debts and the country's total debt-load is higher at 360pc of GDP - much of it external debt.

"There is huge private sector deleveraging going on and the banking system has big problems. It is unclear how much of this private debt is going to end up on the state's door-step," said Mr Michels.

"Without a sizeable haircut to its debt stock, Portugal will not be able to move into a viable fiscal path. We expect a haircut of 35pc at the end of 2012 or in 2013."

AMBROSE EVANS-PRITCHARD / **LINK**

Crucial talks over a debt deal between lenders and the Greek government were suspended over the weekend as the representative of bondholders flew out of Athens empty handed.

Charles Dallara, managing director of the Institute of International Finance (IIF), a lobby group representing private creditors who have lent €47bn (£39bn) to the Greek government, has so-far failed to reach agreement on the key interest rate of the new bonds Greece will issue.

Athens was anxious to strike a deal ahead of a meeting of eurozone finance ministers on Monday, which could have set in motion the paperwork and approvals necessary to give Greece its next tranche of aid, worth about €130bn.

This will prevent a disorderly debt default when €14.5bn of Greek bonds mature in March. However, Greek government officials said on Saturday that the crisis talks had now been postponed for a few days.

A spokesman for the IIF said that Mr Dallara had travelled to Paris for a long-standing social arrangement and his departure was "in no way a reflection on the talks". The talks have made "substantial" progress, the spokesman said, noting that Mr Dallara was in phone contact with the Greek prime minister and could return to Athens at any point.

International private creditors have already accepted a 50pc "haircut" or loss of their investments in Greek bonds, a move that would cut €100bn from Greece's €360bn debt pile. However, the sticking points appear to be the term to maturity of the new replacement bonds and the rate of interest, or coupon, that they will pay.

The IIF had been pushing for an average coupon of 4.25pc as it became clear that the haircut could grow to as much as 70pc.

"Talks were underway between Mr Dallara, Greek prime minister Lucas Papademos and finance minister, Evangelos Venizelos when a snag was hit," a Greek government official said. "It became known that the Troika [the International Monetary Fund (IMF), the European Central Bank and the European Union] insisted on a more realistic, smaller rate."

"We were informed that the IIF authorised Mr Dallara to negotiate a compromise at 3.8pc," said a senior Greek banker who is close to the negotiations.

★ ★ ★ *UK DAILY TELEGRAPH* / **LINK**

The first casualty of war is said to be the truth but, in financial crises, it is trust that dies. While the after-effects of the recent crisis are constantly debated, this deeper issue remains unaddressed.

Paul Seabright, a professor at the Toulouse School of Economics, has identified traits that underpin social systems such as money: the capacity to weigh up the costs and benefits of trusting others and the instinct to return favours in kind or seek revenge when trust is betrayed. When it is working well, the system enables strangers to safely deal with each other. But this fragile system, on which the global economy depends, is now at risk of failing.

"... Instead of risk-free return, government bonds now offer "return-free risk", in the words of Jim Grant"

Money, a mechanism of exchange and a store of value, galvanised modern economies. Debasement of currencies through quantitative easing and artificially low interest rates undermine these functions.

This is encouraging interest in alternative paper money, such as the Bavarian Chiemgauer, the Lewes Pound or the BerkShares programme in Massachusetts. With limited acceptance within a small area and (sometimes) a finite expiry date, alternative currencies encourage local business and emphasise community values. They also indicate distrust of governments, banks and global finance. Once an unquestioned and secure store of wealth, government bonds are threatened by the risk of sovereign defaults or destruction of purchasing power. Instead of risk-free return, government bonds now offer "return-free risk", in the words of Jim Grant.

The rising value of gold is also evidence of these concerns. Wealthy savers are switching from financial instruments to alternative assets – farmland, fine arts and other collectibles – to preserve the value of their savings. But these savings are locked in unproductive investments and cannot circulate freely.

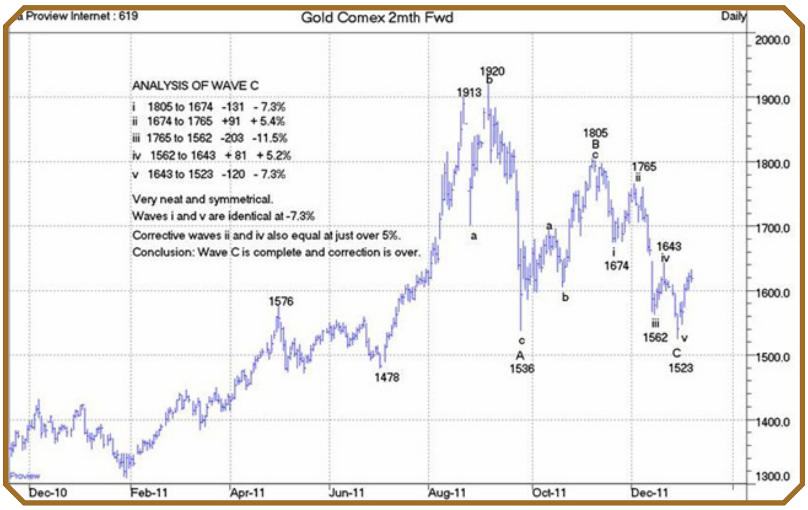
Reviled and mistrusted, banks are losing legitimacy. In the US, on Bank Transfer Day (November 5, 2011), an online campaign launched by an unhappy Bank of America client, disgruntled customers withdrew money from traditional banks, transferring it to not-for-profit credit unions. The growth of peer-to-peer lending firms, such as Prosper and Lending Club is part of the same trend. If it continues, the trend may lead to a significant contraction in the availability of credit globally, with serious consequences for growth.

The limits of policymakers' tools have been mercilessly exposed. Fiscal policy is severely restricted across the world and with interest rates in most developed countries near zero, the scope for conventional monetary policy is also limited. The European Central Bank is being called upon to print money to deal with the eurozone debt crisis. At best, this will be a palliative measure. And it would not be without nasty side-effects, undermining trust in money, government bonds and, ironically, central banks.

★ ★ ★ *SATYAJIT DAS* / **LINK**

Gold is unique amongst metals, partly because it is not consumed, but also because it has some unusual qualities. It has no utility value. One cannot eat it or drink it. It earns no income, does not corrode and does not tarnish. Other qualities include divisibility (a quantity of gold can be divided into smaller quantities) and it is fungible, (one ounce of gold can be substituted for another ounce of gold of the same degree of fineness). There are large stocks of gold available and new annual production has generally been less than 2% of the stock of gold. These are the very qualities that caused gold to be used as money over the millennia.

Other metals and commodities are produced for consumption. When their stocks build up due to supply exceeding demand, holders become forced sellers due to the cost of storage or due to spoilage. Thus the price of the commodity drops to a level where marginal producers go out of business until demand exceeds supply. Then stock levels decline until they are exhausted and conditions of shortage prevail. This results in sharply rising prices for that commodity, eventually attracting new suppliers. In soft commodities, weather conditions can also play havoc with stock levels, causing dramatic price changes.



CLICK TO ENLARGE **SOURCE: ALF FIELD**

The point is that with all commodities other than gold, stock levels are important determinants in the price of the commodity. Gold has been accumulated over the years because it was money or as a hedge against a range of fiscal, economic and political risks. The stock of gold relative to new annual gold production has always been high.

In 1971, when the $35 per ounce link between the US dollar and gold was severed, it was assumed that all the gold produced throughout prior history was about 90,000t. This is a rubbery figure and should probably be a higher number. As it is not important to this discussion, we will use 90,000t as a starting point. Over the centuries some gold was lost or was no longer available to the market. If we assume that about 15,000t was lost, it means that in 1971 about 75,000t of gold was available to the market. New production in 1971 was 1,450t, less than 2% of the available stock of gold.

One reliable figure available in 1971 was that gold held by central banks and official institutions was about 37,000t. By deduction, the remaining 38,000t of the available stock must have been owned by investor/hoarders in the form of bullion, coins or jewelry. New production of 1,450t in 1971 was meaningless when compared to stocks of 75,000t. The future gold price was going to be determined by what existing holders of gold did with their stocks and what the level of demand would be from new buyers. For several reasons there was considerable new buying of gold during the 1970's, resulting in a sharply rising gold price.

Fast forwarding 40 years to our current situation...

ALF FIELD / **LINK**

A year of political bickering in the United States and debt crisis in Europe has negatively affected China, raising serious questions for 2012: Will China slide with the rest of the world into an economic downturn? With risks guaranteed to increase, will Chinese banks remain profitable? What direction will financial reform take, and what will drive it?

Liu Mingkang is in a good position to answer these questions. As chairman of the China Banking Regulatory Commissiona (CBRC) from its founding in 2003 until his retirement in October, Liu personally presided over its quarterly analysis conferences. The mainland's banking regulator still maintains this tradition, winning it the praise of industry insiders. In late December 2011, Liu talked with Caixin about China's economic position in the world in the coming year and the task of financial reform.

Caixin: What kind of global economic situation can we expect in 2012?

Liu: I've said in the past that this economic crisis will spread from the United States to Europe and finally land in Asia. Now we can see that it's already begun influencing Asia.

For example, growth in China's auto industry has been cut in half. A stock of over 750,000 autos had accumulated in warehouses as of November, now up to nearly 800,000. Even though this is all part of a natural cycle, cars grow obsolete quickly. This kind of stock could spiral out of control, which indicates that this is quite a serious excess of capacity.

Or take the shipbuilding industry for example. That's been affected by changing demands from Europe and the United States, too. As of right now, they haven't had a single order for a long time. I trust that the relevant state departments are already rigorously controlling the expansion of production capacity in these industries.

From a macro perspective, the global economic situation has four major characteristics.

First, there have been massive changes to power structures that push growth. Contribution rates to the global economy from nations outside the G8 countries have for the first time reached and surpassed that of the G8. It's possible that the global economic growth rate for 2012 won't reach 3 percent, but emerging economies should hold to around 6 percent.

Second, there have been changes to market growth structures. In the past, the United States and Europe were the major consumer markets, and China was the world's factory. Forty percent of our exports were shipped off to the United States and Europe, more if one factors in exports transited through Hong Kong. But that proportion slid dramatically in 2011, as Asia (including the Middle East) became the major export target. Even though Asia still didn't buy as much as the United States and Europe last year, the proportion is shifting. African and South American markets are still not terribly big, but they too are growing.

Third, the role of government has changed greatly in every nation. For one, they have begun to actively support the development and adjustment of business. This has mostly been accomplished through expansionary fiscal and monetary policy. For another, governments have begun strengthening regulation where there was none before in domains that experienced problems during the financial crisis. Whether the G8 or G20 come to a consensus or not, governments should begin playing a larger role in domains where pure market force fails.

CAIXIN / **LINK**

Europe's underlying problem is not budget deficits or even unsustainable debt. These are mainly symptoms. The real problem with Europe is the huge divergence in costs between the core and the periphery – in the past decade costs between Germany and some of the peripheral countries have diverged by anywhere from 20% to 40%. This divergence has made the latter uncompetitive and has resulted in the massive trade imbalances within Europe.

Trade imbalances, of course, are the obverse of capital imbalances, and the surge in debt in peripheral Europe in the past decade – debt owed ultimately to Germany and the other core countries – was the inevitable consequence of those capital flow imbalances. While European policymakers alternatively sweat and shiver over fiscal deficits, surging government debt, and collapsing banks, there is almost no prospect of their resolving the European crisis until they address the divergence in costs. Of course if they don't resolve this problem, the problem will be resolved for them in the form of a break-up of the euro.

The best resolution, and the one Keynes urged without success on the US in the 1920s and 1930s, is that Germany take steps to reverse its trade surplus. It could boost disposable household income and household consumption by cutting income and consumption taxes, and as German household income grows relative to the country's total production, the national savings rate would automatically drop and the trade surplus contract and eventually become a deficit. Or Germany could engineer a massive increase in infrastructure spending.

If Germany doesn't do either, and especially if it imposes austerity, there must be a surge in unemployment for many years within Europe as German excess capacity meets dwindling demand in peripheral Europe. This surge in unemployment will force the peripheral countries into the unenviable choice either of absorbing that surge in unemployment themselves, or of forcing the unemployment back onto the core countries by abandoning the currency that is at the heart of their lack of competitiveness.

The historical precedents – and much of the commentary coming out of Germany – suggest that Germany will not take steps to reverse the trade surplus. Countries that run large and persistent trade surpluses never seem to understand that their surpluses are mainly the consequences of domestic policies that generate additional domestic growth by absorbing foreign demand.

MICHAEL PETTIS / **LINK**

Remember the sharp rise in taxi medallion prices over the past few years? I thought that the price was pretty justifiable back then, in October, although I did have my concerns:

Any time you see a chart like the ones above, you have to worry that there's a bubble. Plus, there's political risk: the mayor can print new medallions, making the existing ones worth a little less (but not a lot less, given that the income from medallions is largely fixed).

Since then, however, two things have happened. First, New York City agreed to print 2,000 new medallions — that's a very large increase. And secondly, Charles Komanoff — you remember him — has done the hard math of what this means for congestion and taxi incomes.

The first thing to understand is that while 2,000 cars might not seem very much in the context of a city which sees 800,000 cars per day, in fact it's huge. Taxis spend 40 times as much time driving in congested areas as private cars do, so 2,000 medallions is the equivalent of 80,000 private cars. And when you impact the amount of traffic that much in an area which is already highly congested, the effects can be enormous:

Table 1: Impacts of Adding 2,000 Taxi Medallions (results for weekdays)

	Current Conditions	Add 2,000 medallions	% Change
Number of medallions	13,237	15,237	+15.1%
Average CBD travel speed, mph	9.5	8.4	-12.1%
Average in-cab travel time, minutes	13.8	14.8	+7.5%
Average hail time, minutes	5.4	4.2	-21%
Total taxi journey time, minutes	19.2	19.1	-0.5%
Taxi trips per day	471,200	472,000	+0.2%
Taxi trips per shift	28.8	23.3	-19%

The bottom line, here, is not just significantly more congestion, with travel speeds dropping on average from 9.5 mph to 8.4 mph. That inconveniences everybody, of course, not least the cab drivers themselves, who will take a whole extra minute, on average, to get to where their passenger wants to go. That decreases the number of fares they can pick up per day, and hurts their income.

And at the same time, the number of people wanting to take a taxi is likely to go down, when traffic speeds fall, rather than up. If you have fewer people hailing a greater number of cabs, then it's simple math that the number of fares per cab shift is likely to fall. According to Charles's calculations, it will fall in total a good 19%.

If taxi fares stay constant, that means a 19% drop in taxi-fare income, per cab. Fares won't rise enough to cover that fall. And of course the income for the driver is going to fall more than 19%, because the medallion owners are going to be very reluctant to drop the amount they charge the drivers per shift.

All of which implies to me that if there's a medallion-price bubble, then the introduction of 2,000 new medallions is likely to prick that bubble. And conversely, if medallions keep on changing hands for a million dollars a pop even after those 2,000 new cars are on the road, then we can be pretty sure that there's no bubble here at all..

FELIX SALMON / **LINK**

Let's now see if I can outline the choices Europe faces. First, let's take Greece, because it is instructive. Greece has two choices. They can choose Disaster A, which is to stay in the euro, cutting spending and raising taxes so they can qualify for yet another bailout; negotiating more defaults; getting further behind on their balance of payments; and suffering along with a lack of medicine, energy, and other goods they need. They will be mired in a depression for a generation. Demonstrations will get ever larger and uglier, as the government has to make even more cuts to deal with decreasing revenues, as 2.5% of their GDP in euros leaves the country each month. There is a run on their banks. Any Greek who can is getting his money out.

Greek voters will then blame whichever political group was responsible for choosing Disaster A and vote them out, as the opposition calls for Greece to exit the euro. Which is of course Disaster B.

Leaving the euro is a nightmare of biblical proportions, equivalent to about 7 of the 10 plagues that visited Egypt. First there is a banking holiday, then all accounts are converted to drachmas and all pensions and government pay is now in drachmas. What about private contracts made in euros with non-Greek businesses? And it is one thing to convert all the electronic money and cash in the banks; but how do you get Greeks to turn in their euros for drachmas, when they can cross the border and buy goods at lower prices, as inflation and/or outright devaluation will follow any change of currency. It has to. That is the whole point.

"...The only real options are Disaster A or Disaster B. Whether they opt to go straight to the drachma (Disaster B) is only a matter of timing. They will get there soon enough"

So how do you get Zorba and Deimos to willingly turn in their remaining cash euros? You can close the borders, but that creates a black market for euros – and the Greeks have been smuggling through their hills for centuries. And how do you close the fishing villages, where their cousin from Italy meets them in the Mediterranean for a little currency exchange? What about non-Greek businesses that built apartments or condos and sold them? They now get paid in depreciating drachmas, while having to cover their euro costs back home? Not to mention, how do you get "hard" currency to buy medicine, energy, food, military supplies, etc.? The list goes on and on. It is a lawyer's dream.

There is a third choice, Disaster C, which is worse than both of the above. Greece can stay in the euro and default on all debt, which cuts them off completely from the bond market for some time to come. This forces them to make drastic cuts in all government services and payments (salaries, pensions etc.), and suffer a capital D Depression, as they must balance their trade payments overnight, or do without. Then they choose Disaster B anyway.

The only real options are Disaster A or Disaster B. Whether they opt to go straight to the drachma (Disaster B) is only a matter of timing. They will get there soon enough.

Why then do they wait? What's the point of going through all these motions? Because Europe fears a disorderly Disaster B. For the rest of Europe, it is the Abyss. The Greek hope is that Europe (read Germany) keeps funding them in order to keep back from the edge of the Abyss.

As one European diplomat noted, "There is a growing sense that despite the valiant efforts of Papademos ... the reluctant Greek establishment is biding its time to the next elections, banking on the assumption that the world will continue to bail them out, no matter what."

Europe is getting closer to the point where it must make a decision about what to do with Greece. In theory, the deadline is March 29 for the next round of funding. It is a game with very high stakes and deadly serious players. Can Sarkozy be seen as weak and giving in to Greece, with elections coming up in April? Can Merkel appear to give in and keep her troops in line? There are elections not long after that in Greece. Can Papademos cave in to further cuts and promises on future debt that will be hard to keep and intensely unpopular?

The markets are getting exhausted. There will be no private market for Greek debt at any number close to what is sustainable. Greece will be on European life support for a very long time if they stay in and there is no disorderly default. It will mean hundreds of billions of euros over the decade, debt forgiveness, etc. There are no good choices.

JOHN MAULDIN / **LINK**

Almost half a decade after the onset of the rich world's credit bust, depressing evidence of its after-effects is visible in everything from feeble output figures to swollen jobless rolls. But for a truly grim picture, read a new report on deleveraging by the McKinsey Global Institute. It points out that in many rich countries the process of debt reduction hasn't even started. America has begun to pare its debt burden, although the drop is small compared with the build-up in 2000-08 (see chart). But many European countries are more, not less, in hock than they were in 2008. There the hangover could last another decade or more.

These transatlantic differences stem from the trajectory of private debt. Government borrowing soared everywhere after 2008 as government deficits ballooned. But in America the swelling of the public balance-sheet has mirrored a shrinking of private ones. Every category of private debt—financial, corporate and household—has fallen as a share of GDP since 2008. The financial sector's debt is now at its 2000 level. Corporate indebtedness, never very high, has shrunk. So, more importantly, has household debt. America's ratio of household debt to income is down by 15 percentage points from its peak in 2008, after rising by over 30 percentage points in the eight preceding years. McKinsey reckons America's households are between a third and halfway through their debt-reduction process. They think the household-debt hangover could end by mid-2013.

SOURCE: ECONOMIST/MCKINSEY

In Europe private debt has fallen much less and in some cases even risen. In Britain the financial sector's debts have grown since 2008. In Spain corporate debt, far higher as a share of GDP than in most rich countries, has barely budged. But the biggest difference is among households. Even countries which saw the biggest surges in household debt during the bubble era, such as Britain and Spain, have scarcely seen a dent since 2008. McKinsey's analysts reckon it will take British households up to a decade to work off their debt burdens.

It's not that American households have been more frugal or disciplined. Household debt has fallen largely thanks to defaults, particularly on mortgages.

ECONOMIST / **LINK**

Sadly, the lull proved but brief. The first two weeks of the year were surprisingly calm for the storm-tossed euro zone. But a gale is blowing again. First a series of downgrades from Standard & Poor's, a leading debt-rating agency, coincided with a stand-off in the "voluntary" restructuring talks between Greece and its private bondholders. Now there are signs of a continent-wide recession. The euro crisis is back.

Indeed, the next few weeks could be decisive for the single currency's future. Several euro-zone governments must sell huge amounts of debt in bond auctions. They are also due to wrap up negotiations over the new "fiscal compact", demanded by Chancellor Angela Merkel of Germany to enforce budget discipline, at a European Union summit at the end of January. And the brinkmanship in Greece's debt talks could yet lead to a disorderly default (see article).

What happens in Greece could be dramatic and painful, especially for the Greeks. If their country is forced out of the euro zone after a chaotic default it will cause problems for everyone. Yet Greece is small and its creditors see a restructuring as inevitable. The crucial country is Italy.

"... What happens in Greece could be dramatic and painful, especially for the Greeks. If their country is forced out of the euro zone after a chaotic default it will cause problems for everyone"

Italy is too big for the existing rescue fund to bail out. (Spain is at risk too, but its debt is a lot smaller and the markets are more confident it will be repaid.) Italy is unique in its combination of size and punishingly high bond yields (currently 6½%). It is hard to see the euro surviving were the world's third-biggest debtor judged unable to pay its creditors.

The immediate consequence of this for Mrs Merkel is that any sort of restructuring of Greece must therefore come with a credible plan to "backstop" Italy (and other weak countries), at least in the short term. Without such backing, the markets will simply move on, perhaps very quickly, from Greece to Italy, and the many banks that have lent to it. A credible firewall from the European Central Bank (and possibly the International Monetary Fund) would stop them.

But staving off contagion is not enough. Italy also needs lower interest rates on its bonds. Sadly, the country epitomises the economic and political problems in Mrs Merkel's strategy of relying on fiscal austerity to save the euro.

In economic terms, Italy's main problem is not public profligacy. Its debt may be huge, but it is running a primary budget surplus (ie, before interest payments), its overall budget deficit is much smaller than France's, and its recent budget puts it on course to eliminate that deficit in 2013. Under a new government, led by Mario Monti, a former European commissioner, Italy has regained the place at the top European table that Silvio Berlusconi lost (see article). Mr Monti has not merely pushed through a tough budget, but he is also embarking on a difficult, if overdue, set of liberalising and structural reforms to open up sheltered parts of the economy to competition.

★ ★ ★ *ECONOMIST* / **LINK**

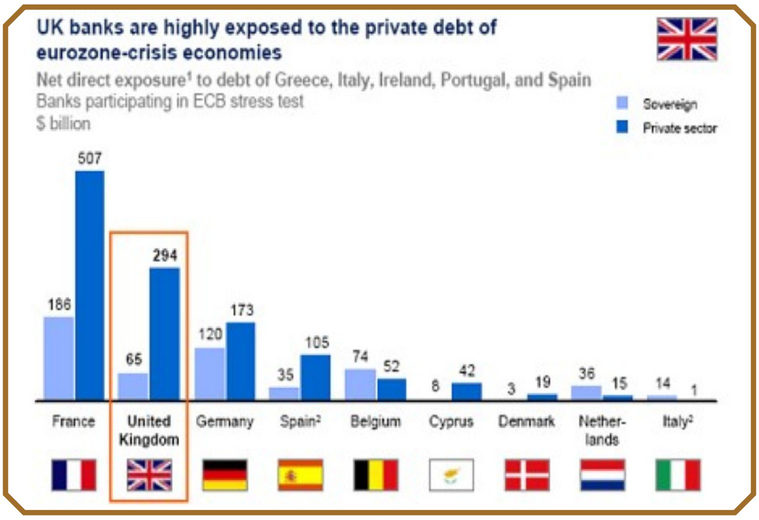
Britain has sunk deeper into debt. Three years after bubble burst, the UK has barely begun to tackle the crushing burden left by Gordon Brown. The contrast with the United States is frankly shocking.

The latest report on "Debt and Deleveraging" by the McKinsey Global Institute shows that total public and private debt in the UK is still hovering at an all-time high. It has risen from 487pc to 507pc of GDP since the crisis began.

As the chart above shows, as recently as 1990 Britain's debts were still just 220pc of GDP. Has a rich country ever been debauched so fast in peace time?

The ordeal of belt-tightening will be grim, dragging out for a generation if Japan is any guide. The Japanese at least began their post-bubble debacle as the world's top creditor nation with a trade super-surplus and a savings rate of 17pc. Britain has no such buffers.

It is a very different picture in the US where light is emerging at the end of the tunnel. American banks, firms, and households have been chipping away at their debts, more than offsetting Washington's double-digit deficits.



SOURCE: MCKINSEY/UK DAILY TELEGRAPH

The total burden has dropped to 279pc, down from 295pc at the peak of the boom. Households have purged roughly a third of the excess, roughly tracking the historic pattern of post-bubble deleveraging.

US debt is already lower than Spain (363pc), France (346pc), or Italy (314pc), and may undercut Germany (278pc) before long -- given the refusal of the European Central Bank to offset fiscal contraction with monetary stimulus.

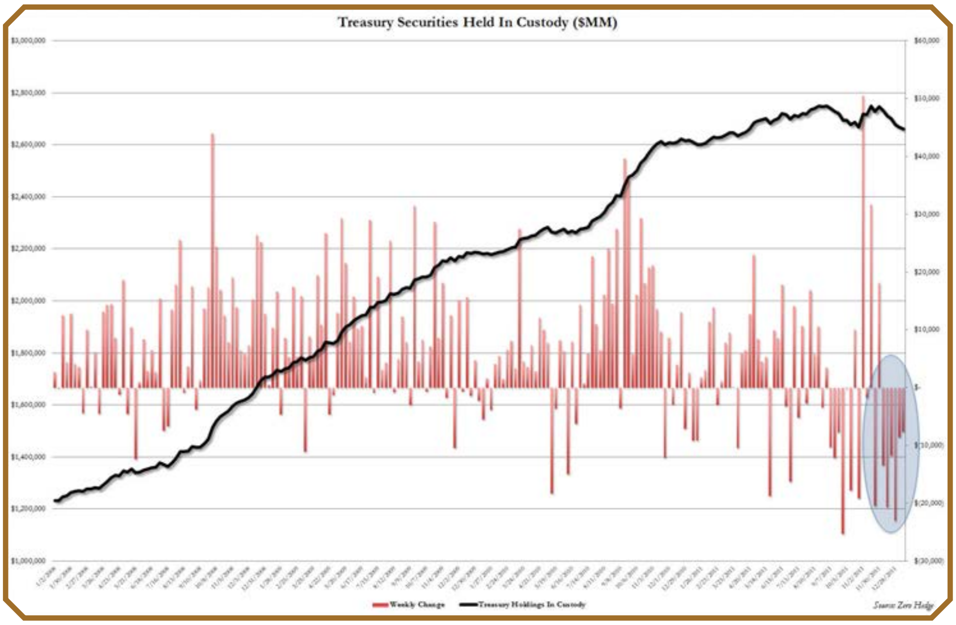
One is tempted to ask what all the fuss was about in the US. The debt of financial institutions is just 40pc, compared to the UK (219pc), Japan (120pc), France (97pc), Germany (87pc) and Italy (76pc). Bank debt has dropped from $8 trillion to $6.1 trillion -- accelerated by the Lehman collapse -- as lenders rely more on old-fashioned deposits.

Tim Congdon from International Monetary Research said US banks were never as damaged as claimed and now have the highest capital ratios in over thirty years. The rate of loan write-offs has dropped from 3.2pc to 1.9pc, a faster improvement than after the financial crisis of the early 1990s.

“There has to be a prospect that Fed funds rate will move back to a more normal level – say, 2pc to 4pc - over the next couple of years,” he said. If so, this will come as an almighty shock to the bond and currency markets. Almost nobdy is prepared for such a turn of events.

In hindsight, the US property boom was was remarkable modest compared to what happened in Spain, or what is happening now in China now where the house price to income ratio in Beijing, Shanghai, and Shenzhen is near 18. America's ratio peaked at 5.1 and is already back to its modern era average of three. The excesses have been unwound.

AMBROSE EVANS-PRITCHARD / **LINK**



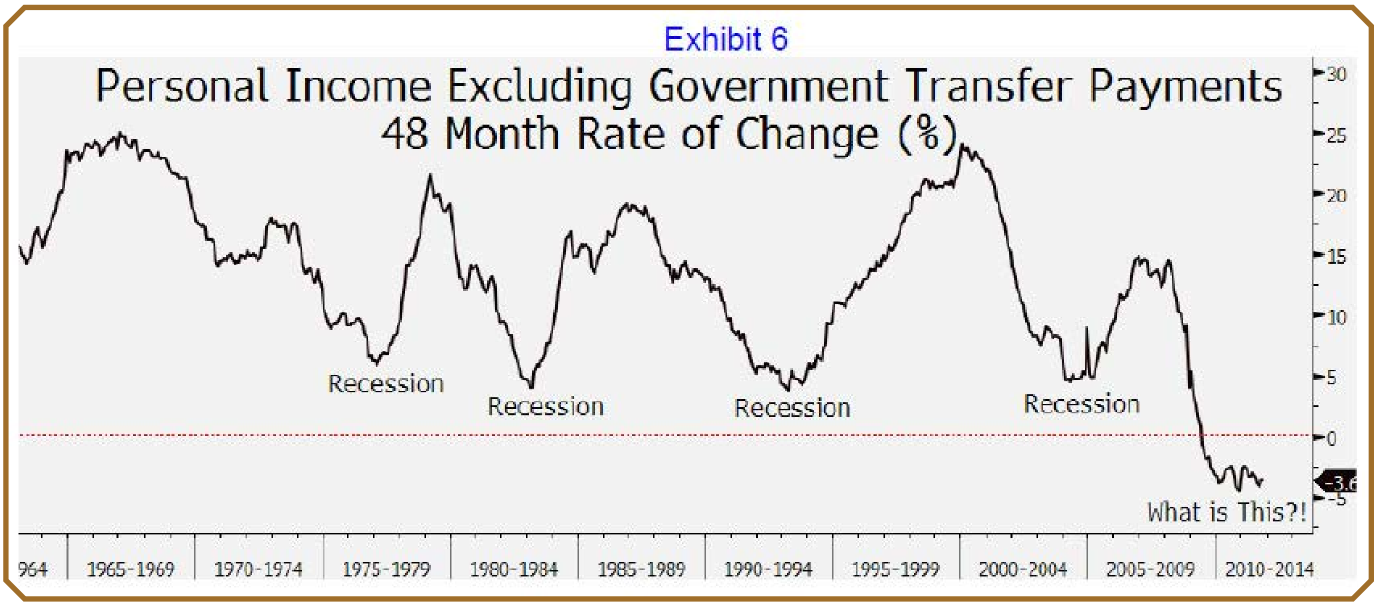
CLICK TO ENLARGE

SOURCE: ZEROHEDGE

After we pointed out last week when we noted that there was a record monthly dump of Treasury paper from the Fed's custodial account amounting to some $69 billion, the week ended January 4 has seen yet another outflow, this time amounting to $9 billion in US Treasuries. This is the 5th week in a row of foreigners selling US paper, and while it has yet to match the record 6 weeks of outflows from October (discussed here), the consolidated outflow notional is now a record high at $77 bilion, higher than the previous record of $52 billion.

★ ★ ★ *ZEROHEDGE* / **LINK**

A scary chart posted by Michael Panzner shows the precipitous drop in the rate of change of personal income in the last few years as the GFC has taken its toll...



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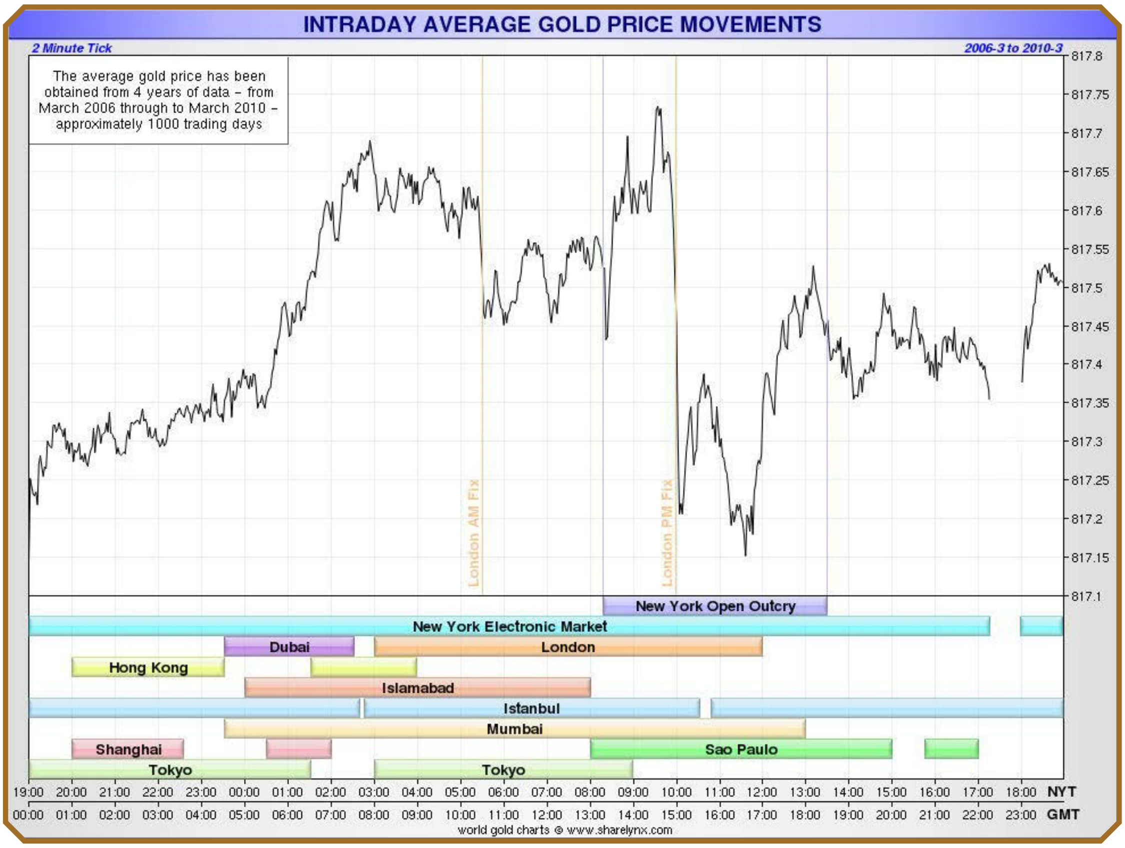
SOURCE: FINANCIAL ARMAGEDDON/ZEROHEDGE

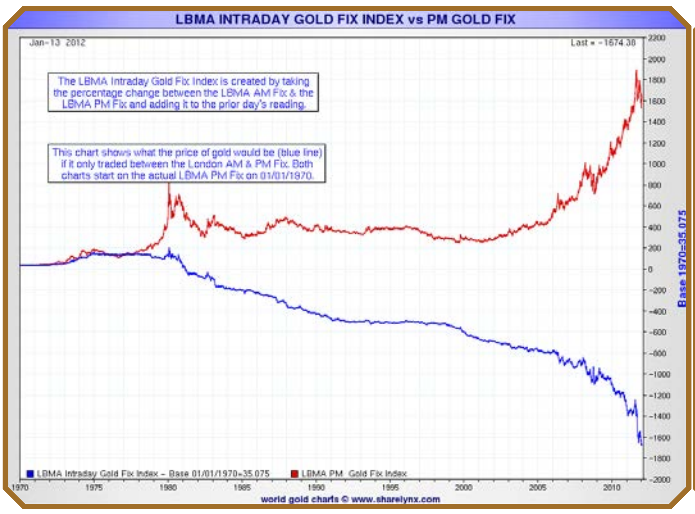


SOURCE: CASEY RESEARCH/SHARELYNX

The top chart shows the intraday average gold price over a 24 hour period between 2006 and 2010: 1,000 trading days.

Below (left) shows what the gold price WOULD be if it only traded between the London AM and PM fixes while the chart below, right, demonstrates what the gold price would be if it hadn't traded between the AM and PM fixes.

Bottom line? Without that specific period between 1970 and today, gold would be trading at $3,345...

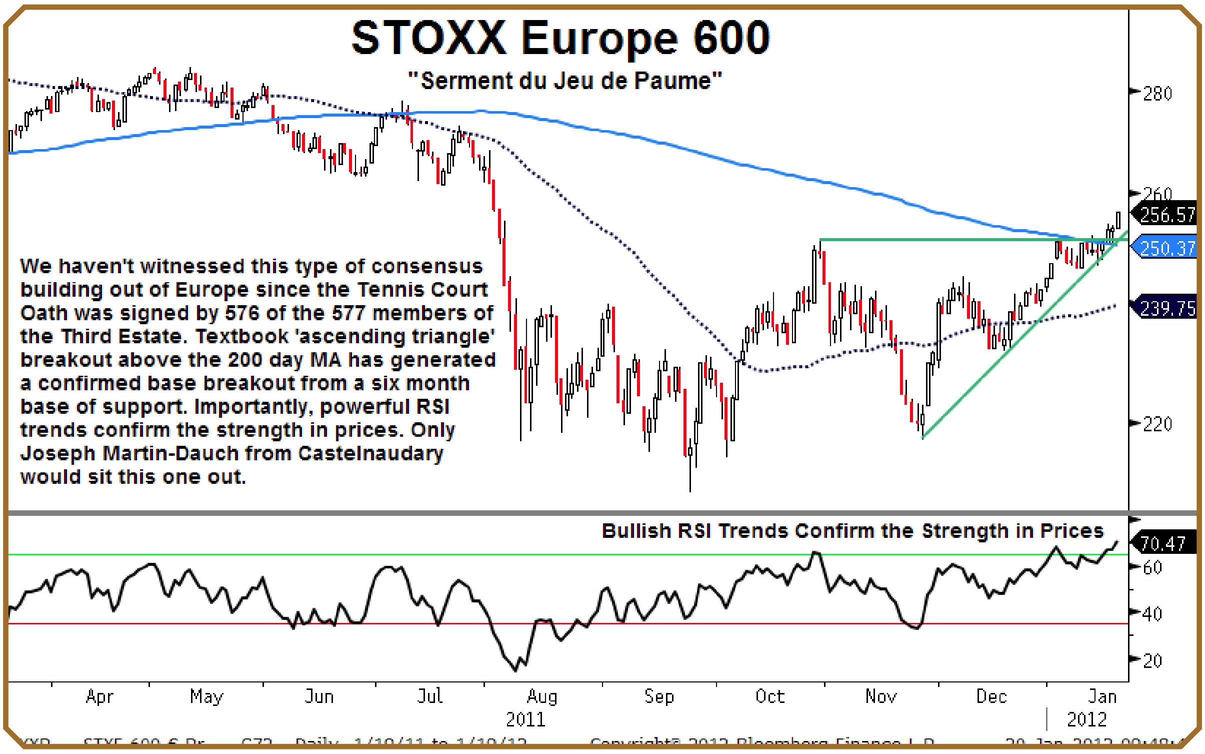


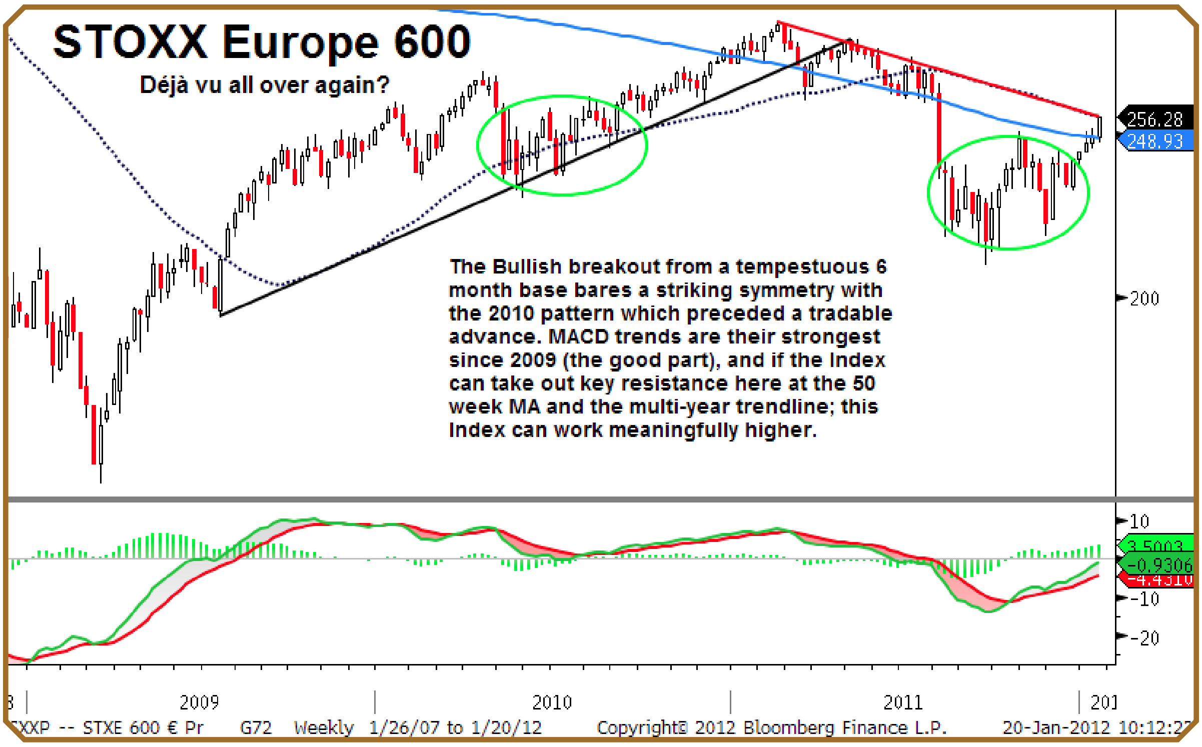
CLICK TO ENLARGE **SOURCE:** CASEY RESEARCH/SHARELYNX

CLICK TO ENLARGE **SOURCE:** CASEY RESEARCH/SHARELYNX

Richard Ross of Auerback Grayson - my favourite chartist - is back with a bullish look at European equities. Saddle up!

rross@agco.com





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The man who puts the Yogi into Bear, Marc Faber, talks to Bloomberg TV about the upcoming bond market meltdown and explains why, even though he is expecting the end of the global financial system as we know it, he is still bullish equities.

Marc reveals how he lost a bet to David Rosenberg that will cost him a bottle of whiskey, and compares the current bond market to the last throes of the NASDAQ bubble.

Call me old-fashioned, but even though he may have been wrong so far about those government bonds, I'll still side with Marc...

Andrew Lilico, managing director at Europe Economics, talks about the timing of a Greek debt default and the prospect of contagion in the euro zone. Lilico also discusses Spanish and Italian bonds with Mark Barton on Bloomberg Television's "The Pulse."

Lilico sees a default in March.... then comes the contagion

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CLICK TO LISTEN

I had the great privilege of speaking with Jim Puplava of Financial Sense this past week.

In a wide-ranging conversation, Jim and I discussed China, Japan, Australia, Europe and the United States and tried to get a sense of how the issues facing each of these areas of concern may or may not end up being resolved in 2012...

What a voice...

CLICK TO WATCH

What a life...

Etta James Obituary

Hmmm...

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