FALSIFYING BANK BALANCE SHEETS

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Our title is borrowed from a caption of the Chicago economist and monetary scientist Melchior Palyi (1892-1970) writing on the fiscal and monetary legerdemain of the U.S. government in his Bulletin #401, dated February 27, 1960, as follows.

Faking balance sheets legalized

A corporation publishing faked balance sheets would be barred from every stock exchange. It may even face criminal prosecution. The objective is to protect the public against fraud. *But exactly the same fraudulent practice has been legalized in so far as commercial and savings banks, and life insurance companies are concerned.* They can carry government bonds on their books *at par* value. A $1,000 bond may be quoted in the market at $800 or less; the balance sheet of your bank will still show it at $1,000. The purpose of this regulation, adopted by all federal and state supervisory agencies and by the Securities Exchange Commission as well, is to give those bonds a sacrosanct status and guarantee against paper losses. Thereby they are promoted to an absolutely safe and "liquid" status. The bank examiners count the bonds of the federal government, whatever their maturity and actual market price may be, as *prime liquid* assets, just like cash. The more bonds in the portfolio, the more liquid is the bank by the examiners' standards, — never mind the paper losses.

It is small wonder that the banks purchase long term federal obligations, thereby creating a market for them. The result is that with rising interest rates and declining values of medium- and long-term securities, the modest capital and undivided surplus of the banks – reserves against losses – are impaired. In the case of quite a few banks the entire capital and all reserves have been lost. In some cases, even a part of the deposits has been wiped out.

Silence of the Sea

But the public knows nothing about this sad situation. No newspaper dares to discuss it, or the preposterous practices of the government at the root of it. The "Silence of the Sea" covers them up. Those on the inside (and insight) hope and pray that a recession will reduce the pressures on the capital market, lower interest rates, raise bond prices, and wipe out the losses. Very likely it will; but what about the next cycle? And, above all, for how long, or how many times, will the depositors and savers permit themselves to be fooled and victimized? Sooner or later every legerdemain, however clever or subtle, is exposed – and backfires.

A further consequence is that the bond portfolio of the banks "freezes up". By selling bonds the bank would convert paper losses into real losses, which would skyrocket if major amounts were liquidated. While the boom and high interest rates obtain, the "prime liquidity" turns out to be the very opposite, unless the bonds are monetized at, and the losses shifted onto, the Federal Reserve. But the central bank can be relied upon to resist the "temptation" to absorb either or both.

The above was written in 1960. In 2009 we are wondering what has hit our banks. No mystery there. It was not subprime mortgages nor other loose lending practices. The banking crisis is entirely self-inflicted or, more precisely, government-inflicted the origins of which go back almost ninety years: faking balance sheets. That practice cannot go on forever. The day of reckoning comes when capital is called upon to do what it is supposed to do: to tie over the bank during a temporary setback. The kitty is opened, and found empty. Bank capital is gone, due to earlier legerdemain in trying to paper over paper losses. (No pun intended.)

The situation is actually worse, as far as the condition of our banks is concerned. So far deposits have not been affected during this crisis. Depositors feel secure in the belief that they are protected by the government and its deposit insurance scheme. Here is Palyi, writing in the same article on this subject:

Dumping ground for the federal debt

Government agencies that have no other choice in investing their funds, though they are not organs of the Treasury, are an obvious dumping ground for the debt of the federal government. A most interesting case in point is the Federal Deposit Insurance Corporation (FDIC). It sinks the ”insurance” premiums paid by the banks into long-term government bonds, as a guaranty fund representing less than 2 percent of "insured" deposits. The FDIC itself has brought out in its Report for 1957 that, in effect, deposit insurance is relevant only in the case of a banking crisis – in which case it would not be helpful at all. All its funds would be exhausted at once if a single one among the eight or ten biggest banks would get into trouble, to say nothing of a wide-spread bank-run. The public's impression is that the government guarantees deposits *which it does not.* Worse still, in order to make good on the "insurance" of even a small fraction of ”insured" deposits, the FDIC would have to liquidate its own holdings that would break the bond market. Not only is this a phony arrangement which serves only to mislead the public, but it also *induces the banks to neglect building up their capital accounts properly for the protection of the deposits. Rather, they rely on the "insurance" – and on their own holdings of government securities.*

The hare-brained Geithner-plan

Now, 50 years later, we have a fully-fledged banking crisis on hand, and the FDIC will soon face its first real test since its establishment in the 1930's. Is deposit "insurance" a myth as suggested by Palyi, designed to mislead the public? There is plenty of evidence that it is. Why did the big Wall Street banks not sell government bonds from portfolio before begging Congress for bailout money? On the face of it this would have been a good time to sell, as the bonds are quoted above par value by the market, thanks to a super-low interest-rate structure. Could it be that the bond market is rigged? Could it be that high bond values are artificially maintained, e.g., by tempting bond speculators to the long side of the market with risk-free profits, and threatening those on the short side with sudden death — the essence of open market operations as I have long suggested? This time we shall find out.

If you examine the latest measures initiated by the Geithner Treasury, there is indeed reason for alarm. Treasury Secretary Timothy Geithner openly invites private investors to speculate, *risk free*, in buying the toxic assets of the banking system. The risks, should they materialize, are covered by pledging, most improperly, the assets of the FDIC. If the gamble succeeds, private investors may keep the assets they have bought on the cheap. Otherwise the FDIC will pick up the tab and will reimburse investors for their losses.

Let me ask the only relevant question. Why would private investors, in their right mind, speculate in toxic assets which *have no market*, given the fact they can already speculate, directly and risk-free, in the "ultimate" asset that is held in the guaranty fund for those toxic assets, that *do have a market* in which the troubled banks compete with overseas central banks for the bonds of the U.S. government? The Geithner-plan is a hare-brained plan, and is bound to fail.

Portfolio frozen as the Antarctic

When it does, there will be a run on the banks. It will be ugly and unstoppable. Only about ten percent of the money supply is in the form of Federal Reserve (FR) notes, and people will be scrambling for them. The printing presses will be run 24 hours a day, seven days a week, and they will still not be able to meet the demand. Apparently, foreigners are already scrambling for FR notes. They could of course have FR deposits in the form on electronic money, but they wouldn't touch them with a ten-foot pole. They want dollars *they can fold*.

Make no mistake about it, behind this unprecedented world panic and bank run is the book-keeping legerdemain that the U.S. government and its bank examiners have adopted after the 1921 panic in the bond market. Thereby the commercial and savings banks, as well as insurance companies in the U.S. were authorized to carry government bonds at par value in the balance sheet, as if they were a cash item, in complete disregard for what they would fetch in the open market. Moreover, banks and insurance companies could also use them as gambling chips, buying and selling them to pocket risk-free profits. They just have to second-guess the Federal Reserve (Fed). Whenever the Fed has nature's urge to go to the open market to relieve itself (read: to buy more bonds for the purposes of collateral in order to be able to increase the money supply), they could pre-empt it in buying the bonds first. In this way they bid up the price of bonds and then dump them in the lap of the Fed for a quick profit.

Now the whole shady scheme of misleading the public through balance-sheet hocus-pocus is coming unstuck. Make-believe bond values have backfired badly. As it turns out, the banks' portfolio of government bonds is as frozen as the Antarctic − just as Palyi predicted fifty years ago that it would be.

Grand Canyon-size holes in the balance sheets

The banks cannot liquidate it without revealing Grand Canyon-size holes in their balance sheet, several times larger than bank capital. They desperately need to retain their portfolio of government bonds for "window-dressing" purposes, that is, to show at least the remnants of what had been bank capital in happier times. They desperately try to hide the fact that even the ruins of their capital are gone.

The much advertised "stress-test", no doubt, is using the same metric that has steered the banking system to the ground during the past four-and-a-half score of years: the metric assuming that government bonds can never lose value, and bank balance sheets are there to falsify based on that false metric. Such an assumption is especially dangerous when the interest-rate structure is at the low-end of the spectrum, and the country is suffering from a chronic balance of payments deficit. It is difficult to see how one can treat the stress-test and its results with respect.

We shall see how adroitly Ben Bernanke will handle the printing press which he is in the habit of boasting that the U.S. government has given him to use in a situation like this. He will not be able *physically* to print FR notes so fast as to replace electronic money that has been lost, or will be lost through rejection by the public. Electronic money had been created in the belief that nothing more was needed to pacify the markets. But it is one thing to create electronic money with a click of the mouse; it is quite another thing to print FR notes on real paper with real ink.

This is the secret of deflation, and the answer to the much-debated question whether you can have hyperinflation and deflation all at the same time. The answer is that you can, because hyperinflation refers to electronic money that people reject, and deflation refers to FR notes that people hoard.

The moment of truth has arrived. You cannot fool all the people all of the time. The Emperor is naked: the tailors who created his garments are impostors.

Too bad for the impostors. Unlike in Andersen's story where they decamped in a hurry, Bernanke and Geithner stayed and will have to face the ire of the Emperor — and that of the people when they find out that their deposits are "gone with the wind".

April 27, 2009

Calendar of Events

Instituto Juan de Mariana: Madrid, Spain, June 12-14, 2009

Seminar with Prof. Fekete on Money, Credit, and the Revisionist Theory of Depressions

For information, contact: gcalzada@juandemariana.org

OroY Finanzas & Portal Oro: Madrid, Spain, June 18, 2009

Gold and Silver Meeting Madrid 2009
For information, contact: preukschat_alex@hotmail.com or
gcalzada@juandemariana.org or
http://www.portaloro.com/aemp.aspx or
info@portaloro.com

Santa Colomba Conference 2009, Palazzo Mundell, Siena, Italy, July 10-12

Conference: The Challenge of Global Money; by invitation only

San Francisco School of Economics, San Francisco, California, July 25, August 1 & August 8, 2009

Investment Seminars: Trading Gold, Wealth Management
The Gold and Silver Basis; Backwardation; Trading Gold in the Present Environment; Wealth Management under the Regime of Irredeemable Currency. Given by Professor Fekete and Mr. Sandeep Jaitly of Soditic Ltd., London, U.K. Enrolment is limited, first come first served. For details, check: www.sfschoolofeconomics.com,
contact: ibischoff@sfschoolofeconomics.com

San Francisco School of Economics, San Francisco, California, July 27-August 7, 2009

Two-week academic course: Money and Banking, taught in person by Professor Fekete
Enrolment is limited; first come, first served. The Syllabus for this course can be seen on the website: www.professorfekete.com,
For further details, check: www.sfschoolofeconomics.com
For enrolment contact: ibischoff@sfschoolofeconomics.com

San Francisco School of Economics, San Francisco, California, July 23-August 9, 2009

Private consultation with Professor Fekete available
contact: ibischoff@sfschoolofeconomics.com

University House, Australian National University, Canberra: first week of November, 2009

Peace and Progress through Prosperity: Gold Standard in the 21st Century
This is the first conference organized by the newly formed Gold Standard Institute.
For further information, e-mail: feketeaustralia@gmail.com ,
On the Gold Standard Institute, e-mail philipbarton@goldstandardinstitute.com

Professor Fekete on DVD: Professionally produced DVD recording of the address before the Economic Club of San Francisco on November 4, 2008, entitled *The Revisionist History of the Great Depression: Can It Happen Again?* plus an interview with Professor Fekete. It is available from www.Amazon.com and from the Club www.economicclubsf.com at $14.95 each.