# *Fedbook!*

*Fed at Risk*

Nobody can miss the ongoing fight between Trump (White House) and Powell (Fed). It is all over the media and has repercussions on the financial markets. Nobody can one miss the recent Facebook challenge with the advent of its new crypto-currency: Libra. It is also all over the newspapers and the "Fedbook" is now lurking.


*Le projet "Libra" d'une cryptomonnaie propre à Facebook est encore loin d'aboutir. Getty Images/iStockphoto*

But few have noticed the emergence of a new debate about MMT, which stands for Modern Monetary Theory. It has not been widely disseminated; nevertheless five Senate Republicans already want Congress to denounce MMT, especially as it gained fans among Democrats[1]. Indeed, with MMT Powell is not at risk, but the Fed is!

[1] Kathia Dmitrieva, Bloomberg News, May, 3, 2019.

*Gold Standard*

There was a time when the Gold-Standard prevailed. Money, that is, gold, could only expand and feed domestically the public sector (G-T) as well as the private sector (I-S), if and only if the economy was able to generate a trade surplus (M-X), since in an open-economy the following identity does prevail:

$$(M-X) = (G-T) + (I-S)$$

*MMT*

With MMT, the identity is rewritten in the following way:

$$(T-G) = (I-S) + (X-M)$$

This illustrates now that money is being created via the domestic budget deficit (T-G) rather than via any external trade surplus (M-X). The government determined ex-ante the quantity of money that is necessary in the economy via its excess spending. At the Fed, a computer prints money at will to finance in-and-of itself the whole budget deficit. End of the Fed!

If inflation becomes a risk, taxes are being raised and bonds are being issued to soak all excess money prevailing in the economy. But such macro-decisions are being implemented ex-post with regard to government spending, never ex-ante, as it is being the case nowadays. Hence, both the Fed and the Treasury are in the hands of the government, the former for printing money[2,] the later for fine-tuning liquidity via taxes and bonds[3.]

*Fractional Banking*

Under MMT, the prevailing system of fractional reserves becomes history. Currently, banks need to fulfill both the reserve and the capital requirements in order to issue credits.

- Under MMT Reserves are being added to the banking system to enable it to expand credits whenever the budget deficit widens. Since budget deficits always expand, courtesy of increasing government spending,

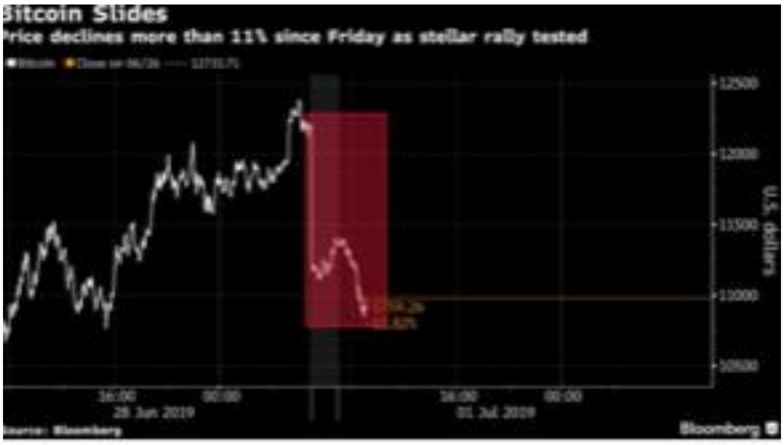
[2] Nikki Schwab, "I Don't think there should be an independent Fed, says Trump ally Arthur Laffer", The New York Post, June 20, 2019
[3] Michel Santi, Cette MMT qui n'a rien de moderne, La Tribune, 11 juin 2019

the overnight interbank rate will asymptotically converge towards zero[4] overtime. A zero rate is therefore the norm, when MMT prevails, as has been the case in Japan for more than a decade. Under these circumstances, the Fed’s funds rate would not anymore be a monetary tool to control banking reserves, nor would it be a bickering issue between the White House and the Fed. Taxes along with bond issuances would carry ex-post the heavy weightlifting in the draining of excess banking reserves. In many countries[5] reserves requirements are already a thing of the past, and the whole system of fractional banking[6] is no more.

- Under MMT, capital requirements for banks remain au contraire in place to prevent under-capitalized institutions to operate as banks and issue credits.

## *Crypto-currencies*

Digital currencies are already of two kinds. Bitcoin is money with a price but no value, which explains its immense volatility. Just recently, its price went up to $12’500 just to fall back below $11’000 only within minutes.




[4] J.M. Keynes, The General Theory of Employment, Interest and Money, Chap. 24, Palgrave Macmillan, 1936

[5] U.K., Canada New Zealand, Australia, Sweden, Hong-Kong

[6] Mervyn King, former Governor of the Bank of England, advocated as early 2010 that Full Reserve Banking as opposed to Fractional Reserve Banking merit serious consideration.

On the contrary, Libra will be a currency backed by hard assets such as bank accounts and short-term government securities. Whereas Bitcoin has a price but no value, Libra will have both, i.e., a price and a value. Libra's price will therefore be anchored to its asset value. Hence, its price volatility will be limited. Equities have also a price and a value, the former fluctuating around the later, unlike gold, oil and the dollar, whose prices are known to all traders but whose value remained unknown.

According to Aristotle, money has three functions, namely, (1) Unit of account, (2) Store of value, (3) Means of exchange.

> (1) As a unit of account, Libra, like Bitcoin can serve in determining how much a good is worth. As a result, new exchange rates will surface: $/Libra, Gold/Libra, €/Libra, etc. As another unit of account, it will be of poor usage.
>
> (2) As a store of value, Libra will be able to service its customers because of its reduced volatility. Initially Bitcoin was to be a new means of exchange but has quickly evolved into a kind of digital gold to store value, despite its huge volatility.
>
> (3) As a means of exchange, Libra should help its customer base to buy things and pay each other, which in this respect is not different from Paypal. Its transaction cost is likely to be far more competitive. Bitcoin failed as a new payment mechanism because its network could not handle a large number of transactions.

Therefore, Libra could initially be a better means of exchange and a more stable store of value than Bitcoin. Things could be priced in Libra, so what! For the crux of the matter is not (1), (2), (3) but rather could credits be granted by Facebook, thereby making Libra a substitute for sovereign monies. To this end, Facebook as a bank needs to satisfy existing capital requirements and be granted a license by the FED, the ECB or any other sovereign states[7] Given its current market capitalization, Facebook will have no problem abiding to what ever the capital requirements may be. But as far as getting a banking license Facebook with its 2.6 billion potential users has already put on high alert all the central banks of the world together with their financial regulators[8,] whose task is to keep the financial system stable, governable and predictable. With Libra the revolution against the "Seignorage" of state-only-money[9] has only begun, and the seeds of far more financial instability have therefore been sowed.

## *Conclusions*

The more capable investors over the long run are those who remain ahead of the game and are not surprised by changes. They raise questions before anybody else and provide an answer by creating the future. Those who have been able to see 40 years ago that the world would be grabbed by disinflation first and deflation next, courtesy of China entering the world capitalist market in 1980, have been right all along. They made well on their bond positions. In our book new fundamental macro-changes lie ahead:

As Bridge water Co-Chairman – Ray Dalio – says: "something like MMT is coming, whether we like it or not"[10.] Why? Because debt and tax alike become both unbearable. An alternative way to finance growing deficits at a zero rate is therefore quite necessary. Japan has been leading the way. Trump wants the U.S. to follow suite rapidly and is twittering Powell to do so. If gold is currently entering a new bull market it is probably because the White House is in the early stage of taking over the whole business of printing money for its own deficit needs. Currency debasement – the dollar - is sure to follow. Taxes and Bond sales will henceforth take the back seat in deficit financing and only be used ex-post for drainage purposes of reserves.

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[7] Delphine Cuny, Pas de services bancaires sans license pour Libra et Facebook, insiste la Banque de France, La Tribune, 25 juin 2019
[8] Huw Jones, Tom Wilson, Politicians need to move fast as Facebook and Co move into finance : BIS, Reuters, June 23, 2019
[9] Nicolas Baverez, La ruée vers l'or version Facebook, Le Point, 27 juin 2019
[10] Ben Holland, Bloomberg News, May 2, 2019

Libra will gain more influence not as a substitute to sovereign monies but as a more powerful provider of bank credits. Imaging the GAFA – Google, Amazon, Facebook, Apple – all joining the consortium[11] behind Libra and getting a license to carry out banking activities. Given their multi-trillion dollar market capitalization they would be in a position to issue credits like never before. Corollary: stock markets will also have to rise like never before in order to balance asset and liability growth and avoid a crash.

Investors should shun debts and prefer equities. The Dollar, the Yen and the Pound are prone to debasement while the Euro is not and will never be, courtesy of its German guardian. In the end, Libra might have a chance against excessively debased currencies. The people of Venezuela[12] might indeed be the first ones to elect Libra as their own new national currency.

PhC, PhD

[11] The consortium has initially been enrolled by Mastercar, Paypal, Uber, Spotify.

[12] J.M. Keynes : "the best way to destroy the capitalist system is to debauch the currency." The Economic Consequences of the Peace, 1919