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PULSE ON THE MARKET

Tucker Hearts Warren
Trade War Woes
Auto Loans Delinquent

COMPARING U.S. BANKS TO THEIR FOREIGN PEERS

by L. Carlos Lara

WHEN TO EXPECT THE NEXT RECESSION

by Robert P. Murphy

AUSTRIAN ECONOMICS: THE PEOPLE'S SCIENCE

Interview with C. Jay Engel

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THIS MONTH'S FEATURES

WHEN TO EXPECT THE NEXT RECESSION

BY ROBERT P. MURPHY

The yield curve has inverted again, and other signs point to an impending downturn.

COMPARING U.S. BANKS TO THEIR FOREIGN PEERS

BY L. CARLOS LARA

As we've long warned, the next financial crisis will probably start in Europe.

AUSTRIAN ECONOMICS: THE PEOPLE'S SCIENCE

INTERVIEW

C. Jay Engel is a careful scholar who respectfully studies other approaches, including Marxism. This allows him to appreciate the Austrian School that much more.

IN EVERY ISSUE

DEAR READERS

LARA-MURPHY REPORT

The great classical economists recognized that capital and interest were market phenomena, and that tinkering here would lead to disaster. Just another example of old wisdom that has been largely forgotten.

ECONOMIC DEEP END

PULSE ON THE MARKET

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ONE MORE THING

EVENTS AND ENGAGEMENTS

Learn more in person from Lara, Murphy, and other Austrian economists, at these upcoming appearances.

ABOUT LARA & MURPHY

L. CARLOS LARA is CEO of United Services and Trust Corporation, a consulting firm specializing in in business advisory services with a primary focus on working with companies in financial crisis. His background in capital formation and business rehabilitation makes him a regular speaker at credit and business conferences.

In 2010 he co-authored the highly acclaimed book, *How Privatized Banking Really Works* with economist Robert P. Murphy.

He is a co-creator of the IBC Practitioner Program for financial professionals and sits on the board of the Nelson Nash Institute.

ROBERT P. MURPHY is Research Assistant Professor with the Free Market Institute at Texas Tech University. He is co-author of *How Privatized Banking Really Works*. He is the author of *Choice: Cooperation, Enterprise, and Human Action* (Independent Institute 2015) and co-host with Tom Woods of the popular podcast Contra Krugman.

Murphy has a Ph.D. in economics from New York University. After spending three years teaching at Hillsdale College, he went into the financial sector working for Laffer Associates. With Nelson Nash, Carlos Lara, and David Stearns, Murphy is co-developer of the IBC Practitioner Program.

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"What Regulates Interest? What is Interest? It is the service rendered, after a free bargain, by a borrower to the lender, in remuneration for the service he has received by or from the loan. By what law is the rate of these remunerative services established? By the general law that regulates the equivalent of all services; that is, by the law of supply and demand."

— Claude Frédéric Bastiat (1801-1850)

NOTE from the Editors: We apologize for the tardiness of this issue, which was due to an illness and other stumbling blocks. (Everything is fine!) We are now back on schedule.

In a twenty-first century world of *"fractional reserve banking,"* long-term zero, and near zero interest rates, and now even the idea of *"Modern Monetary Theory (MMT),"* the natural market rate of interest has all but disappeared. But the wisdom of *Frédéric Bastiat* pierces through our present rate of interest debates and acts as a type of compass to help reorient us back to what rate of interest is economically sound and moral. Although the subtleties of the presentation would benefit from the later development of subjective value theory (from the hands of Carl Menger in 1871), nonetheless it is impressive how intuitively and passionately the classical economist Bastiat describes and defends the market economy.

In his famous essay on interest, from which the above quote was taken, Bastiat was actually challenging the socialist doctrines of his day promoted mostly by individuals such as *Pierre-Joseph Proudhon (1809-1865)* and *John Ruskin (1819-1900)*. These men preached an ideology that was discouraging people from economizing in order to accumulate *capital*—capital in the sense of tools, equipment, or machinery for increasing production.

In his arguments Bastiat first seeks to remind us that the attributes of *value* and *scarcity* are foundational elements of the law of supply and demand. Hence, all marketplace exchanges are always gauged by these two criteria. He uses a simple example to make us see this important point by comparing an individual who offers us a cup of cold water from the abundant spring waters nearby against the more valuable service provided by an individual who offers us "the same" cup of cold water when we are parched and out in the middle of a desert. The distinction

is at once apparent and we suddenly understand the intuitive workings of how a true market rate of interest is derived.

Bastiat then follows up his defense by asserting that *"the reduction in the rate of interest is proportional to the abundance of capital."* Consequently, when capital is scarce it is precisely then that the capitalist can command the rate of interest and have the upper hand in the marketplace—including that of labor. Labor, on the other hand, has the advantage when capital is abundant. Now, if the laboring masses only understood this one principle and how it brings abundance within their reach they would support every measure possible in the rapid accumulation of capital.

Bastiat makes us see that without capital there is eventually a deficiency in everything in an economy, including food and jobs. *"This is no declamatory morality; it is a chain of causes and effects, which is capable of being rigorously, mathematically demonstrated."* Today, we only have to think of the circumstances in modern day Venezuela to see what these chains of causes and effects have wrought.

But as always socialists claim the exact opposite. They continually stress that *capitalism* tyrannizes the laborer and these misguided proclamations do nothing more than stir up insecurity and uncertainty among the naïve masses. Still, their harmful message is an effective means of injuring the formation of capital while at the same time worsening the economic plight of the poor. In this way, and many others, socialism eventually deprives us of everything including our freedom. *"It is only an evil dream of perverted and intoxicated imaginations. No; a plan so defective has not proceeded from the Divine Mind. To affirm it, we must begin by denying the existence of God."*

This is strong language coming from Bastiat, yet how many of us that are a part of the *growing ten percent* would actually disagree with him? We guess that most of you would not. In this present-day economic environment what we say and do as practitioners of *Nelson Nash's Infinite Banking Concept (IBC)* is what is bringing economic hope to a hopelessly confused world. This makes us unique ambassadors in the marketplace because our message is the only message that allows individuals to peacefully and legally secede from our corrupt monetary regime. IBC is the true route to financial freedom. It's great that we're all a part of it.

Yours truly,

Carlos and Bob

Tucker Hearts Warren

TUCKER CARLSON PRAISES "ECONOMIC PATRIOTISM" OF ELIZABETH WARREN

Tucker Carlson stirred up a hornets' nest—again—when he recently issued a monologue on his popular TV show, praising Senator Elizabeth Warren's call for "economic patriotism." Specifically, Carlson agreed with Warren's criticism of multinational corporations that relocate jobs to other countries, all the while being subsidized by U.S. taxpayers. Carlson went so far as to blame the Republican leadership in D.C. for being dedicated to doctrinaire libertarianism and Austrian economics. (!!)

Needless to say, this is silly. Say what you will about the Fed's multiple rounds of QE, the huge increase in the federal debt under both Obama and Trump, and the expansion of the federal footprint in health care and the financial markets that occurred under *Bush* and Obama... but it wasn't "the free market." The tragic irony here is that if and when a major economic crash occurs, both Elizabeth Warren and (apparently) many FOX viewers will blame it on laissez-faire.

This whole episode underscores the importance of sound economic theory. There are too many moving parts in the real world for people to clearly isolate cause-and-effect merely from observation. When unemployment next surges, Democrats will quite naturally blame "Trump's tax cuts for the rich," while Republicans will blame the tightwad Jerome Powell and his interest rate hikes. Only with a solid foundation in economic reasoning can the average American hope to understand what's really going on. This is why we stress the importance of the great classical and Austrian economics writers.

Trade War Woes

U.S. CONTINUES TO FLIRT WITH TRADE WAR AGAINST CHINA, MEXICO

One of the biggest market movers recently has been the possibility of a full-blown trade war. We won't rehash the standard case for free trade here again, but instead we'll point out just how harmful it is to mix politics and commerce. Business owners should be worried about things like resource supplies, market demand, and inventory management. They shouldn't have to monitor Twitter to see if the president is having a fruitful meeting with foreign leaders.

Now it's true that tax and regulatory policies may, in some situations, place U.S. companies at a strategic disadvantage vis-à-vis their foreign competitors. Yet if so, the safest solution is for the U.S. government to *reduce* the burdens it places on American firms. If it's still the case that (say) the Chinese government maintains barriers to American-made goods, then you don't fix the problem by turning around and taxing transactions where Americans try to import goods from China. You don't make America great again by taking away options from American consumers. It's much better to lead by example, by having a relatively free market economy at home and show the world just how productive and rich America becomes under a policy of liberty.

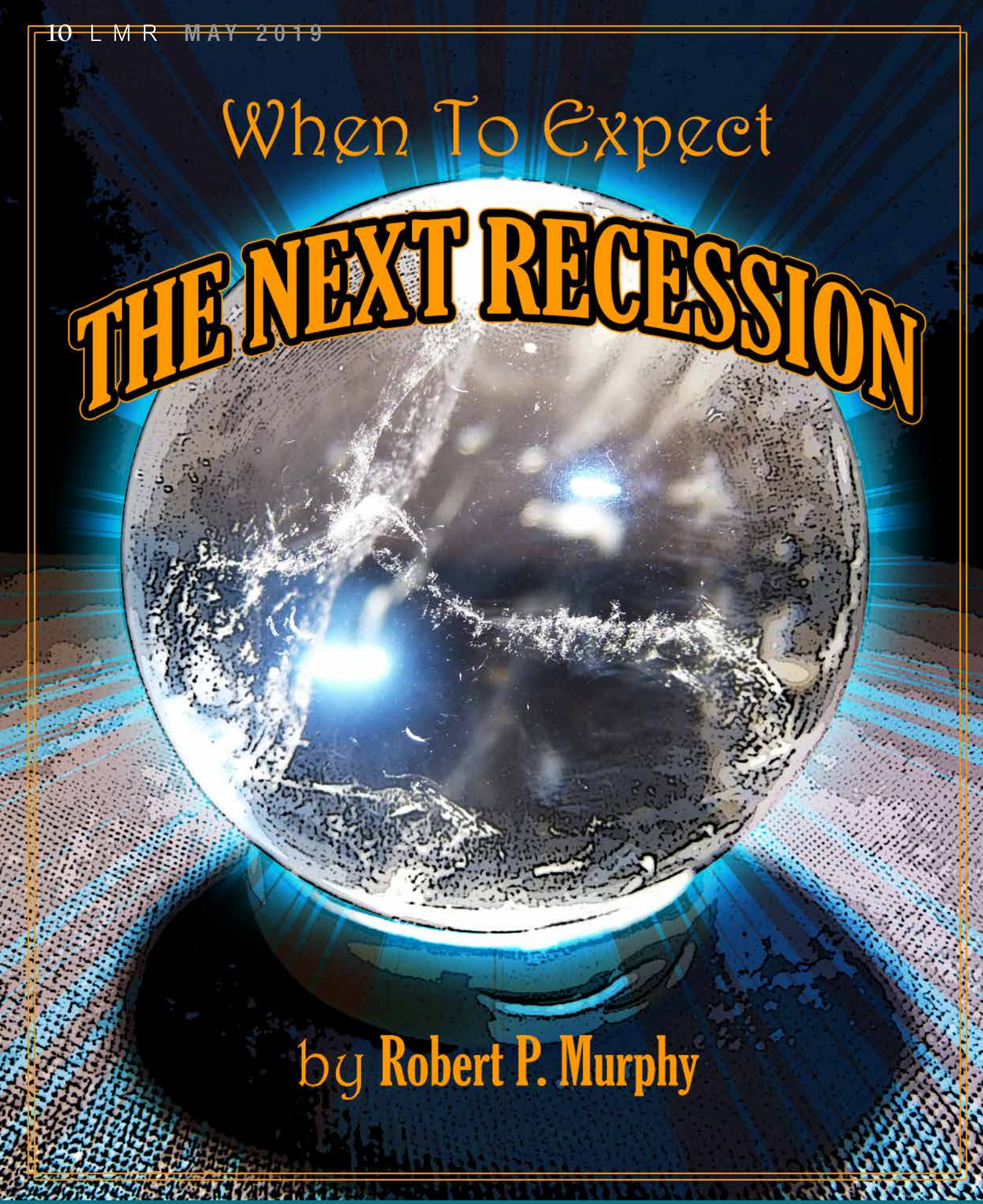
Auto Loans Delinquent

AUTO LOANS IN BAD SHAPE

Despite the official statistics painting a rosy scenario, there are growing signs that the economy is resting on quicksand. For example, Zero Hedge reported in mid-May that some 4.7 percent of auto loans were more than 90 days past due. For perspective, the figure was as low as 2 percent back in 2005. Back when the financial crisis hit, auto loan delinquencies starting rising and didn't hit the current level (4.7 percent) until the third quarter of 2009.

By itself, a single statistic on auto loan delinquencies doesn't tell us much, but in the broader context of our warnings about the fragile economy, it's yet another bit of evidence that the markets are about to tumble.

When To Expect THE NEXT RECESSION



by Robert P. Murphy

Carlos and I have been warning since 2009 that the Federal Reserve (then under the leadership of Ben Bernanke) was blowing up another giant asset bubble, even bigger than the one that burst and led to the financial crisis. Although it's crucial for the average household and business owner to understand what causes the business cycle, the more practical concern is obviously: *When will this new bubble burst?* In other words, *when is the recession coming?*

Now to be sure, Austrian economics doesn't give you a crystal ball. Indeed, one of the insights of the Austrians is that human beings are inherently unpredictable, and cannot be neatly described by a system of equations the way physicists can do so with material objects.

However, Austrian economics—particularly the Mises/Hayek theory of the business cycle—*does* give us a better sense of what's coming. For example, back in October 2007 I used the Austrian approach to publish

Now to be sure, Austrian economics doesn't give you a crystal ball.

an article with Mises.org worrying that we might be in store for "The Worst Recession in 25 Years?"[1] Note that this was almost a full year before the financial crisis struck, and well before most Fed officials were ad-

Table 1. NBER Business Cycle Expansion Lengths

Recession Trough to Following Peak	# of Months of Expansion
February 1961 – December 1969	106 months
November 1970 – November 1973	36 months
March 1975 – January 1980	58 months
July 1980 – July 1981	12 months
November 1982 – July 1990	92 months
March 1991 – March 2001	120 months
November 2001 – December 2007	73 months
June 2009 – ???	120 months and counting…

Source: National Bureau of Economic Research (NBER), https://www.nber.org/cycles.html.

mitting that there was much trouble at all.

At our recent seminar for business owners in Nashville, Carlos and I presented in-depth analysis on the state of the economy, and how to tailor IBC policies to respond to an individual's unique situation. In the present article, I'll summarize some of my main points regarding the timing of the next recession.

The Longest Recovery on Record

For starters, let me point out that we are currently in the *longest "recovery" on record.* In other words, when the National Bureau of Economic Research (NBER) dates business cycles according to their peaks and troughs, we are currently in the midst of the longest expansion since the previous recession bottom. (See Table 1.)

I should mention that in the above table, I stopped going back once I hit the early 1960s, but there isn't a longer "expansion" on the books going back as far as the records are kept—all the way to 1854.

Now these facts by themselves don't prove anything, of course, but I *do* want people to realize just how unusual it is that we've gone this long without another (official) downturn.

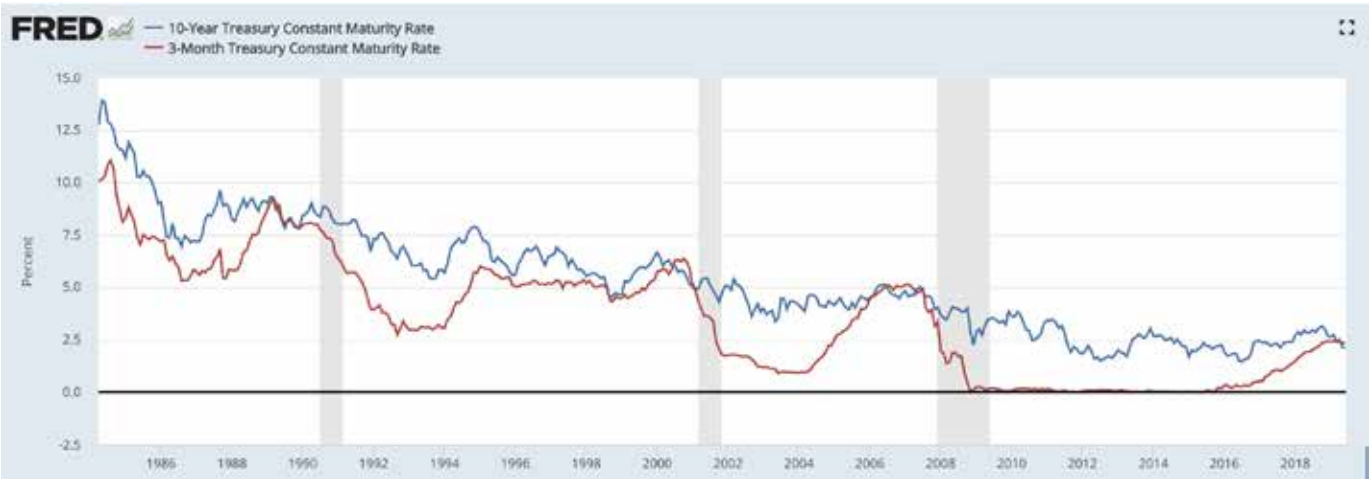
We are currently in the longest "recovery" on record.

The Yield Curve Inversion

The inverted yield curve is another indicator that a recession is near. (See Figure 1.)

In Figure 1, the blue line is the yield on the 10-year Treasury, while the red line is the yield on the 3-month T-bill. As the chart indicates, if we look at the last three

Figure 1. Yield Curve Inversion



recessions (indicated by the gray bars), the red line jumped above the blue line shortly before the recession struck. This is known as an "inverted yield curve," because the yield on the shorter maturity bonds is higher than on the longer maturity ones.

The inverted yield curve is another indicator that a recession is near.

As the figure *also* reveals, currently the yield curve is inverted again. (The official Daily Rates posted by the Treasury[2] show that the yield on the 3-month has been higher than the 10-year since May 23.) Technically, the economic literature studying the "predictive power" of the yield curve would want to see an inversion that lasts for a good month before classifying it as a definite signal, but we are surely in dangerous territory at the moment. (In next month's issue of the LMR we can provide a more definitive judgment.)

Fed Continues to Sell Off Assets and "Destroy" Base Money

Finally, in Figure 2 I show that the Fed continues to let its balance sheet shrink, despite the perception in certain quarters that the Fed has switched to an "easier" policy.

As Figure 2 indicates, the Fed has allowed the assets on its balance sheet to "roll off" at the same pace, notwithstanding all of the happy talk Fed officials have given about loosening up.

Don't misunderstand me: The chart in Figure 2 doesn't *contradict* what Fed officials have been saying. They are talking about the future, and how they will stop the asset roll-off sooner than they originally announced, and how they won't hike interest rates as rapidly as the markets originally expected.

Even so, my point is a simple one: *The Fed is still tightening,* in the sense that it's letting its assets mature and thereby "destroying" dollars as the principal is repaid to the Fed without being rolled over. In terms of

Figure 2. Total Federal Reserve Assets

standard Austrian business cycle theory, the Fed is still continuing the behavior that will bring on another crash.

Powell Can't Back Down Easily

Furthermore, there are several reasons that the Fed *needs* to continue tightening. For one thing, the balance sheet is still bloated compared to historical norms. For another, as interest rates rise, the Fed has to pay ever higher volumes of interest payments to the banks, as part of the "interest on excess reserves" policy that was inaugurated in October 2009.

This is a subtle point so let me elaborate. Back in October 2009, the Fed began the new policy of paying the commercial banks interest on their reserves, if they kept them parked at the Fed. (This is what led me to tell shocked audiences, "Right when the government was bailing out bankers in order to prevent a credit crunch, they also began paying the banks to *not* make loans to their customers.")

In the beginning, the policy wasn't very expensive, because the Fed only paid 25 basis points—i.e. 0.25 percent—on the reserve balances. However, when the Fed wanted to start raising interest rates, it did so by increasing the rate that it paid the banks. Because no loan is safer than getting guaranteed money from the Fed, the banks naturally raised *all* interest rates across the board; the Fed's rate was a floor.

As of early May, the interest rate the Fed pays on both required and excess reserves is 2.35 percent.[3] If the Fed *hadn't* started shrinking its balance sheet, the banks would still have had some $2.8 trillion in total reserves with the Fed.[4] At the current interest rate, that would work out to $2.8 trillion x 2.35 percent = *$66 billion in annual payments* to the banks. In order to reduce that number

In a sense, the public gets hit with a double-whammy.

to a more reasonable amount, the Fed "had to" let its balance sheet shrink, thereby reversing some of the previous inflation and sucking money out of the system. Right now, there are "only" about $1.5 trillion in total reserves in the system, meaning that the Fed is paying the banks "only" $1.5 trillion x 2.35 percent = $35 billion on an annualized basis.

It's mind-boggling to stop and ponder this situation. In the wake of the financial crisis, the Federal Reserve "created money out of thin air" electronically in the very act of buy-

ing up Treasuries and mortgage-backed securities. Then, partly to make sure the newly-created money wasn't used to fuel further commercial bank loans, the Fed began paying the banks to keep this new money parked with the Fed, rather than using it as the basis for new loans to their customers.

In a sense, the public gets hit with a double-whammy: First, the purchasing power of their dollars is diluted by the Fed's monetary inflation when it first buys up "toxic assets" and government debt. Then, the Fed uses the income it earns on these assets in order to subsidize the bankers, rather than remitting the earnings to the Treasury and reducing the federal budget deficit.

(A parenthetical paragraph for purists: When a commercial bank grants a loan to a customer—perhaps someone needs a mortgage to buy a house—strictly speaking the bank doesn't "lend out reserves" to the customer. However, by granting a loan to a customer, a commercial bank is now more likely to have *other banks* demand payment during interbank clearing processes. For example, when the new mortgage applicant actually buys his house, the check ends up being deposited in some *other* bank most likely, and then *that* bank will want the original bank to "settle up" by transferring over some of its reserves. So even though the process is complicated, in practice it is still true that when the Fed started paying interest on reserves back in October 2008, this had the effect of discouraging banks from granting loans to the public. For those who want more details

on the process of Fed money creation and bank loans, Carlos and I carefully explain it all in our book, *How Privatized Banking Really Works.*)

There are lots of nuances and moving parts in all of this, but just keep this in mind if you are getting lost: Ever since Nixon severed the last remnants of the gold standard, there *have been no formal constraints on the Federal Reserve's ability to create money.* Hasn't our economy behaved exactly as you would expect, if a bunch of powerful people got their hands on a printing press?

There are several independent lines of argument that lead me to expect a recession to start in either late 2019 or the first half of 2020.

Conclusion

There are several independent lines of argument that lead me to expect a recession to start in either late 2019 or the first half of 2020. Now it's true, this could be postponed (yet again) if the Fed were to announce a fourth round of QE. However, I don't think Powell could really get away with doing so, *before* a giant crash. He would lose credibility with world investors, inasmuch as the official unemployment rate is at rock bottom levels and the most recent official announcement of GDP growth was at a healthy 3.1 percent.

Finally, let me lay my cards on the table: I think it is quite obvious that there is a powerful network of officials inside the government—call them the "Deep State" for lack of a better term—who want Trump out, if for no other reason than that he's too unpredictable. To the extent that the Fed and other powerful people have some control over the *timing* of the next crash/recession, it would serve their interests if they let it happen right before Trump's attempt at re-election.

References

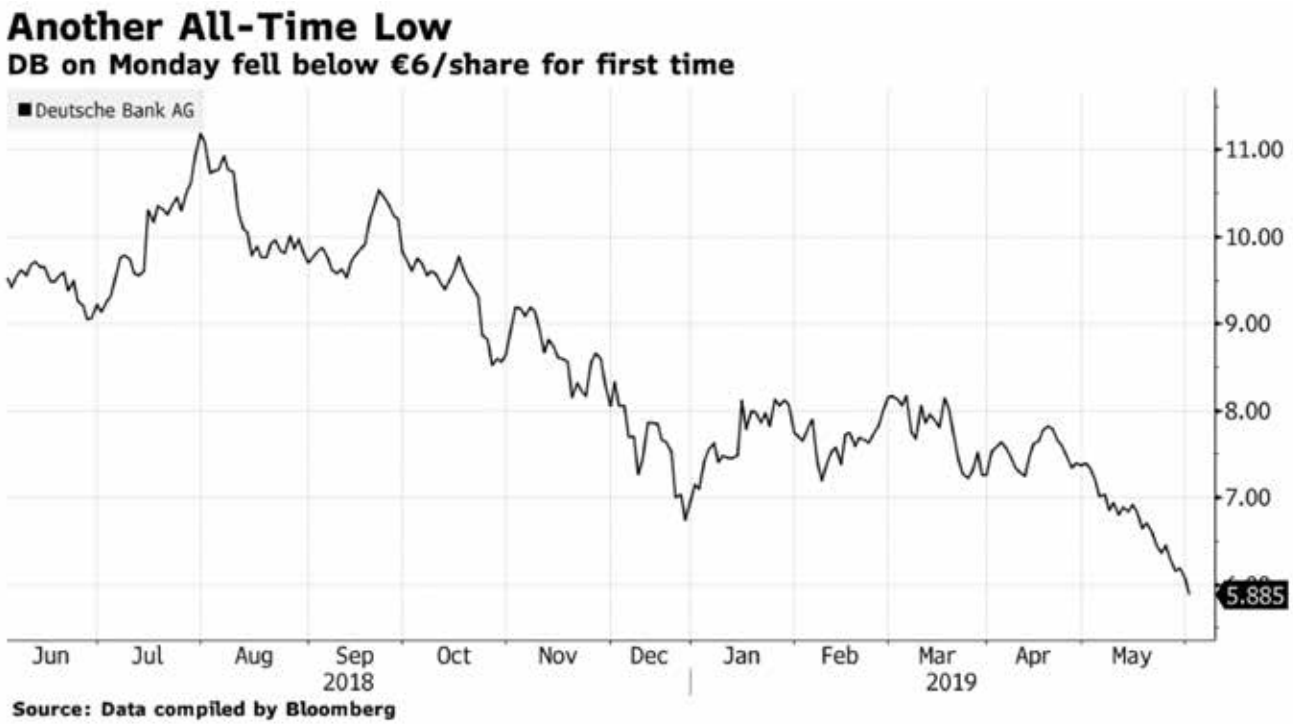
1. See: https://mises.org/library/worst-recession-25-years.
2. For Treasury yields see: https://www.treasury.gov/resource-center/data-chart-center/interest-rates/pages/textview.aspx?data=yield.
3. See: https://www.federalreserve.gov/monetarypolicy/reqresbalances.htm.
4. For total reserve balances, see: https://www.federalreserve.gov/monetarypolicy/reqresbalances.htm.

Comparing **U.S. Banks** To Their Foreign Peers

by L. Carlos Lara

***Deutsche Bank*, Germany's flagship** bank with a prominent U.S. presence, is back in the news again. And again, the news is bad. This time the beleaguered institution announced to its shareholders that the intended merger between it and rival competitor *Commerzbank* has come unraveled. The reason this is such a bleak report is because the collapsing of these negotiations closes the door on one of Deutsche Bank's last remaining maneuvers to resuscitate itself and its announcement has knocked the wind out of its hopeful investors. In response the stock dropped to a record new low this past Monday (June 3) sounding an alarm, once again, to all of its bondholders.

I have been covering this particular European bank off and on in the ***LMR*** since February 2016. In my article, "Like Lehman Brothers in 2008, Deutsche Bank—Five Times Larger—Is In Trouble," I was reporting at that time that *Standard & Poor's Rating Services* had just lowered the bank's credit rating to just barely above junk status (BBB+), even lower than *Lehman Brothers* rating's downgrade only three months before its collapse. The sobering announcement at that time sent Deutsche Bank's shares into a free fall and almost halved their price of €21 a share to €13. According to Bloomberg analysts, Monday's devastating drop in share price to less than €6 a share for the first time ever reflects more than a 90% slide since its peak before the financial crisis. Bloomberg also reported that *"Deutsche Bank's euro contingent convertible bonds fell on Monday to their lowest level since January, while the price*



of credit protection on the bank's subordinated debt jumped to the highest since 2016."[1]

Contingent Capital

Almost simultaneously with this story I was contacted by an avid LMR reader who wanted to know what effect this devastating news would have on all the holders of Deutsche Bank's contingent convertible bonds, and would it trigger a bail-in? His question is so timely and intuitive that I have devoted a part of this article to answering it and at the same time using it to draw a comparison between U.S. banks and European banks that many of us may not be aware of, especially since the 2008 financial crisis.

Monday's devastating drop in share price to less than €6 a share for the first time ever reflects more than a 90% slide since its peak before the financial crisis.

There are some big differences between U.S. banks and their foreign counterparts, explaining why Bob and I have often intimated that the next banking system breakdown could easily begin overseas. In fact, under closer scrutiny, it's not a stretch for me to claim that since *Contingent Convertible* Bonds became so prevalent in Europe they have the potential to ignite massive bank runs that could be the entire Eurozone's undoing, including the euro itself.

Background

(In order to provide the reader the prevailing circumstances to the development of these unusual investments that came into vogue soon after the 2008 financial crisis, much of what follows is drawn from my February 2016 LMR article.)[2]

Briefly, when banks need to raise money, they have two basic options. One option is to sell shares of stock and pay shareholders dividends from their profits. Of course, when there are no profits no dividends are paid, which is great for conserving capital. The drawback is that selling shares dilutes the value of existing shares, meaning that the original owners now have to share any future profits with the newcomers.

The other option is to sell bonds in return for funds from bond

investors. Of course, using this method the bank has borrowed money from its bond investors and they become its creditors. The bank must pay the principal amount of the bond at a stipulated time in the future, but in the interim must make interest payments to these bondholders.

In a low interest rate environment, it is advantageous for the bank to sell bonds rather than issue stock. At the same time, investors like to buy bonds in a low interest rate environment if the yield (interest payment) is high enough and also because of their priority status over stockholders in cases of default or bankruptcy liquidation.

But what stood in the way of selling bonds after the 2008 financial crisis was the *Basil III Accord* regulations for European banks and the *Dodd-Frank Act* for U.S. banks.

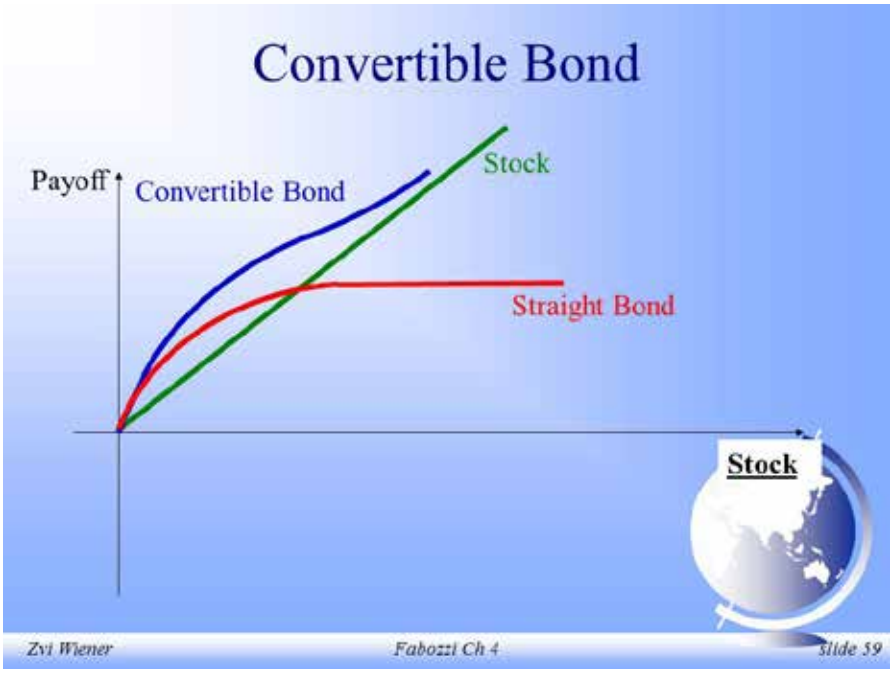
Since *Contingent Convertible* Bonds became so prevalent in Europe they have the potential to ignite massive bank runs that could be the entire Eurozone's undoing, including the euro itself.

Regulators both here and abroad insisted that under these new rules financial institutions must raise more equity capital to bolster their reserves rather than take on more debt (as in issuing bonds) as part of their capital adequacy and liquidity requirements. Consequently, banks and regulators together came up with a special kind of bond—a *hybrid*—that would satisfy the purposes of the regulators and at the same time serve as an alternative to prevent banks from having to issue more shares of their stock.

What is this unusual investment?

It's a *convertible* bond, a debt instrument that actually starts off as a bond and pays out annual interest rates to its bondholders in the same way an ordinary bond does. But these convertible bonds, under certain critical thresholds, can be flipped from a debt obligation to equity ownership in the bank, thereby creating instant liquidity for the bank in times of a financial crisis. Of course, this is great for the bank, but not so fortunate for holders of these hybrid instruments, especially if the bank is in serious financial trouble. This is the hybrid bond's main *"contingency"* and why they are called *contingent convertible bonds.* This convertibility allows them to be classified as "Tier 1 securities." Sometimes you often hear them referred to as *"Cocos."*

These convertible bonds have been very popular and have sold quite well for yield-seeking investors in this low interest rate en-



vironment, particularly in Europe where we have even seen negative interest rates. According to a report put out by Bloomberg earlier this year, $181 billion of these contingent convertible bonds were "snapped up in the first five years since they came to market in 2013."[3] They pay somewhere around 6-7% interest making them very desirable in a low-yield environment. Although normally institutional buyers purchase these instruments for their investment portfolios, now even retail investors have been lured into buying them in spite of the fact that part of their contingency includes the provisions for substantial haircuts of up to 100% when they flip to equity. In other words, under certain conditions the bank can write them off completely for a complete loss to the investor!

Banks and regulators together came up with a special kind of bond—a *hybrid*—that would satisfy the purposes of the regulators and at the same time serve as an alternative to prevent banks from having to issue more shares of their stock.

The fear is that with each progressive downturn of Deutsche Bank's financial stability, the day will eventually come when it won't be able to make its interest payments to its bondholders. Containing this fear is next to impossible in Europe where Deutsche Bank's problems are characteristic of many other banks throughout the Eurozone where book values of banks are grossly overstating the real value of their equity. This anxiety is mixed with anger from mom and pop bond investors who have come to realize that these convertible bonds have been specially designed to take money away from them even before the bank faces a collapse, sort of a bail-in before a proper statutory bail-in.

U.S. Banks Have Recovered; European Banks Remain Weak

After the 2008 financial crisis, the Dodd-Frank Act with its scores of regulations

aimed at beefing up bank reserves have made U.S. banks financially stronger by insisting they re-capitalize. On the other hand, Europe's banks remain fragile since they have failed to raise sufficient equity capital and their earnings, due to the ongoing European economic crisis, have not rebounded. This makes raising capital even more difficult for these barely solvent banks.

This is true, not only in seriously troubled countries like Greece, Spain, and Italy, but also in France and Germany. It's as though the EU regulators are turning a blind eye and are not willing to force the banks to be re-capitalized as they should be. Many of them continue to carry uncollectable loans on their books that should have been written off long ago. Consequently, investors are anticipating huge losses that the banks are delaying and failing to acknowledge. Ultimately, the outcome is predictable. The banks will have to clip bondholders with a severe haircut and issue hundreds of billions of euros in equity at drastically discounted prices. But this gutting of their balance sheets will also lead to demands for government bail-outs, which no government in the Eurozone wants to provide, so regulators are being tolerant while providing cheap funding to disguise the severity of the problem. Even talking about it could cause a run on the banks, which they definitely don't want.

The U.S. Banking System Is Small Compared To Its Peers

According to a research report by *"The Clearing House,"* the U.S. banking system is small at 117% of GDP compared to 332%

for Germany, 373% for the UK and 421% for France. In terms of asset as a percentage of GDP, the U.S. is the lowest among the G-7 countries as in the chart below:

The U.S. banking system is also less concentrated than the banking systems of peer countries. Based on assets held, the top five banks held 56% of the country's total banking assets which is the least among the G-7 countries. When the largest five banks' assets are compared as a percentage of GDP, they are relatively small as well."[4]

What these graphs reflect is that, although the U.S. has the largest economy in the world with a GDP of $21 Trillion as of 2019, finance, insurance and real estate, collectively known as the FIRE Sector, are the major industries. This is why in 2008 the financial and real estate sectors triggered the financial crisis that brought the global economy to near devastation and why Europe in particular remains weak to this day.

Europe's banks remain fragile since they have failed to raise sufficient equity capital and their earnings, due to the ongoing European economic crisis, have not rebounded.

But there are also too many banks in Europe, far more than in the U.S., thus competition for depositor money is extremely fierce. On top of the fact that depositors are genuinely reluctant to deposit their money in financially weak banks, competition from

The U.S. banking system seems financially strong and vibrant compared to that of our neighbors yet as most LMR readers know, the U.S. commercial banking system is spilling over with problems.

stronger outside banks lures away those much-needed deposits. For example, even U.S. banks now offer foreigners online banking services without too much difficulty. Even the national Post Office in many countries accepts deposits, adding an additional layer of competition.

This lack of depositor money makes European banks highly dependent on short-term borrowing in order to make loans and fund their operations. These short-term loans have been previously provided by U.S. money market funds, but even these markets are increasingly closing to them due to the severity of their solvency issues, forcing the ECB to step in and provide temporary alternatives. Ultimately, however, it will get back to doing what is painfully necessary, which includes massive lay-offs, liquidation of assets, and bank closures.

For the remaining banks, most bank analysts believe that some sort of Euro TARP is unavoidable in order to help recapitalize the banks. Standing in the way of such actions is Germany who won't have any part of bank bail-outs for fear of destroying the euro and disintegrating the eurozone. From all appearances it's as though the European Central Bank is thinking the same way. What seems obvious is that while the timing of the European banking system collapse is unpredictable, unfortunately the outcome isn't.

Deutsche Bank's future could be the triggering mechanism that sets it all in motion and is the bank to keep watching.

U.S. Banks Are Closing Branches

Even though U.S. banks are smaller in number and concentration of assets to GDP than the banking systems of peer countries, U.S. banks want to reduce the size of their operations even further by getting rid of many of their bank branches. Reuter's reports that banks don't really like operating them because they cost too much money. "A branch office cost between $2 and $4 million to get up and running and another $200,000-$400,000 annually to operate."[5]

For this reason, all the major banks are closing more branches than opening new ones, but bank executives say that certain customers still like coming to the branches. It's obviously not the younger customer. It's the older customer and business owners who frequent the branches the most. Business owners need to make cash deposits and make change runs frequently and also want to negotiate business loans and lines of credit face-to face. U. S. Bancorp executives told Reuters that "proximity to their business is a very, very important factor to their bank selection and their continuing relationship with the bank."[6]

Most bank analysts believe that some sort of Euro TARP is unavoidable in order to help recapitalize the banks.

The one thing European banks should be doing—namely, shedding unprofitable operations as quickly as possible—is what U.S. banks are not hesitating to undertake, and can't seem to get enough of it. This marks still another major contrast between the banking system we have here in the U.S. to that of Europe.

Conclusion

Whether here or abroad we live in a world of banking and for most people it is difficult to imagine running a household, a business, and even a country without a commercial bank close by. Banks represent the main depository for our money, a safe place to temporarily store our money until we are ready to deploy it. In a sense they are the primary cashflow systems of all economies yet as we have seen in these simple comparisons these banks are not invincible.

The U.S. banking system seems financially strong and vibrant compared to that of our neighbors yet as most ***LMR*** readers know, the U.S. commercial banking system is spilling over with problems and bank deposits since the 2008 financial crisis have become riskier than ever for all depositors.

Although the Dodd-Frank Act has pro-

vided the necessary impetus to have banks increase their capital reserves to help insure the safety of our U.S. financial system, its rules and regulations, for those who understand them, can be harsh and not necessarily designed in our best interest. Furthermore, Dodd-Frank is just a law, it has no power to stop a financial banking crisis from erupting.

Be prepared. A financial crisis can engulf us in the blink of an eye.

Our central bank, the Federal Reserve, like the central banks of all foreign nations, manipulates the rate of interest that creates the false booms and busts that can have such serious consequences for our economies. More reason to be skeptical of all banks and keep them at a safe distance. Under these circumstances the alternative bank to use is *Nelson Nash's Infinite Banking Concept (IBC).*

Learning how to wean your household and business away from the commercial banking system is one of the most prudent endeavors you can possibly entertain, especially during these uncertain times and IBC is the way to do it.

If you are not familiar with IBC, pick up a copy of Nelson Nash's book, *Becoming Your Own Banker,* or get a copy of his most recent book, *The Case for IBC,* co-authored with Bob and me. https://infinitebanking.org/store/ Learn about the best kept secret in America that can help protect your household and business from the next financial crisis.

When you are ready to open up your own IBC "alternate" bank be sure and get in touch with one of our *Authorized IBC Practitioners* found at the *Nelson Nash Institute* website. We encourage you to do it soon. https://infinitebanking.org/finder/ Be prepared. A financial crisis can engulf us in the blink of an eye.

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Austrian Economics: **The People's Science**

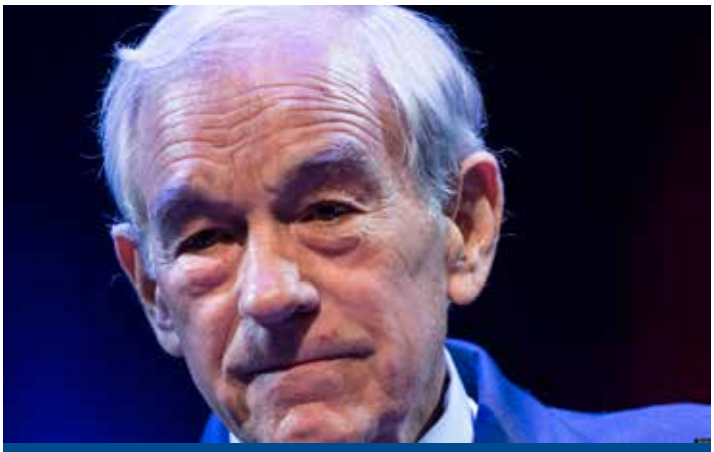
Interview with **C. Jay Engel**

C.Jay Engel lives in Northern California with his wife and four children where he runs several start-up businesses. As a hobby, he has initiated the new Austro Libertarian Magazine.

Lara-Murphy Report: How did you discover Austrian economics?

C. Jay Engel: Like so many others of my generation, I was a college student during the golden years of the Ron Paul movement. At the start, my discovery was sourced in his mentioning Austrian Economics on the debate stage. I was not interested necessarily because I was disillusioned with "mainstream economics," but more because [Ron] Paul was to me a fascinating individual and in the spirit of curiosity-driven investigation, I began to dig deep. First came the subject of the Federal Reserve, perhaps the defining feature of his candidacy. But this quickly gave way to the philosophical setting of his own anti-Fed narrative.

Ironically, I had begun my college years as a business and economics major but shifted quickly to general "Public Policy" due to my complete lack of interest in mathematics. At that point, I wanted nothing to do with economic studies. By the time I was preparing my final paper, I had settled on the Federal Reserve as an engine of destruction for my topic. This personal development was because for me, Austrianism offered something else, something more relatable. Far from being the "dismal science" as Thomas Carlyle termed it, and further still from being an arcane and technically sophisticated field of study, I began to realize that economics ought to be the people's science. I therefore discovered Austrian economics on the back of a sort of populist political movement, which if you think about it, is quite spectacular.



"...because [Ron] Paul was to me a fascinating individual and in the spirit of curiosity-driven investigation, I began to dig deep. First came the subject of the Federal Reserve, perhaps the defining feature of his candidacy."

So although I was in college at the time, my discovery of Austrian Economics came about through my own curiosity and the important service

that the Mises Institute provided in having freely available more Austrian literature than I could have dreamed of wading through during the course of formal education. There is something to be said about an economic school of thought that appeals to an average person in this way– basic economics really does not have barriers to entry that depend on much beyond critical thinking and the ability to read.

LMR: In your online writing, you have pursued an in-depth analysis of socialist thought. Can you explain for our readers?

CE: Socialism is interesting to me at an intellectual level. I often distinguish between intellectual socialism and pop-socialism. Whereas the latter includes your typical envy-laden utopian who simply pushes for more free goods and services (arguably the more common socialism), there actually are deeply developed bodies of socialist thought. One of the reasons Marxism and Neo-Marxism are interesting to me as an outsider is they tend to be holistic and systematic. A lot of free-market leaning individuals miss this.

"Far from being the 'dismal science' as Thomas Carlyle termed it, and further still from being an arcane and technically sophisticated field of study, I began to realize that economics ought to be the people's science."

For instance, many free-marketers simply deride socialism as being a set of policies built on theft and redistribution. But at a more fundamental level, the redistribution, for the true socialist, is literally the process of eliminating the imbalances that result from theft, not the committing of theft itself. For them, the capitalism is the theft because it is the situation where a capitalist (or a non-laborer) is skimming off the top of other people's labor thereby exploiting them. So it's meaningless to tell a socialist that they advocate theft—for them, it's the opposite: they are trying to get rid of theft.

This means that true socialism, the intellectually conscious socialism, is not to be confused with your run-of-the-mill welfare-statist or left-interventionist such as Elizabeth Warren, and certainly not Hillary Clinton. True socialists really start at the most basic and fundamental level, just as libertarians do. They have their own formulations of homesteading and the subsequent distribution of resources along their own stipulations about what is fair and just. Welfare to them is mere capitalist "reformism"; or, trying to make an inherently bad system somewhat more functional.

So what is fascinating to me is the intellectual socialists have what they consider to be a internally self-consistent edifice by which to critique the current world of laws and government and economic justice. Obviously, I believe their edifice is tremendously mistaken—and dangerous—but nevertheless, as a libertarian who has my own system of critique against the system as it exists, I think it's important to be able to interact with a body of thought that is gaining in popularity.

"True socialists really start at the most basic and fundamental level, just as libertarians do. They have their own formulations of homesteading and the subsequent distribution of resources along their own stipulations about what is fair and just."

LMR: Following up, you had one of us (Murphy) on your podcast to discuss Modern Monetary Theory (MMT) through the lens of a socialist. This might sound quirky to some readers, but we were actually very complimentary to the socialist in question. Can you explain?

CE: As indicated above, many socialists familiar with their own traditions understand that institutions that characterize the modern economic system are not simply tools that can be used to further their causes. The Federal Reserve, for instance, is not an institution that can simply adjust the supply of money and level of interest rates, and bring people out of poverty. The

socialists understand that these institutions are not their friends.

Unfortunately, they dismiss them as features of capitalism whereas we Austro-Libertarians categorize them as systematic deviations from the free market.

But nevertheless, the socialist critique of Modern Monetary Theory was helpful in two ways: one, brought to light the fact that the economy itself is made up of actual people and resources and no amount of aggregate trickery and financialization schemes from the top can actually create more goods for more people. There is a real economy that sits behind the central bank that spends its time and efforts monetizing government debt. MMT advocates spend their time promoting the idea that we have overcome the balanced budget restraints of a pre-1971 monetary system—but what the socialist in question explains is that financial trickery is not a real-world solution that actually helps actual people.

And secondly, perhaps less controversially, the socialist in question spends a considerable amount of time explaining where MMT came from, and how it has positioned itself in relation to the other dominant camps of economic commentary. Who promotes it, the academic institutions from which it stems, and the particular economic developments that have fueled its rise. Alexandria Ocasio-Cortez, for instance, promotes the idea, but it's not like she frequents these wonkish economic blogs. She got this idea from an advisor who comes from a particular academic setting.

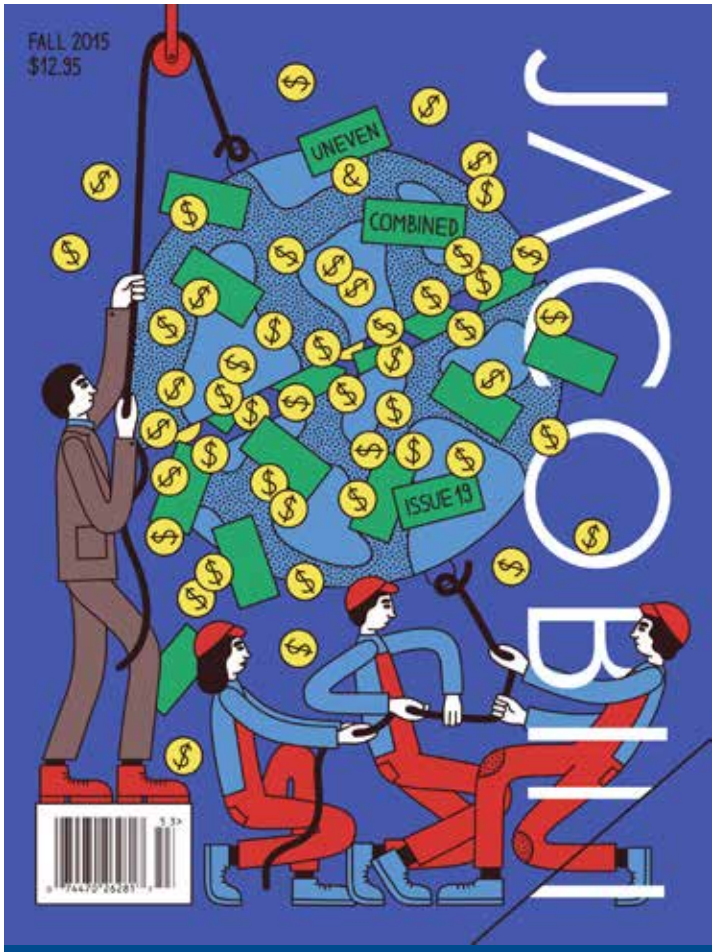
LMR: You've just launched a new journal. What's its purpose?

CE: There are several layers to this. On one hand, the initial motivation stemmed from my own interest in understanding the ins and outs of the intellectually-committed socialist movements, which led me to subscribe and read in depth the increasingly popular *Jacobin Magazine*. What struck me was their brilliant balance of visual elegance, graceful prose, and intellectual stimulation. Their contributors, topics, narratives, and presentation are all world class. Last year they had a massive and technically intricate 7,500 word essay on the ins and outs of Shadow Banking, for instance—not something most people picture being featured in a socialist magazine.

The content, of course, is disagreeable, as you would expect of a socialist outlet and it has never tempted or swayed me in the least. But if they had

found a market for tens of thousands of young radical leftists to subscribe to their print publication in our day and age, surely there must be a market out there for an Austro-Libertarian version!

But beyond just that initial motivation, as I have developed to acquire more substantial interested from Mises U alumni, Austro-Libertarian figureheads, and even young scholars in these circles, I have begun to realize there's something deeper. The best way to explain it is to note that in self-consciously Austrian and Rothbardian tradition, we have online blogs and articles, which serve as a great medium for day to day commentary on current affairs and especially application of theory to real world happenings. And on the other side of the spectrum we have the vital academic journals such as the *Quarterly Journal of Austrian Economics.*



"Young people want more. That's why they are flocking to Jacobin. And my hope is that we can get some flocking to the side of liberty and capitalism in a world gone mad."

But Jacobin serves as a midway, or a bridge, between socialist blogs on one side, and academic Marxist journals such as *Catalyst Journal.* And thus, our Austro Libertarian Magazine was intended to match this bridge-role. But being a magazine, we don't just want content that contributes to theory; that is the role played by the QJAE and the Journal of Libertarian Studies. We want application, reflection, commentary, and content that is "downstream" from the much more capable journals in terms of original contribution. Thus, we seek to include columns

of short stories, literary criticism, modern graphics and artistry, and so on.

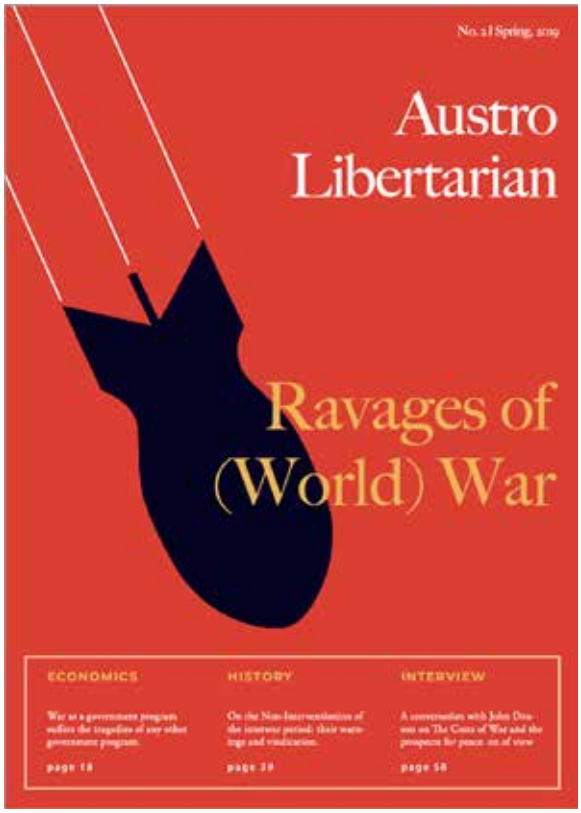
What has struck me most of all in the first year is that 85% of our subscribers are buying the print version. Of course, we offer a digital only plan, but few are interested. This speaks to the need and demand for a publication that people can hold in their hand and experience in an attempt to once in a while take a break from the digital barrage of cheap information that is digested nearly every hour of the day. Young people want more. That's why they are flocking to *Jacobin*. And my hope is that we can get some flocking to the side of liberty and capitalism in a world gone mad.

LMR: In your inaugural issue, you begin with a quote from Randolph Bourne, who famously said, "War is the health of the State." For another reference point, Murray Rothbard once wrote that the "war question" was the most essential to human liberty. For our conservative readers who were more upset at (say) Obama's raising the minimum wage, rather than George W. Bush's invasion of Iraq, can you explain why you think their priorities are misplaced?

"War requires centralization economically and politically; not only does it push for collectivization over individual responsibility, but it replaces the communities and local harmonies with nationalistic tendencies. War is the greatest Progressivist force in our time."

CE: I have a personal interest in the conservative case for strong hesitancy toward war; I grew up in a politically conservative family and still consider myself a social and economic conservative. While it's quite simple to make an anti-war case from a Rothbardian-libertarian perspective, I think the conservative angles are vital as well. For one thing, it is a prerequisite to warmaking that all the true conservative principles are undermined on the build up to, and exercise of, war itself. War not only requires massive taxation and inflation, it also tears

apart families, undermines social normalcy, and degrades the moral habits and norms of communities. War requires centralization economically and politically; not only does it push for collectivization over individual responsibility, but it replaces the communities and local harmonies with nationalistic tendencies. War is the greatest Progressivist force in our time.



At an economic level, we are aware of the detriments and negative consequences of various policies such as minimum wage increases. But these consequences affect only specific aspects of our lives; war is an engine of socio-economic transformation. This transformation is quite revolutionary and therefore contradicts what should be a conservative principle: that social and economic change ought to be natural and slow. To me, war is a useful means that governments have in their natural desire to accumulate more power. And of course, the more power they accumulate over time, the more natural society breaks down. Not only do we pay for war with the destruction of our economic resources, but we pay for it with our lives, our cultural norms, and our freedom. As Ludwig von Mises once noted, "war is harmful not only to the conquered, but to the conqueror." If war is the health of the state, then it should be the great enemy of true conservatives everywhere.

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Note: The economists and financial professionals interviewed in the LMR are given the freedom to express their views, without necessarily implying endorsement from the editors.

EVENTS & ENGAGEMENTS

NOTE: MANY OF THESE EVENTS ARE OPEN TO THE PUBLIC. CONTACT US FOR FURTHER DETAILS.

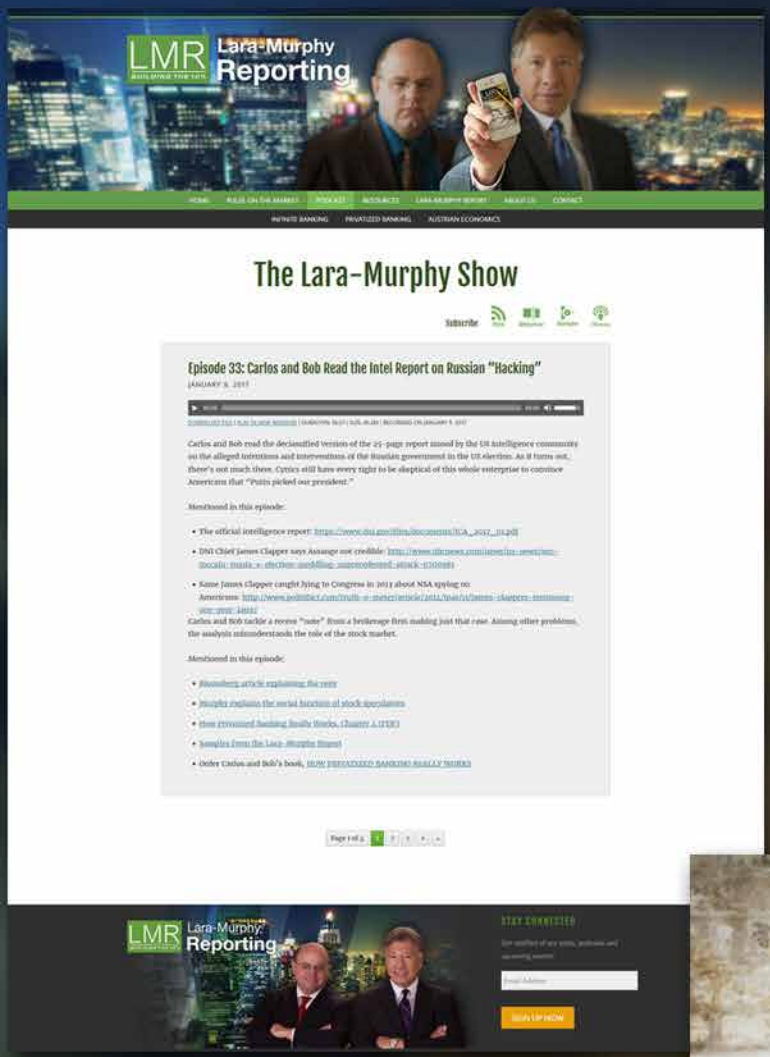
JULY 14-20, 2019
AUBURN, AL

Murphy presents on Austrian economics at Mises University.

AUGUST 17, 2019
ATLANTA, GA

Nelson Nash Institute presents the IBC Seminar for the General Public.

SOME EVENTS MAY BE CLOSED TO GENERAL PUBLIC.
FOR MORE INFORMATION ON EVENTS CONTACT: RPM@CONSULTINGBYRPM.COM



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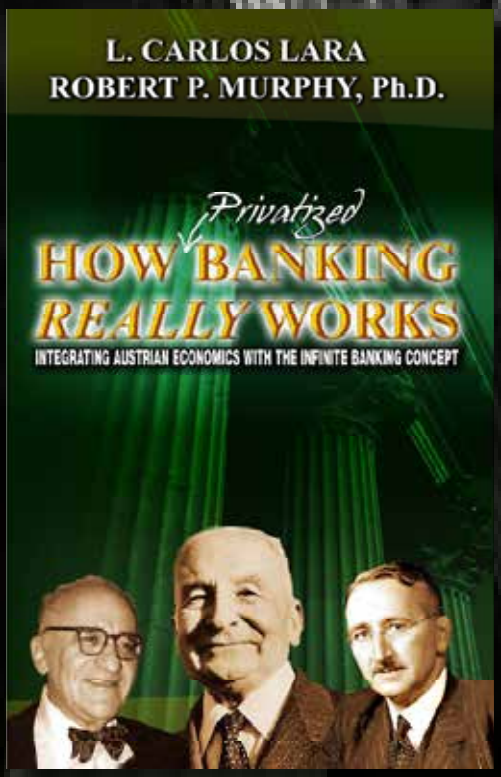

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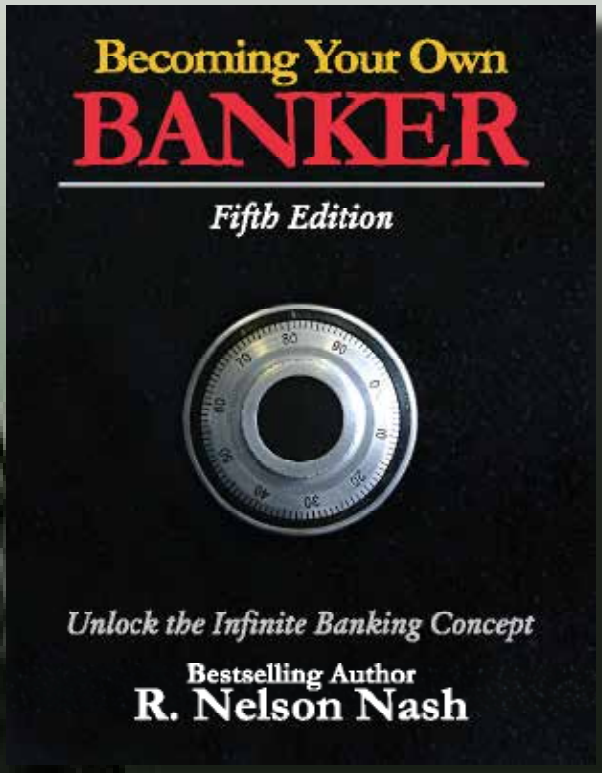

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