From: FX University Daily
To:
Sent: Tuesday, September 15, 2009 9:50 AM
Subject: Auditing the Fed: The $2 Trillion Question...

FX UNIVERSITY DAILY

A Publication of World Currency Watch

FX University Daily: Tuesday, September 15, 2009

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Auditing the Fed: The $2 Trillion Dollar Question

(And a Currency in Crisis)

Good day traders!

Good Day Currency Traders!

It's no secret that the Federal Reserve doesn't want to be audited – at least not publicly.

So far this year, the Fed has fought tooth-and-nail in court to reject Freedom of Information requests from independent news organizations including Bloomberg and Fox News.

Both news organizations wanted to know how the Fed is spending all this bailout money, and both were daring enough to sue for those secrets the Fed doesn't want to share.

In fact, even after a judge ordered the Fed to show their hand to Bloomberg last month, the Fed is still stalling. The Fed's lawyers already asked for a stay, and they have until September 30th to file an appeal.

Meanwhile, Congress isn't too thrilled with all the spending either.

Congressman Ron Paul (R-TX) proposed the bill H.R. 1207 to conduct a comprehensive show-and-tell audit to get a better peek under the Fed's skirt.

So far, this bill has 285 co-sponsors in the House and 24 co-sponsors in the Senate, so theoretically it could pass.

That's really interesting. Especially considering the Fed already has to undergo an extensive audit every year by an outside auditor retained by the Board's Office of Inspector General, according to their website.

The purpose of this audit? So Congress can keep tabs on the Fed's spending. And yet, Congress is still trying to find out more.

It's interesting, but not necessarily shocking. Over the last two years, the whole concept of "Fed transparency"

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11 times bigger than the Internet bubble…
7 times bigger than sub-prime…

"AMERICA'S LAST GREAT BUBBLE IS ABOUT TO EXPLODE"

The last time it imploded was in 1976. The five years that followed were among the most extraordinary in economic history: Oil leapt 3-fold, gold leapt 6-fold, the Dow plummeted 28%, and inflation ratcheted up to 12%, almost destroying the fabric of the American economy. But this time the trends will be *bigger*, and they will move *faster*…and the fall-out will be far greater.

Here's how to turn what is poised to be the next great global crisis into a personal fortune…

First, what exactly does it mean when you say the Federal Reserve's balance sheet has swelled to nearly $2 trillion on this crisis? (Or if you want to get technical – Bloomberg just estimated the Fed and U.S. government had pledged $12.8 Trillion in stimulus programs when the stock market finally started to recover in March.)

Where does all that money go?

It's often said the Fed simply "prints more money" to cover this alphabet soup of stimulus programs, bailouts, and market crises. While that's true, it doesn't necessarily tell the whole story…

What "Printing More Money" Really Means

Personally, every time I hear about the Fed printing more money, I always imagine the iconic image of the German woman shoving deutschmarks into the fire to keep herself warm, after her currency collapsed in WWI.

The implication is that every time the Fed prints more money, there are more dollars circulating, and the dollar edges closer to becoming worthless. Possibly even kindling for a future fire.

Now here's the truth in that statement. The Fed *does* drag down the dollar's value with their mountains of spending, their cut interest rates, and other programs designed to prop up the equity markets. So you see the dollar's value drop in value, as the Fed spends more.

But the Fed doesn't really have to "print money" to grow their balance sheet. They don't have to run the printing presses or circulate mountains of dollars.

No here in 2009, if they want to expand their balance sheet, they simply add a couple extra zeroes to the bottom line. Or in other words, they massage their accounting, to the point that makes Enron look tame.

You must understand the Federal Reserve bankers are the masters of "fractional reserve banking." Now fractional reserve banking takes place all over the world. It basically means banks only have to keep a small percentage of their deposits in reserve, but they still have to be able to lend out all these deposits on demand.

It's a tricky business. But it means banks don't really have to keep enough dollars in their vaults. They simply have to have the future promise of money to pay back future loans.

(And thanks to institutions like the FDIC, banks can still stay open even if the public knows the bank doesn't really have enough money in its vaults to pay off everyone if they all showed up at once.)

It's the same with the Federal Reserve. When they expand their budget or their balance sheet, they're really creating the promise of *future* money creation. In the meantime, they keep a fraction of these money promises in reserve, and loan it out to banks and other institutions at will.

If they were just running printing presses to create more dollars, they could spread those dollars and eventually spark inflation (assuming consumers started spending those dollars). But as it is, they're just promising money some time in the future, with their own brand of accounting.

Our Head Researcher at World Currency Watch, Ashish Advani calls the Fed's accounting rules "mark-to-make-believe" instead of "mark-to-market."

In other words, the numbers are estimates at best. You can see the proof right on the Fed's website. They have their own version of the "money supply" and also show how loans are calculated and channeled through the various banks and other institutions. If you look at them, you'll notice the numbers are very close.

And yet, you'll also notice that the rate of loan growth in the past 30 years has been greater than the growth of money supply. This shows that the Fed is less dependent on the printing press and more dependent on the rules it uses to allow banks to create money.

For example, low interest rates allow people to take out loans they otherwise couldn't afford. The Fed can also set the reserve rate of money banks need to keep on hand. And thanks to lax rules there, it's significantly less than the 10% "requirement."

Eerily Alike, But Loans Grow Faster than Money Supply …

Why does this matter? It's important to understand that the vast majority of this money creation takes place electronically, with some very interesting accounting rules that would land the accountant of a real company in prison. It means the Fed essentially is paying its 'crisis intervention' tab with dollars that don't exist yet.

Or they do…but just on their books.

So in the long run, the Fed may as well be running those printing presses because the result is essentially the same. It systematically breaks down a currency's value when you constantly create more money out of thin air.

Tomorrow, we're going to dive into the most interesting investments that the Fed is buying this year and why. Till then…

Good Currency Investing,
Kat Von Rohr, Editor of FX University

P.S. The Fed has done more than just create money out of thin air to fix this crisis. Bernanke and his buddies are also pouring money into a few key investments to help prop up the markets. In fact, they may be fueling one of the largest bubbles in market history. Later this week, your editor Chuck Butler will release a special "Fed awareness" video that gives the details on how to protect your dollar holdings and the rest of your portfolio from this coming threat.

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