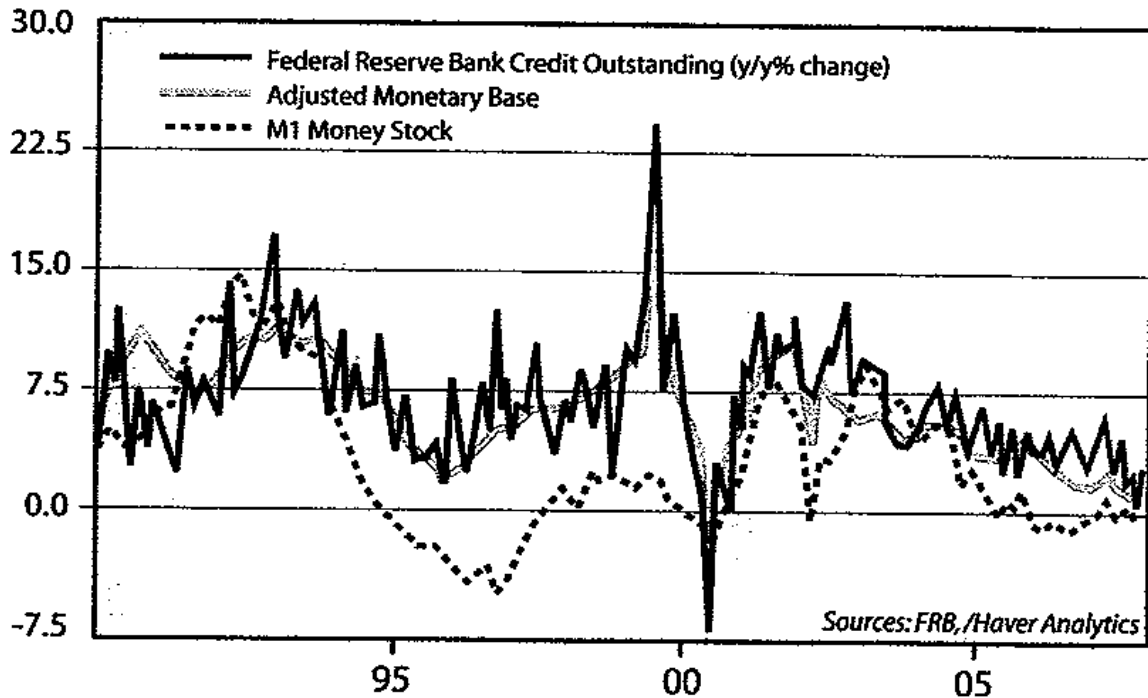


WE WIN; THEY LOSE

WEB BUZZ 2008.07.28

By far the most important chart in the world of economic and financial markets is that seen below. What it tells us is that the Fed is not printing money. As a matter of fact, monetary conditions have become tight. This is just the opposite of what the financial community believes.



Adapted from the Richëbacher Letter

This is what is taking place that will decide in spades the argument between inflation and deflation. The Fed has pegged the Federal Funds rate at 2%. When it does that, it cannot control the reserves available to the banking system. It is impossible to control both supply and demand at the same time. If the banks are creating new deposits through loans, the Funds rate tends to move above 2%. In order to maintain the 2% rate, the Fed must buy government securities, thereby reducing the reserves available to the banking system.

Just the opposite takes place when the banks are reducing loans. The federal funds rate goes below 2% as the banks increase their reserves through the collection of loans. Under these circumstances, the Fed must sell government securities to mop up those reserves and return the funds rate to 2%. The latter is exactly what's going on today. Deflation wins, and inflation loses. You can lower interest rates, but you cannot force banks to make loans. In other words, you can lead a horse to water, but you can't make him drink. Inflation has been, and always will be, a monetary phenomenon, à la Milton Friedman's astute observation. As you can see from the chart above, we have no M1 growth, without which, sustainable inflation is impossible.