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LMR

BUILDING THE 10%

BREAKING NEWS ISSUE!

WARNING:

MARKET VOLATILITY AHEAD

—AND SOON!

by L. Carlos Lara

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ABOUT LARA & MURPHY

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> *"In all times, but more especially of late years, attempts have been made to extend wealth by the extension of credit."*
>
> *—Frédéric Bastiat (1801-1850)*

We should notice in Bastiat's statement just how long ago he made it and then realize we could easily say the identical thing in our day. His next statement underscores the misguided public acceptance of such an idea and the deception.

"I believe it is no exaggeration to say that since the revolution of February, the Parisian presses have issued more than 10,000 pamphlets, advocating this solution of the social problem. The only basis, alas! of this solution, is an optical illusion."

He is right. The money mechanics of central bankers is a form of sleight of hand that is not only illusionary, but also nefarious and duping. The study of central banking history can tell us a lot about why central banks behave the way they do. It explains why they are so secretive and mysterious. Just make sure you go all the way back to 1694 with the Bank of England to begin your study. You'll find that it is a long history, but the money manipulation remains virtually the same right up to our modern times.

"The first thing done is to confuse cash with products, then paper money with cash; and from these two confusions it is pretended that a reality can be drawn." Bastiat teaches us that the trick to preventing confusion comes in separating paper money from the products that constantly change hands in the economy—which are the real objects of loans.

In 1694, King William III wanted to finance a war so he provided a private bank, the Bank of England, a monopoly on circulating currency. It was an unfair competitive advantage that provided the King the necessary financing he needed, but it also established a symbiotic relationship with a key borrower—the British Crown. This relationship with government and its monopoly to transform assets set the pattern for all modern day central banks including our own Federal Reserve in 1913.

So when we say that our money is not really under our control, this is exactly what we mean. The Federal Reserve actually controls our money and the federal government mandates this situation through coercion. It's a lesson that each generation must understand because the power to print money at will in the end is an injustice to taxpayers who are ultimately made to pay for debts which are of no concern to them. This realization is always confirmed during the time of a financial crisis. The long history of central banking is one of created crisis and the further consolidation of central bank power.

Just thought you needed that important reminder again.

Carlos and Bob

PULSE ON THE MARKET

Health Care Fail, Part Deux

REPUBLICANS ONCE AGAIN CAN'T FOLLOW THROUGH

It's déjà vu all over again: Just as we reported back in March, here again we comment on the Republican failure to repeal ObamaCare. In a dramatic late-night vote, Republican senators John McCain, Lisa Murkowski, and Susan Collins joined with the Democrats to vote against the "skinny repeal" bill.

Rather than attempting to completely overturn ObamaCare, the "skinny repeal" would merely have abolished the individual mandate and delayed the employer mandate, while leaving much of the rest of the Affordable Care Act's provisions in place.

In short, the Republican "skinny repeal" bill would try to have its cake and eat it too. It would get rid of the yucky stuff (like fining healthy young people if they didn't sign up for health insurance), while keeping all the goodies (like requiring health insurers to give policies to everybody).

As we said back in March, this outcome is understandable but nonetheless tragic. Once a new entitlement is enacted, it is notoriously difficult to unravel. Given the new baseline, any attempt to roll back ObamaCare will be seen as literally *killing the poor* in order to give money to rich people.

A genuine move towards more competition and patient control would help lower health care costs, and thus make health *insurance* less of an issue. (Part of our problem is that people conflate health care and health insurance; the terms mean different things.) It is clear that we lack a "free market" in health care; it's difficult to do comparison shopping when hospitals won't tell you beforehand how much a procedure will cost. Yet the problem here isn't markets or capitalism; it's government intervention, as spelled out in *The Primal Prescription* (by Doug McGuff and Robert P. Murphy).

It's too bad that the Republicans who have cloaked themselves in free-market rhetoric for years under Obama now can't deliver. Their timidity serves to justify the caricature held by progressives, in which they think free-market ideology is merely a cover to funnel tax dollars to rich people.

PULSE ON THE MARKET

MADURO CRACKDOWN

CRISIS CONTINUES IN VENEZUELA

Venezuelan President Nicolas Maduro continues cracking down on political opponents. An election in late July put in power a legislative “superbody” that replaced the opposition and further solidified power in the hands of Maduro. The Trump Administration has imposed sanctions on certain Venezuelan officials, including Maduro himself. As reported by NPR, this is *“only the fourth time that the U.S. has sanctioned the sitting leader of another country. In announcing the sanctions, National Security Advisor H.R. McMaster referred to the ‘outrageous seizure of absolute power through the sham election of the national constituent assembly’ and said of Maduro that he is ‘not just a bad leader. He is now a dictator.’”*

Amidst all the condemnations of political power and sympathy for the Venezuelan people, precious little commentary is given on *why* the economic situation is so bad. The simple answer is that the Venezuelan government’s socialist policies (implemented under Hugo Chavez) set the country up for disaster. In particular, the deadly combination of money printing and price controls caused goods to disappear from store shelves, as literally described in textbook economics.

And yet, such is the poor understanding of economics that most analysts give at best a passing reference to this obvious cause-and-effect relationship. It would be like explaining a plane crash on government corruption, rather than on a mechanical failure.

The sad example of Venezuela underscores the need for an informed citizenry. This is why our goal of Building the 10% is so critical, and why we focus our efforts on training financial professionals—the people who talk to people about their money—in Austrian economics.

TRUMP STAFF SHAKEUP

HIGH TURNOVER IN THE TRUMP INNER CIRCLE

Yikes! White House Communications Director Anthony Scaramucci was fired a mere 10 days after being appointed, due to over-the-top language and gossiping used in a phone

conversation with a reporter. The controversial Scaramucci—nicknamed "The Mooch"—had prompted the resignation of White House spokesman Sean Spicer and (apparently) White House chief of staff Reince Priebus.

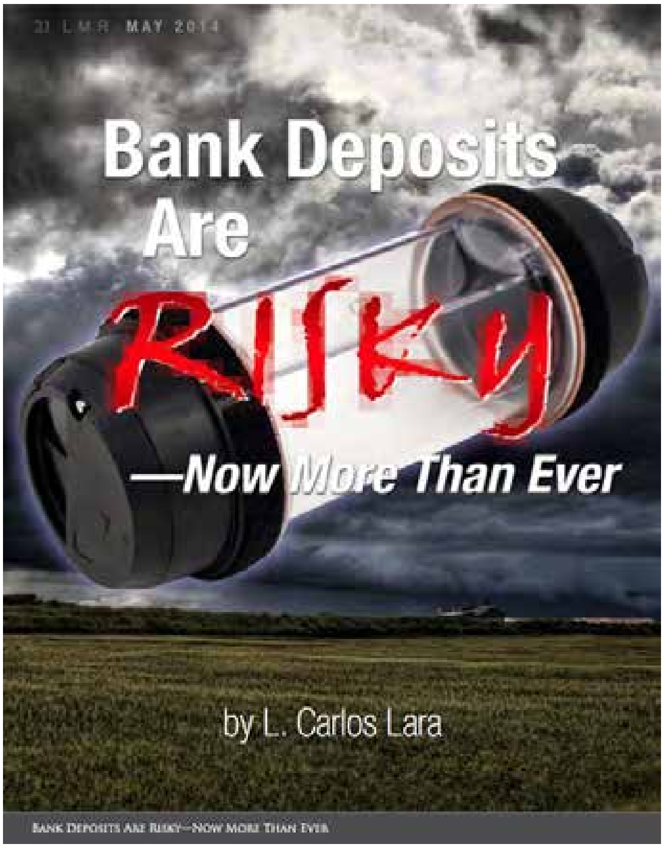
At this point, retired Marine General (and former Homeland Security Secretary) John Kelly is the new White House chief of staff.

It's hard to explain what the heck just happened. Trump cynics point to yet another episode of the insanity / incompetence coming from the White House, while Trump fans interpret it as a clever move to take attention away from RussiaGate and to reset everybody's expectations with a seasoned pro like General Kelly now in charge. Maybe a little of both? From the outside, it's hard to distinguish those rival hypotheses. We'll just have to wait and see how policy shakes out. Thus far, Trump's actual actions in office haven't been nearly as bad as his worst critics claim—anything better than "literally Hitler" is a win on this criterion—but he also hasn't achieved very much after his shocking election victory.

RISING INTEREST RATES & BANK BALANCE SHEETS

BY ROBERT P. MURPHY

This is a special issue of the *Lara-Murphy Report*. I want to shine a spotlight on Carlos' article because it exhibits why the *LMR* is so unique. Not only does it give financial analysis from the perspective of Austrian economics and Nelson Nash's Infinite Banking Concept (IBC)—already a rare thing—but we occasionally get gems where Carlos is an investigative reporter, uncovering connections among government policies that require reading huge reports written in legalese.



Long before places like ZeroHedge were covering the story, Carlos had explained to our readers that depositors would be on the hook if and when a major crash occurred.

The last time Carlos did this, he discovered the setup for a "bail-in" in the Dodd-Frank Act.[1] Long before places like ZeroHedge were covering the story, Carlos had explained to our readers that depositors would be on the hook if and when a major crash occurred and the FDIC's coffers bled dry.

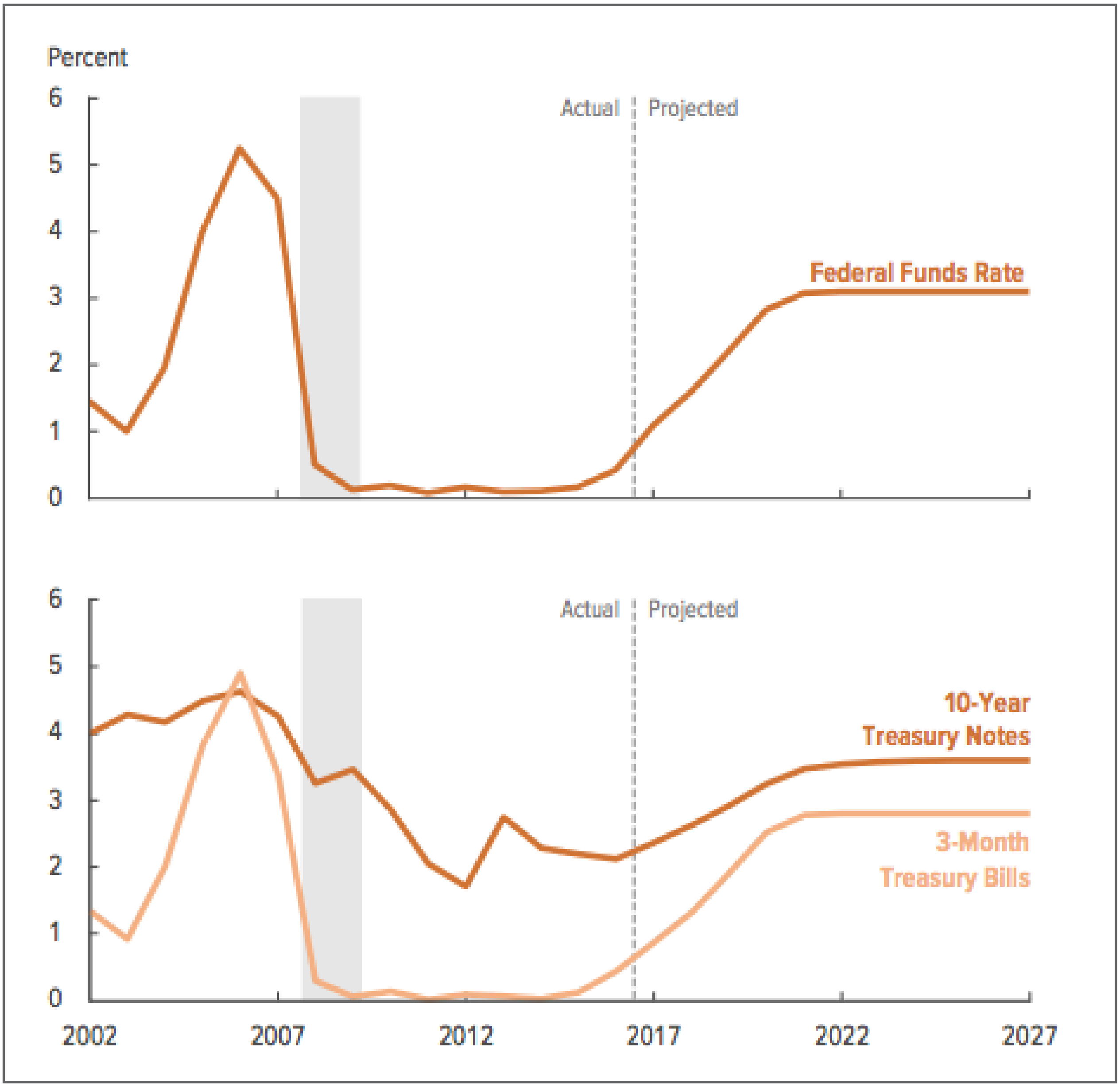
In this month's issue, Carlos theorizes that as the Fed unloads its bonds, changes in government regulation will encourage financial institutions to absorb them. In my article, I will complement Carlos' analysis but spelling out some of the ramifications of his provocative but compelling suggestion.

THE FISCAL CRUNCH

Before diving into the more esoteric analysis, let's run some simple numbers. As of this writing, the federal government "Debt Held By the Public"[2] (which does include Treasury bonds owned by the Fed, but *not* bonds in the so-called Social Security trust fund) was $14.4 trillion. Of that amount, $1.7 trillion consisted in Treasury bills (which mature in one year or less), while another $8.8 trillion consisted in Treasury notes (which mature in two to ten years). Therefore, several trillions of dollars of debt will mature in the next few years.

At the same time, short-term rates are extremely low. The nominal yield on one-month Treasuries is 1 percent while the yield on three-year Treasuries is just shy of 1.5 percent. Over the next couple of years, a

Figure 1. CBO Projections of Select Interest Rates, 2002-2027



SOURCE: Figure 2-9 of CBO, "The Budget and Economic Outlook: 2017 to 2027."[3]

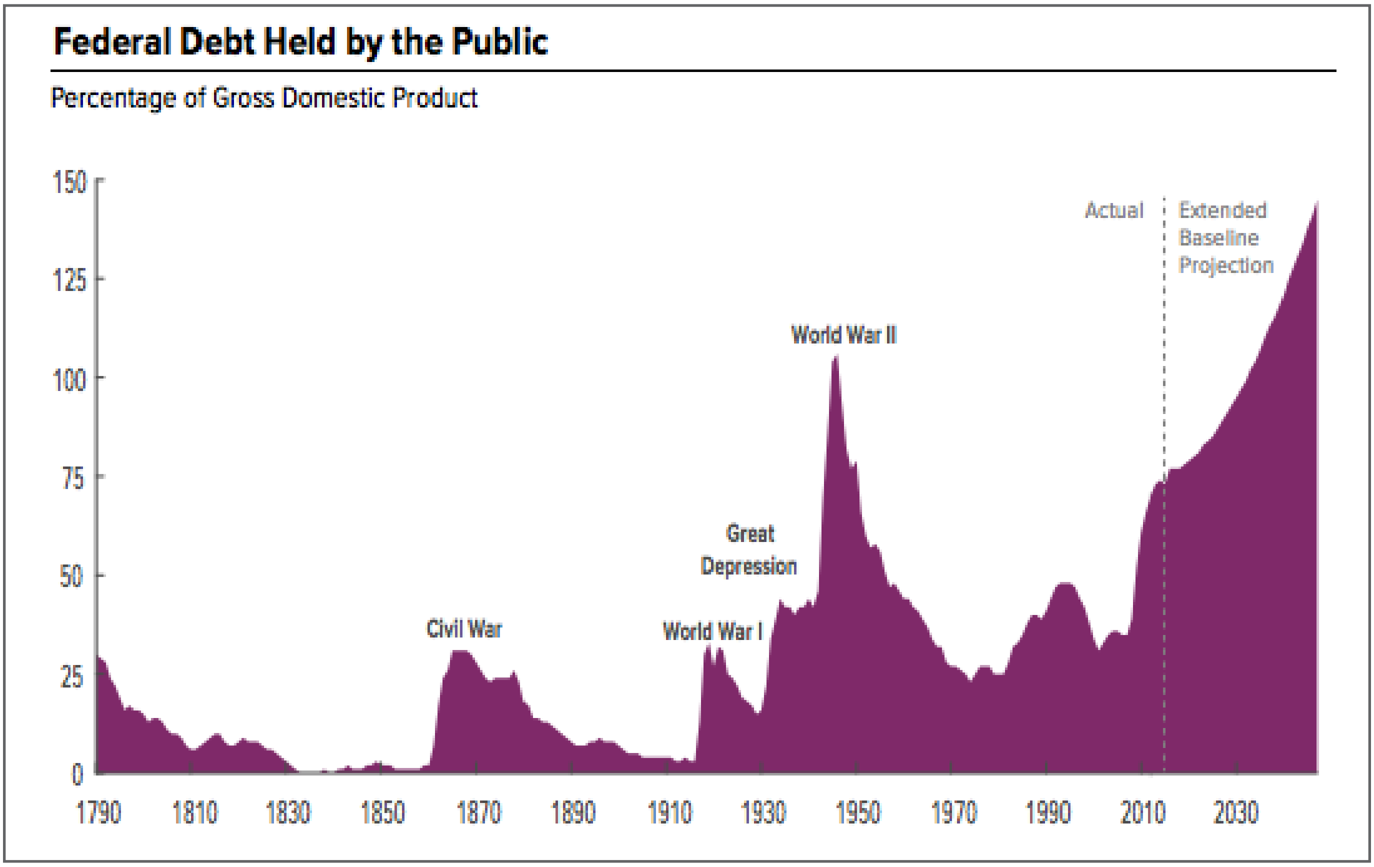
shift upward in short-term rates of just 1 to 2 percentage points could therefore imply a doubling of the interest cost associated with this portion of the outstanding debt.

This is huge: It would mean another $50 billion in annual financing costs, just on the short-term debt alone, in the next few years. (In Fiscal Year 2016 the *gross* total interest on the federal debt was some $433 billion, though the net interest on the federal debt was $241 billion.[4]) And of course, as more time passes and more of the bonds are refinanced at higher rates, the interest cost would grow even more staggering.

Indeed, in its baseline scenario the CBO projects that federal government net interest costs will rise from $241 billion in 2016 to $768 billion by 2027. As a share of the economy, those figures translate into 1.3 percent in 2016 to 2.7 percent in 2027. Yes that's right: In a mere decade, almost three percent of the entire economic output of the country will be absorbed just by interest on the federal debt.

Part of the story of how we got here is that the Obama Administration ran enormous budget deficits at the same time that interest rates plummeted. (To be sure, a Republican administration would have done the same thing.) Just as a household can get by with racking up huge credit card debt so long as those "balance transfer" offers keep coming in the mail, so too have Americans not really felt the sting of the fiscal profligacy of the last decade. But with interest rates rising to more normal levels, the vise will tighten.

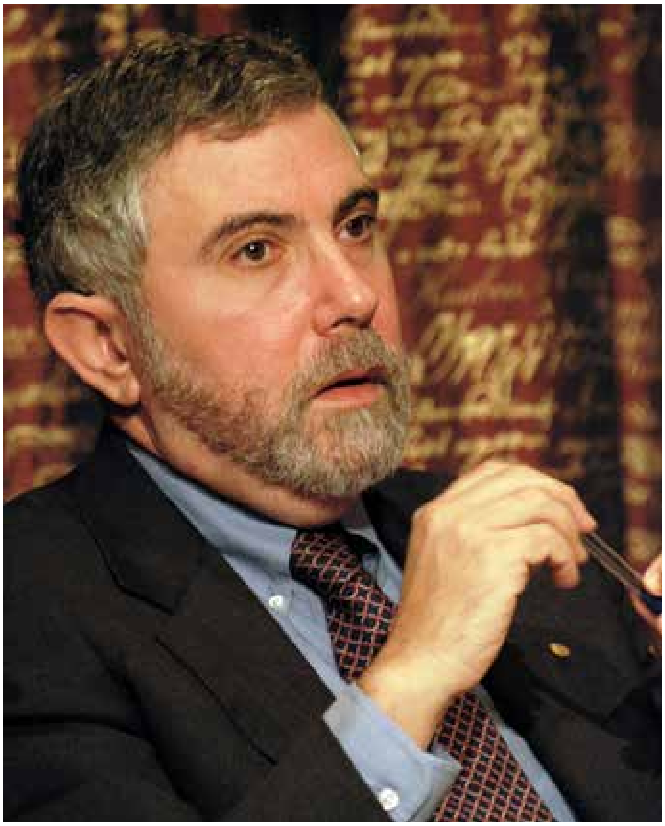
Figure 2. CBO Projection of Federal Debt Held by the Public as a Share of GDP, 1790-2047



SOURCE: Figure 1-8 in CBO, "The Budget and Economic Outlook: 2017 to 2027."[5]

DON'T WE "OWE IT TO OURSELVES"?

Some Keynesian commentators, such as Paul Krugman, argue that to the extent the Treasury debt is held by Americans, then it doesn't really represent a burden on Americans per se. After all—so Krugman argues—in the year 2027, the IRS will take $768 billion from American taxpayers, in order to give most of it right back to Americans who hold Treasury securities. So how does that hurt Americans?



Some Keynesian commentators, such as Paul Krugman, argue that to the extent the Treasury debt is held by Americans, then it doesn't really represent a burden on Americans per se.

There are several things wrong with this glib analysis. For a full explanation, see my recent lecture at Mises University as well as an earlier article for EconLib (linked in the endnotes).[6]

But for our purposes in this article, let me make two points. First, to the extent that massive increases in government debt make it politically possible for the government to *spend* more than it otherwise would, then the growing debt does indeed impoverish future generations because resources are channeled into political outlets. Our grandchildren inherit a smaller assortment of factories, tractors, and offshore oil rigs because fewer resources were directed into private investment.

Second, the *burden* of government debt can indeed fall more heavily on future generations. It is a subtle mechanism (and see my video and/or article in the endnotes for more detail), but here's the gist of it: If the government spends (say) $500 billion today through taxation, then the people alive today feel the pain; they are coerced against their will into handing over the money, which then might be spent in a way they enjoy.

However, if the government finances $500 billion in spending through a budget deficit (i.e. borrowing the money), then nobody alive today has to complain. Nobody is being taxed extra for that money, and even the people handing it over are doing so *voluntarily*. They look at the safety and yield on Treasury securities, and decide that lending Uncle Sam that money is a good investment.

Since there's no such thing as a free lunch, it must be the case that deficit finance therefore shunts the burden of the deficit-financed spending onto future taxpayers, including those not yet born.

Down the road, when today's lenders decide to retire, they can *sell* their Treasury securities to young workers who aren't yet born today. So it's true, those young workers (once they grow older) may end up receiving the interest and principal from the Treasury, but that "transfer" among Americans down the road doesn't represent a pure wash. It's because the Americans (in the year 2060, say) who are receiving the large tax payments to retire their bonds had to (in the year 2030, say) pay retired folks for the predecessors of those bonds. That is the very real sense in which all the Americans in the year 2060 (say) can be collectively poorer due to government deficits run decades beforehand.

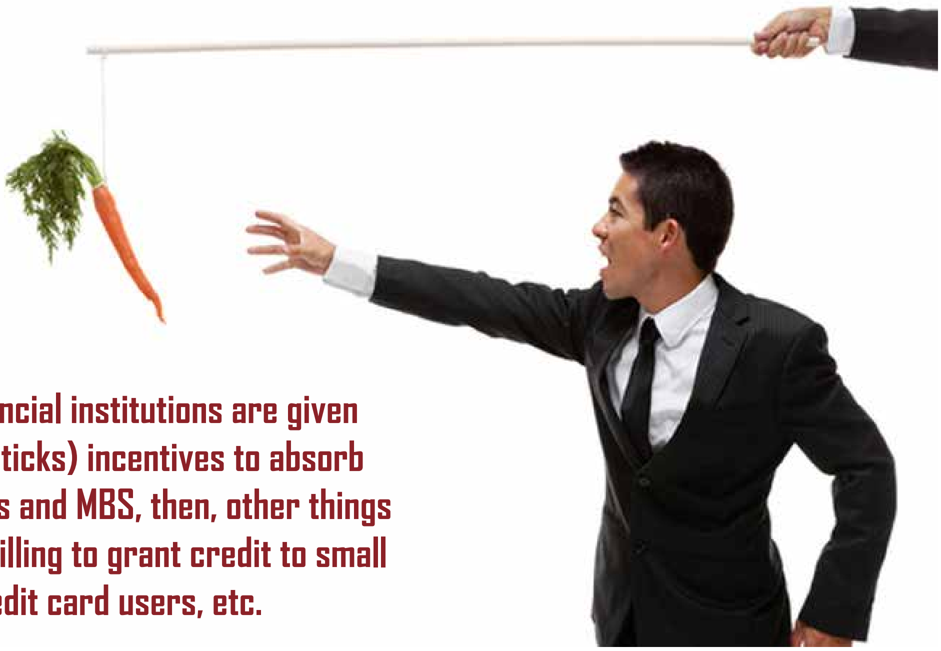
To repeat, this is a subtle mechanism, and I got into heated arguments with professional economists about it. The key fact to remind ourselves is that *if government spending today is financed by deficits, then nobody feels the pain.* Since there's no such thing as a free lunch, it must be the case that deficit finance therefore shunts the burden of the deficit-financed spending onto future taxpayers, including those not yet born.

COAXING THE BANKS TO ABSORB FED ASSETS

As Carlos explains in his article this issue, we are alarmed at what appears to be an "exit strategy" for the Fed in which changes in financial regulation will encourage large institutions to add more Treasury securities and even mortgage-backed securities to their balance sheets. Presumably, the purpose of this strategy (assuming we're right) is to limit the sharp spike in Treasury yields and mortgage rates that would otherwise occur, if the Fed begins selling down its assets as Yellen & Co. keep promising they intend to do.

This is a complex topic and warrants further analysis in future articles. But for now, let me make two points.

First, to the extent that this strategy works, it is yet another example of the government placing its own needs (and that of Wall Street) above that of the average person. Remember during the bailouts in the fall of 2008 how people like Treasury Secretary Hank Paulson assured us that all of these measures were taken to keep credit flowing to Main Street? Well, in October 2008 the Fed instituted a



If banks and other financial institutions are given (through carrots and sticks) incentives to absorb more Treasury securities and MBS, then, other things equal, they will be less willing to grant credit to small businesses, credit card users, etc.

new policy, in which it *paid commercial banks to not make loans to their clients.* They called the new policy "interest on excess reserves," but what it did in practice was pay banks to keep their loanable funds parked at the Fed.

Similarly, if banks and other financial institutions are given (through carrots and sticks) incentives to absorb more Treasury securities and MBS, then, other things equal, they will be less willing to grant credit to small businesses, credit card users, etc. By keeping it artificially cheap for the government to carry its debt, more of the "pool of savings" will be devoted to politically-approved channels.

Second, if Carlos and I are right that the Fed's policies have blown up another asset bubble—including a bubble in Treasuries—then artificially encouraging U.S. financial institutions to load up on these assets is a bad idea. If Treasury yields spike and/or the housing market crashes again, the banking system will be that much more vulnerable, because they've artificially expanded the amount of Treasuries and MBS on their balance sheets.

The dark comedy in all of this is that, should these events come to pass as I've described, we can be sure people like Elizabeth Warren and Bernie Sanders will lament that Dodd-Frank "wasn't enough," and that "raw capitalism" had once again wrecked the financial system.

CONCLUSION

Even if things go according to plan, we should expect rising interest rates over the next few years. This will put incredible pressure on the federal government's finances, since its debt burden (relative to the economy) is now at levels only seen during World War II.

The dark comedy in all of this is that, should these events come to pass as I've described, we can be sure people like Elizabeth Warren and Bernie Sanders will lament that Dodd-Frank "wasn't enough," and that "raw capitalism" had once again wrecked the financial system.

Carlos' research (presented in his accompanying column this issue) suggests that the government has a plan to coax financial institutions into accepting the Treasury securities and mortgage-backed securities that the Fed will begin selling in the next few months. Although this might contain a crash in these sectors, it will simply concentrate the pain of tightening onto other sectors.

Furthermore, the measure in reality will only *postpone* a crash. When the crash occurs, the banking system will be that much weaker for having been induced to load up on government debt and housing derivatives.

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5. Full CBO report available at: https://www.cbo.gov/sites/default/files/115th-congress-2017-2018/reports/52370-outlookonecolumn.pdf.
6. My talk on the burden of government debt at Mises University 2017 is available at: https://www.youtube.com/watch?v=7Z9NPXI7iCI. My article "Government Debt and Future Generations" (June 1, 2015) is available at: http://www.econlib.org/library/Columns/y2015/Murphywardebt.html.

WARNING: MARKET VOLATILITY AHEAD — *AND SOON!* .

BY L. CARLOS LARA

As this issue of the *LMR* goes to print, the Federal Reserve is expected to reiterate to the Congressional committee its plan to begin unwinding its multi-trillion bond buying programs as early as this September. Without a doubt this is a big deal. It is so big that it is inconceivable to think that this process will have no effect on financial markets. Our general consensus is that we have arrived at the point for exercising thoughtful concern and caution due to what's coming our way.

It's been nine years since the start of this buying spree and market watchers are all speculating about what will happen when the Fed reverses course. Yet there seems to be agreement among most observers that this massive sell-off of bonds by the Fed will certainly impact interest rates, though the impact on stock prices is less clear. Some analysts believe the Fed's unwinding will have significant effects that will ripple across other sectors of the economy. But quite frankly no one really knows for sure what to expect. There is no pat formula for what is about to happen.

Jamie Dimon, the Chairman and CEO of J.P. Morgan Chase & Co., speaking at a recent conference in Paris, expressed the commonly accepted sentiment. *"We've never had QE like this before, we've never had unwinding like this before. Obviously that should say something to you about the risk that might mean, because we've never lived with it before."*[1]

The Fed's tentative plan is to sell about $6 billion worth of Treasury bonds and $4

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billion worth of Mortgage Backed Securities *per month* and gradually increasing the amount it sells every 90 days. The target is to reach $2 trillion (roughly the amount of currency in circulation), which will take three to five years to complete.

We should also keep in mind that it is not just our own central bank that is doing this. All world central banks have been providing their economies similar massive stimulus since the 2008 financial crisis and now they too are targeting a similar unwinding process as well. The Bank of International Settlements announced this new course just last month (June 25th.).[2] In other words, the unloading of bonds out of central bank balance sheets will soon be international in scope.

However, there is still more to consider. In addition to these unique central bank maneuvers there is one other important event that is occurring here in the U.S. simultaneously. This is the U.S. Treasury Department's recent report in response to President Trump's Executive Order 13772[3] for regulating the financial system. This is a preliminary report for purposes of creating a new law. Spearheaded by Treasury Secretary Steve Mnuchin, this report among other things is aimed at scaling back excessive government regulations and specifically the Dodd-Frank Act.

Hidden among some of the recommended changes in its 149 pages is a curious suggested change to the current enhanced *Supplementary Leverage Ratios (eSLR)*, or what is often referred to as the necessary stress tests for the financial system's required Tier 1 Capital[4] needs. This required capital leverage ratio is a part of Dodd-Frank. The report's suggested changes ironically seem to provide for a loosening of this current law while at the same time providing a way for the banking system to be able to accommodate all these bonds that will soon be pouring into the marketplace.

As it stands today, Treasuries and mortgage-backed securities make up a substantial part of secure investments for financial institutions due to their liquidity. But the significant recommendation of the report is to change how they are taken into account in the determination of the leverage ratio in order to spur the banking system toward more economic growth.

My own interpretation is that although this report may at first seem like an unrelated event to the proposed actions of the Fed, it actually reads as though it is working in tandem with it—almost as though it was planned. The language is technical to be sure, but it is easy enough to understand if you take time to think through the rationale. All these bonds that will soon flood the market will need to be purchased by somebody and it appears that it will ultimately be the banking system.

To see this all in perspective and in order for us to determine our own plans of action in the midst of these converging events we need to walk through some of the specifics.

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HOW WE GOT HERE

Recall that in 2008 as the commercial banking system of the U.S. slid into insolvency due to the unraveling of the mortgage crisis, the Federal Reserve made an extraordinarily large purchase of bank-owned and near valueless mortgage-backed securities in order to stop the spiraling descent and spread of the calamity into the entire financial system. This action was quite literally *unprecedented* with nothing of equal comparison to it in U.S. banking history.

Just exactly how big a purchase was it? In 2008 alone the Fed's balance sheet went from $920 billion to $2.3 trillion, with most of its growth occurring between November and December of that year, a period of a mere 60 days! Along with the Congressionally approved $700 billion *Troubled Asset Relief Program (TARP),* which was literally a taxpayer capital investment in the U.S. financial system (a bailout), the total of the economic stimulus exceeded more than $1 trillion.

All these bonds that will soon flood the market will need to be purchased by somebody and it appears that it will ultimately be the banking system.

Surprisingly, it did not stop there. Fed Chairman Ben Bernanke, determining that dropping interest rates down to zero was not enough, continued to feed the stimulus via open market operations to make sure, as he believed, the Fed's Great Depression errors were not repeated. By June of 2010 the amount of bond purchases reached a peak of $2.1 trillion.

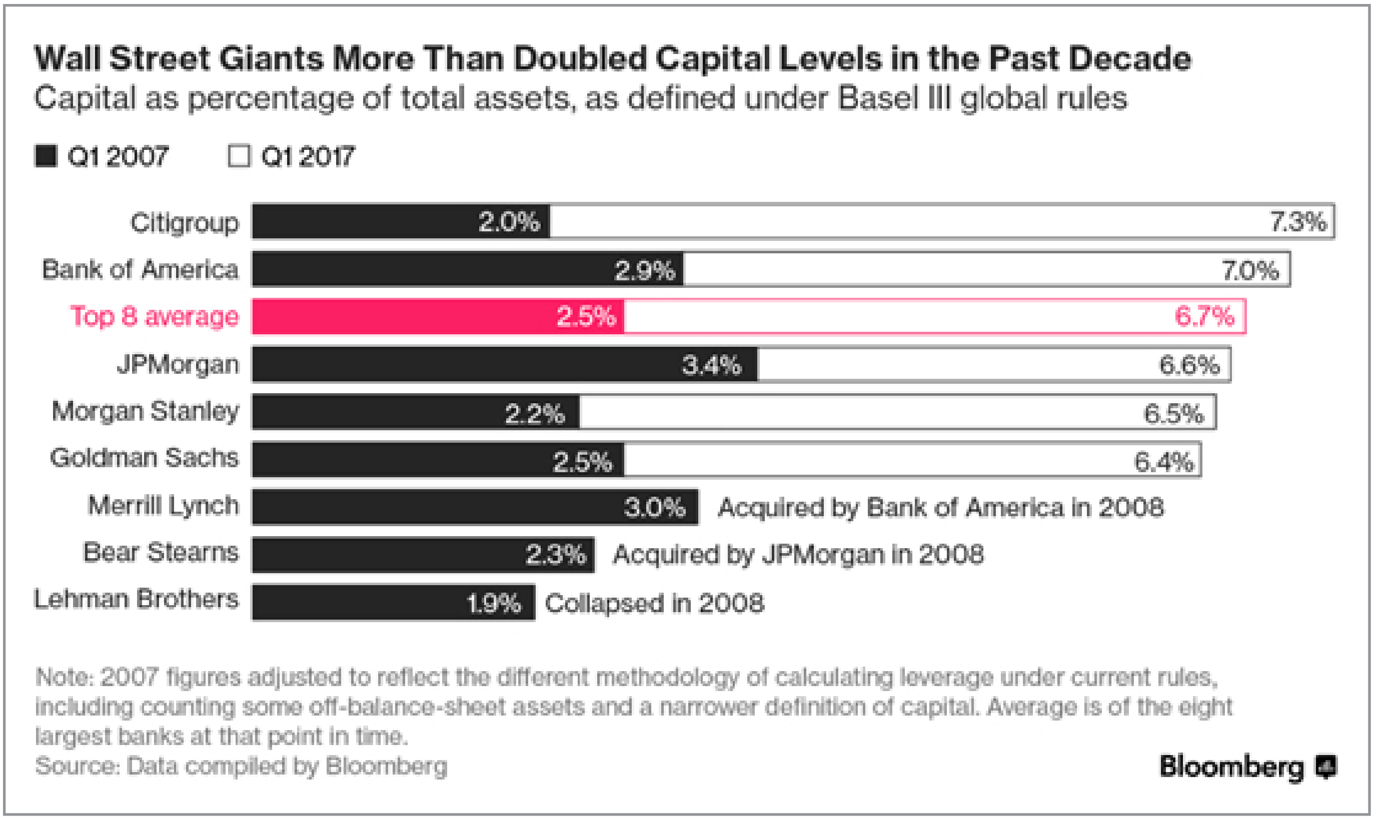
In November of 2010 a second round of *Quantitative Easing (QE)* was resumed that added an additional $600 billion of bond assets to the Fed's balance sheet by June 2011. Round three began in September 2012 and ended in October 2014 adding another $1.64 trillion and accumulating a current total of $4.5 trillion in assets. Today this total includes $2.7 trillion in Treasury bonds and $1.8 billion in mortgage-backed securities. These are all facts that can easily be researched.

WAS QE EFFECTIVE?

Most regular readers of the ***LMR*** know by now that this strategy was and is classic Keynesian mechanics. But one surprising critic of Bernanke's actions comes out of the Research Division of the Federal Reserve of St. Louis. Stephen D. Williamson, vice-president of the St. Louis Fed and author of a working paper dated July 2015, finds plenty of faults in Bernanke's decisions during the crisis. In his report he states, *"There is no work, to my knowledge, that establishes a link from QE to the ultimate goals of the Fed—inflation and real economic activity."*[5]

The one place where we have all seen QE provide a direct impact is in the S&P 500 where it has soared by 215% since the fi-

The one place where we have all seen QE provide a direct impact is in the S&P 500 where it has soared by 215% since the financial crisis.



nancial crisis, which also had the curious effect of giving some people a false sense that all is well with the economy. But as far as tangible benefits are concerned only a very limited few individuals, namely those tied to big business, banks, and Wall Street, have actually been economically rewarded. As for the economy at large it has unfortunately remained anemic.

Williamson is quick to point out that as for stimulating inflation, reducing unemployment, or sustaining economic activity, the results of QE are dismal. (A note for clarification: We at the ***LMR*** of course do not agree that the Fed *should* try to boost prices. But the Fed has adopted higher price inflation as an official goal, and Williamson's point is that the Fed's chosen means have not been adequate to the stated ends.) Many economic analysts agree with Williamson by simply pointing to the *Gross Domestic Product (GDP),* which has yet to rise above 2.5 percent for any calendar year since the QE stimulus programs began nine years ago.

In fact a lagging GDP is one prime reason why many, including President Donald Trump, believe we need to try something else in order to stimulate the stagnant economy. The focus has been on matters like overhauling the tax code and stripping away excessive government regulation. This is in essence the slant of the Treasury Department's report dated June 2017, put out by Steven T. Mnuchin, an ex-Goldman Sachs executive and Wall Street veteran.

OVERHAULING DODD-FRANK

The Treasury Department's Report For Regulating the U.S. Financial System made several strong recommendations directed principally at the U.S. Depository System and the Dodd-Frank Act.

In summary, the 149-page report makes many suggestions, but it does take the theoretical posture that the Dodd-Frank Act may have thwarted the potential for QE to achieve a successful full recovery of the economy due to its excessive regulation in certain critical areas of the financial system. Furthermore it claims that Dodd-Frank may still be blocking economic growth unless certain adjustments are made. Pointing specifically to several economic studies, the report stresses that the U.S. is demonstrating the slowest economic recovery of the post-war period. It also exposes the burdens of a prolonged period of low interest rates, which have reduced the return on household savings and returns to institutions—all of which are certainly true.

It further singles out that most banks and Wall Street titans now have sufficient capital reserves, except for the small list of global *Systemically Important Financial Institutions (SIFI).* Yet there continues to be a lack of credit availability especially in residential mortgage lending, which it says is *"the largest stalled asset"*[6] followed by small business lending, which has not even recovered to 2008 levels.

Although the report does not recommend eliminating the *Volker Rule,* a rule that discourages banks from taking too much risk in certain types of investments such as derivatives and private equity financing, it does recommend a substantial amendment to it. This is a suggested change that will clearly benefit big banks since we have known that before the Volker Rule went into effect in 2014,[7] the largest U.S. banks generated a sizable amount of profits from currently restricted activities well after the economic downturn of 2008.

The 149-page report makes many suggestions, but it does take the theoretical posture that the Dodd-Frank Act may have thwarted the potential for QE to achieve a successful full recovery of the economy.

With regards to the so-called "bail-in" requirements outlined in the *Orderly Liquidation Authority (OLA)* under Title II of the Dodd-Frank Act, no comment was offered. But the report did emphasize its full support of the Dodd-Frank's "core principle of preventing taxpayer-funded bailouts and the safety and the soundness of the financial system."[8]

But by far the most important suggested change in the U.S. Treasury's report is in re-

gards to the calculation of the *Supplementary Leverage Ratios and the Liquidity Covered Ratio (LCR).* The report wants certain key items deducted from the calculation. **"In particular, deductions from the leverage exposure denominator should be made for:**

- **Cash on deposit with central banks;**
- **U.S. Treasury Securities**
- **Initial margin for centrally cleared derivatives"** [9]

According to the report all three of these assets are considered "low risk" assets, yet by adding them into the leverage ratio calculation it causes the ratio to reflect the bank as being *"over leveraged"* thereby forcing the bank to either have to sell assets or raise equity in order to continue receiving customer deposits. It is for this reason the report wants them excluded from the calculations altogether. If you take a calculator to these proposed exclusions you can see that it really does position the banks to be able to increase their lending, investing, and purchasing abilities.

Yet clearly this is a loosening of the rules that, depending on how one evaluates it, could potentially re-open the systemic risk problem of *"too big to fail"* financial institutions once again. At the same time it should also tell us that such a change does pave the way for banks to have more room for the purchases of additional U.S Treasuries and very soon there will be a lot of them to buy.

THE LEVERAGE RATIOS IN SIMPLE TO UNDERSTAND NUMBERS

Without getting too technical, we need to briefly demonstrate the effects these changes will have on the leverage ratios to understand what the report is talking about. The Dodd-Frank Act, (and the Basel III Accord), established a 3% minimum ratio requirement for the *Tier 1 Capital Leverage Ratio.*[10] Tier 1 Capital is a bank's core capital, which is made up of the bank's common stock and its retained earnings. This number is then divided by all the banks' other tiered *"consolidated assets"* in order to arrive at the mandatory ratio.

Using a simple example where $30,000 is the bank's Tier 1 Capital and the consolidated assets are $1M, we can easily see that the ratio would be 3% and according to the ruling the bank would be adequately capitalized to withstand the shocks of an economic crisis such as what we had in 2008.

> Such a change does pave the way for banks to have more room for the purchases of additional U.S Treasuries and very soon there will be a lot of them to buy.

However, if the consolidated assets were increased by an additional $500,000 to $1.5 million with the same core capital of $30,000, the ratio would only be 2% and the bank would not have met its stress test ratio requirement. But if we excluded $500,000 from the original $1M in consolidated assets with still the same $30,000 in core capital, the ratio jumps up to 6% and now the bank is well above the required 3% and is sufficiently capitalized.

So, if the $500,000 being excluded happens to be the suggested *(a.) cash on deposit with central banks* and *(b.) U.S. Treasuries,* then the bank can now take on more customer deposits and/or buy more U.S. Treasuries to the tune of $500,000. Once again, these are simple numbers and calculations so you need to be extrapolating these numbers in your mind into billions. But this is the main reason for the suggested exclusions.

With regards to suggested asset *(c.) initial margin for centrally cleared derivatives,*[11] this one exclusion is directly tied to the report's suggestion of altering the *Volker Rule* freeing the banks to invest in somewhat risky, but very profitable investments. Even though common sense tells us that accepting initial margin (collateral) for risky transactions actually makes a bank safer, counting these assets into the leverage calculation and with the Volker Rule unchanged as it is, makes banks less profitable. To exclude these assets from the leverage calculation and amending the Volker Rule makes banks, especially big banks, more profitable. The idea is that profitable banks make the economy more robust.

CONCLUSION

What I have attempted to highlight in this article is what I believe is part of a well-orchestrated plan, designed by top banking officials behind closed doors, to re-shuffle the assets within the banking system once again. The goal of course is to continue to have the banking system profit from this enormous

unwinding process in the same way massive profits were achieved in the winding up of it. Though it seems at first that these developments and announcements of the upcoming event are unrelated due to their time sequence and who is actually making them, they are actually all moving in tandem. They are actually showing us where these bonds are going to eventually wind up.

The problem is that in the course of these actions there will undoubtedly be man-made financial tremors and shocks that will ripple throughout the entire economy. Therefore you would be wise to begin your preparations now. Robert Murphy and I have already prescribed a balanced approach that you can follow in the video *"How to Weather The Coming Financial Storms."* If you haven't seen it or need a re-fresher on that strategy go here and get started: https://lara-murphy.com/video0916/

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Unintended Consequences

IN MEDICAL DEVICE REGULATION

Interview with Shannon Clark

Shannon E. Clark is the Founder and CEO of UserWise, Inc., a medical device consultancy. UserWise helps medical device manufacturers and start-ups design safe and easy-to-use medical devices, ranging from surgical robots to home-use injection platforms. Shannon recommends early implementation of human factors engineering to (1) streamline the design and regulatory review process and (2) reduce the possibility of use-related injuries.

Before founding UserWise in 2015, Shannon was a Human Factors Engineer at Intuitive Surgical and Abbott Laboratories, where she led cross-functioning teams to perform usability risk analysis and updated guidelines in operating procedures for human factors. She graduated in 2010 from UCLA with a B.S. in Mechanical Engineering and a technical breadth in Technology Management. She is a Certified Professional Industrial Engineer, she holds two patents, and she has published three books.

Lara-Murphy Report: How did you become interested in Austrian economics?

Shannon E. Clark: I learned about Austrian economics last year when my friend Peter Kallman shared information about the Mises Institute on the Vin Armani Show.

"Austrian economics promotes a viewpoint that society is in a natural state of progress."

Austrian economics promotes a viewpoint that society is in a natural state of progress; the economy evolves naturally based on unique purchasing decisions made by individuals. By allowing individuals to make their own decisions, pure equity is attainable. Individuals make decisions based on their own subjective perception of value, which decisions contribute to a broader societal shift optimized towards progress. When individuals or groups make decisions on behalf of others, the outcome is not optimized.

I share the worldview of the school of Austrian economics because I think that, with a natural state of checks and balances, individual economic transactions will produce positive outcomes for everyone involved.

LMR: Can you explain what your company does?

SEC: UserWise helps medical device manufacturers to design safe, usable, and effective medical devices via the usability engineering process. We assist companies to generate optimized user experiences for their customers. We also meet with the U.S. Food and Drug Administration (FDA) on behalf of clients and complete all compliance documentation related to usability.

"Our usability studies reveal critical mistakes caused by sub-optimal user interface design. Then, we assist the companies to redesign their product to make each mistake impossible."

To design an exceptional product, a designer must make thoughtful predictions and assumptions about how the product will actually be used, in real life. The Usability Engineering process is the best shortcut for correctly predicting how the product will actually be used. The usability engineering process includes user research (e.g. interviewing end users), user surveys, usability testing (i.e. behavioral studies), and expert analysis.

UserWise is the bridge between the manufacturer and the end user of its medical device. For example, UserWise recruits surgeons to come to our usability lab to perform a simulated surgery with a prototype surgical robot. We observe the surgeon's actions through a one-way mirror to determine whether the user interface confuses the surgeon such that he/she makes a mistake that could lead to patient harm.

Inevitably, our usability studies reveal critical mistakes caused by sub-optimal user interface design. Then, we assist the companies to redesign their product to make each mistake impossible.

LMR: Can you explain to our readers some of the obvious absurdities in the realm of medical devices? In particular, how human error persists when one might have thought it would be quickly stamped out?

SEC: According to one report, each dollar invested in early-stage user-centered design efforts was estimated to return between $2 to $200 to the product manufacturer.[1] There is a strong economic case for following the usability engineering process.

Baking usability into a product's design via usability testing and evaluation can lead to the following benefits:

- Reduced development intervals and costs
- Competitive differentiation
- Reduced product liability exposure
- Repeat sales from highly satisfied users
- Decreased training costs
- Lower on-market support costs

It seems like a no-brainer to obtain user feedback when developing a medical device, right?

Unfortunately, many medical device manufacturers are only baking usability into their product design because they are forced to do so by the FDA. I believe that this is due to lack of competition among medical device companies, a UX "brain drain," and excessive regulatory burdens.

Lack of Competition

Medical device manufacturers are mini-monopolies created by the regulatory environment. Developing a medical device can take 3 to 8 years, mostly due to the level of rigor with which manufacturers must test their product and generate compliance documentation. The amount of investment required to design and develop a medical device prevents some entrepreneurs from even attempting to enter the field. This creates huge barriers to entry for competitors and reduces the need to make an easy-to-use product for competitive reasons.

Phones, Apps, and commercial websites have no choice but to offer user-friendly user interfaces. If their user interface is difficult to use, they lose market share.

Unfortunately, medical device manufacturers can "get by" with suboptimal user interfaces because they aren't experiencing that competitive pressure.

"Medical device manufacturers are mini-monopolies created by the regulatory environment."

There are additional barriers to entry for an innovator designing a new medical device. Venture Capitalists prefer to invest in a medical device that has a proven track record of FDA approval and of government reimbursement. A track record with the FDA means that a similar medical device must have been developed and this predicate product must have been cleared by the FDA. As a result, most medical device start-ups are producing medical devices with incremental levels of innovation, rather than medical devices that are game changers.

UX "Brain Drain"

When working in medical device corporations, I saw this happen time and time again: An exuberant engineer or UX (User Experience) designer from a prestigious university desires to "save the world" by helping to design a medical device. Within the first couple weeks of work, he/she realizes that each and every small modification to the existing prototype requires onerous levels of documentation and hours of meetings to persuade stakeholders that the change is beneficial. This creates a change-averse culture in which this once-enthusiastic engineer cannot thrive. As a result, he/she leaves the medical device industry to design visually compelling websites or consumer widgets.

Working in a medical device company requires tenacity and patience, but innovators generally like projects that move fast. The out-of-box thinkers and designers

do exist in the medical device industry, but I theorize that we would see more of them if medical device development was a faster-moving process.

Excessive Regulatory Burdens

Recently, we uncovered over 100 usability defects in a medical device prototype and alerted the manufacturer. These usability defects could lead to high training costs, excessive service calls, and potential errors that could affect patient care. The manufacturer decided not to change the design because such changes could lead to months of retesting. Design improvements could compromise their ability to quickly initiate the FDA submission process, which has a 3-month or longer turnaround time.

"An exuberant engineer or UX (User Experience) designer from a prestigious university desires to "save the world" by helping to design a medical device. Within the first couple weeks of work, he/she realizes that each and every small modification to the existing prototype requires onerous levels of documentation and hours of meetings."

After completing the medical device design and fully testing the product, a manufacturer must wait a full calendar quarter before making its first sale. With this environment, some manufacturers create minimum viable products that meet baseline safety requirements, but have suboptimal user interfaces.

LMR: What's been the FDA's role in all of this?

SEC: In 1996, the FDA updated its Quality System Regulations and included statements that highlighted the need for usability testing of medical devices. Economic incentives were insufficient to drive usability testing, most likely due to lack of competition (due to payer silos[2] as well as regulatory barriers).

Economic incentives continued to be lacking over the next decade. For example, the FDA received 56,000 reports of infusion pump incidents, including 710 deaths, and issued 87 infusion pump recalls between 2005 and 2009. Many of these events were attributed to human error.[3] Clearly, poor user interfaces can set users up for failure and directly threaten patient safety.

Around this time, the FDA began more strictly enforcing existing regulations related to usability engineering. Now, medical-grade usability

"The FDA received 56,000 reports of infusion pump incidents, including 710 deaths, and issued 87 infusion pump recalls between 2005 and 2009. Many of these events were attributed to human error."

testing is required to validate the safety and efficacy of each medical device.

LMR: For our final—and unfairly open-ended—question: What are some of the major reasons that medical device design doesn't seem as innovative and sensible as in other industries? Do you have any ideas on what could improve it?

SEC: Suboptimal medical devices may result from lack of competition, lack of human resources, and regulatory hurdles. Here are a couple of things the FDA could do to improve innovation:

- **More transparent and consistently-applied regulations –** The FDA is constantly evolving their views and interpretations of the regulations published in 1996. One way that UserWise helps clients is through our frequent interactions with the FDA to keep track of shifting viewpoints on, for example, how usability testing should be conducted. If the FDA "froze" their regulatory expectations, and applied expectations consistently among manufacturers, designing new medical devices and improving existing medical devices would become cheaper.

- **Shorten FDA review turnaround times –** By reviewing medical device submissions and providing feedback to manufacturers quickly, manufacturers may be more open to addressing usability issues and could create second generation, improved designs faster.

- **Focus on safety issues rather than ease-of-use issues –** The FDA's mission statement includes protecting public health "by assuring safety, efficacy and security" of medical devices. The FDA has been heightening its focus on enforcing regulations on the ease-of-use of medical devices, rather than just focusing on safety-related aspects. I think most device users, especially nurses, would agree that medical devices need to be easier to use. However, I do not believe that regulation is the best avenue for achieving this goal. While a well-intended FDA initiative, requiring medical-grade usability testing for non-safety-related aspects of medical devices could delay patient access to the new medical devices and ultimately reduce usability. I would recommend that the FDA permit manufacturers freedom to quickly iterate and improve upon design aspects that have no potential to cause serious patient harm. If the FDA pulls manufacturers into drawn-out negotiations or extensive, medical-grade usability testing to address ease-of-use issues, the manufacturers will be more reluctant to make improvements to their designs when the improvements are not required by the FDA.

"I continue to be optimistic that we can identify a more market-oriented solution related to medical device design and usability, and reduce the need for the government's involvement in the process."

As I continue to contribute to world standards committees, present at conferences, and meet with usability experts at the FDA, I push for streamlined usability regulations that are not onerous or prohibitive. I continue to be optimistic that we can identify a more market-oriented solution related to medical device design and usability, and reduce the need for the government's involvement in the process. ◆◆◆

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EVENTS & ENGAGEMENTS

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

JULY 11 & 12, 2017
NASHVILLE-BRENTWOOD, TN

Lara and Murphy present IBC Tax Strategy at Private Physician Dinner and Business Owner Breakfast for Three C Corporation.

JULY 23-29, 2017
AUBURN, AL

Murphy teaches at Mises University.

OCTOBER 7, 2017
NEW YORK CITY, NY

Murphy speaks at 35th Anniversary Gala for Mises Institute.

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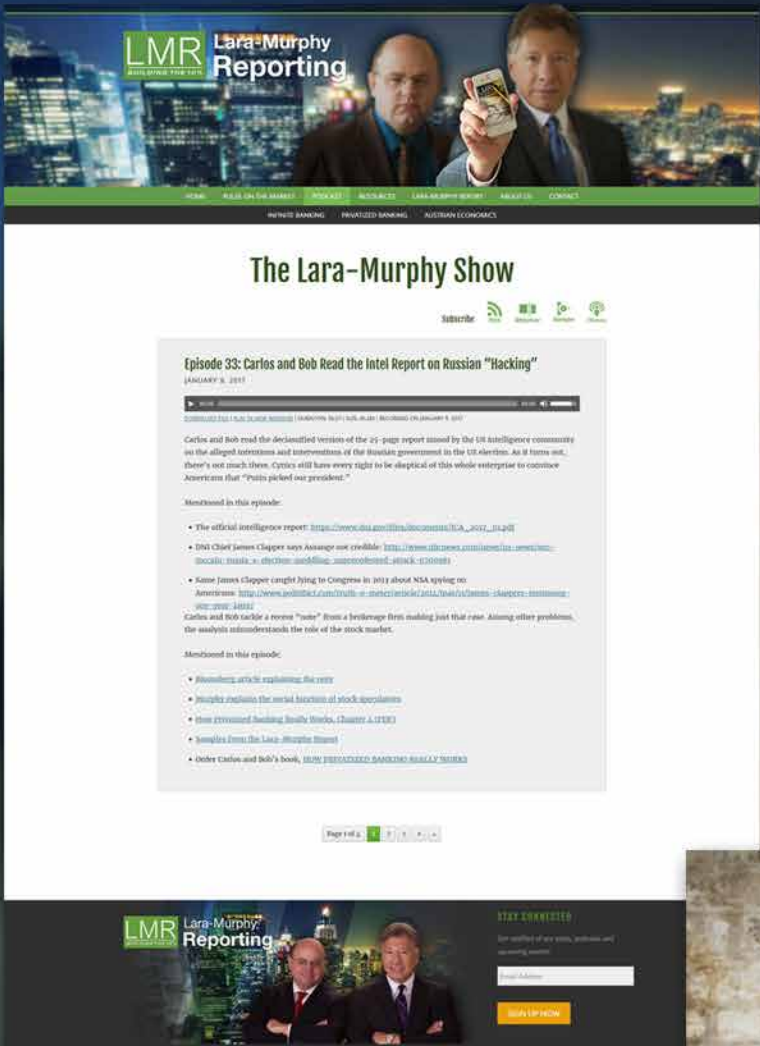

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