Protection from a currency collapse

Description

USA: While markets seem becalmed, financial conditions are rapidly deteriorating. Last week Jamie Dimon of JPMorgan Chase gave the clearest of signals that bank credit is beginning to contract. Russia has consolidated its rouble, which has now become the strongest currency by far. The Fed announced the previous week that its balance sheet is in negative equity. And there's mounting evidence that we have a nascent crack-up boom.

Russia now appears to be protecting the rouble from these developments in the West, while previously she was only attacking the dollar's hegemony. China has yet to formulate a defensive currency policy but is likely to back the renminbi with a commodity basket, at least for foreign trade. If it is taken up more widely by the members if the Shanghai Cooperation organisation and the BRICS, the development of a new commodity-based super-currency in Central Asia could end the dollar's global hegemony.

These are major developments. And finally, due to widespread interest in the subject, I examine the outlook for residential property values in the event of a collapse of Western fiat currencies.

Against the grain of the establishment, for years I have been warning that the world faces a fiat currency collapse. The reasoning was and still is because that's where monetary and economic policies are taking us. The only questions arising are whether the authorities around the world would realise the dangers of their inflationary and socialistic policies and change course (extremely unlikely) and in that absence in what form would the final crisis take.

History tells us that fiat currencies always fail, only to be replaced by Mankind's sound money — metallic gold, and silver. And now that fiat currencies have seen a rapid debasement followed by soaring commodity and raw material prices, interest rates should be considerably higher. Yet, in the Eurozone and Japan they are still suppressed in negative territory. The reluctance of the ECB and the Bank of Japan to permit them to rise is palpable. Worse still, even with just the threat of a slowdown in the issuance of extra credit by the commercial banks, we suddenly face a sharp downturn in economic and financial activities.

Commercial banks in the Eurozone and Japan are uncomfortably leveraged and unlikely to survive the mixture of higher interest rates, contracting bank credit, and an economic downturn without being bailed out by their respective central banks. But so massive are the central banks' own bond positions that the losses from rising yields have put them in negative equity. Even the Fed, which is in a far better position than the ECB and BOJ, has admitted unrealised losses on its bond portfolio are $330bn, wiping out its balance sheet equity six times over.

So, without the injection of huge amounts of new capital from their existing shareholders the major central banks are bust, the major commercial banks soon will be, and prices are rising uncontrollably driving interest rates and bond yields higher. And like a hole in the head, all we now need to complete the misery is a contraction in bank credit. On cue, last week we got a warning that this is also on the cards, when Jamie Dimon, boss of JPMorgan Chase, the largest commercial bank in America and the Fed's principal conduit into the commercial banking network, upgraded his summary of the financial scene from "stormy" only nine days before, to "hurricane". That was widely reported. Less observed were his remarks about what JPMorgan Chase was going to do about it. Dimon went on to say the bank is preparing itself for "a non-benign environment" and "bad outcomes".

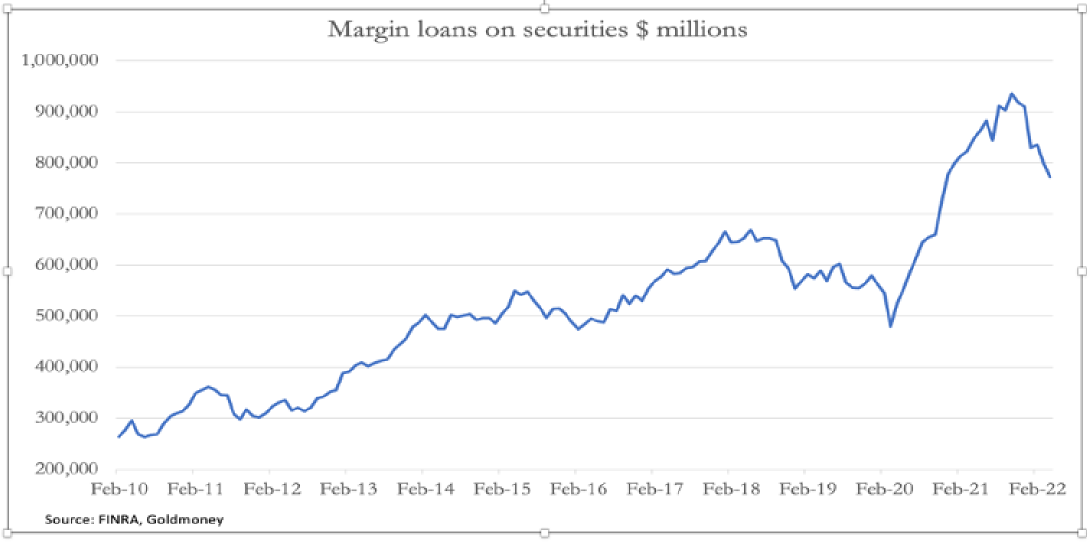
We can be sure that the Fed will have spoken to Mr Dimon about this. JPMorgan's chief economist, Bruce Kasman was then urgently tasked with rowing back, saying he only saw a slowdown. No matter. The signal is sent, and the damage is done.

We are unlikely to hear from Dimon on this subject again. But you can bet your bottom dollar that the cohort of international bankers around the world will have taken note, if they hadn't already, and will be drawing in their lending horns as well.

The importance of monitoring bank credit is that when it begins to contract it always precipitates a crisis. This time the crisis revolves more around financial assets than in the past, because for the last forty years, bank credit expansion has increasingly focused not on stimulating production of real things — that has been chased overseas, but the creation of financial ephemera, such as unproductive debt, securitisations of securities, derivatives, and derivatives of derivatives. If you like, the world of unbacked currencies has generated a parallel world of purely financial assets.

This is now changing. Commodities are creeping back into the monetary system indirectly due to sanctions against the world's largest commodities exporter, Russia. Financing for speculation is already contracting, as shown in Figure 1. Given recent equity market weakness this is hardly surprising. But it should be borne in mind that this is unlikely to be driven by speculators cleverly taking profits at the top of the bull market. It is almost certainly forced upon them by margin calls, a fate similarly suffered by punters in cryptos.

Figure 1. Bank credit for financial speculation is already contracting



Bank deposits, which are the other side of bank credit, make up most of the currency in circulation. Since 2008, dollar bank deposits have increased by 160% to nearly $19.5 trillion (M3 less bank notes in circulation). But there is the additional problem of shadow bank credit, which is unknowable and is likely to evaporate with falling financial asset values. And Eurodollars, which similarly are outside the money supply figures will likely contract as well.

We are now moving rapidly towards a human desire to protect what we have. This is fear, instead of the desire to make easy money, or greed. We can be reasonably certain that with the reluctance of banks to even maintain levels of bank credit the move is likely to be swift, catching the wider public unawares. It is the stuff of an apocalypse.

A financial and economic crisis is now widely expected. Everyone I meet in finance senses the danger, without being able to put a finger on it. They are almost all talking of the authorities taking back control, perhaps of a financial reset, without knowing what that might be. But almost no one considers the possibility that this time the authorities will fail to stop a crisis before it turns our world upside down.

Nevertheless, a crisis is always a shock when it comes. But its timing is always anchored in what is happening to bank credit.

The true role of banks in the economy is as creators of and dealers in credit. The licence granted to them by the state allows them to issue credit where none had existed before. Initially, it stimulates economic activity and is welcomed. The negative consequences only become apparent later, in the form of a fall in the expanded currency's purchasing power, firstly on the foreign exchanges, followed in markets for industrial commodities and raw materials, and then in the domestic economy. The seeds for the subsequent downturn having been sown by the earlier expansion of credit. As night follows day it duly follows and is triggered by credit contraction. Since the end of the Napoleonic wars, this cycle of credit expansion and contraction has had a regular periodicity of about ten years —sometimes shorter, sometimes longer.

A cycle of bank credit is a more relevant description of the origin of periodic booms and slumps than describing them as a trade or business cycle, which implies that the origin is in the behaviour of banking customers rather than the banking system. How it comes about is important for an understanding of why it always leads to a contractionary crisis.

The creation of bank credit is a simple matter of double entry bookkeeping. When a bank agrees to lend to a borrower, the loan appears on the banker's balance sheet as an asset, for which there must be a corresponding liability. This liability is the credit marked on the borrower's deposit account which will always match the loan shown as an asset. This is a far more profitable arrangement for the bank than paying interest on term deposits to match a bank's loan, which is the way in which banks are commonly thought to originate credit.

The relationship between his own capital and the amount of loan business that a banker undertakes is his principal consideration. By lending credit in quantities which are multiples of his own capital, he enhances the return on his equity. But he also exposes himself to a heightened risk from loan defaults. It follows that when he deems economic prospects to be good, he will lend more that he would otherwise.

But bankers though their associations and social and business interactions tend to share a common view of economic prospects at any one time. Furthermore, they have their own sources of economic intelligence, some of which is shared on an industry-wide basis. They are also competitive and prepared to undercut rivals for loan business in good times, reducing their lending rates to below where a free-market rate would perhaps otherwise be.

Being dealers in credit and not economists, they probably fail to grasp the fact that improving economic conditions — growth in Keynesian jargon — is little more than a reflection of their own credit expansion. The currency debasement from extra credit results in prices and interest rates rising, especially in fiat currencies, undermining business calculations and assumptions. Bankruptcies begin to increase as the headline below from last Monday's Daily Telegraph shows:

Bankruptcy boom: Experts warn there is a storm coming

The signs are already ominous.

While this headline was about the UK, the same factors are evident elsewhere. No wonder Jamie Dimon is worried.

As a rule of thumb, bank credit makes up about 90% of the circulating media, the other 10% being bank notes. Today in the US, bank notes in circulation stand at $2.272 trillion, and M3 broad money, which also contains narrower forms of money stands at $21.8 trillion, so bank notes are 10.4% of the total. The ratio in December 2018 following the Lehman crisis was 10.7%, similar ratios at different stages of the credit cycle. Therefore, at all stages of the cycle, it is the balance between greed for profit and fear of losses in the bankers' collective minds that set the prospects for boom and bust, and not an increase in the note issue.

A further consideration is the lending emphasis, whether credit has been extended primarily to manufacturers of consumer goods and providers of services to consumers, or whether credit has been extended mostly to support financial activities. Since London's big-bang and America's repeal of the Glass-Steagall Act, the major banks have increasingly created credit for purely financial activities, leaving credit for Main Street in the hands of smaller banks. Because credit expansion has been aimed at supporting financial activities, it has inflated financial assets values. So, while central banks have been suppressing interest rates, the major banks have created the credit for buyers of financial assets to enjoy the most dramatic, widespread, and long-lasting of investment bubbles in financial history.

Now that interest rates are on the rise, the bubble environment is over, to be replaced with a bear market. The smart money is leaving the stage, and the public faces an unwinding of the bubble. The combination of rising interest rates and contracting bank credit is as bearish as falling interest rates and the fuel of expanding bank credit were bullish. As loan collateral, banks have retained financial assets to a greater extent than in the past, and their attempts to protect themselves from losses by fire sales of stocks and bonds when they no longer cover loan obligations can only accelerate a financial market collapse.

While the financial sanctions imposed on Russia have led to a tit-for-tat situation with Russia saying it will only accept payments in roubles from the "unfriendlies", there can be little doubt that sanctions have come at an enormous cost to the imposers. In a recent interview, Putin correctly identified the West's inflation problem:

"In a TV interview that followed his meeting with the African Union head Macky Sall in Sochi, Putin added that attempts to blame Ukraine's turmoil for the West's skyrocketing cost of living amount to avoiding responsibility. Almost all governments used the fiscal stimulus to help people and businesses affected by the Covid-19 lockdowns. Putin stressed that Russia did so "much more carefully and precisely," without disrupting the macroeconomic picture or fuelling inflation. In the United States, by contrast, the money supply increased by 38% – or $5.9 trillion – in less than two years, in what he referred to as the 'unprecedented output of the printing press'."[i]

This is important. While the West's monetary authorities and their governments have suppressed the connection between the unprecedented increase in currency and credit and the consequence for prices, if the quote above is correct, Putin has nailed it. In all logic, since the Russians clearly understand the destabilising ramifications of the West's monetary policies, it behoves them to protect themselves from the consequences. They will not want to see the rouble sink alongside western currencies.

And indeed, the policy of tying Russian energy exports to settlements in roubles divorces the rouble from the West's mounting financial crisis. It is further confirmation that Zoltan Pozsar's[ii] description of a Bretton Woods 3, whereby currencies are moving from a world of financial activity towards commodity backing, is correct. It's not just a Russian response in the context of a financial war, but now it's a protectionist move.

Russia enjoys the position of the world's largest exporter of energy and commodities. For the West to cut itself off from Russia may be justifiable in the narrow political context of a proxy war in Ukraine, but it is madness in the economic perspective. The other nation upon which the West heavily relies, China, has yet to formulate a proper currency policy response. But the alacrity with which China began stockpiling commodities and grains following the Fed's reduction of interest rates to the zero bound and its increase of QE to $120bn monthly in March 2020 shows she also understands the price consequences of the West's inflationism.

The difference between China and Russia is that while Russia is a commodity exporter, China is a commodity importer. Her currency position is therefore radically different. The Chinese advisers who have absorbed Keynesian economics will be arguing against a stronger currency relationship with the dollar, particularly at a time of a significant slowing of China's GDP growth. They might also argue that they have preferential access to discounted Russian exports, the benefits of which would be squandered if the yuan strengthened materially. One can imagine that while Russia is certain about her "Bretton Woods 3 strategy", China has yet to take some key decisions.

But everything is relative. It is true that China is offered substantial discounts on Russian energy and other commodities. It is in her interests to accumulate as much of Russia's commodities as she can — particularly energy. But it must be paid for. Broadly, there are two sources of funding. China can sell down its US Treasury holdings, or alternatively issue additional renminbi. The latter seems more likely since it would keep the dollar well away from any Chinese-Russian trade settlements and could accelerate the start of a new offshore renminbi market.

All these moves are responses to a crisis brought about by Western sanctions. Given the history of price stability for energy and most other commodities measured in gold grammes, Russia's move represents a barely transparent move away from the world of fiat and its associated financial ephemera to a proxy for a gold standard. It is a statist equivalent of the latter, whereby Russia uses commodity markets without having to deliver anything monetary. While protecting the rouble from a collapsing western currency and financial system it works for now, but it will have to evolve into a monetary system that is more secure.

One possibility might be to use the new commodity-based trade currency planned for the Eurasian Economic Union (EAEU), which is likely to rope in all the Shanghai Cooperation Organisation network, and possibly the commodity-exporting BRICS as well. It has been reported that even some Middle Eastern states have expressed interest though that's hard to verify. In the financial war against the dollar, the announcement of the new currency's terms would represent a significant escalation, cutting the dollar's hegemony down at a stroke for over half the world's population.

It would also raise a question mark over the estimated $33 trillion dollars of US financial assets and bank deposits owned by foreigners. Timing is an issue, because if the new EAEU trade currency is introduced following a crisis for the dollar, the move would be protectionist rather than aggressive, but it seems likely to trigger substantial dollar liquidation in the foreign exchanges either way.

The elephant in the currency room is gold. It is what Zoltan Pozsar of Credit Suisse terms "outside money". That is, money which is not fiat produced by central banks by keystrokes on a computer, or by expansion of bank credit. A basket of commodities for the proposed EAEU trade currency is little more than a substitute for linking their currencies with gold.

So, why don't Russia and China just introduce gold standards? There are probably three reasons:

- A working gold standard, by which is meant an arrangement where members of the public and foreigners can exchange currency for coin or bullion takes away control over the currency from the state and places it in the hands of the public. This is a course of action that modern governments will only consider as a last resort, given their natural reluctance to cede control and power to the people. Nowhere is this truer than of dictatorial governments such as those governing Russia and China.
- It could be argued that to introduce a working gold standard would give America power to disrupt

the currency by manipulating gold prices on international markets. But it is hard to see how any such disruption would be anything other than temporary and self-defeating.

- Proceeding nakedly into a gold standard, when America has spent the last fifty years telling everyone gold is a pet rock, yet at the same time grabbing everyone else's gold (Germany, Libya, Venezuela, Ukraine… the list is pretty much endless) is probably the financial equivalent of a nuclear escalation, only to be considered as a last resort. Clearly, it is the most sensitive subject and a frontal challenge to the dollar's post-Bretton Woods hegemony.

While national governments are considering their position in the wake of sanctions against Russia, the status of their reserves, and how best to protect themselves in a worsening financial conflict between Anglo-Saxon led NATO and Russia, ordinary people are acting in their own interest as well.

Most of us are aware that second hand values for motor cars have soared, in many cases to levels higher than new models. The phenomenon is reported in yachts and power boats as well. And on Tuesday, it was reported that US citizens had escalated their credit card spending to unexpected heights. Is this evidence of a flight from zero-yielding bank deposits, or the emergence of wider concerns about rising prices and the need to acquire goods while they are available at anything like current prices?

When it comes to their own interests, people are not stupid. They understand that prices are rising and there is no sign of this ending. Their mantra is to buy now before prices rise further, while they can be afforded and the liquidity is to hand. While it is probably too dramatic to call this behaviour a crack-up boom, unless something is done to stop it a crack-up boom appears to be developing.

But the asset which is on many peoples' minds is residential property. Where residential property prices are dependent on the availability and cost of mortgage finance, rising interest rates will undermine property values. Given that the loss of currencies' purchasing power fails to be reflected yet in sufficiently high interest rates, mortgage rates for new and floating rate loans can be expected to rise substantially, driving residential property prices lower. But this assumes that a financial and currency crisis won't occur before interest rates have risen sufficiently to discount future losses of a currency's purchasing power.

It seems unlikely that that will happen. It is more likely that increases of not more than a few per cent will be sufficient to destabilise the West's monetary order, with systemic risk spreading rapidly from the weakest points — the Eurozone and Japan, where interest rates rising from negative values will expose as demonstrably insolvent the ECB and the Bank of Japan, while major commercial banks in both jurisdictions are the two most highly leveraged cohorts.

That being the case, and if a banking crisis originating in a deflating financial asset bubble requires insolvent central banks to rescue commercial banks, there is a significant risk that the West's fiat currencies could lose credibility and collapse as well. Therefore, as well as the effect of rising mortgage costs (which will probably be capped by the emerging crisis) we must consider residential property values measured in currencies which have imploded. It is not beyond the bounds of possibility that measured nominally in fiat currencies, after a brief period of uncertainty property prices might rise. A million-dollar house today might become worth many millions, but many millions might buy only a few ounces of gold.

That appears to have been the situation in 1923 Germany, reported by Stefan Zweig, the Austrian author who in his autobiography recounted that at the height of the inflation US$100 could buy you a decent town house in Berlin.[iii] It might have been several hundred million paper marks, but at the time US$100 was the equivalent of less than five ounces of gold.

Any investor in real assets such as real estate and farmland must be prepared to look through a collapse of financial asset values and a currency crisis. For a time, they will have to suffer rents which don't cover the costs of maintaining property.

But the message from Germany in 1923 is that it is far better to hoard what the Romans told us is legally money, that is everlasting physical gold. And the lessons of history backed up by pure logic tell us loud and clear that gold is not a portfolio investment. It is no more than money. An incorruptible means of exchange to be hoarded and spent after all else has failed.

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Category

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