The Clash: The Pen Is Mightier Than The Printing Press (06/05/20)

Money can be created in two ways - governments can print money and bankers can create fountain-pen money.

Fountain-pen money is created by banks when they make a loan. The simplest case is when two people use the same bank and one of them increases his overdraft when he makes a payment to the other. The latter’s bank deposit rises. In the bank’s books, loans rise on the asset side of the balance sheets and deposits rise on the liability side. The money supply increases as the entry is made in the bank’s books. Until the late twentieth century, the records were kept manually by clerks using fountain pens, and the money was created at the stroke of a banker’s pen. This is the explanation of the term fountain-pen money.


Breakin’ rocks in the hot sun
I fought the law and the law won
I needed money ‘cause I had none
I fought the law and the law won
I fought the law and the law won
I Fought The Law: The Clash

There is a war raging in Europe. It is a war over who controls the money printing press. It is a war fought in courtrooms and ‘behind closed doors, in the corridors of Brussels, Berlin or Paris’ (see President Macron’s Acropolis Speech of September 2017). These days more likely it is fought on the video equipment that links those three seats of power in Europe that notably, according to the French President, does not include Rome or any of the other fifteen states that comprise the Eurozone. It is a war for control over who runs Europe and it is a war in which the people are bystanders because apparently the President of France was wrong.

‘The corridors’ where power resides in Europe are not in Brussels, Berlin or Paris but they are in Luxembourg and Frankfurt. At least that is where power lies according to the decision of the German Federal Constitutional Court (GFCC) of May 5th 2020. In that decision the European Court of Justice (CJEU) in Luxembourg and the European Central Bank (ECB) in Frankfurt are accused of a grab for power which sees them acting ultra vires and not ‘safeguarding the principle of democracy’. In the history of Europe this is not quite the equivalent of that first shot at Fort Sumter in 1861, but it is a moment that will shape the future of the continent perhaps as profoundly.

What once were known in another era and in another land as ‘states rights’ have been very strongly asserted by the GFCC. With this decision Europe reaches peak federalization, at least the form of federalization that comes via the backdoor. If federalization is to proceed it can now only come through very bold political decisions and thus through the front door of the democratic process. The Solid Ground has long maintained, in full support of the words of President Macron, that such decisions cannot be made in dark corridors but under sunlight - still the best disinfectant. In sunlight the push for federalization will likely fail.

Your author studied constitutional law a very long time ago at Queen’s University Belfast. That was at a time when the constitution of the state was disputed and our lecturer on constitutional law was murdered outside the lecture hall for his support for the existing constitution. It has not been the fate of many of the readers of this report to be involved in such deadly constitutional disputes and thus most people assume that when it comes to that sort of thing ‘It Can’t Happen Here’. The ruling by the GFCC, that the CJEU and the ECB are acting beyond the law and not ‘safeguarding the principle of democracy’
and states rights within the European Union, however, should focus the mind on the simple fact that the real struggle for the federalization of Europe has yet to begin.

The main constitutional debate in Europe, whether pursued peacefully or otherwise, is in front of us and not behind us. No doubt many who lived on the American continent believed that the federalization project would be complete not long after the victory of 1783. It turned out it was only secured in 1865, after a bloody internal conflict that also destroyed the currency and financial assets of half the country. If the unelected ECB and CJEU are acting *ultra vires* on the federalization process, who will fill the vacuum on their retreat? Can the GFCC really command such a retreat? If not federalization, then what?

*The Solid Ground* will return to the impact on the ECB’s balance sheet of this decision in due course, but first to the frontal attack by the GFCC on the CJEU, something that this analyst believes to be, in the long term, just as important. It is important because this decision questions not only the standing of the CJEU to uphold the laws of Europe but also its impartiality in so doing. The power of the CJEU to interpret the laws of Europe is limited by this decision, and that matters when unelected institutions are the federalizing force in the absence of political progress. As the GFCC reminds the CJEU: ‘even under the Lisbon Treaty, the Member States remain the ‘Masters of the Treaties’ and the EU has not evolved into a federal state’. Democratically elected governments can drive further federalization in the EU, but the ECB and the CJEU cannot. Specifically the CJEU ‘cannot and need not completely correspond to the practice of domestic courts; yet the CJEU also cannot simply disregard such practice.’ Member state law limits EU law; it cannot be ignored or overridden by unelected judges in Luxembourg. There are ‘states rights’ and those rights cannot be overridden by the CJEU or, by definition, any other EU body. Where now for federalization?

This bar to the power-grab by the EU’s unelected institutions has implications not just for the legality of the ECB balance sheet expansion, called the Public Sector Purchase Programme (PSPP), but for any further expansion of the ECB balance sheet. That includes the expansion currently underway to finance the response to the health emergency and the economic reconstruction that will follow. According to the GFCC, ‘the EU has not evolved into a federal state’ so it cannot legally produce a federal answer to this emergency; that response must come from the member states driven by their politicians. To shift to a federal answer through the central bank, the politicians would first have to change the law to explicitly mandate the ECB in such a task. The GFCC decision requires such overt federalization and seeks to outlaw covert federalization. The ball has been hit where it belongs, into the court of elected politicians and not in the court of the un-elected academics and lawyers who run the ECB and the CJEU. Closing the route to continued covert federalization exacerbates the political crisis caused by the EU response, or lack of it, to the current crisis. The GFCC has forced politicians to take or avoid taking bold decisions to federalize or not to federalize in broad daylight.

The GFCC judgement eviscerates the decision of the CJEU, that supported the right of the ECB to run the PSPP and states clearly that the court acted *ultra vires* in making that decision - the most damning decision one court could possibly pass on the decision of another. The GFCC refers to the CJEU decision as ‘simply untenable from a methodological perspective, given that it completely disregards the actual economic policy effects of the programme’. On top of that ‘the judgement of 11 December 2018 [by the CJEU on the PSPP] contradicts the methodological approach taken by the CJEU in virtually all other areas of law.’ That is as clear an accusation of bias as one court is likely to ever make about another, as the accusation is that the CJEU junked long-held practices to avoid asking the key constitutional question on which it was asked to adjudicate. The accusation that the CJEU deliberately amended its practices to avoid finding against ECB action is a damning verdict on what is supposed to be an independent body protecting the rights of citizens under the laws of Europe.

Even if the GFCC thought that the CJEU was acting within the laws of Europe, which it does not, it also strongly insinuates that it acted with bias in how it interpreted the law. One can see why the GFCC believes that having such an unelected body at the heart of the European project is indeed the danger to democracy that they flag up in their judgement. The GFCC is claiming a return of power to member states, but also stating that the CJEU is biased in its interpretation of those laws where it does have standing to adjudicate on. This is a very major push-back against federalization. Whether it matters
today or tomorrow, it does matter as the GFCC has strong powers to enforce its decision. It can compel the Bundesbank to shrink its balance sheet and thus, based on current laws, compel the ECB to shrink its balance sheet. Do the citizens of the Eurozone know that such power lies with the un-elected judges at Karlsruhe? How might they feel if support for their government bond markets were effectively withdrawn by such a body? This crisis and the decision of the GFCC are shining a light upon where power really lies within the EU. Time will tell whether the electorates of the member states like what they see beneath that light.

While your analyst is more interested in the long-term implications for the federalization of Europe from this decision, most investors will be more interested in the impact on the ECB balance sheet of this frontal attack on federalization by the back door in the EU. The GFCC does not mince its words on the expansion of the ECB’s balance sheet:

>A programme for the purchase of government bonds, such as the PSPP, that has significant economic policy effects requires that the programme’s monetary policy objective and economic policy objectives be identified, weighed and balance against one another. By unconditionally pursuing the PSPP’s monetary policy objective - to achieve inflation rates below, but close to 2% - while ignoring its economic policy effects, the ECB manifestly disregards the principle of proportionality.

As to whether the ECB was ‘actually ignoring its economic policy effects’, the GFCC states that it cannot tell, as the ECB has not provided sufficient evidence for such a review. Of course, that also means the CJEU ruling on the legitimacy of the programme proceeded without such evidence - in other words it was a rubber stamping exercise! To argue that another court is wrong in fact or in law is one thing but the GFCC ruling is that the CJEU did not even bother to look at the evidence! The GFCC has a simple remedy:

>Following a transitional period of no more than three months allowing for the necessary coordination with the Eurosystem, the Bundesbank may thus no longer participate in the implementation and execution of the ECB decisions at issue, unless the ECB Governing Council adopts a new decision that demonstrates a comprehensible and substantiated manner that the monetary policy objectives pursued by the PSPP are not disproportionate to the economic and fiscal policy effects resulting from the programme.

The GFCC wants the ECB to provide ‘comprehensible and substantiated’ evidence that its monetary policy is not ‘disproportionate’. Amazingly it wants that within three months: the equivalent of light speed in the judicial process, surely aimed at playing a role in influencing the pace of current ECB balance sheet expansions. If the ECB fails to provide such evidence within three months, or if the GFCC rules that, based on the evidence provided, the ECB policy is not ‘proportionate’, then the Bundesbank will be required by German law to liquidate its holdings of government bonds. As the ECB itself is bound by the so-called ‘capital key’ to hold assets in proportion to its ownership structure, such a liquidation by the Bundesbank would force the ECB to unwind the entire EUR2Trn PSPP. Such an unwind would come at a time of unparalleled peacetime issuance of debt by the governments of the member states! ECB support for member state government bond markets would be removed from the market just when it was needed most. Government bond yields would rise dramatically, particularly in those highly indebted countries with a history of default or restructuring of their government debt.

The prospect that the GFCC would compel the Bundesbank to liquidate its government bonds held under the PSPP programme and force a mass liquidation of government bonds by the ECB will focus political minds in the Eurozone. In particular in Germany it would force politicians to confront the difficult question as to whether the capital key can be abandoned. Could the central bank behind the euro really be allowed to buy assets based entirely upon its own judgement without limitation? That would be a huge decision for a German politician to endorse and while it is possible that they might do so, it is not probable that they will do so, especially as 2021 is an election year in Germany. So if the mutualization of debt seems off the table and the federalization of debt by the back door, in Frankfurt supported by Luxembourg, is not possible - then what happens next?
The key alternative to more federalization in Europe is the decomposition of the Eurozone, through the imposition of capital controls, in pursuit of financial repression. The imposition of capital controls within the EU and the Eurozone would allow each member state to conduct the financial repression necessary to solve each country’s unique problems associated with their very differing debt levels. If the ECB is constitutionally barred from effecting such a repression, because it also constitutes a back-door federalization, then each country will have to find other ways of inflating away their debts. If each state can lash their savers to their ship of state, then they can use domestic savings as a flotation device to save that ship. If each state can take control of its commercial banking system, then it can create the money that it needs, through the power of fractional reserve banking, to generate the inflation that the ECB is now more clearly constitutionally barred from creating.

These actions require capital controls to prevent savings from fleeing such abuse and also to prevent newly created money from fleeing to other jurisdictions within the Eurozone. Each country needs to abuse its own savers and to create money that creates inflation local to it, and for this capital controls are essential. Such controls have already been used in Greece and Cyprus and, in the opinion of this analyst, this time they will be permanent and not temporary in nature.

Having long labored the argument for financial repression, *The Solid Ground* will not reiterate the mechanisms through which domestic savers are forced into the killing pens of government securities in an age of inflation. While that sounds a simple exercise, it involves member states seizing an extreme power for government to whip local savers with euro-denominated assets into just one specific euro-denominated asset - their local government debt. Such power is anathema to the free movement of capital within the Eurozone. If this is the *de facto* end of the free movement of capital in the euro, then it is also the end of the euro. This is not the only body blow dealt to the single currency from the pursuit of financial repression. Government bonds are no killing pen for savers without the use of the bolt gun that is inflation. So how to create inflation, if the ECB cannot or is not permitted to do so?

The ECB creates printing press money, but it is the Eurozone’s commercial banks that create fountain-pen money. The mechanism by which commercial banks create money is no secret - it has been around since the seventeenth century and arguably, in Italy, even before that. A member state that controls its commercial banks controls the creation of money and can create unlimited euros. Well, it can create unlimited euros if the member state controls the banks, ensuring they do what they are told and thus ignore all previous regulatory fetters on balance sheet expansion - particularly those imposed from outside the member state. It can, of course, only create unlimited euros if the ECB continues to provide liquidity to those commercial banks, then clearly in breach of their regulatory obligations.

The ECB has proved once that it will deny such support to banks, as it did in an attempt to swing the democratic election in Greece against an Anti-EU party, but such punishment beatings are likely only deliverable to small member states. If the ECB was unprepared to whip a larger member state into line, then through control of local banks that state could fund itself with the ‘magic money tree’ that is a state-controlled commercial banking system. Such a state would not have to leave the EU, but simply break all the rules of the EU and see if it could be thrown out, by the other 18 Eurozone members, or via the unconstitutional backdoor by the withdrawal of support by Christine Lagarde. With France now desperate to utilize its own commercial banking system for a similar purpose, one should not expect punishment beatings from the ECB for any state that goes rogue with the creation of fountain-pen money.

This dynamic does create a different form of Eurozone crisis. As the total amount of euros created is likely to have impacts on pan-Eurozone inflation, it is a direct attack on ‘frugal’ states’ savers by ‘rogue’ southern elements as long as those elements retain the support of the ECB. In such a situation, the refusal of the ‘frugal’ minority to mutualize debt within the Eurozone can be met with their worst nightmare by the majority - the money creation function moves from Frankfurt and shifts south to state-controlled commercial banks. In such a situation the ‘frugal’ states would also be keen to support a form of capital controls that would prevent the surge in liquidity that would undermine the purchasing power of savings in their own countries. In a confluence of interest those member states pursuing aggressive
repression would be keen to lock up liquidity in their own countries to generate inflation and reduce debt-to-GDP ratios. There would be a growing alignment that capital controls would be the monetary flood-control barrier to reduce debts in one country without destroying savings in another. Such a system is no longer a single currency system.

Regular readers will know that The Solid Ground has long forecast that the state would seize control, if not necessarily ownership, of the commercial banking system to implement financial repression. It is just such control that is necessary to run the successful financial repression that keeps inflation well above interest rates. It allows this alchemy while allowing the state to steer credit, in a world where it is allocated by fiat and not price, to the deserving causes that help politicians get re-elected. The Solid Ground has expected this shift in control of commercial banks to happen in the next recession.

Here we are and with a scale of recession and a moral cause, apparently, that sees the state directly controlling the flow of credit through the commercial banks. While some will see this as a temporary aberration, associated with what we are told are war-like conditions, historians will remember that all financial repressions begin with temporary measures in pursuit of victory in war. When victory comes, however, repression remains, because the cost of victory is an astronomical debt-to-GDP ratio. This victory will come at a similar price, but not because of the scale of spending or even the GDP contraction associated with the particular way we fight this ‘war’. The excessive debt-to-GDP burden reaches unparalleled levels because it was at unparalleled levels even before this ‘war’ began. It is this crisis that has brought banks under the control of the state, but it would be naïve to imagine that the state will relinquish control when the war is won. When our own VE day and VJ day come there will then be the task of creating a land ‘fit for heroes’, a new Marshall Plan, and a reduction in debt burdens which requires that the ‘temporary’ control of commercial banking systems continues. With some member states more in need of credit and money than others to achieve this task, then a single currency cannot prevail.

In the post-GFC world we have seen the failure of central banks to use the printing press to boost the total supply of money when the commercial banks are tardy at creating their fountain-pen form of money. The Solid Ground has long argued that QE was a disastrous policy because it was very good at creating debt, primarily from non-bank financial institutions, but failed to create much money as commercial bank balance sheet expansion was muted. As a result, debt rose faster than nominal GDP and ever-greater fragility built up in the global financial system.

In any normal recession commercial bank balance sheets would contract and thus fountain-pen money would be destroyed - as happened in the GFC. Because of such destruction of fountain-pen money in the GFC, the central bankers were aggressive in expanding their balance sheets to offset that destruction of money by the creation of printing press money. We are now very likely living through the expansion of both printing press money and fountain-pen money. This time the state is pushing commercial banks to lend and thus create money, and within the fledgling single currency system that has profoundly political implications. The state control of banks, and the ability to create fountain-pen money on political demand, is incompatible with a single currency.

The printing press is constrained by the pen. The pen of the commercial bankers failed to create the credit and money that the central bankers thought they could conjure up through their command of interest rates and the size of their own balance sheet. The pen of the commercial bankers did not respond to the offered inducements. The pen of the judges in Karlsruhe now seeks to confine the operation of the printing press, on the grounds that running the press to purchase ever more debt is a breach of constitutional law and fails in ‘safeguarding the principle of democracy’. The result has to be for politicians to use the pen that their voters have given them to rewrite such laws. EU member states have already seized the fountain-pen from the commercial bankers to generate the financing and money each needs to escape their respective debt traps. They must now seize the pen that writes laws to either end the capital key that limits use of the ECB’s printing press, or alternatively legally limit the flow of capital cross border in the Eurozone.
Your analyst continues to believe that they will choose the latter path, and that history will show that this was the first step towards the dissolution of the euro. On May 5th 2020 the covert federalization process, the threat to the ‘principle of democracy’ that the GFCC has highlighted, ended and now only bold political decisions, probably requiring the support of the people through referenda and probably treaty change, can complete the federalization process. Such things do not happen quickly and in the opinion of this analyst the political boldness does not exist to do them anyway. The constitutional sprawl of the ECB supported, according to the GFCC, by the ultra vires acts of the CJEU allowed the can of federalization to be forever ‘kicked down the road’. The GFCC has ruled this form of ‘kicking’ to be unconstitutional and now it is up to the politicians to federalize or not. Without a rapid decision to move towards much greater federalization, each state has to ask itself a simple question:

Should I stay or should I go now?
Should I stay or should I go now?
If I go, there will be trouble
And if I stay it will be double
So come on and let me know
Should I stay or should I go?

Should I Stay or Should I Go? - The Clash
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