The Train Now Arriving at the Finland Station - Discounting Regime Change (15/09/20)

‘If only Karl had made some capital, instead of writing about it!’

Karl Marx’s Mother (quoted in a letter from Karl Marx to Friedrich Engels, April 30th 1868)

In early April 1917 Vladimir Lenin and his party left Finland and crossed the border by sleigh into Russia. Eight days later he was in Petrograd atop a train at the Finland Station proclaiming revolution. By October the Bolsheviks had stormed the Winter Palace. In February 1918 they repudiated past government debts. At what stage was it right to begin to discount the regime change?

Today a monetary revolution is already in progress and, in monetary terms, Lenin has crossed the border. Global bond investors are still fully committed to pricing in the ancien régime. This too will pass, and probably quickly, and bond prices will move to price in the new monetary regime. The consequences from regime change are so dire for bond investors that the time to adjust your portfolio is now - and not when the monetary train of revolution reaches the Finland Station.

The Imperial Russian Government 5% State Loan of 1906, to be honoured in gold and held primarily by French investors, was trading around 75 when Lenin crossed the border; it was trading just about 60 when the Winter Palace was stormed; and was below 50 when the Bolsheviks repudiated the debt of the previous governments in early February 1918. Even then investors held out hopes that this regime change would not last, or the new government would be less draconian in their views on debt repayment.

The bond price did not fall below 20 until 1922, with the counter-revolution of the White Russians defeated. In 1927 the then not-so-new regime offered French bondholders 15 for their bonds - an offer that was rejected. The bonds reached negligible values during the Great Depression when the ability to repay foreign currency debt, all basically borrowed in the form of gold, collapsed globally. What the holders of the Imperial Russian Government 5% State Loan of 1906 did not know, as Lenin boarded his sleigh to cross the frozen Torne River, was that this regime change would last until 1991.

The Solid Ground is convinced that the monetary regime change has already happened. There has been a surge in broad money growth. That money has been created largely by governments and not by unilateral central bank action. The newly created money is in the hands of those who will spend it and not, as it was with QE, in the hands of those forced by contract to save it. These are facts and not forecasts. Now that politicians, acting in desperation, have seen the power of their actions to create money, they will not easily relinquish that power back to central bankers. If that is not a regime change, I’m not sure I am ever going to see one.

Financial markets remain unfazed by the change. They believe this is not regime change but a temporary and expedient measure that will be reversed. Lenin may have crossed the border but the assumption is he will never reach Petrograd, perhaps due to a timetabling error? Wishful thinking brings easy slumber – until it doesn’t.

Those studying the causes of the Russian Revolution would never start with Vladimir Lenin boarding a train in Zurich for his journey to Russia. Clearly the socio-political collapse of...
Russia was already underway and Lenin left for Russia because the Tsar had abdicated. The current financial equivalent of that long brewing socio-political collapse in Russia is the record high debt-to-GDP levels of the developed world. This is a problem that central bankers were tasked to solve and they sought to do so through the reform they call quantitative easing (QE).

It was a reform that failed, much as the Tsar’s constitutional reforms of October 1905 failed to do anything to address the structural inequities undermining the Imperial Russian regime. It was the failure of those reforms to make any material impact on the underlying structural problem that lead to the very high probability of a major regime change – not to occur until October 1917. In the face of such failures a rupture is inevitable and now governments have seized the tools to create money following the failure of the reform of QE to make any improvement to the overriding structural problem - record high debt levels. World non-financial debt-to-GDP is at the highest level ever recorded and only regime change can do something about it. The necessary regime change has already happened, and the only real question is - will it be reversed?

The power to create money is not necessarily seized by the state in order to create inflation, but it has been seized at a time when they desperately do need to create inflation. As with Lenin’s crossing of the border, it could be entirely coincidental that this has happened now! It may indeed be possible that the unelected central bankers will rise up and seize the power back from democratically elected governments, providing faith for some, like those who held their Imperial Russian government debt during the 1920-1921 civil war, that this regime change will not stand.

The fact that so little has changed in financial markets since governments across the world took on monetary powers does suggest a touching faith that the band of central bank brothers, equipped with determination and clutching their doctoral papers, can indeed wrest the power to create money back from the state. Your author shares no such faith. It is a social and political imperative to reduce record high global debt-to-GDP ratios and the powers to do so now rest in the hands of those seeking re-election, and not those seeking affirmation and a good dinner in Basel. The prospect that the power to create money is handed back from those seeking re-election to those with a record of ten years of failure to solve the structural problem is possible, but highly unlikely. There would have been no revolution in 1917 had the constitutional reforms of 1905 solved the problem. There would have been no seizure of money creation powers by governments in 2020 if the reform of QE, launched in 2009, had solved the problem.

Last week we hosted an event for ERIC where I discussed these first government steps into money creation with Stuart Graham of Autonomous Research. Stuart has been analysing banks from a bottom-up perspective for just about as long as I have been analysing money and credit from a top-down perspective. His presentation of the data on the role of the state in the growth in bank lending is eye-opening. Basically, there is no loan growth this year in either European or US banking that is not backed by a government guarantee! The data is very clear that we have the first bank credit boom in a recession in history, because the state has taken over a portion of the banks’ books. That portion of the book is divorced from any considerations of credit quality and divorced from any relation to the shape of the yield curve.

There are now two portions of a bank’s loan book - its market book, the size of which is determined by market considerations of price and credit quality, and secondly its policy book set in size by government edict. It is banking with Chinese characteristics, and all of it creates money when it creates credit. So whatever the central bankers have been up to since March, all of the money created by the extension of commercial bank credit is the
result of government edict. That portion of the revolution is already behind us, but there is more to come.

That there is to be more money creation in this revolutionary way is also a given. Stuart’s data shows how the only country where the full credit guarantees have been utilised is Spain. As soon as Spain reached the limit to its programme, it simply increased its size. Across Europe there are massive government-backed bank credit lines still to be drawn down. In her press conference last Friday Christine Lagarde mentioned in passing that the state bank credit guarantees combined are equivalent to 20% of Eurozone GDP! Stuart’s data shows that the guaranteed loan programmes account for 80% of the existing corporate loan books in the UK and around 40%-50% in Germany and Italy - most are still to be utilised!

We shall see how much of that is utilised but that's a lot of money for the governments to create, independently of the central bank, in a single currency zone. Your analyst keeps getting told that these are small and temporary incursions by the state into the money making process. These numbers are anything but small and as to how temporary they are, well that's a commitment ‘more honour’d in the breach than the observance’ when uttered by politicians.

The argument for the inflationary power of regime change relates not just to the fact that governments are very clearly now in the business of money creation. It relates to the fact that this is a very potent form of money that is being created. Stuart’s data shows that almost all of the bank credit being created under the European guarantee schemes, with the exception of Germany, is going to small and medium sized companies. The trend is the same in the US where the only driver of bank credit growth is the Paycheck Protection Program (PPP) that is restricted to smaller companies.

Money in the hands of these institutions has entirely different consequences for GDP than money in the hands of savings institutions or large companies. The events of 2008-2009 do show us how big companies can rush to hold large precautionary cash balances and those balances may not ultimately be used. Small companies have no such luxury in this pandemic. This newly created money is what keeps them alive in a period of depressed operating cash flows and it keeps them alive because they spend it. Indeed, there is ample evidence that this cash is flowing well beyond the remit of what it was intended for and there are consumption booms underway for numerous big-ticket items that are suddenly within the reach of the many and not the few.

It was Jeremy Corbyn, I believe, who first suggested the policy of ‘quantitative easing for the people’. He suggested it because, whatever it might mean for savers, it would clearly create a boost to consumption and probably initially to employment. Stuart’s data shows clearly that it is small and medium sized companies and not large companies that have received this newly created money and they are much more likely to spend it than large companies or the savings institutions that received the bulk of the money created via QE. This is not QE for the people, but it is a form of money creation for the people. The only sound reason to believe that the surge in money being created is not inflationary is that it will congeal rather than flow. Money so disbursed by the government on such terms is like hot gravy, delicious when consumed quickly, and not to be left to congeal.

The surge in broad money growth in this recession is entirely different from the collapse in broad money growth in the GFC. The Solid Ground has previously drawn attention to the repayment of US corporate credit lines in May of this year. Your analyst still believes that the market has missed this and continues to mistakenly attribute the boom in US bank credit growth to a temporary credit draw-down by large companies. That this is not the case has very important consequences for inflation. In October 2008 we saw large companies draw down emergency credit lines as the commercial paper market froze. When the commercial
paper market re-opened those credit lines were repaid, bank credit contracted and by early 2010 US broad money growth had reached near record lows, despite a massive expansion in the Fed’s balance sheet.

In conversations with numerous investors since June, your analyst has heard the same analysis that the growth in credit and money will be reversed as soon as those credit lines are repaid by large corporations. They’ve already been repaid. What Stuart’s data shows, from a bottom-up perspective, is also that the repayment of those credit lines is behind us, but the net result has been no contraction in US bank credit. Government credit guarantees and banks’ appetite for debt securities has ensured that as of September 2nd US bank credit is at a new record high - after almost all of those credit lines have been repaid.

In 2009-2010 we saw really easy fiscal policy and a very expansionary Fed, but despite the Fed’s actions near-record tightness of monetary policy as broad money growth reached just 1.6% year on year in March 2010. Today we are witnessing highly expansionary fiscal policy, a very expansionary Fed, and broad money growth at the highest level ever recorded in peace time. Bank credit continues to grow and as almost all the growth in bank lending relates to PPP it will not contract, given that most of this debt is ultimately to be forgiven under the terms of the programme. While the Main Street Lending Program is making little traction, expect reforms to make it work and possibly a PPP extension and more government guarantee credit to flow. A Biden Presidency will almost certainly bring a green new deal and government guarantees of bank credit are likely to play a key role in financing that revolution. There are zero signs of any forces of counter-revolution.

In Europe Stuart’s data shows how take-up of the credit guarantee programmes are advanced in Germany and Spain, with France somewhere in the middle and Italy bringing up the rear. It has taken a while for the Italian banks to get into gear but they are getting there. There is plenty more bank credit growth and money creation growth to come in Europe. Broad money in the Eurozone is already growing at 10.3% year on year, a level briefly exceeded in 2007, when Eurozone inflation was rising towards 4%, but not sustainably exceeded since 1982 (well before there was a single currency).

Once again this is a massive contrast with what happened in the GFC where euro M3 growth was contracting year on year by November 2009. This is not the GFC and we have Eurozone governments freed from prior fiscal restrictions, a central bank in expansionary mode, and euro broad money growth just about to breach record highs. Bank credit growth in France and Italy is now likely to add more monetary fuel to the fire. In Europe, as in the US, there is no sign of any counter-revolution and the head of the ECB praises both the size of the fiscal expansion and also the credit guarantee programmes that amount to 20% of Eurozone GDP. She has to - as it is the only route to reach the 2% annual rate of inflation that she craves.

Much of course depends upon the growth of these government bank credit guarantees, and Stuart and I discussed how likely such programmes are to continue. My opinion is clearly that this is a new tool, the magic money tree, that meets political goals on redistributing wealth both directly as well as indirectly, through the creation of inflation, and it will thus be expanded. Stuart’s conversations with European bankers indicate that they are delighted to now be seen as part of the solution, and not part of the problem. Be careful what you wish for but there seems to be little likelihood, at least in Europe, that the banks will resist the expansion of any such programs. As Stuart pointed out, one of the few areas in which European banks do lead their global competitors is in their ability to assess and finance green loans. Where such an expertise exists and is met by demand, a little government facilitation would probably be very welcome indeed.
In the long-run the most important impact of these credit guarantee programmes is that they allow each of the 19 sovereign governments of the Eurozone to create as many euros as they desire. Not just enough to reflate their economies, but enough to get them elected. The ECB is egging them on to create as many euros as possible, given their recognition that the central bank is out of monetary ammunition. In one bound the governments are free from the strictures of a single monetary policy run by the academics of Frankfurt and also free of fiscal policy restrictions dictated from Berlin. Of course, in the long-run that has profound implications for the sustainability of the single currency, but today it’s time to praise the Lord and pass the monetary ammunition. There is virtually no prospect of Christine Lagarde intervening to restrict the monetary largesse that will now be the very glue that keeps the European project alive. This Tsarina is leading the charge on the Winter Palace.

Stuart also produced some excellent long-run data for the US and the UK bank share prices back to 1893, looking at how bank equity had performed in periods of very high inflation. Without going into detail on performance, the simple answer is that they performed badly. He also took a look at the performance of US bank equity in the last period of yield curve control, 1942-1951, and also showed how price-to-book ratios declined in such a period.

In the much longer UK post-WWII financial repression bank valuations were also structurally depressed. Regular readers will have read my review of *The Deficit Myth* and be very aware that such yield capping is accompanied by the massively distortionary administrative measures that reduce return on equity for most companies in such an era. Stuart and I agree on much, but particularly that a move to cap government bond yields, when it comes, as it must, will be an outright negative for bank share prices.

Today it is the world’s central bankers who meet in Basel. In late November 1912 it was the International Socialist Congress and they agreed a manifesto that would, via the direct action of the workers, stop any future war. Of course, when that war came each one of the national socialist organisations present at Basel in 1912 reverted to supporting their respective national governments in their struggle for the survival of the nation state. Similarly, the central bankers who meet at Basel will also revert to the support of their national governments whose struggle is not for military victory but for victory over a crushing debt burden that creates an existential risk to internal stability.

High idealism produced the Manifesto of the International Socialist Congress of Basel in 1912 but it was not an idealism that survived the political expediency of the summer of 1914. Good intentions are the first casualty of necessity. There is no reason to expect any clear-out of personnel amongst central bankers, fewer meetings at Basel or less succulent lamb for dinner. Power is not necessarily lost in such visible ways, nor so visibly are good intentions destroyed.

Power can pass via compromise in pursuit of what appears to be a national necessity. With the monetary regime change already behind us, those who expect counter-revolution to be forged over dessert at *Centralbahnhofplatz 2* have the same touching faith in idealism that the members of the International Socialist Congress had in their ability to prevent a war. This will not be the first time that the world has changed forever but that after dinner the Port still passes from right to left.

All regime change ultimately suffers its own regime change, and so it was on Christmas Day 1991 when the red flag was lowered for the last time over the Kremlin. There were cheers in France as 315,000 holders of the pre-communist Russian debt now expected to be made good on their ancestors’ investment. And they were. In 1997 the government of the now Russian Federation finally made payment on the debt owed to the people of France and issued by the pre-Communist Russian governments. Of the principal USD200bn then owed
on Russian gold loans to French citizens, the Government of the Russian Federation settled USD400m. The maximum payment to any one bond holder, regardless of how many bonds they held, was USD14,000.

Today the monetary regime change is noted but dismissed. It is dismissed because apparently it may be temporary. Even if it is temporary, the inflationary consequences from the change may not be apparent for a year or even more! In the opinion of this analyst the right time for the markets to discount regime change in relation to the price of the Imperial Russian Government 5% State Loan of 1906 was well before Lenin left Zurich. Today, in terms of the modern monetary equivalent he has crossed the Torne, is headed south, and is just a few days from what was once Petrograd but by 1924 had become Leningrad.

Today the Government of France can borrow ten-year money at a yield of minus 19 basis points. Liberte, egalite and fraternite must perish in France if investors profit from that investment over its holding period. There has never been a bigger financial bet, in France or elsewhere, than that priced into the government debt of the ancien monetary regimes. Well, not since 1917 or perhaps even 1789.

With no bread in the form of yield, do not expect the cake of capital gain that can only come from a decade of price stability - even higher debt burdens, more inequality of wealth and more social and political instability. When should you discount the monetary regime change that has swept the world? Yesterday is the safest option, as members of the ancien regime usually discover when it is just too late.

‘There is nothing new except what has been forgotten.’

Marie Antoinette
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