Stron’s Ghost and a Failure to Communicate (08/06/18)

Well, it has been a bit more than a fortnight since the last Fortnightly. Your analyst has been busy travelling and also writing the new quarterly report - *When Monetary Systems Fail - A Guide for the Cautious*. At almost sixty pages it’s a bit of a blockbuster, but then it’s not every day you have to write about the breakdown of the global monetary system. The last time it was happening your analyst was more concerned about the break up of John, Paul, George and Ringo than Bretton and Woods.

Much has changed since the last Fortnightly analysed Jay Powell’s incredible speech in which he basically told the emerging markets that US monetary policy would henceforth pay no attention to the economic outcomes of countries managing their exchange rates relative to the USD. If that sea change in the operation of the global monetary system was not enough, we then had another sea change in the form of a constitutional crisis in Italy - for a day. The new quarterly report assesses ‘the contract’ of the new Italian government and makes it clear that the one-day constitutional crisis for Italy is the opening salvo in a barrage that threatens the constitutional settlement for Europe.

There are clear structural problems for the euro in its failure to create a more unified fiscal and hence political constitution. Those structural problems with the European monetary system have arisen as the pressures on the monetary system, centered on the monetary policy of the US Federal Reserve, now comes under extreme strain. While investors continue to focus on the likely pace of economic growth and the prospect of rising inflation, the global monetary system is breaking down. Let Urjit Patel, Governor of the Reserve Bank of India, explain how that system now faces a ‘crisis’:

"Global spillovers did not manifest themselves until October of last year. But they have been playing out vividly since the Fed started shrinking its balance sheet. This is because the Fed has not adjusted to, or even explicitly recognised, the previously unexpected rise in US government debt issuance. It must now do so.

It can simply recalibrate its normalisation plan, adjusting for the impact of the deficit. A rough rule of thumb would be to reduce the pace of its balance-sheet contraction by enough to damp significantly, if not fully offset, the shortage of dollar liquidity caused by higher US government borrowing.

If it does not, Treasuries will absorb such a large share of dollar liquidity that a crisis in the rest of the dollar bond markets is inevitable."

Mr Patel has just written an open letter to Jay Powell telling him that his analysis of the Fed’s role in the global monetary system, delivered in Zurich in May and analysed in the last Fortnightly, is wrong and is leading to an ‘crisis’ that is ‘inevitable’. For those investors sticking to investing based purely on business cycle considerations, this is a wake up call. This open letter from Mr Patel shows clearly how the Fed’s relationship with those who have chosen to link their exchange rates to the USD has now changed. It is a change that augurs a very strong USD and, after Patel’s ‘crisis’, the need for a new global monetary system.

History does not remember well those investors who ignored such structural changes.

Those who stuck to business cycle investing in the late 1960s and ignored the risks of the collapse of the global monetary system paid a very high price with the breakdown of the Bretton Woods system in August 1971. These respective missives from Powell and Patel make it clear that the current system, in which numerous emerging markets link to the USD as the key to their monetary policy, is now ending. If you don’t think that has profound consequences, then imagine what happens to your portfolio if the USD continues to rise, and the biggest of all emerging markets, China, devalues. Following that, with the imposition of capital controls, would leave those investors chasing the business cycle looking, at best, naïve.

Having considered the market consequences of such a breakdown, let us consider where we are in the process of breakdown. Well, to steal a phrase from a chain-gang movie released in the dying days of the Bretton Woods system, ‘what we have here is failure to communicate’ (Cool Hand Luke - 1967). There are many ways in which the Reserve Bank Governor of India can communicate with the Chairman of the US Federal Reserve. Without knowing for sure, one expects that e-mail is one possible avenue and a phone call is also likely to be accepted. More formally, there are the bi-monthly meetings of central banks at the BIS in Basle. However, on this occasion the Governor of the RBI thought it appropriate to communicate through an open letter in the Financial Times.

This in itself should make investors take notice. It indicates that the private communications of the RBI view fell on deaf ears within the Federal Reserve. Perhaps, more importantly, it indicates the RBI Governor considers this to be a very serious matter indeed, or why else would he alert the world to an impending ‘crisis’.

The Fed never asked for other central bankers to link their monetary policy to the US through managing their currencies relative to the USD. There was little the Fed could do to stop it after President Clinton’s attempt to establish an agreed new global financial architecture, in the shadow of the Asian economic crisis, had come to nothing. However, link to the USD they did and, given just how competitive exchange rates had become after the 1997 crisis, they enjoyed a long ride of current account surpluses, easy money and growth. This long ride was then extended by the Fed’s exceptional monetary policy post-GFC that further boosted external surpluses through massive capital inflows, leading to more easy money.

Twice in recent years, once in the taper tantrum and then again with the alleged ‘Shanghai Accord’, the Fed did flinch from removing the easy money that had powered the huge capital flow and easy money boom for EMs. However, this Fed Chairman has a different opinion and likely a long memory. He probably remembers that it was the quiescence of Benjamin Strong to low US rates, to help the Governor of the Bank of England keep sterling on the gold standard, that led to a spectacular credit-fuelled asset boom and bust in the US in the 1920s. Similar quiescence by Bernanke and then Yellen to help EM central bankers with their monetary policy may have already pushed the US credit cycle into dangerous territory. Each time the Fed flinches from attacking the current credit bubble, in reaction to credit problems in emerging markets, they simply permit their domestic credit bubble to get bigger and bigger. If Ben Bernanke was the central banker who learned the lessons of the great depression, then Jay Powell is the central banker who has learned the lessons of how we got to 1929.

In July 1927, in the home of Ogden Mills on the North Shore of Long Island, a fateful meeting took place between Norman Strong, Governor of the Federal Reserve System of New York, and the key European central bankers.

‘Strong, though increasingly sympathetic to the French point of view - much to Norman’s discomfort - had arrived at the conference with his mind
already made up. The only way to reduce selling pressure on the pound in the short run would be to cut U.S. interest rates. It helped that the domestic indicators he relied upon - price trends and economic activity - also justified a cut. And though he recognized that the stock market was a big stumbling block - he ruefully predicted to Charles Rist as the meeting got under way that a cut would give the market "un petit coup de whisky" - it was a risk he was willing to take.\(^2\)

It was not just with the benefit of hindsight that Strong's actions in adjusting US monetary policy to benefit the United Kingdom were seen as a mistake. Herbert Hoover, Secretary of Commerce in 1927, was not pleased with the decision and sent a memo to the Chairman of the Federal Reserve:

> The safety of continued prosperity will depend on caution and resistance to expansion of credit which will further stimulate speculation... Our banking system can check the dangers of speculative credits... The real test will be whether we can hold this prosperity without an era of speculation and extravagance with its inevitable debacle... Unless our financial policies are guided with courage and wisdom this speculation can only lead us to the shores of depression... Not since 1920 have we required... a more capable administration of credit facilities than now... inflation of credit is not the answer to the European difficulties. They are far deeper than that.\(^3\)

July 1927 to October 1929 was a wonderful 38 months of further expansion and stock market excess. And then it wasn’t.

It has now been 27 months since the Fed last flinched in its attempt to constrain credit and instead focused on stabilizing EM currencies, particularly the Rmb, in the so-called Shanghai Accord in February 2016. Jay Powell has explained in very clear terms why it is time to stop flinching; the ghost of Benjamin Strong is watching.

\(^2\) The Lords of Finance: 1929, The Great Depression, And The Bankers Who Broke The World (Liaquat Ahamed)
\(^3\) Quoted in The Memoirs of Herbert Hoover: The Great Depression, 1929-1941
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