The Solid Ground

Established 1995

The Solid Ground Newsletter Going Forward

We live in an age of change and 2021 will see a major change for *The Solid Ground* Newsletter as it becomes available by subscription only. Subscriptions for institutions will continue to be available through *www.eri-c.com.* Individual subscriptions can be arranged from 1st February at www.russellnapier.co.uk, where payment can be by credit card or bank transfer.

In 2015, after twenty years of writing research for professional investors, I decided to launch a regular newsletter and provide it free of charge to all ERIC subscribers. This decision was made to bolster ERIC registrations and build a platform for the sale of the high-quality investment research which I considered then, and still do, to be essential for a thriving financial services industry. ERIC now has hundreds of providers, each with descriptions, research examples and service overviews for subscribers to check out and this is increasingly augmented by newsletter and video content. ERIC now also has many thousands of registered users and buy side users increased 35% year-on-year in 2020. ERIC users represent 75% of the assets under management of the world's top four hundred asset managers. The company also has a large and growing team of very experienced sales associates keen to help all its subscribers find the research that they need for the challenges ahead.

At ERIC we look forward to continuing to provide access to the high quality and independent research that I believe will be even more important in the age of repression that lies before us. The conscription of the financial services industry in inflating away the world's record high debt levels has begun. Under the guise of macro prudential regulation this will accelerate and the need for independent non-conflicted opinion will only become ever more important. At ERIC we will continue to make such research available for our subscribers. There is much work still to do at ERIC, but after almost six years the need for the free provision of *The Solid Ground* Newsletter, as part of the free ERIC subscription, has run its natural course.

It has always been difficult to find a balance between the provision of free research and the paid-subscription service. Increasingly, getting this balance correct has restricted what I have been able to cover in the Newsletter. With markets moving particularly quickly it was necessary to produce additional Newsletters in 2020, and these had to be provided to subscribers only given the nature of the content. With the Newsletter now moving to a subscription-only basis, it will be easier to strike the balance between the content of the Newsletter and the full-service package of quarterly reports, conference calls and face-to-face meetings.

Going forward I will still be providing video clips free of charge on ERIC, but the Newsletter will only be available on subscription from 1st February onwards. There will be no change in any way for existing subscribers. Free access to the Newsletter will come to an end at the end of January. There will then be an additional new package for access to the Newsletter only for institutions at an annual subscription price of £5,000. The full package that includes the in-depth quarterly report, conference calls and email follow ups, including the Newsletters, will continue to be available to institutions at £15,000 per annum. For further details on any package please email- tsgnewsletter@eri-c.com

So far *The Solid Ground* research has not been available for individuals but that will now change. ERI-C is now taking instructions to arrange an **Individual Private subscription to The Solid Ground Newsletter** to start from 1st February, where each edition will be sent to personal email addresses.

Both new *The Solid Ground* Newsletter subscription priced items are up on ERI-C. To be sent details, register your interest or arrange a subscription to either of the Institutional or Individual Private subscription directly, please either contact your ERI-C representative or email tsgnewsletter@eri-c.com .

We enter a new era for both *The Solid Ground* and for ERIC in 2021. It is an era of huge challenges for both. *The Solid Ground* will seek to continue to draw on an understanding of financial history, credit creation, money creation and crucially an understanding of the tools of repression with the aim of guiding subscribers on asset allocation. ERIC will continue to provide access to the independent voices of our hundreds of providers that are increasingly essential in our world turned upside down.

Russell Napier, January 2021

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The Death of Commercial Banking: Controlling Money Supply Without Raising Interest Rates or Shrinking the Central Bank Balance Sheet (27/01/2021)

> *It ain't what you don't know that gets you into trouble. It's what you know for sure, that just ain't so.*
>
> Mark Twain
>
> *Whatever gets you through the night*
> *It's alright, it's alright*
> *It's your money or your life*
> *It's alright, it's alright*
>
> John Lennon, Whatever Gets You Thru The Night

You think you know that monetary policy is controlled by a central bank adjusting interest rates and/or the size of its bank balance sheets. You are wrong. The consequences of being wrong on this will be the greatest cause of wealth erosion in the modern age. Investing in what we used to know as 'commercial' banking is particularly dangerous. Clinging to the belief in the *ancien regime* may of course get you through the night. It's your money or your life.

History will show that in 2020 we returned to a policy of monetary control based on the quantitative control of credit starting with bank credit. With that quantitative control of credit comes the political necessity of the qualitative control of credit. Any good in limited supply, not allocated by price, is effectively rationed and there are always those that the state needs to be at, or near, the front of a ration queue, whether for credit or anything else. The quantitative and qualitative control of credit means that there is no such thing as 'commercial' banking, just policy banking through the control of formerly commercial institutions managed by the authorities.

By controlling the supply of bank credit via quantitative targets the authorities directly control the supply of money without recourse to interest rates or the adjustment of reserve balances through changes in their balance sheets. Yes, you can indeed control money supply without ever raising interest rates if you are prepared to directly control the rate of bank credit growth. Just such control, without the nuisance of rising interest rates, is now an imperative for governments in an age of record high debt-to-GDP. In this world interest rates lose both their importance as a signal and also their ability to materially influence resource allocation. That's not exactly what you learn in economic text books or perhaps put into your model of how the world of finance works.

In this new form of banking, formerly known as commercial banking, the quantity and composition of credit is controlled by *diktat* and not by interest rates. This comes at a time when long-term interest rates are capped, the yield curve does not materially steepen and thus banks' net interest margins do not materially expand. At the same time, the authorities determine the level of deposit rates through setting short-term interests. Call it what you like, but this analyst will not call it 'commercial' anything when the cost of funds, the interest paid on loans, the quantity of loans and the composition of loans are determined by the state. What valuation an investor might put on what used to be called the 'equity' of such an institution is uncertain, but the Chinese example suggests a deep discount to book value is appropriate.

Everything has its price, but the correct price of the equity of institutions whose key role is to steer credit to where it is required by the state should be at a significant discount to net assets. Your analyst is very convinced that this transformation of commercial banking is essential for any successful financial repression: to reduce our current record high debt-to-GDP ratios something that is engineered through the creation of high levels of broad money growth. What investors also need to consider is what a move to such a form of banking means for the future of capital markets. Can they be left to be commercial allocators of credit if the banking system is forced to provide credit at uncommercial rates?

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The future role of the capital markets in a repression is difficult to quantify because our last peacetime repression started from a very different place. Financial repression was already being implemented in the UK as Nazi tanks rolled into Poland in September 1939. From September 1939 the financial markets, where private sector lender met private sector borrower, were replaced with a system that financed total war. When the war ended there was little left in the way of capital market activity financing private sector ventures. Most private sector savings were financing the government and the government chose which producers to back to win the war. The eradication of the use of savings to fund the private sector made the post-war continued repression, in pursuit of lowering government debt-to-GDP levels, relatively easy.

As the commercial banks were the main conduit of credit, and as the savings institutions were already full to the gunwales with government debt, there were very few 'free' pools of capital at large. Even so, as private savings accumulated post WWII they, not surprisingly, set off in search of returns outside the repressionary system which, of course, given that capital controls were still in place, meant financing the UK private sector economy but on more commercial terms. The government set off in the pursuit of what would have been called at the time, the spivs, by seeking to corral their money into the government controlled financial system. Today we start with a huge pool of free capital despite the fact that is has already been somewhat forced, through the guise of regulation, to hold more government debt than it would choose. Controlling 'free' capital on this scale is a new challenge for a peacetime government

It is not today a matter, as it was in 1945, of controlling that rare fish of free capital seeking to escape to more productive waters. Today the repression begins with a need to control shoals of capital that course through the currents of global finance. The politically and morally difficult task of controlling these shoals was easily done in 1939, in response to a peril that threatened a Fascist tyranny across Europe. Despite the tragedy of the global pandemic, no similarly large peril now faces any country; yet the need to create a repression and inflate away debts is just as high as it was by 1945.

The total debt-to-GDP ratios (measuring government debt, household debt and non-financial corporate debt) of the developed world are, in aggregate, higher than they were in 1945. There is thus a larger problem than faced the authorities in 1945 as, at this stage, capital continues to swim freely to where it would like to invest and not where the governments need it to invest. The scale of capital markets creates a daunting task for authorities seeking to control money supply, by controlling bank credit, and to prevent a boom in credit in the non-bank sector which would likely be triggered by permanently negative real interest rates.

Purveying the seas before them, in pursuit of their catch, the central bankers will most probably turn to the financial regulator who will likely turn to finance ministry officials, each remarking to the other, 'You're gonna need a bigger boat'. When it comes to government never ever underestimate the ability to build 'a bigger boat'. The construction of that colossal craft means the death of commercial banking. Let Eric Monnet explain, in his truly excellent book *Controlling Credit: Central Banking and the Planned Economy in Postwar France, 1948-1973:*

> *Moreover the goals of a policy of intervening in credit allocation were multiple, and use of the term were, consequently, numerous and often vague and multivocal: it could be pursued for purposes of monetary policy (attempting to limit the credit level through better allocation), industrial or social policy (helping key economic sectors), budgetary policy (giving priority to government financing), trade policy (favouring credit for exporting sectors), capital controls (favouring domestic loans), financial stability (preventing an excess of credit that is potentially disconnected from real activity in particular sectors) and so on.*

Can you think of any governments that would like to control the supply of money, the allocation of credit, provide ample government finance, finance exports, restrict the outflow of capital and promote financial stability? What's not to like? If you think this combination might appeal to governments, then a return to the quantitative control of credit is the answer to all of their dreams and the subject of all of your nightmares.

The Solid Ground believes that the move of government debt-to-GDP ratios to new record highs means that a shift to such a system is not just a choice for governments but more of a necessity - as it was from 1945. Driving this necessity is the need to create enough money to push nominal GDP higher and debt-to-GDP levels lower. This can be done while the banks play an increasing role in financing the government. In France from 1948 commercial banks were forced to assign 20% of the increase in their loan books to the provision of credit

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to the government. When the financing of the government became strained, a new law was passed that mandated that at least 25% of all bank assets had to henceforth be composed of government debt.

The central bank always provided liquidity to commercial banks at rates below market rates, thus controlling the supply of credit to the banks and discouraging the use of the money markets. Throughout this period there were regular restrictions on consumer credit as the need of the government and the need to meet industrial policy goals were so great in an age of constrained credit. With credit rationed some forms of credit were effectively declared outlawed in the pursuit of meeting the quantitative targets. Once imposed, quantitative targets must lead to qualitative targets, and those targets are set by politicians and bureaucrats. To be clear, the most likely credit to be outlawed is the form that seeks to gear up existing earning streams rather than to build new earning streams. Those sectors most likely to be credit constrained in our new era are private equity, commercial property and the use of debt for the re-purchase of shares. These sectors will probably face a prolonged re-equitisation.

None of this new monetary policy need entail raising interest rates, which will surprise those educated in economics and not political economy. As Monnet explains, the *Banque de France* sought to control the supply of money and inflation by controlling bank credit:

> *It was directly controlling the bank credit supply, as well as bank liquidity, that the bank believed it could act on the money supply and prices….. But it now believed that the priority given to credit in the postwar reconstruction required it to directly control its supply, rather than regulating demand through interest rates.*
>
> *Controlling Credit: Central Banking and the Planned Economy in Postwar France, 1948-1973*

It was, of course, a belief that money and inflation could be controlled without the use of interest rates that played such a major role in the outbreak of high inflation in the 1970s. Controlling the supply of bank credit is easily said but not easily done when an elected official has any number of interest groups at the door seeking cheap credit and offering in return political favour and electorate pleasing benefits. That bank credit and money are difficult for politicians to control is a lesson for another day. Today expediency rules.

The crucial difference between today and 1945 is that so much credit is created and exists outside the banking system. If the authorities are to control the supply of money by controlling commercial bank credit, and not interest rates, they will need very effective restrictions on the creation of non-bank credit. With every incentive for the private sector to take advantage of negative real interest rates, debt levels could soar if the non-bank system was not in some way constrained in credit creation. Without such administrative controls on non-bank credit, repression would fail as debt-to-GDP ratios would rise.

As the key creator and owner of such non-bank credit is the investment management community, their capture must follow on from the capture of the banking system. Regular readers will know that your author expects the Working Group announced by the Bank of England, Her Majesty's Treasury and the Financial Conduct Authority to morph into a committee that both limits and steers the flow of non-bank credit. This Working Group explicitly targets qualitative control of credit, the 'productive' at the expense of the non-productive but history will show that such control comes in the context of quantitative control.

How many macroeconomic models are valid in a world where interest rates cease to be the tool to control bank credit growth, money supply growth or inflation? With government guarantees backing bank credit growth we have already entered a world where credit is being created and steered, in the worst recession since at least the 1930s, to where government wants it to be. *The Solid Ground* believes that this is the new normal and that in time we will thus have the same problem in distinguishing public credit from private capital, as analysts did in the post WWII period.

> *It became difficult to separate public credit from private credit, in the sense that it is difficult for a bank, even a private one, to do without the credit guarantees or facilities provided by specialized institutions or the Banque de France. If one includes the nationalized banks, it would appear that 90% of the credits granted during the 1950s were – in various forms – under the state's tutelage.*
>
> *Controlling Credit: Central Banking and the Planned Economy in Postwar France, 1948-1973*

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Maybe we can return quickly to a world where commercial credit is allocated without government guarantee. Then, of course, maybe instead the governments simply realise how powerful these guarantees are not just to create credit and money, but to push credit to support the projects likely to meet their political goals. *The Solid Ground* believes in the latter outcome and thus that we have already crossed the Rubicon and entered a world of quantitative, thus qualitative, credit control.

Of the many fascinating things one learns in Monnet's book, the most important for investors is the role ending credit controls played in the birth of the euro. It appears that controls ended independently of the drive to create a single currency, as they were ending across the developed world in the 1980s, with debt-to-GDP levels by then having been reduced to manageable levels. However Monnet speculates, as your analyst has often done, how a single currency project could be created or exist in a world of quantitative credit control. With nineteen separate nations seeking to control their banks to produce the credit they need, thus creating euros, how can there be any monetary discipline? The politics of having just one currency, subject to varying degrees of money creation by each government, would almost certainly have prevented the formation of a single currency. Now that we have returned to the quantitative control of credit, can the single currency survive the return to a system that would almost certainly have prevented it ever being created?

It is often glibly said that we live in an era when debts must be inflated away. That is true, but the implications are far from glib. Inflating away those debts involves changing the tools of monetary control from interest rates to credit controls. Interest rates become less of a gauge of any fundamental factor, whether the supply and demand for savings or inflationary expectations. This is a world turned upside down where most models, utilising even forty years of historic data, will tell you the wrong things at the wrong time. It is a world turned upside down as it was post 1945, particularly if you are a saver. The final word goes to Evelyn Waugh, speaking in 1960, on the moral consequences of seeking to preserve and grow savings in an era of repression:

John Freeman: *You made something of a fortune before the war, before it was all taxed away.*

Evelyn Waugh: *Never saved a penny and, of course, no honest man has been able to save any money in the past twenty years.*

BBC Face to Face programme, 26th June 1960

In Liverpool just a few months before, John Lennon and some friends - Paul, George and Pete - had become The Beatles. The then Prime Minister had proclaimed that "most of our people have never had it so good". Evelyn Waugh bore the heavy burden of a saver, but for those unburdened by savings and enfranchised with debt - the party had more than another decade to run. By 1976 the country was seeking an emergency loan from the IMF. Whatever gets you through the night.

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