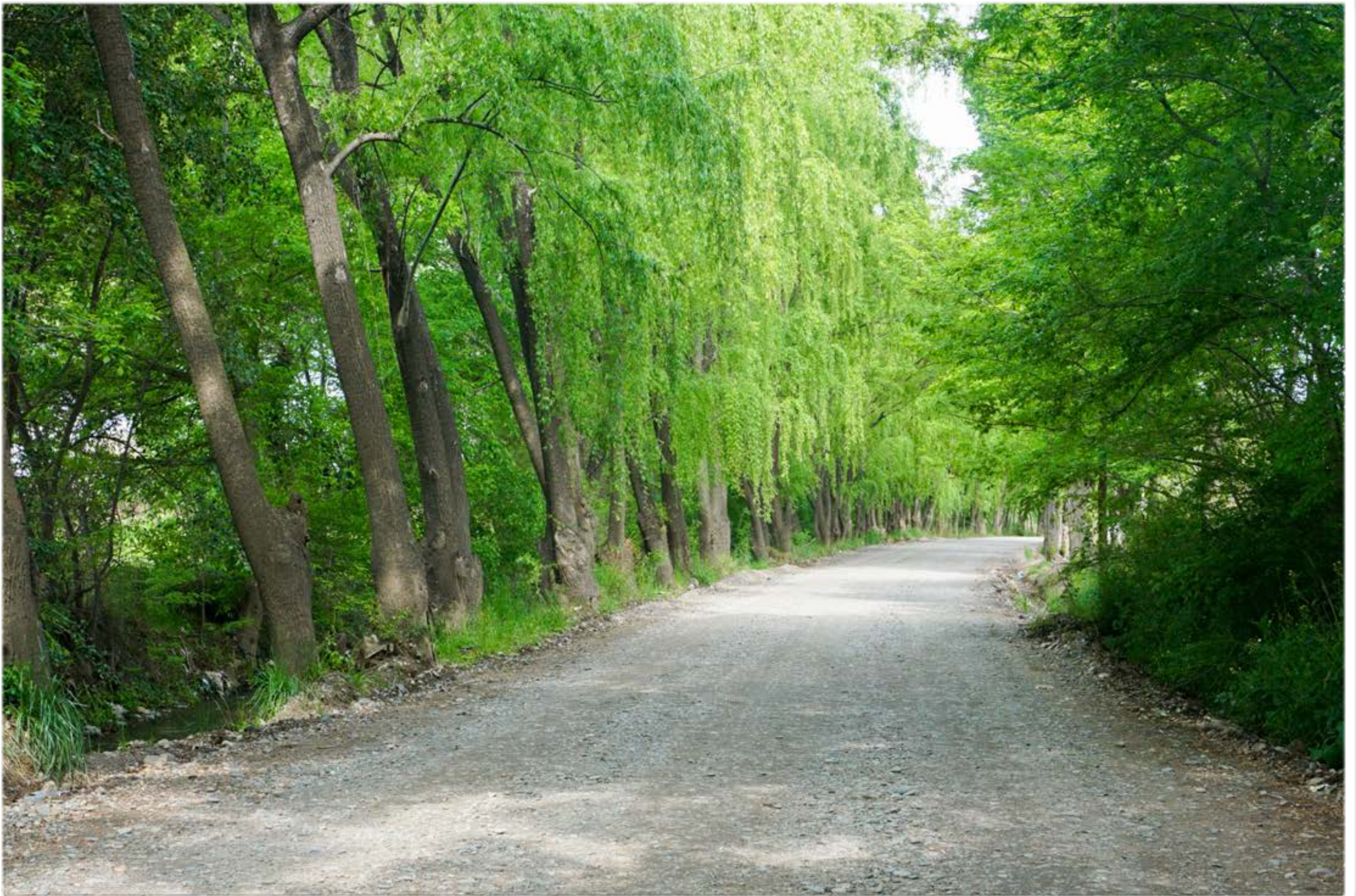
WHAT CAN WE DO?



By Urs Bruegger

> *"In the middle of difficulties lies opportunity." Albert Einstein*

Another financial crisis is unfolding before our eyes.

When we face such difficulties, there is also the chance to find a way to fix what the world has been ailing from since 1995, recurring financial crises that have led to low growth.

The world has moved through the Asian flu crisis of 1997, the 2000 stock market crash, the 2008 financial crisis and the 2011 eurozone sovereign debt crisis without solving the cause in the first place.

Have you ever wondered why in 1995 the behaviour of financial markets and economies changed so much?

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The S&P 500 Index roared into life in 1995 on soaring volumes.

The 1995 magic wand balance sheet tool

JP Morgan launched their RiskMetrics Valuation at Risk (VaR) model to the marketplace. RiskMetrics was a banker's dream come true. RiskMetrics was a magic wand balance sheet engineering tool. It turned 100million into hundreds of billions of dollars, at the wave of the wand.

US banks' leverage ratios exploded, balance sheets swelled. With interest rate ceilings on deposits, otherwise known as Regulation Q already phased out, banks in the US revolutionised and americanised the previously quiet eurodollar market by creating vast amounts of credit-based money in their balance sheets.

What 1995 means

Before 1995, the dollar was global money, M3. Real US growth rates averaged 3.5% 1950 to 1995 through the Energy Crisis and Great Inflation of the 1970s when the Fed miscalculated the costs of the Vietnam war and created too much money. Money behaved over time as it should: 5% money supply = 3.5% growth + 1.5% inflation. 15% money = 3.5% growth + 11.5% inflation.

With 1995, the dollar became M2 and the money created in bank balance sheets M3. Money started to behave odd, like: 10% increase in M3 = 2.5% GDP + 2% inflation plus real estate & stock market boom & crashes.

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New global money of a very different quality

It is produced from collateral, inherently unstable and prone to crisis. Its supply depends on bank balance sheet capacity, what is acceptable collateral and counterparty risk in the repo markets. Because it is all short term money that needs to be rolled over all the time, it can vanish into thin air in an instant.

From a bad start to the global dollar short

The Bretton Woods system of 1944 on the dollar, convertible into gold, with fixed exchange rates, was never sustainable. The growing public debt incurred by the Vietnam war forced the US to abandon first gold convertibility and then in 1973 the fixed exchange rate system. Released of such restrictions, the Fed too rapidly expanded money supply, ending in the Great Inflation. Abandoning the gold standard readied the monetary system for the switch from actual money to credit-based money as the global reserve.

> *"Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output"*
> *Milton Friedman*

The 1970s and 1980s behaviour of inflation was textbook monetary theory. Money worked. An increase in money supply caused inflation. The law of supply and demand applied. Too many dollars, the price falls, remove dollars from the economy, the dollar rises.

US dollar index graph: The rapid increase in money caused the dollar to fall after 1973. In 1979, the incoming Fed chairman, Mr Volcker, immediately embarked on monetary tightening. The ensuing rise of the dollar could only be reversed in the internationally concerted action, agreed upon by the G-5 nations at the New York Plaza Hotel in 1985. A consequence of the Plaza Accord was the sharply gaining yen. Japan's monetary and fiscal overreaction led to the 1986-1991 Japanese asset price bubble.

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From 1995 to 2011, with ample M3 supply, the direction of the dollar was determined by who produced collateral-based money, how much, and where it went. The eurozone sovereign debt crisis of 2011 was a watershed moment. Many non-US banks exited the collateral market place. US treasuries became the only eligible collateral in repo markets. Since 2011, the ratio dollar supply to eurodollar supply has been setting the course of the dollar. The ratio rises and falls with its denominator, eurodollar supply. The denominator decreases, the dollar gains. Vice versa, hopes of an economic recovery in 2017, only to be dashed a year later, caused eurodollar supply to increase and the dollar to weaken that year. In times of acute dollar shortage, 2014 and 2020, the US currency gains sharply.

Dollar index graph: In 1995-2000 US banks dominated credit-based money. The banks bought US assets priced in dollars with their eurodollars. The dollar rose. In 2002, non-US banks in Europe and Japan became the largest supplier of global money. 2002-2008, the Europeans bought PIIGS (Portugal, Ireland, Italy, Greece, Spain) assets in euros, London real estates in pound sterling and a lot of emerging market assets in local currency. The Japanese pumped credit-based money into China. The dollar fell. In the 2008-2011 recovery period, some non-US banks went back into collateral money, others stood on the sideline. The dollar stagnated. After the 2011 eurozone debt crisis, PIIGS securities were no longer eligible collateral, leaving only US treasuries in the system.

How bad is it this time?

The 2020 collateral money crisis may turn out as bad or worse than 2008. Credit-based money has vanished into thin air as collateral is being withdrawn. This leaves the dollar, once global money, now national money in a currency with a global responsibility, to make up the shortfall.

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What can we do?

The immediate task at hand is to reverse the direction of the dollar. A rising dollar will do irreparable damage to a word indebted in the US currency. The second job is to replace the current system with a better one.

The steps to take are clear:

1. The US re-establishes the US dollar as the global reserve;
2. The Fed regains control over money it lost in 1995;
3. The Fed increases dollar supply substantially above demand. This will cause inflation to rise and the dollar to fall. 3%, 4% inflation is good, it means there is adequate supply.
4. Allow the world to recover while nations, under the leadership of the US, get together and work out a lasting solution.
5. Arrange a second Bretton Woods conference. Replace the dollar as the global reserve.

There is no alternative.

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