



Oil, Money & Gold: How a Rising Oil Price Can Trigger Deflation and a Monetary Revolution (09/01/20)

'Oil does not make very good money. It does not sit neatly in bank vaults. You cannot trade a quarter of it for a tuna sandwich, or a barrel for a pair of shoes. On a very large scale you might be able to trade it for a million pairs of shoes, but the trade would be cumbersome. Gold became money because it was so indestructible and finite; the destiny of oil is to burn. Ironically monetizing the oil helped to produce the age of paper money, and the destiny of paper money is also to burn, except that paper money is really a misnomer, because the money is really blips in a computer, and blips do not burn. Not literally.'

Paper Money, Adam Smith (aka George Goodman), Summit Books 1981

The subject of this week's *The Solid Ground* is the price of oil, the ensuing wealth transfer when it rises, and whether the indirect deflationary impacts from this transfer offset its direct inflationary consequences. However, before we get on to who gets the money, who loses the money and what the consequences are, there follows a brief advertisement for the 5th Annual Global Independent Research Conference in London on February 3rd.

Conference organizer Research for Investors is now owned and run by ERIC as part of our role to bring high quality independent research to the investment management profession. This conference corrals a wide range of independent analysts, both micro and macro, all under the same roof for informed and hopefully contentious debate. If you are interested in attending to gain a wider view of what is available from the independent research sector and to listen to some informed debate, you can learn more at the following link – <http://www.researchforinvestors.com>. If you are looking for something beyond the oligopoly of opinion offered by the 'usual suspects', then perhaps it's time to take one day to see what independent opinion is available. I look forward to seeing you there.

In another diversion before we get down to the analysis, you might be entertained by this recent broadcast from BBC Radio 4 in which your author discusses some important financial mistakes that include sheep's dentures and the sovereign debt issue of a fictional country - <https://www.bbc.co.uk/sounds/play/m000cys7>.

A rise in the oil price transfers wealth from billions of consumers primarily to a small band of savers. Those are the savers who own oil production facilities and also the savers who own the companies that service those producers. Of course some consumers also benefit, and while these used to be roustabouts and truck drivers and other divers friends of Jack (Daniels, that is) they now include a band of Playstation veterans who manipulate shale drilling rigs from air-conditioned cabins. These consumers know how to enjoy their bounty, when it comes, but despite their healthy appetites this is 'small beer' in consumption terms when compared to the wealth transfer away from billions of other consumers.

The impact of such a transfer from consumers to the savers producing oil is more deflationary than inflationary, to the extent that those who benefit from this particular wealth transfer, being already somewhat wealthy and somewhat satiated, have a higher propensity to save than the average citizen. Most famously this wealth transfer led to the petrodollar boom of the 1970s and major declines in developed world GDP growth. This is how a rising oil price turns consumption into savings.

'Before I reached my twenty-sixth birthday, after less than two years in the bank, I had been to twenty-five countries and was one of the four bankers managing \$150- million international loan portfolio. It was an unusual life for a twenty-five year old. I travelled overseas three to four months a year. In Hong Kong, I was met at the airport by a chocolate brown Rolls Royce, in the Philippines by a red Jaguar, in Saudi Arabia by a stretch Mercedes. I stayed at Claridges when in London, at the Oriental in Bangkok, and at the



Meridien in Jeddah.I catalogue these items specifically to impress the reader, because this sort of corporate largesse is truly unusual, even in the world of international business. Yet in the late 1970s it was very much the prerequisite of the young American banker, who was to be found in great numbers roaming the streets of Third World cities such as Kuala Lumpur, Rio de Janeiro and Seoul, briefcase in hand, looking for deals to finance. He did not have to look far. Since OPEC raised the price of oil, both the public and private sectors in the Third World had been in a borrowing mood. In those years total loans outstanding to the non-OPEC Third World more than tripled - from \$94 billion to \$294 billion.

Selling Money: A Young Banker's First-Hand Account of the Rise and Extraordinary Fall of the Great International Lending Boom, S.C. Gwynne, Wiedenfield & Nicolson, 1986

The young S.C. Gwynne, who went on to a career in journalism, and whose book on the Comanches was a finalist for the Pulitzer Prize in 2010, was downstream from the gusher turning oil revenues into investments. At the other end of that gusher was a young David Mulford, a future Under-Secretary for International Affairs at the Treasury and US Ambassador to India, who arrived to work at the Saudi Arabian Monetary Authority (SAMA) in 1975:

SAMA needed help to diversify away from the banks, he explained. They needed the help of 'real investment bankers' who would commit to stay five years and be sworn to secrecy. These investment bankers would help negotiate direct-country loans, then corporate loans to the safest and strongest companies in the world: and finally, they would create some form of equity portfolios that would give SAMA exposure to the West - all without upsetting Western markets and inviting scrutiny possibly retaliation.....

These large books, and more like them, were lined up on two shelves. Each book represented one of SAMA's eighteen deposit banks. Every deposit entry was a thing of beauty, but they were unreadable by me or Leonard... My eyes were drawn to the bottom of the column which was in Arabic numbers. The total at the bottom read something like \$20,160. As an investment banker I automatically added three zeros. "Over 20 million dollars," I observed. "No," they corrected me, "here you have to add six zeros."

Packing For India: A Life of Action in Global Finance and Diplomacy, David Mulford, Potomac Books, 2014

The savings of Saudi Arabia and other oil producers were recycled into investment opportunities and of course investment bankers found the projects for those savings to fund. The negative impacts on real economic activity in the developed world, caused by that wealth transfer from consumers to savers, are well documented. However this slowdown in real growth was accompanied by rising, not falling inflation, as the higher price of oil as an input price led to higher prices for many items in the CPI basket. The net effect was the creation of a new phenomenon called Stagflation - a phenomenon so new to economic experience that the word had only been invented by British politician Iain McLeod in 1965. So if the increased tension we see in the Middle East augurs a persistently higher oil price, does it augur a world of lower real growth but accompanied by higher inflation? If that's the outlook, then it's time to sell government debt and buy even more gold.

The Solid Ground does not believe that a higher oil price will lead to a combination of lower real growth and higher inflation - just lower real growth. The actions of OPEC in the 1970s sent the price of West Texas Intermediate (WTI) from a low near US\$20 in 1970 to a high of just above US\$120 before the end of the decade. A similar rise in the price of WTI from its starting price in 2020 would see the oil price rise to US\$360 per barrel! Given that magnitude of rise, perhaps we should expect US inflation to reach the low double-digit level it reached in the late 1970s. Each investor will have their own opinions on whether a price rise of this magnitude is likely, given the growing structural shift away from oil as a source of energy. In the opinion of your analyst a rise in the oil price of the scale witnessed in the 1970s remains highly unlikely, thus a similar large direct impact on inflation is unlikely.



Investors, worried about the inflationary impact of a rising oil price, should also remember how the surge in the WTI price from US\$60 per barrel to US\$145 per barrel, from 2007 to 2008, was accompanied by rapidly slowing economic activity and only a moderate increase in inflation; to be rapidly followed in mid-2008 by an oil price collapse, an economic collapse and deflation. The rise in the oil price then turned out to be short-lived, but also importantly that oil price rise from 2007 to 2008 occurred against a background of moderate growth in broad money, particularly compared to the money growth bonanza of the 1970s. Against such a monetary background the 141% rise in the oil price had little impact on inflation. Indeed *The Solid Ground* believes that an oil price surge now, given the still anaemic growth in global broad money, would likely be more deflationary than inflationary for the world economy.

OECD total broad money growth numbers are not available for the 1970s but growth was 14% as the 1980s began and rose to just over 19% by 1987. The contrast with today's environment is marked. As at 3Q 2019, OECD total broad money growth was just 4.8% - the fifth lowest quarter of year-on-year growth ever recorded. In the 1970s the rise in the oil price and the ensuing rise in wages was accompanied by a monetary policy that kept interest rates far too low and allowed money growth to reach levels never previously recorded in peacetime. Monetary policy accommodated the inflation, caused directly by the rise in the oil price, because most central bankers and politicians simply could not live with the consequences for real economic growth by not accommodating that inflation.

Perhaps today a permanently higher oil price would also result in such accommodation but at this stage, with world broad money growth near record lows, the initial impact would be a major decline in real economic growth likely to more than offset the direct inflationary consequences from a rise in the oil price. With the world debt-to-GDP ratio just below a record high and well above December 2007 levels, the impact of a major wealth transfer from consumers to oil producers could trigger a deflationary debt crisis - a thing, as we have recently witnessed, that is much more virulently deflationary than the initial decline in consumption.

Your analyst thus believes that the net impact of a much higher oil price, even one that endures for many quarters, is more likely to be deflationary than inflationary. This view would change if there was a sudden rise in OECD total broad money growth to perhaps double the current level. Those who worry about such a sudden move and its inflationary consequences are thus focused on the rise in US broad money growth from 4% in March 2019 to 7.4% in November 2019.

As commercial banks are the engines of money creation, we can assess the outlook for broad money growth by watching trends in bank credit. In the US in the first half of 2019 there was an acceleration in the growth in bank credit, primarily driven by a move from banks to buy Treasury securities. By August 2019 year-on-year growth in bank credit had reached 8%, spurred by a 20% growth in bank holdings of Treasury securities combined with a 5.6% year-on-year growth in 'loans and leases in bank credit'. Since that peak in August the growth in US commercial bank credit has slowed to an annual rate of just 3.2% in the fourth quarter of last year. If that quarter represents the new trend in US commercial bank credit growth, then broad money growth will trend back towards 4% - the very low end of its historical range.

It is possible that the rise in the oil price combined with the current level of broad money growth could provide the kindling for much higher inflation in the US, but it is not probable, particularly if recent trends in bank credit growth continue. Elsewhere in the world there is nothing in the trends in broad money that would suggest that monetary policy is accommodating a higher inflation caused directly by a rise in the price of oil. Until there is a marked and prolonged change in the growth of broad money, the rise in the oil price is thus more likely to be disinflationary due to impacts in reallocating wealth from billions of consumers to mainly just a few select savers. It has been noticeable in the few trading days of 2020 that the price of long-dated Treasury securities has tended to rise when the oil price has risen and fallen when the oil price has fallen. It's a synchronization attributed to 'risk on' and 'risk off' moves but also coincides with a view that higher oil prices, given the current monetary environment, can act in the aggregate to push inflation lower rather than higher.



Should the rise in the oil price continue, it will likely trigger a scale of wealth transfer and ensuing deflation that must trigger a major monetary revolution. The intellectual groundwork for that revolution has been sown in the minds of the proponents of Modern Monetary Theory (MMT) in the same way that Communism was first sown in the minds of Marx and Engels in 1848. From paper to proof to implementation requires not a revolution but simply an event that makes it clear that burning money, in the pursuit of debt relief, is not just intellectually but morally sound.

A continued surge in the oil price could be that event, and subscribers will know of the others that now threaten the orthodoxy that savers should be rewarded, not punished, for taking risks. The new orthodoxy, originally sown long ago in the mind of Keynes, is ready again for harvest. It will be time for the euthanasia of the rentier, formerly known as the saver, through the burning of money. *The Solid Ground* continues to foresee that the event that brings this new orthodoxy will be a deflationary bust, and investors need first to prepare for that bust. The only asset class that is likely to provide positive real returns through both deflationary bust and the burning of paper money has not changed since George Goodman penned his treatise on *Paper Money*:

Gold became money because it was so indestructible and finite; the destiny of oil is to burn. Ironically monetizing the oil helped to produce the age of paper money, and the destiny of paper money is also to burn...



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