Russell Napier: The coming credit crisis will be outside the U.S.

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Erik: Joining me now is Russell Napier, who of course is the founder of ERIC – not my name, Erik with a K – but Eric with a C, an acronym for the Electronic Research Interchange. And of course it is a very prominent website for the sale of institutional research to institutional investors.

Russell, it's great to have you back on the program.

You know, ever since the 2008 financial crisis, I've predicted that eventually this response of encouraging even more borrowing would eventually set us up for another credit crisis in the United States. Well, so far, I'm either very, very early or very, very wrong. And of course in this business, very early equals very wrong.

Is there objective reason – I know that you are much more deeply in touch with the data than I am – to expect another credit crisis either in the United States or elsewhere in the world?

Russell: Well, there is an objective analysis. And it may surprise your listeners to know what it is, because it doesn't relate to the absolute level of debt, even the absolute level of debt relative to GDP.

For instance, Japan has now reached a debt-to-GDP level of 375%, without a credit crisis. So it suggests that the levels of debt, the thing that keeps you and I awake every night, may of itself not provide that much information on timing.

What has provided information on timing is the growth rate of the debt to GDP relative to trend. So I'm sure your listeners will know the difference because you could actually have quite a low level of total debt to GDP and still have a very high growth rate of debt to GDP relative to its trend level.

And when the growth is more than 9% above trend, there is a 50/50 chance of a systemic banking crisis within three years.

One of our objective measurements is the debt service ratio for the economy as a whole, aggregate data. And that relates only to the private sector, not the public sector. And that looks, once again, at how far the current debt service ratio is above trend.

And both of these indicators are put together by the Bank of International Settlements with new data they created after the Great Financial Crisis because we didn't really have very good data on private sector debt before the crisis.

So, to cut to the bottom line, Erik, using these two measures, we conclude that America does not within the next three years face a systemic banking crisis.

There are high levels of debt, particularly in the corporate sector. Corporate debt to GDP has reached a new all-time high, above 2007 – but not much above 2007. Offsetting that, the private sector has degeared pretty significantly.

The thing that seems to insulate America somewhat from this is that, not just that the aggregate growth in debt is not that great because of a degearing in the private sector, but because so much of this debt post-2010 is not held by the banking sector at all. Growth in bank assets has been really rather subdued post-2008-2009. But it's really the growth in the bond markets.

And a credit crisis would really be where the inability or willingness to repay debt wipes out equity in the banks. And that's what we traditionally think of as a credit crisis.

Whereas if we get defaults in the corporate bonds sector, it clearly has an impact. But it has an impact on pensioners, on life insurance funds, and, to some extent, on mutual funds that happen to own fixed-interest securities. And these institutions, on the whole (bit of a generalization), are not geared.

So the theory of this was always that, by spreading the credit risk more widely over stronger pools of capital and a geared banking system, that when credit defaults come, as they inevitably do, the impact is not a crisis.

This cannot be said for most markets outside of America, where most of the credit risk still rests on bank balance sheets.

And, just to cut back to the key indicator, if we just go on the growth rate of the debt service ratio and debt to GDP relative to trend, 43% of the world's economic system is flashing up red for danger. But America is most clearly not on that list.

So we can maybe talk about what that 43% of global GDP is.

Of course, if I said to you that I have an objective indicator which gives you a 50/50 shot of a systemic banking crisis within three years, obviously it leaves open the prospect that I can be wrong. But those are the best objective indicators we have. And on those, it should not happen in the United States.

Erik: Okay, to summarize – and make sure I've got this right – you're saying that, because

the risk in the United States really falls on real money, people who are not using a lot of leverage, perhaps the US does not face any imminent risk.

But you're saying there is a very large imminent risk elsewhere in the world. So where else in the world? Which countries, which economies? And what would be the potential risks and also the knock-on effects? Is there a contagion risk that that spreads into a global credit situation?

Russell: Okay, we are looking at two separate indicators here, and we'll class them as red for danger and amber for warning. So which countries in the world have two reds for danger on both of these measures?

And remember, it's a very specific definition here, a systemic banking crisis within three years. So actually, Erik, that's quite a bit bigger than your standard credit risk. It's something on a bigger scale than that. Because not all credit crises turn into banking crisis.

So here are the four countries that we have two reds for danger: Hong Kong, Canada, China, and Turkey. Turkey, I think, is already in significant default. That's being politicized to pressure the domestic banking system to keep lending money anyway, but it's already there.

Now, the others are important, particularly China obviously. Because it is such a huge proportion of world GDP and a huge proportion of marginal growth rates.

But this is not a new story for China. It's been going on for several years. And, in many ways, it's already bucked the trend by being able to continue it.

But, to put it into context, in the first quarter of last year – and this data comes with a significant lag – but in the first quarter of last year, China's debt-to-GDP ratio grew by 5% in three months. So it's a country which is not producing at great growth in money, but it's producing a great growth in credit.

I'm sure many of your listeners are in Canada. Canada is on this list and Hong Kong is on this list. These are important countries, but not as important as China.

Countries with one red is a much longer list. Remember, these are not contingent – it's not necessarily true that, because you are flashing red on the two indicators, that you've got a greater possibility of a credit crisis than because you have one red indicator on the objective measure.

So one-reds are: Japan, the Netherlands, Singapore, Chile, Thailand, Colombia, Saudi Arabia, and Indonesia.

There are several emerging markets in there, but several that are not emerging markets. Japan, Netherlands, and Singapore are all on that list. And Saudi Arabia hardly counts as an emerging market either. Crucially, the Netherlands is inside the Eurozone.

And I just want to mention a few of those that are on amber. And the amber ones actually are not that different in terms of what they're telling us. It's almost a 50% chance for systemic banking crisis within three years.

But in that list we have France, Belgium, and Finland. So we now have four countries inside the Eurozone that are likely to have a systemic banking crisis. And this is really, really important.

Your listeners will know what happened in 2007-2009. They will know the extreme reactions of the policy makers in the US, particularly the central bank, to that crisis.

But this is a very different problem for Europe where we have 19 countries in the Eurozone, four of them likely to have a systemic banking crisis. But just one level of interest rates to be delivered to all of them. As you know, that interest rate is currently close to zero or below zero.

Where do we go in monetary policy is one of the bigger questions we're asking for all of the countries in the world. But it's a particularly big question to ask for Europe.

If the next economic downturn does threaten systemic banking crises in four of those countries but not in the other 15 – and, crucially, France is one of them – so this really is a huge chasm at the center of the Eurozone. So when we look at this data for aggregate debt, likely credit crisis, I think the biggest thing it throws up is a huge risk in mainland Europe.

All of that together, to me Erik, suggests a strong dollar. That the risk of a slowdown becoming a credit crisis does create extreme monetary policy. And if America is not to be in that count, is not to be having to follow an extreme monetary policy – it may be an easier monetary policy – but not the extreme monetary policy associated with saving banking systems from collapse, then that is likely to be a strong dollar. Particularly when we're talking about 43% of the global economy likely to be facing problems of this magnitude.

So a strong dollar, but particular problems for the Europeans because France and Germany are at the core of this entire project of creating a single currency. One of them has a debt-to-GDP ratio of 329%. The other has a debt-to-GDP ratio of 181%. And they both have the same interest rate. And I think that is leading us to a very dangerous place for Europe.

Erik: Russell, as you were speaking, the wheels were spinning in my mind. It seems as if what you're saying is we don't have this systemic banking and credit crisis risk in the United States, at least on the immediate horizon.

But the list of places where we do see that risk, we're not talking about Zimbabwe and little countries. We're talking about major economies like Europe and Canada and China and Hong Kong. These are really big systemically important economies. That to me just spells what has to be a major capital flow expectation.

You already mentioned one aspect of it, which is a strengthening dollar, in this outlook. But I would think there is also a flight-to-safety trade into US Treasuries. And, depending on the mandates of the institutions that we're talking about, potentially also into US corporate credit, if corporate credit is what's failing elsewhere around the world.

So what would you see in terms of what we should expect around international flows? And does it at some point result in European regulators and other regulators putting in some kind of capital controls to prevent that flight to safety?

Russell: I tend to agree with that, that capital will be leaving these jurisdictions. First, because of the risk to credit. And we've already seen this already, that risk to credit. To the extent that it also threatens banking systems, takes things all to a completely different level.

To watch corporate credit melt down is to lose money in corporate credit. To watch a meltdown in corporate credit, which threatens bank stability, threatens deposits. So we're on an entirely different level of risk once a normal credit deterioration infects the banking system.

Because the last one infected the banking system, we've come to believe they all infect the banking system.

That's not actually true. Quite often, you have a credit deterioration without threatening deposits. But this data suggests that the banking system itself would be threatened.

Crucially, in Europe we have a thing called the Bank Resolution and Recovery Directive which, if implemented, would see depositors in banks in Europe take a loss.

Now, those depositors would have to have a deposit in excess of €100,000, or €100,000 is guaranteed by the government. But depositors in excess of that could face or should face under the law, a significant capital loss once other parts of the capital structure have been burned through.

So I'm talking about that to try to show you why we might indeed get capital flight with very little deterioration at all, because of that new change in legislation in Europe which clearly did not operate the last time we had a banking crisis in Europe. All depositors, almost without exception, certainly in the 2008-2009 episode, were made good. So that could target capital outflow.

I have written for over a year now that this outlook for American equities is therefore reasonably positive if this economic malaise does not infect US economic growth. And that's, I'm sure many of your listeners will realize, quite a big if.

But the more this is something outside of America, not in it, it brings lower inflation to America, it brings lower Treasury yields to America. The first impact of which is bringing lower inflation.

The second impact, the one you mentioned, that capital flow could be coming to Treasuries as a safe-haven asset. And a lower discount rate for future cash flows usually means a higher valuation.

And I think we've been watching that, actually, for the last 12-15 months as global growth has slowed but US growth has not been yet too badly hit.

And finally, and most importantly, the point you raise is what would European policy makers in particular do about this? A move to helicopter money (which I'll leave, Erik, because I think you might want to discuss that in more detail) seems more and more likely, given Christine Lagarde is at the European Central Bank.

But you mentioned capital controls. And of course we get to a stage where that becomes a real possibility. It is noticeable that the Euro has been followed pretty consistently for a long time with a current account surplus.

And if you have a country with a currency with a large current account surplus, and its exchange rate is falling, that suggests they already have significant capital flight.

In my conversations with high-net-worth individuals in Europe, they do fear something from the government that will be bad for their wealth. Whether they're as explicit as fearing capital controls, I couldn't possibly say. But they fear some sort of policy reaction next time that will be extremely bad for savers.

So I would argue that there is a shift of savings already underway out of Europe, which is beneficial for the United States and has been beneficial for the United States assets.

But in the next recession, when it comes, should it come, the structural issues in Europe are so great, the responses from the government would have to be so great that, indeed, accelerated capital flight is really something that is coming.

And it may sound that I'm being unduly patriotic here, but I think a large portion of it would also come to the United Kingdom, which now has a stable center-right government which should be in place for five years.

So the United Kingdom economy is not a beneficiary of problems in Europe. They're much too closely tied to Europe for that. No one in this country should wish any ill on the European economy. It's bad for all of us.

But capital flight is a different issue, given the stability, the political stability in this country compared to the coalition building which is necessary across Europe at a time when all of these things are forcing European politics towards the extreme left and the extreme right.

So that capital flight – with these problems developing in Europe that are going affect capital

flight from so many angles, but I wouldn't rule out political instability as being a key thing in Europe that sends capital fleeing for safety.

Erik: Now, Russell, the expectations that you've described around a credit and potentially credit and banking crisis all sound very deflationary to me.

But you were reading my mind when you brought up helicopter money. If we get an introduction to helicopter money, which I think is very likely at some point during this process, a lot of people have opined that what tips us from deflation into inflation will be the appearance of helicopter money, which is pumping money into the real economy as opposed to asset markets.

So how does that all net out in terms of inflation versus deflation, in terms of what's coming?

Russell: I'm just putting together now my last 25 years of work writing for institutional investors. I note that my first reference to deflation comes in 1998, after the Asian economic crisis when Asia was exporting deflation around the world.

And, really, in every business cycle since then, at the bottom of that business cycle we have had to either write about or contemplate deflation – or actually experienced it. And we have experienced it three times in America since 1998, albeit sometimes a fairly marginal deflation.

But it was something that was supposed to be institutionally impossible. And I was told by any number of academics that it could never happen because of fiat money. But it happened anyway.

All of that is going to the point to say, Erik, that I think I will change my mind if we get to helicopter money. That, to constantly write about the risk of deflation in cyclical downturns given the structural over-air of deflation for 25 years, has been one thing.

But when politicians and central bankers both have to act in concert to construct this policy, when they resort to helicopter money, I think I won't – however long my career may last from here – will not be writing about deflation again. I think this is the last time.

So I think it's potent. I think it's a drug. It's very hard to stop. And I think it's debilitating in the long run. And if you have something that's potent, addictive, and debilitating, I think it changes the next 20 to 30 years.

So I would agree that when it does come it's going to have a very profound impact.

Second point, we get the disease first and then we get the cure. So it may be possible for central banks and governments to collude on this policy without a shock. But it's much more likely that it's a shock that brings them to this extreme policy, an extreme policy which really has no history of success.

The success it has had has been temporary – that's ended up with addiction and pretty destructive outcomes. But we need quite a shock before people are prepared to take that risk.

And, most importantly, I think (and something for maybe a longer discussion), is it also brings financial repression.

I want your listeners to think of what happens the day that modern monetary theory is announced in Europe. What happens to long-term bond yields, which are currently close to zero? I would argue that they would jump by 150 to 200 basis points very, very quickly indeed.

Institutional investors know the addictive nature of this policy. They know longer outlooks of this policy. If you're holding 10/15/20-year government debt, you really want to get out as soon as possible.

Those jumps in long-term bond yields in some way offset the positive move you had by infusing money into the real economy at the short end. That has to be stopped.

And I don't think you'll find anybody in the MMT camp who could foresee allowing interest rates to be set by the market – long-term rates to be set by the market – as they get on to the business of printing money and putting money into the real economy.

So the outlook for America – assuming America has not had to resort to the same policy, which is the underlying basis for this discussion we're having at the minute – they may get there eventually, but certainly not as quickly as Europe.

I think most savers in Europe, whether they are institutions or whether they are private sector citizens, will be scrambling to get their savings out of the system. It may be good for growth, maybe, in the short run. It may be good for equity markets in the short run. I don't doubt that.

But fixed-interest investors, I think, will be rushing for the exits.

And that is where, perhaps, maybe only those capital controls can allow the state, allow the central bankers to manipulate those long-term interest rates as they provide that dose of morphine which is supposed to reinvigorate the patient. But as most of us know it really numbs the patient.

Erik: Russell, I am numbing my brain to this because what I fear is a lot of what you're saying is really – that really big important things are going to change based on policy, based on government action that is very hard to predict in terms of its timing. Because the argument that you just made a moment ago, which is you want to be the heck out of duration risk when MMT hits the stage, makes perfect sense. I get it.

But just a few minutes ago, when you were talking about how there's very likely to be this

credit crisis and potentially banking crisis elsewhere in the world but not in the United States right away, that sounded like an incredibly bullish argument for US duration risk.

And it sounds to me like it is a very bullish argument for duration risk – until the day they change the rules, at which point you want to get the hell out as soon as you possibly can. And it's impossible to predict when that day is coming, because it's political.

Am I missing anything there?

Russell: No, I agree with that.

And, just for the record now, I've been pretty bullish on US long-term government bonds for the past several years on the basis that they wouldn't change the rules, that they would continue with the old rules, that we would have a disinflation rather than reflation. And I continue to hold that view.

But, back to the point of a few minutes ago. This is really going to change things.

Now, if I can write for 25 years about the risk of deflation and then tell you that I'll probably never have to write that again, then I'm clearly talking about a long-term structural bear market in duration and fixed-interest securities. And anybody who's looked at the charts of very long-term interest rates knows that these are 30- to 40-year bear markets.

This policy will begin, whether it comes from Europe initially or whether it comes from China printing more money with a flexible exchange rate, it will kick-start something I think that will put the bear market in these instruments for a long time.

Personally, I own 30-year Treasuries. I believe that there is a final deflationary shock coming, as I said, really coming from outside the United States of America from the two sources I mentioned, either Europe or China. And that will be very bullish.

But this is much more dangerous than previous purchases of fixed-interest securities in America because this is somewhere towards the end of a very, very long bull market. I think it's a 40-year bull market. Now we're getting very close to the last year, year and a half (who knows?), six months of this bull market. There may be very significant gains to be made in that last period.

But you're absolutely right, Erik. When they change the rules of the game, we have to think twice about playing the same game as we played before. And I think the whole point in changing the rules of the game is to inflate away indebtedness, being no doubt why the rules are changing.

MMT proponents might tell you it's a need to create more money or it's a need to move wealth and inequality of wealth. No, it's a need to inflate away debt. And you do not want to be owing

debt when those changes in the rules come.

So it's probably a more dangerous asset class to hold than in the past, as we're in the dying days of the bull market. But there still could be a significant final rally for the institutional framework. And we'll begin to inflate away those debts, as is absolutely essential as the most likely way for any democracy to proceed.

I think it's highly predictable. It has been for a long time, as many people know. But we just don't know when. So, final call is there is one last push for this bull market, but we're living in much more dangerous times if you're a fixed-interest investor.

Erik: Okay. So the call for now is long US duration risk but pay close attention and be ready for the rules to change.

Let's talk a little bit more about the rules changing, how the rules might change, and what the other implications of the rules changing would be.

I think you and I agree that helicopter money is coming in some form at some time, perhaps first in Europe. I want to talk about what are the other ramifications and implications for the investment world.

One of my predictions here has been I think it's going to be perceived as fantastically successful at first. Because all of the negative implications of helicopter money, they take a while to kick in. So I think that there is going to be a huge victory celebration and the negative aspects are going to be delayed for a couple of years until it's probably too late.

Am I on the right track? And how do you think about planning ahead for this changing of the rules that's coming in the macro landscape in the next few years as helicopter money is introduced?

Russell: Well, I've never personally experimented with morphine and heroin, but what you've described to me there, Erik, I think is the kind of – if we are talking in medicine terms, I think morphine has kind of the same effect on patients that you've just described for an economy.

I'm on record as saying I think the European bank share prices could double within weeks after a move to modern monetary theory. It's basically – when you start to inflate away debts, you're taking a lot of the risk away of bankruptcy. And these bank share prices are priced for bankruptcy.

Now, you might say, well, if you produce 10% inflation, you'll produce 15% interest rates. But the whole point about the financial repression that comes with modern monetary theory is you don't. And you're letting people escape from the price they should be paying for borrowing too much money.

So I think you're right. In the very short run, you get a hell of a run-up in equity prices, particularly bank share prices.

However, and this is the key, we have history with financial repression. We've had it before, this move by the government to inflict the wrong cost of money. Not just at the short end, but the medium term and the long end as well. And what it does produce over the long term is really, really bad asset allocations.

And that period that we had over the past lasted from the end of World War II right up until the early 1980s and, at some places in Europe, into the early 1990s. The United Kingdom itself went bankrupt. Or it certainly had to go to the IMF for support in the late 1970s because of these policies.

I've got a 90-minute presentation of all of those policies, Erik. But I think they all come and all stem from the move to modern monetary theory. It's what the modern monetary theory helicopter people don't like to talk about. Which is the other side of their policy which is effectively destroying market prices for – and important market prices – to savers that direct investment.

But you're absolutely right, this takes longer to unfold. And for those institutions that are having their debts relieved, then the share prices should probably go up in the short run, not down.

Erik: Russell, I've got to believe our listeners' heads are already spinning. And I hate to do this, but we've got to make them spin a little harder. Let's expand this conversation now to incorporate negative interest rates.

Seven or eight years ago, if you were attending a professional finance conference and you started talking about negative interest rates, you would have been laughed out of the room as an amateur who just doesn't understand economics, because that's impossible.

We've somehow, in less than a decade, gotten to the point where it seems like nobody even questions the reasonableness of negative interest rates – paying a fee for the privilege of lending money to someone.

How does this all unfold? And what do you expect – and I shouldn't probably assume – I think negative interest rates are going to be part of this equation that you're already describing. Maybe I shouldn't assume that.

So let's start with is negative interest rates a part of this? And, if so, what does it mean? How do we plan for it? How should we think about it?

Russell: Okay, to alleviate that, you basically need nominal GDP growth higher than interest rates. Or you need inflation higher than interest rates. So the reason we've ended up with

negative nominal rates is they just failed to generate inflation.

So I won't argue it to you, Erik, but if they did manage to generate inflation – let's pick Europe – of 4-5%, interest rates would not be negative. They would be somewhat higher. They are probably quite happy to permit that.

However, from our last answer to your last question, there is no way they are going to allow them to rise close to inflation or above inflation. So I don't think necessarily that financial repression means negative nominal rates. Obviously you can get there quicker if you're inflating away debt if you keep rates negative in nominal terms.

But there's no reason why they shouldn't go up a little bit, as long as they remain significantly below inflation.

They are with us at the moment. And they've been alleviated a little bit in the last two months, but they're still with us. And the minute they're destroying the financial system –

We have a financial system we know was really invented in the 19th century, in terms of commercial banking anyway, but also in terms of insurance and other things. They all developed rapidly in the 18th century and they've never had to cope with interest rates like this. They're part of the problem that might take us to modern monetary theory, because they are simply destroying the stability.

We always think of banks, but I think more importantly we should think of life insurance companies. Particularly in Northern Europe, they guarantee certain yields to investors which have been impossible to attain in any reasonably risk-free way for a long period of time. But also pension funds in Northern Europe, when we simply don't have the level of reinvestment returns that are anywhere near likely to be able to satisfy the obligations to pensioners going forward.

So I look at negative nominal rates as already creating a crisis. They're already, if you like, leading us up to modern monetary theory. Modern monetary theory coming along because these negative rates have done so much damage to the financial system.

But I do see that interest rates will be allowed to go up somewhat. Certainly market forces will try to push them up dramatically if we move to MMT.

I don't think the authorities will need to keep them negative if they generate this inflation. I think they'll succeed in generating inflation. Soon there will be a little bit of positive yield on these instruments.

However, and this is the crucial thing, the key to losses for investors in the long-bond market is not with nominal losses on the bond. It is the real losses on the bond. And that is where you're going to lose your money.

So we may not look at huge negative nominal returns from bonds in the 20 to 30 years. It will be losses – and in real terms. So if that's the "X" between nominal and the real losses in bonds over the long term, it could come with slightly higher interest rates but, ultimately, interest rates that are never allowed to approach a level that is close to or higher than the rate of inflation.

Erik: Okay. If your prediction is that interest rates stay way below the inflation rate, put another way that's a negative real yield.

That just immediately brings gold to my mind, because gold generally thrives on negative real yields. Tell us about how gold fits into the story.

Russell: Absolutely. Gold is a strange beast because they didn't really have market prices for it for a long time because gold was money and money was gold. So the price of the two didn't diverge.

But when we do have a free gold price decoupled from being money, the level of real interest rates has been a key driver for the gold price. And the deeper into the negative real rates, the more likely it is that the gold price goes up.

So that's the first forecast.

The second forecast, obviously, is what we just discussed, is really how governments back away from markets.

When governments decide that market prices are delivering the wrong results and want to suspend them – and particularly long-term interest rates – well, in a world where the government gets into that business, suspending market prices, we have a threat to liberty.

There is less liberty in a country where the government dictates where your savings should go to. And that might be just liberty in the free movement of capital or it may be deeper forms of liberty than that.

But that is where the gold price gets a second kick.

It is not an asset which is easy to manipulate for governments. I know – in 1933 I think it was when Roosevelt passed his famous Act on the confiscation of gold. But, ultimately, gold was a significant asset class in those days, held by individuals.

That is not where we are today. Today most of the wealth of the world is held by institutions. It is not held in the form of gold. And institutions are very, very easily manipulated because they are regulated. You don't need to own a financial institution if you can regulate it –

So gold is this little asset class which the state may eventually come after. But it really poses no threat to its ability to sequester (covertly or overtly) people's savings if they have some savings in regulated financial institutions.

So eventually, the state may come after those who own gold. But, for a long period of time, gold will be an asset class which is really of little interest to them because there is so much plucking of rich feathers from the regulated financial institutions.

So it's very much a bull market in gold. It's probably lasted as long as the bear market in bonds, which I think is probably 30 years.

How long will it take to reduce our debt-to-GDP ratios to a reasonable level? Well, that depends on the gap between inflation and interest rates. But 30 years doesn't seem an unreasonable period. Unless, of course, we go for dramatic moves in inflation such as France did after World War II – 60-70% when they weren't able to halve their debt-to-GDP ratio in just a few years.

That I think is dangerous and far too structurally, politically and socially dangerous to be contemplated. Certainly they had that level of control. So I think more like a 30-year period of inflation, 3-4% above interest rates is more likely.

So that's a very prolonged bull market in gold.

Erik: Russell, would I be correct to interpret what you just said, if I put it another way, as the only way out of this debt situation is to inflate away the real value of that debt? That process might take 20 or 30 years to play out because there is so much debt. And during that process, gold is the obvious place to be. That's the speculative bet to make if you expect and want to be rewarded for correctly anticipating that it will take decades to unwind the overhang of debt that we have by inflating it away.

Is that the gist of it?

Russell: That is the gist of it.

And, of course, they don't always have control. Particularly with the history of inflation, one which modern monetary theorists are keen to ignore.

But is it that we just provide the right level of inflation and everybody is happy and nothing changes? Behavior changes. And velocity in particular changes.

So at any given point in time, the attempt by central bankers and governments combined to keep inflation just a couple of percentage points ahead of interest rates can easily get out of control. Inflation can easily break out as velocity goes up, as unionization probably comes back (quite rightly) to defend workers from the impact of inflation.

There's so many things that they simply don't control, even though they think they can control everything. So gold is a particularly good cover in these surprising bursts of inflation that might come along as well.

It is worth just reminding ourselves that there are quicker ways to get rid of your debt burden. Which is excessively high levels of inflation. Whereas I don't think any developed world country will go for that. You never know.

You can never be too sure that there wouldn't be a political party somewhere – we're looking at extreme left and extreme right making greater grounds across the world – that they wouldn't go for the short, short shock to get rid of these debt burdens very quickly.

And that would mean levels of inflation which are 20-30-40%. So that's not a key forecast.

But we have to remember there is a risk for some states that – if you like, the institutional fabric of the state begins to crumble. And as it begins to crumble, they resort to the printing press as a solution. It's never been a good solution, but many people, whether they are in Venezuela or Zimbabwe or Argentina, have resorted to it in the past.

There are many people who may resort to that short-term solution which could take inflation well above that level. In which case, destroying debt burdens happens really quite quickly indeed.

But my forecast is that the developed world nations on the whole will avoid that rush to short-term destruction of debt values and not in purchasing bond terms and try to go it slowly. Financial repression – is a phase that some of your listeners will have heard of.

I was once asked by a retired lady how I would put that phrase into English. Which is a very good question, I think. And I replied that it was stealing money from old people slowly. And the "slowly" bit is important. Because you don't want to frighten the horses. You want to try and keep them corralled in fixed-interest securities. So, on the whole, doing it slowly is probably the democratic way to do it.

Erik: Russell, I am in complete agreement with you that it is profoundly unlikely that developed major economies would consciously and intentionally resort to extremely high inflation. I don't think anybody is going to think that is the right solution and implement it intentionally.

But I want to come back to what you said about how easily inflation can start to run away.

While Paul Volcker was still alive, he said what he did in the '80s could not be done today. Because you can't solve a runaway inflation problem by dramatically increasing interest rates when you have the amount of debt that we have today because it would just cripple the entire global economy. Starting with the US government, which would be unable to roll its debt

burden.

So how would they fight – as you say, it's very easy for inflation to start to get away from you. What do they do in order to combat that?

Russell: Well Mr. Volcker wasn't wrong in very many things. In fact, I'm sure your listeners could send in some things he was wrong in, but I personally can't think of very many at all. So he was certainly right about that.

When Volcker took over – it's a remarkable story that isn't told in this whole story of that great change – is that America's debt-to-GDP ratio, certainly its government debt-to-GDP ratio, but even its aggregate, was reaching very low levels.

Well that wasn't a sign of great success. In fact, it was a sign of the previous theft of savings from fixed-income investors. And it worked.

But the very high levels of inflation during the '70s in America and the United Kingdom actually brought Reagan and Thatcher to power at a time when government debt-to-GDP was at incredibly low levels.

So the Volcker pain – and it was incredibly painful for the private sector – would be just on an entirely different level today. Because it's not just in the ways of government debt to GDP. It's there in the private sector as well.

So what on earth could they do if inflation begins to get out of control? Because they're simply not prepared to use interest rates.

Well we have a great historical incident of that, which is what happened before Volcker. And what happened before Volcker, before Miller, but during Arthur Burns is that the Republican president of the United States, Richard Nixon, introduced price controls and credit controls.

Those were also backed by the Democrats. And Jimmy Carter, when he came along, was also into trying to persuade people not to borrow money.

You've got to remember that if you keep inflation above interest rates, we're all going to borrow money. We're all massively incentivized to borrow money.

So this is the problem with modern monetary theory and creating a little bit of inflation. It inevitably puts you on to more controls unless markets –

And the ones I've just mentioned there, I think, are the key ones: price controls and credit controls and attempting to keep bank credit growth quite low, even though we all want to borrow. And through keeping bank credit growth low, keeping money supply low.

The Office of Price Commission, established by Richard Nixon, was set up and run by a man called Donald Rumsfeld. Donald Rumsfeld was quite busy. You can imagine how many companies were asking for price rises. And you had some help called Dick Cheney.

So, for those of us who believe that certain parties, Republican or Democrat, have ideological limits and are stretching those to the things they will do, I think the whole concept that Richard Nixon appointed Donald Rumsfeld and Dick Cheney to be the price czars, the price commissioners, shows you that when things get tough, when the going gets tough, the tough get going. And anything is possible.

So the bottom line in that is: less market and more control. And I don't think it really matters whether it's Elizabeth Warren or Donald Trump who happens to be in the White House at the time. We've already seen that, in extreme situations, a Republican president such as George Bush Jr. was quite capable of effectively nationalizing the banking system.

So the short answer to your question, Erik, is less pricing and more control – if inflation gets out of control.

But not that great jump in nominal rates, which is the tough, tough medicine that Volcker could inflict but which I think we just could not deal with in the modern economy.

Erik: Russell, I could go on for another hour talking to you about all of the different nuances and implications of the issues we're talking about for the US economy.

But I want to use the time that we have remaining to shift gears now and talk about another subject that you wrote about in the *Solid Ground Quarterly Report* which, for the benefit of our institutional audience, is just a terrific piece of research that's offered through the ERIC website.

You talked about China basically trying to avoid getting into a cold war with the United States. If I've interpreted you correctly, you think that it is inevitable that we eventually fall into a US-China cold war. That is, needless to say, both a huge geopolitical and economic prediction.

Did I get it right, first of all? And, beyond that, please give us a summary of what your thinking is, what people should expect, and what it means both for the world and for investors.

Russell: Yes, we are in the foothills of a cold war. I think those actually are the words of Henry Kissinger, not me. So there's not just me who thinks we are in the foothills of a cold war.

This one is very different from the last cold war, which many of your listeners will have lived through, because it comes at a time when there are – the last one came at a time when there were no economic capital or even political links, really, between what became the Soviet Union and what came to be called the West.

So severing the two bits, bringing down that iron curtain, had a very, very limited economic and financial dislocation.

Creating an iron curtain, if you like, around China (or wherever the Chinese influence may spread to) is going to create a huge economic and financial dislocation, given how integrated that China is, clearly, to the world trading regime. But also let us not forget to the world's financial regime.

It's a country that may have capital controls and may restrict some citizens' flow of capital out of that country. But there are significant – very, very significant – foreign investments in China, in not so much the listed market, but in the world of foreign direct investment.

So a cold war has profound, profound economic implications which I think initially are deflationary. Dissevering these links is going to create a financial crisis somewhere. Now, it may be Hong Kong or it may be Singapore. Or it may be France. They also lend a lot of money into Asia.

But that dislocation is initially deflationary.

However, in the very long term, I think it's generally inflationary as we get back into a cold war and we seek to source all the goods and products that currently flow from China. We can source them elsewhere. Adding the capacity to do that will take some time. And I think it's a little bit inflationary.

Of course, in terms of my timing and your timing and everyone listening to this, I think the crucial thing is can we have a cold war with China keeping its currency stable against the US? And I think the answer is no.

It seems to be inconceivable that you can be in that form of conflict and decide to use the monetary policy of your enemy (hopefully a cold war enemy). It just seems highly, highly unlikely.

So, in that light, the recent trade agreement between America and China seems to be a good indication that it's something that really isn't meant to last.

I can't see how any sovereign country, certainly a sovereign country as big and powerful as China, would agree to hold its exchange rate up, to overvalue its exchange rate, and then call that "overvaluation" based on the fact that its foreign exchange reserve are not rising.

To agree to overvalue its exchange rate – and although American monetary policy plays such a major role of influence in Chinese monetary policy – it's not the move of a sovereign state. And therefore I don't believe it's going to last.

In fact, the concessions that China has made in Part 1 of this trade deal make it very likely to

mean there won't be a Part 2. In fact, they make it even clearer that this is a cold war. That might sound strange, but to concede such a major issue as currency and exchange rate policy at this time in the discussions suggests to me that this will not last.

And therefore it's much more like the Molotov-Ribbentrop deal of 1939 than it is like any permanent lasting trade deal leading to Part 2. Both sides know that this is not the time for them to make a move. They're not ready.

Maybe they're not ready in terms of technology, in terms of their chip production. Maybe they're not ready in terms of military, in terms of where they have their deterrents in terms of missiles.

But, for whatever reason, Part 1 is a holding pattern in what is progressing into a cold war.

And that cold war is taking place in capital movements. It's taking place in technology. It's taking place in intellectual property. It's taking place in trade. And it's taking place militarily.

And anybody who scans the newspapers could see that we're shifting on all five of these fronts. And when you shift on all five of those fronts, it's very hard to believe that there is a lasting trade deal to come.

For investors, the crucial #1 issue, I think, is the stability of the Chinese exchange rate. It won't last much longer. And a world with a flexible Chinese exchange rate is a very different world from the last 30 years.

And then we have all of the problems in assessing the long-term impacts of a cold war well beyond that first initial move in exchange rate. Which, once again, initially should be deflationary.

Erik: Russell, you are best known as a financial historian, and I want to tap into that knowledge for my final question.

Because some of the things that you've predicted in this interview, particularly the stage being set for the European Union in particular, but also other developed economies, to seriously consider capital controls because a lot of the macro drivers that you're describing could potentially encourage large institutions to want to move a lot of their assets out of European markets into US markets.

And that creates a self-reinforcing vicious cycle of dollar appreciation and so forth. So there's good reason to think that capital controls might be in the future.

Meanwhile, you just told us that you see that we're now in the formative stages of a new cold war with China. Certainly in the last cold war, that resulted in the imposition of a lot of rules that would otherwise not have existed, that control who is allowed to invest where in the

world.

So how different might the financial landscape be in the future than what we're used to as we get into this new regime where the European Union needs to be worried about these things and we have a cold war developing?

Russell: We do have a historical parallel which is 1945 to let's say 1980 and probably up to 1989. Realistically, when we talk about the end of the cold war and also liberalization of capital controls in Europe. And kept them much longer than anywhere else.

So I think we can all go back and look at that period in history as a sort of guide to what to do and how to invest and where to make money.

Maybe I can just leave you with one idea of what some of the real winners of that period of history in equities, were companies with very large fixed assets. And those companies were beneficiaries of higher inflation when interest rates turned low.

They were the beneficiaries of that as long as they didn't have to reinvest a huge amount of the cash flow back into the fixed assets. Those weren't sustainable fixed assets without high reinvestment. Those are asset-heavy companies.

We've just had a 40-year bull market in asset-light companies.

So it couldn't be more profound, this turnaround. Not just in the reordering of the terms in financial asset prices. But even within the equity market.

The winners and the losers are likely to be very different in this new world. And I think anybody listening to this will begin to realize that this raises many more questions than answers because it is such a profound change in what we've known, really, since the late 1970s. So, unfortunately for most of us, it's back to the future.

Erik: Finally, Russell, as we close I want to talk a little bit more about the ERIC website and what you offer there.

Just to explain to our listeners, I sourced my questions for today's interview from one of your reports, Russell. It's called *When Debt Matters, Where to Expect Credit Crisis in the Next Recession*. That's a 40-page report. It's only one of the many offerings on your website and we only got to Page 3 in the time that we had for today's interview. So it is a treasure trove of concise, very well-written institutional research.

Tell us a little bit more about what's there and how our institutional audience can find out more about it.

Russell: Thanks, Erik. Well anybody who is regulated can register for free on ERIC. And when

they're free on ERIC there is some free content.

The free content that I produce for ERIC is every couple of weeks. I write an update on what's going on the world. That's really only for regulated institutional investors. I am one of 145 research providers on ERIC, so there are other free contributions on there.

Of course, we all have an economic incentive to be there and that is there is also a subscription package of more detailed reports such as the one you just mentioned, available to institutional investors.

And I'm afraid it has to be institutional investors. That's the nature of our platform. We're not regulated, so we can only match regulated sellers and regulated buyers. But I hope that anybody listening who is a regulated financial advisor is interested in some of the free content we have.

But also have a look to see the investment opinions available. We're looking at, increasingly, an oligopoly of opinion forming in the marketplace, through and through providers. We've got 145. Virtually all of them work outside the confines of investment banks. And I think and I hope that that means they can provide more independent investment advice to all institutional investors.

Erik: And, listeners, you'll find a sample of one of the free pieces that Russell has written linked in your Research Roundup email. [If you're not registered, go to the MacroVoices home page and look for the red Looking for the Downloads? button.]

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