

Imploding credit — the consequences

There is a growing realisation that the world faces a combination of persistent inflation of prices and a recession at the same time. The factors driving both are visibly intensifying. Those of us versed in the cycle of bank credit are aware that it is the contraction of bank balance sheets which is driving the recession, while it is continuing currency debasement driving inflation.

Neo-Keynesians in the establishment think the current position is contradictory, that current rates of price inflation will decline back to their 2% target in a recession, and interest rates can then be reduced to stimulate economic activity.

The key to understanding why prices can continue to rise in a recession requires a fuller understanding of the role of credit in an economy and what it represents. Its role is far greater than commonly thought, with considerably more than several quadrillions of dollar equivalents outstanding. All economic activity and wealth are credit. This article sketches out the various types of credit, and how credit equates to our collective wealth.

It also requires us to differentiate between a currency which is anchored to gold specie and one without a specie anchor. The former imposes a discipline on the state of non-intervention, while the latter encourages intervention. It is that intervention which leads to fiat currencies and all credit based upon it finally collapsing.

The importance of credit

That the monetary authorities do not understand credit might seem unbelievable. But evidenced by their actions, it is the only explanation for their mistakes. Clearly, as well as credit they don't understand the importance of money, having banished gold from its role of anchoring the purchasing power of credit. The vested interest of replacing gold with currency, to obtain for governments the benefit of unfettered debasement, is ignored or forgotten by today's state-educated economists and commentators. Disregarding what drove the dollar off the Bretton Woods standard in the first place, the establishment in the broadest sense can no longer distinguish between credit and legal money.

Currency and credit debasement started with a vengeance in the 1930s, when the dollar was devalued by repegging it to gold at \$35 per ounce from \$20.67 — only that Americans were banned from owning it at any price. Currency and credit expanded from then on.

US M3 money supply had peaked at \$55.2bn in 1929, fell to \$41.52 in 1933 (eerily similar to money supply prospects today), before rising to \$692bn when Bretton Woods was suspended in 1971. That's a multiple of 12.6 times while the dollar was anchored to gold at \$35 per ounce. Since then, credit expansion has been far more dramatic at nearly 32 times, and we have seen the gold price increase from \$35 to \$1725 currently. It is better described as dollar currency and credit losing purchasing power relative to legal money by 98%.

Today, we are acutely aware that prices for energy, food, and consumer goods generally are rising while the economic outlook is deteriorating. Economists call the former inflation and the latter a recession. While it is natural to believe that these conditions are driven entirely by exogenous factors, such as supply chain disruptions and rising interest rates globally, this analysis is too simplistic. It is the massive, government-led expansion of credit which has debased the currency that is the underlying problem.

This is tacitly admitted by economists and statisticians who believed that excessive monetary expansion was a one-off action to deal with the covid crisis and associated problems. But now, the hesitancy in markets is attributable to the growing realisation that further expansion of currency and credit is required to face new challenges. Governments are debasing their currencies in a new round to allow individuals and businesses to accommodate soaring energy prices, which were the consequence of earlier debasement. Collectively, some market participants are now signalling, “Fool me once, shame on you. Fool me twice, shame on me”.

I remarked above that the contraction of M3 between 1929 and 1933 is eerily similar to what we face today. It needs explaining. In the years before the Wall Street crash (which started in September 1929) the Fed had begun to intervene in markets. In 1923, the Federal Open Market Committee was established with Benjamin Strong the Fed’s Governor as chairman (the title change from Governor to Chairman was made in the banking Act of 1935). From then on, the Fed began to conduct monetary policy.ⁱ

Accordingly, the Fed made substantial open market purchases in 1924 and 1927, which suppressed bond yields and therefore market interest rates, to ward off recessions. The latter particularly fuelled mounting stock market speculation as bank credit expanded due to increased credit demand supplied at suppressed interest rates. In 1928, the Fed’s FOMC took fright and reversed its expansionary policies by buying up government securities and raising its discount rates. The following year the market peaked, and the unwinding of the speculative bubble drove the Dow Jones Industrial Index down 89% by mid-1932.

While there are differences today, the similarity to current global monetary and market conditions are striking. The principal dissimilarity is that Strong believed in the gold standard, and guided FOMC policy in that context. But for the first time, the Fed intervened in the economy storing up trouble for the end of the decade. Today, FOMC interventions are far more pervasive, with similar distortions for financial markets but without the sheet-anchor of money —legally that is gold — securing confidence in the currency. We have yet to fully realise the consequences today, with the Dow Jones Industrial Index having lost only 21% so far.

The contraction of bank credit between 1929—1933 is the most important feature of that time. The withdrawal of credit for speculation in the stockmarket was undoubtedly what fuelled the Wall Street crash because withdrawal of credit forced speculators to sell their stocks. If they were not unsecured or secured against physical property, bank loans were secured on stocks. Falling values accelerated the decline as banks liquidated the collateral they held in financial assets, a point famously made by contemporary economist Irving Fisher. The start of these conditions is apparent today in the contraction of bank credit for stock speculation, shown in Figure 1.

Figure 1. Bank credit for financial speculation is contracting (\$ millions)



The psychology of markets informs us that credit contraction of margin loans is driven not by happy profit takers, but by the effect of falling collateral values and banks foreclosing on positions. It is a process that has much further to go.

This brief analysis of the role of bank credit illustrates its financial and economic importance. Not only did its contraction in 1929—1932 undermine financial asset values, but it also plunged the agricultural economy into depression. It is estimated that about 9,000 banks failed, wiping out \$140bn in depositsⁱⁱ. On the asset side of bank balance sheets fire sales of farms and assets of small businesses failed to cover bank loans, but their owners were impoverished and left without a living. The lesson for today is that despite all the regulations designed to make banks safe, severe credit contraction still leads to widespread bank failures.

The experience of the 1930s spawned two very different conclusions. Austrian economists, being the most sophisticated extension of classical theorists, pointed out that the depression was the result of bank credit expansion in the 1920s unwinding, while a new breed of statist economist supported Herbert Hoover and Franklin Roosevelt's view that the failure was essentially of free markets and the solution was in the hands of government. Both presidents were keen interventionists.

Intervention by the state became the foundation of Keynesianism, while the Austrians were widely ignored. However, many neo-Austrians argue that the business cycle can be eliminated if the cycle of bank credit is removed entirely. As to whether this course is practical requires an understanding of credit in its wider form. Bank credit is a small subset of overall credit, albeit an important one.

The nature of credit in the economy

Everything is bought and sold on credit. Legally, money is only gold coin, with silver and copper coin in secondary roles. They have been expunged from general circulation — even coins are now debased tokens — so no money is involved in transactions today.

Banknotes issued by the central bank are credit, debts of the issuer in favour of the bearer. From the days when banknotes were exchangeable for gold coin at the holder's option, we regarded notes as money, or more correctly money substitutes. And most of us still do. But in a world of fiat currencies, they are only credit and must not be confused with money.

We know that added to banknotes, deposit accounts held at a bank are also credit, credit given by the depositor to the bank in return for a *right of action* against the bank. The bank owes the money to the depositor. And always, the other side of credit is debt. In accordance with double-entry bookkeeping, the amount of currency and credit in any country is the sum of all the debts due to every individual and business in it. If there is no debt, there is no currency. Debt is therefore synonymous with wealth because all credit is wealth.

The first use of *circulating* credit was to represent money, that is gold, in paper form. It multiplied it considerably, firstly in the form of banknotes and then as banking developed in bank accounts exchangeable for banknotes and gold. Convertibility into gold for the public ended in most nations following the First World War; but it continued until 1933 in the United States. Since then, bank deposits have only been convertible into banknotes, and even that have become restricted by anti-money laundering and tax avoidance rules imposed by bank regulators. But bank deposits remain freely transferable into other bank accounts by novation.

Today, we are familiar with bank deposits, banknotes, and metallic tokens. The total of these elements makes up money supply statistics, so named for historical reasons though no money is involved. But as we shall see, broad money M3 or M4 are only a small part of total credit in an economy.

The whole economy runs on credit. When you buy a rail ticket, a theatre ticket, or any other token or promise ahead of the delivery of a service or goods, you are a creditor until the service is discharged or the goods delivered. In law, you have a *right of action* against whomever you have prepaid for goods or services. And when a tradesman provides a service to you, he is your creditor until you discharge the debt to him. He has a right of action against you, which is discharged when you pay him what he is due.

In every obligation or contract the party who has the right to enforce the performance of the duty is the creditor, and the party whose duty it is to perform it is the debtor. A credit is the right to compel a person to pay or do something. Hence, large amounts of credit are payable, not in any material substance or money, but in personal services.

There are innumerable other cases where persons enter into agreements to perform services. These contracts to perform services are as much obligations as are obligations to deliver material substances. Therefore, credit can purchase services exactly in the same way as money, currency, or a transfer from a bank deposit. Credit is a purchasing power which can deliver anything that currency can. Credit is a current right to a future payment. And the true function of credit is to bring to the economy the present value of future profits.

Every aspect of our economic and social relations with our fellow human beings is not just based on credit but is credit itself. And credit, insofar as we require to measure it, is based on legal tender. Consequently, the value of all human activities in a modern economy is entirely dependent on trust in the currency.

As stated above, there is a clear distinction between credit and money, the latter only being metallic gold, and formally metallic silver and metallic copper as well. However, money and credit used to be of the same nature. What has changed is the absence of money. Credit is no longer anchored to money by being exchangeable for it. Being no longer anchored to money, credit is now anchored to currency, a form of credit still judged to be superior to bank credit. We can see therefore that there is a hierarchy of credit, loosely as follows:

1. Central bank banknotes. Bank notes issued by a central bank are the highest form of credit, into which all other forms of credit can be exchanged. As a consequence of central banks buying bonds in recent years, there has been an expansion of central bank credit in favour of commercial banks, recorded as reserves on central bank balance sheets. These reserves are accorded the same risk status as bank notes but are not credit in public circulation.
2. Bills of exchange, commercial and government treasury bills, accommodation bills and trade finance not tied to property itself (such as bills of lading and dock warrants), and other negotiable instruments are all credit, ranking with or just below central bank liabilities. While these are always settled through bank deposits, they are frequently between non-bank counterparties so are additional to bank credit.
3. Bank credit is the most common form of circulating credit, ranking behind banknotes but outnumbering them by over ten times or considerably more in many jurisdictions. As well as the central bank's credit risk, bank credit bears the risk of individual banks and a wider systemic risk. Additionally, there is unrecorded bank credit created by the activities of shadow banks, which in today's financialised economies are estimated to be up to half as much again or even more.
4. The counterpart of non-bank obligations which become due under the terms upon which they were granted. It includes all financial transactions agreed for future settlement from the time of dealing to a future specified time. It also includes prepayments, when a broker takes payment on account, and owes a right of action until a transaction is completed and the property in an investment is delivered.
5. Other than paid margins and deposits, derivatives both in regulated and over-the-counter markets. More on the treatment of derivatives follows below.
6. We can also include the property in all investments, financial and tangible, the possession of which is the right to a future income stream paid in credit.
7. Personal credit in the form of rights of action in connection with the acquisition and disposal of goods and services which are not settled immediately. Personal credit transactions are by far the largest quantity of unrecorded credit, mostly settled by novation of bank deposits. The level of an individual's personal credit is shown by the willingness of others to accept deferred payments for services and goods, and personal obligations are often discharged in cash or by barter.

With respect to derivative transactions, there are forms of credit not readily recognised as such which come in two forms, which we can name credit and latent credit obligations. Being commitments to deliver a commodity or financial instrument at a future date, futures are credit, while options and warrants are latent credit being a *right to an action*, instead of a *right of action*. Forwards and swaps are credit, being future commitments to deliver in total.

Dividing the Bank for International Settlements statistics into over the counter and regulated market derivatives categories shows that the financial system has generated an extra \$581 trillion of credit, and \$104 trillion of latent credit for a total of \$685 trillion. These figures are culled from large dealers in thirteens countries, with a triennial survey covering more. Therefore, the OTC element (\$541 trillion of credit and \$50 trillion of latent credit) is incomplete and the true figure is somewhat larger. The capitalisation of equity markets adds a further \$100 trillion, ownership of the property in an equity investment being the right to a future income stream. It compares with global debt of over \$305 trillion

(Institute of International Finance — May 2022), and a global GDP estimated at \$96.3 trillion (Statista — for 2021). The property in fixed assets is similarly credit.

Therefore, it is an error to think of credit as simply being comprised of currency and bank credit. These two categories are merely circulating credit, part of total global credit exceeding quadrillions of dollars equivalent. All this credit is capable of being measured or realised in fiat currencies and is dependent on their stability. Loss of a currency's stability has considerable consequences, not just for the foreign exchanges or the stability of bank deposits, but undermines the very basis of human existence.

These astronomic figures illustrate the overriding importance of credit to society. But they also hint at the far-reaching effects of changes in the rate of interest. On rising interest rates, debt values fall, and derivative values change, benefiting some banks and creating losses for others. The present value of prospective discounted income streams from equities and property are adversely affected, at least initially because dividend streams and rentals are slow to adjust. These effects are, or should be, understood by economists. But the effects are even more extensive, driving down wealth because wealth is credit and credit is synonymous with marketable values of all debt.

The consequences of interest rate management

It is a common error to believe that economic outcomes can be managed through the artificial manipulation of interest rates. From our analysis of credit in the widest sense, it becomes obvious that when changes in interest rates are not set by markets but steered by statist committees, they have a profound effect on our collective wealth. With currency and bank credit being the tip of a far larger iceberg, the consequences of interest rate mismanagement for booms and busts are far greater than recorded by government statistics.

But statist distortions imposed upon credit markets are always temporary in nature, being reversed when control is eventually lost, and markets reimpose themselves. Consequently, when interest rate suppression eventually fails a crisis follows, and the damage done by earlier statist intervention is revealed.

It is in this light that we must consider the situation today, which comes after decades of declining interest rates. It is incorrect, however, to assume that this decline was not a market trend. It was a market trend set against a background of the replacement of the sheet-anchor of legal money by the fiat dollar, demand for which was boosted by its role as the reserve currency, its hegemony, and its dominant role in settling international transactions. Consequently, in fiat form the dollar held its value more than might otherwise have been expected.

The expansion of debt, which is synonymous with credit and therefore national wealth, has been far greater than the numbers recorded in official statistics, as the hierarchal list above attempts to show. And now that the trend of declining interest rates has ended, rising interest rates are leading to far wider wealth destruction than reflected in rising bond yields and falling equity prices. That the trend of rising interest rates has much further to go is clear, given the instability of currencies reflected in inexorably rising prices, and the gap between the true time preference for holders of currencies and their reflection in current state-suppressed interest rates. The dollar's value in terms of its purchasing power in these changed circumstances must be our current focus because its purchasing power is imparted

to all dollar credit, and through its reserve relationship with the other major fiat currencies, to all credit based upon them as well.

Interest rate policies ignore the wider effect on credit. But given that the gap has opened up between central bank interest rates and where they should perhaps be, we can say that the destruction of wealth, being synonymous with the quantity of credit and valued by present values of future income streams, has barely started. And as we have surmised, global credit exceeds quadrillions of dollars, so an underestimation of its destruction is not a trivial matter. In a deep recession, even the creditworthiness of all economic actors will be called into question, so that even personal credit in return for rights of action will be adversely affected.

Commercial bank credit is bound to follow this trend. The maintenance of bank credit levels is fundamental to underwriting bond and stock market values. Yet being easiest to action, the liquidation of financial assets held both on bank balance sheets and off bank balance sheets in the form of collateral is merely the initial phase of contracting bank credit. And as derivative obligations become closed down or mature, they will not be renewed. The only exceptions are asset liquidity, such as treasury bills, short-term maturity government bonds, and reserve deposits at the central banks, held in accordance with Basel 3 bank regulations.

After a prolonged period of decline, rising interest rates now threaten the survival of zombie corporations and all business plans based on the belief that financing costs would not rise. Therefore, a second phase of bank credit contraction aimed at non-financial sectors is already under way but is bound to accelerate as non-performing loans threaten to overwhelm the banks. Mortgage interest payment arrears will mount.

It will be impossible for undercapitalised banks to survive these conditions intact. And as the commercial banking cohort continues to contract their credit obligations, there are bound to be bank failures threatening to undermine the entire banking system. Major central banks themselves already find that the losses on bonds acquired through quantitative easing have pushed their balance sheets into negative equity, a worsening situation as bond yields continue to rise.

By managing interest rates, mainly by forcing them lower than they would otherwise be if set by markets, central banks have unwittingly created the conditions for a global credit contraction on a massive scale. They are now at a crossroads. Either they discharge one of their primary functions, and that is to ensure the integrity of the financial system. Or they seek to discharge another primary function, and that is to prevent a collapse in their currencies' purchasing power. The choice is now that black and white.

The consequences of removing the specie anchor

We now turn to the consequences of the most momentous decision in the last century taken by America as leader of the free world: the abandonment of gold standards and the introduction of the pure fiat dollar.

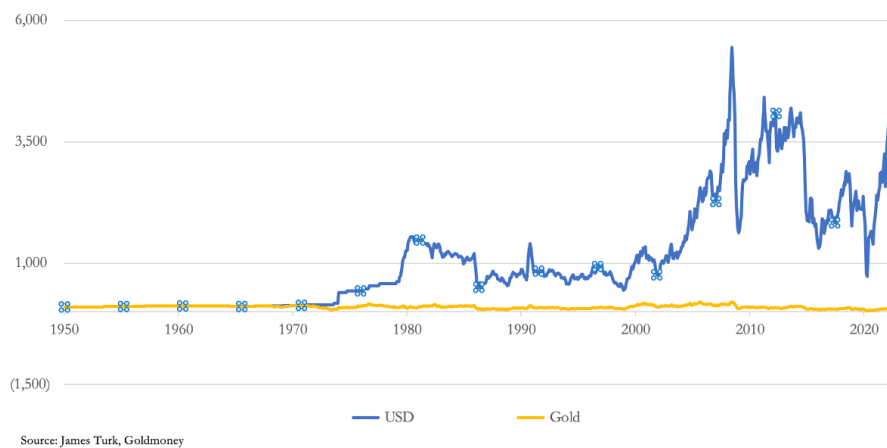
Under a credible gold standard, central banks were called upon to act as lenders of last resort if required to rescue the banking system from a general contraction of credit. So long as the gold standard's credibility held, it did not have to face the consequences of expanding its currency commitments. Admittedly, other than preserving the integrity of the banking system, neither monetary policy nor government action attempted to manage and intervene in the broader economy when proper gold standards applied.

Generally, slumps were mercifully short as credit excesses were rapidly unwound and stability returned. The last such slump in America was in 1920, yet by late-1921 it was over. It was not the business of governments to intervene. Today, virtually every economic activity is regulated by governments, and they attempt to micromanage markets outcomes.

Though few of us seem to realise it, the free expression of individuals satisfying their needs and wants is heavily tampered with. And depressive portions of their income and spending are removed in taxation, and their wealth is stripped from them by currency debasement. In truth, the economic environment bears no relation to that before America's forgotten depression of 1920, and more particularly before the First World War.

Today, the monetary anchor of gold is absent, and fiat currencies are volatile in their purchasing power. The difference between the two is clearly illustrated in the chart in Figure 2.

Figure 2. Crude oil priced in gold and USD. Base 1950=100



The common factor is crude oil. Priced in gold, since 1950 oil has been remarkably steady, and anyone dealing in oil priced in gold could confidently regard all price subjectivity to be confined to oil. Priced in dollars, the price variability has been in the currency rather than the commodity, which is not how it should be. Nevertheless, accounting conventions encourage dealers in crude oil to think the volatility is in oil, and not the currency.

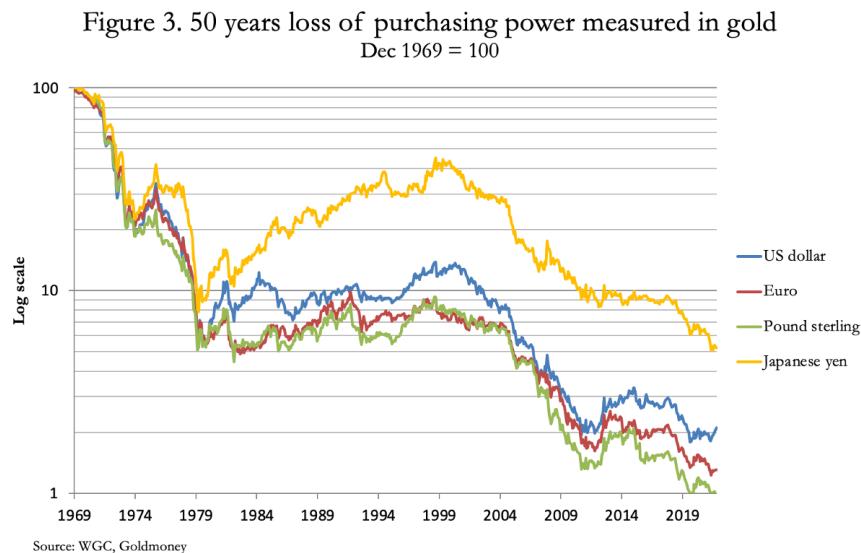
This has important implications for how we should view a credit system anchored to a fiat currency, compared with specie. It tells us that since 1950, and more particularly from the early seventies, through booms and recessions if a credible gold standard had continued from where the Bretton Woods agreement left off (it was "temporarily suspended" by President Nixon in August 1971), the purchasing power of the dollar would have varied, but by considerably less than it has as a fiat currency.

There's more. Figure 2 shows that not only was the oil price in gold considerably less volatile, but measured in dollars it has risen by 33 times, from \$2.57 to \$87 currently with considerable volatility. The steadiness in the oil price in gold — it has in fact fallen 30% in seventy-two years — tells us that it is the dollar which has lost purchasing power while the oil price has fallen slightly, not risen 33 times as the dollar indicates.

Critics of this conclusion have to surmount the legal position. Gold is money, and dollar currency is not. The best the dollar currency can be is a gold substitute on the basis that it can be exchanged for gold at a fixed price, but even in rudimentary form that was

abandoned by President Nixon when he suspended the post-war Bretton Woods agreement.

Figure 3 shows how the four major currencies have fared since the beginning of that decade, indexed to the last day of 1969.



Since that date, measured in legal money the dollar currency has lost nearly 98% of its purchasing power, the euro (back calculated before 2000) 98.7%, sterling 99.2%, and the yen 94.8%. The majority of minor currencies have fared considerably worse.

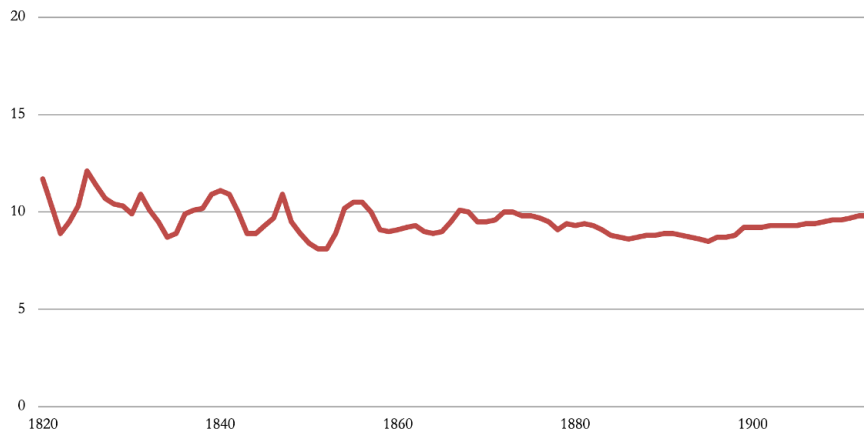
Clearly, this has important consequences for credit — the currencies themselves and deposit accounts held at the banks, which are the circulating media we all use for our daily transactions. Most of the time we are happy to go along with the myth that in any transaction we should view the currency objectively and the items being purchased subjectively. In other words, we can agree with a seller that a dollar is a dollar and any difference of opinion about the price is reflected entirely in the item or service being exchanged.

That would certainly be true if the currency was tied to specie, but as shown in Figure 2 above, when it is not a credible substitute for specie, nearly all the volatility is in the currency. Furthermore, Figure 3 shows that retaining balances in fiat currencies is extremely costly over time. The reality of the situation is not understood by either the public or the foreign exchanges, the latter being totally absorbed in variations in values between fiat currencies, all of which are declining.

We now need to consider the implications of these findings. The contraction of bank credit which has only recently begun, is so far only evidenced in liquidation of financial securities. Given the exceptional balance sheet leverage at the peak of the current bank credit cycle, with Japanese and Eurozone global systemically important banks (G-SIBs) having balance sheet to equity ratios averaging over twenty times, the contraction phase of the cycle promises to be extremely severe. Under a gold standard, the shortage of credit initially causes interest rates to rise, hastening the liquidation of malinvestments and the reallocation of capital to sounder enterprises. The purchasing power of specie-linked currencies rises, consistent with a slump in business activity, before stabilising as credit conditions normalise. Figure 4 below shows the the UK's composite price index covering a

century of the UK's gold coin standard (introduced in 1817), illustrating the price effect of the bank credit cycle. The general price level did vary, but over the century was broadly unchanged. The volatility declined sharply after 1864 when the Bank of England joined the commercial banks' clearing system. As the sole issuer of bank notes, this not only made clearing considerably more efficient, but the effect was to tie commercial bank credit more closely to the Bank of England, which issued the bank notes exchangeable into gold coin.

Figure 4. UK composite price index 1813-1913



Source: ONS, Chronicle of Britain, Goldmoney

The stability afforded by these arrangements is wholly lacking today. The contraction of bank credit, which under a gold standard led to higher interest rates initially, is bound to be met in current circumstances by central banks endeavouring to suppress rates in an attempt to stave off a deepening recession, to rescue the commercial banking network from systemic failure, and to maintain financial asset values. These are primary, mandated responsibilities of a central bank.

After decades of declining interest rates, deteriorating credit conditions are brought about by a new trend of rising interest rates. Holders of fiat currencies are currently offered deposit rates which are still far from compensating them for loss of purchasing power, currently assessed at about ten per cent for consumer prices. Instead of valuing the possession of credit in the form of bank deposits, they have every incentive to eliminate their losses as much as possible by buying goods that they may need in future. Early in this process, consumers and businesses will simply be aware that prices are rising, and there is little sign of the situation ameliorating. That is a fair description of the current position.

At some point, there will be a growing realisation that it is not prices rising, but their fiat currency's purchasing power declining. When the import of the graphs in Figures 2 and 3 above is widely understood, that the objective value is in the goods and not the currency, a fiat currency is doomed.

We must conclude our examination of credit by stating that a currency credibly linked to specie generally retains its purchasing power, despite fluctuations in bank credit. Without that link, the currency eventually fails completely. After fifty-one years of no specie link at all, we appear to be rapidly approaching that end.

ⁱ See *The Fed's Formative Years 1913-1929* by David Wheelock:
<https://www.federalreservehistory.org/essays/feds-formative-years>

ⁱⁱ Reported in *Farming in the 1930s* — Wessels Living History Farm