Beyond the tipping-point

Ladies and Gentlemen

I am going to give you an over-view of what is happening to money. My conclusion is that we are heading for a collapse of paper-money, or put another way, we are heading for hyperinflation. This is the fundamental justification for hoarding sound money, which is, of course, gold and silver. The danger of hyperinflation has been building for decades. To fully appreciate this inflationary danger, we require a clear understanding of the difference between sound money and paper currencies.

The first thing we must understand is that the economic policies of the Keynesians and central bankers are not pure economics. ***Rather, it is the pursuit of social objectives by economic means***. What do I mean by this?

Politicians never consider an economic policy without placing their political motivation first, so long as it can be paid for. Paper money is always available; sound money has to be raised through taxes, which is why paper money is so popular with governments. With paper money the result is continual debasement. There is nothing new in this. Throughout history bankers and economists have conspired with politicians to circumvent the discipline of sound money. The bankers' motivation is monetary inflation unchains enormously inflated profits; for the economists it is often the foolish promotion of their own political beliefs.

Economists think they can improve on the free market by intervention, but when intervention produces unintended consequences they blame the free market; never their own errors of judgement. Bad economists manage to present their errors better to the public than good ones their truths. Bad economists, bankers and governments **all** prefer paper money. This brings me nicely to the subject of Mr Keynes.

We must not forget that at the time Keynes developed his economic theories the world was polarising into the extremes of communism and fascism. Cambridge, his university, was ***the*** recruitment centre for the Soviet KGB. The **previous** century's free market approach was being discarded. His bias was the belief that it was wrong for free markets to benefit the rentier (or saver, or capitalist if you like), at the perceived expense of everyone else.

Keynes devised a way of satisfying his social priorities by economic means, avoiding the excesses of communism. So it was that the nineteenth century, which enjoyed rising prosperity and falling prices - the result of free markets, was followed by a century of growing monetary inflation, government intervention and the destruction of savings - the result of Keynesian economics.

And about inflation, I can do no better than to quote the economist von Mises:

> "Just as the sound money policy of the gold standard went hand in hand with liberalism, free trade, capitalism and peace, so is inflation part and parcel of imperialism, militarism, protectionism, statism and socialism."

He could have written that today: we wage wars against regimes that don't share our values, we protect large companies and whole industries from competition with regulation and government support, we turn to the state to solve all our problems, and we are overwhelmingly dependent on socialist welfare.

He actually wrote this in the 1920s at the time of the German inflation. Germany had its version of Keynes: he was called Georg Knapp. He preached that Money is what government says it is. Money is a government product. The government is sovereign and free to do what it wants to with money.

Germany used this idea to finance a war without increasing taxes. Free wars are popular, at least when they start. In the four years from 1913 the Reichsbank increased money in circulation by 2½ times, covering 85% of Germany's war expenditure for those years. Interestingly, this printing was similar to the scale of the Federal Reserve Board's recent increase in its monetary base over a slightly shorter period: an increase undertaken with considerably less gold reserves, and in peacetime.

And then the post-war German government, still influenced by Knapp, thought monetary inflation would also pay for reparations and the reconstruction of the German economy.

The similarity with Keynes is obvious. This, in a nutshell, is where Keynes has led us to today. One day, he will be a footnote in history, like Knapp, and John Law who engineered France's inflationary collapse 400 years ago – two economic charlatans with a remarkably similar approach to money.

We are dealing with Economics in pursuit of social objectives. To achieve these objectives important elements of economic theory have to be discarded or discredited. Keynes hid these by only dealing in macro-economic generalisations. In his General Theory, he reduces human behaviour to a maths exercise. He never rolled up his sleeves and studied economics at the micro-level. If he had, he might have understood that the human actions we call economics are not governed by a set of equations.

Keynesians believe that governments can soften economic downturns. They subscribe to the ancient fallacy of lack of demand as the reason for recessions, and government deficit spending and the stimulation of consumption, as the road to recovery. In the context of economic history, this is not new.

The post-depression social objective is clearly to maintain full employment. But for this to work on anything other than the very short term, government has to be able to deploy economic resources as effectively as the private sector. The idea that government can actually do this is simply preposterous.

Why then is the **private sector** best at deploying economic resources? Because it provides needed goods or services at the right price at the right time, freely determined by people spending their own money. Government does not have this discipline, instead it has bureaucracy. The primary objective of any government agency is to satisfy and protect itself. The actual need for a service, its relevance and value is always subordinate to the bureaucracy. This is the difference from the private sector: you go into a shop, and the sales assistant asks, ”Can I be of assistance to you, sir?”. You go into a government agency: “Get to the back of the queue and wait until you are called!”

But government waste is only one side of the coin. The other is more important. It is the loss of economic resources taken from productive private businesses and individuals. Today, about half the private sector’s productivity in most socialist democracies is being squandered, lost to the private sector through taxes, diversion of savings and the hidden tax of inflation. That is a loss that’s always ignored, but it is a loss none the less. It is the unseen loss of the economic resources that would otherwise be in the productive hands of private businesses and individuals. For the fact of the matter is the best person to decide how to maximise the economic benefit of his hard-earned money, and how to allocate his valuable savings, is the individual who earned it and not a government agency acting on his behalf.

Anyway, Keynes promoted the idea that government deficit spending, by stimulating consumption, was the way to smooth out economic cycles, and maintain full employment.

But Keynes’s remedy, besides showing a bias against savers, is borne out of a complete misunderstanding of the real reasons for “under-employment”. It ignores the fact that economic cycles are actually the result of fluctuations in money and bank credit. If you have sound money, you don’t have these cycles.

When Britain went on the gold standard in 1821, following the introduction of the gold sovereign, and remained on it until the First World War, this island of less than twenty million people progressed to become the richest and most powerful on earth, in all of history. And it was all done by private businesses without government subsidy!

We didn’t get it all right, because the Bank Charter Act of 1844, which made Bank of England notes legal tender, fully backed by gold of course, failed to understand the role of banks in creating credit. So we still had occasional banking crises as a result of too much credit expansion, but at least they were limited in their damage because the Bank of England couldn’t just print money without having the gold to back it. But if we had banned fractional reserve banking in 1844, we wouldn't even have had those financial episodes and therefore suffered their economic consequences.

To understand why artificial expansion of money and credit drives us into cycles of boom and bust, why it leads to economic instability – the exact opposite of what it is meant to achieve, why it eventually leads to hyperinflation, I must very briefly summarise Capital Theory. This was well known to the early economists of the Austrian School, and it was a pity Keynes could not read German.

Capital theory. Firstly, let us assume sound money: a pool of money that neither increases nor decreases, and let us assume that banks are unable to create credit.

This being the case, a business developing a new product or improving an existing one has to invest its own money, or find a lender with savings. In either case, this takes money away from consumption, money that is reallocated into savings and from there into the proposed investment. And because this money is not spent on consumption, the other resources required for any new project, labour and raw materials, become available. You could say that employment opportunities shift from serving customers towards making things. Lower demand for consumer goods also frees up raw materials. So generally speaking, if there is a shift from consumption into savings, and therefore from savings into investment, a balance is maintained and there is no boom and bust. It is a random, rolling process that is inherently stable and can continue ad infinitum.

But why does a business want to invest? Because by investing in new processes, new products, it offers better value, better quality. It has to adapt to evolving markets to remain competitive. By improving production you lower unit costs. Above all, by successfully gauging consumer preferences, you are part of economic progress. All this is made possible, because both businesses and individuals are prepared to put aside some of their spending and save. It is a process that is determined entirely by the free market, and none of us has the knowledge or the ability, to double-guess this natural process. Importantly, there is no herd instinct; just a random, self-sustaining, progression of improvement. Furthermore, the expansion of production driven by this natural competitive process actually leads to a long-term trend of better value, or increasing purchasing power for sound money, and enhances the capital value of savings.

Now look at the situation when this investment is financed by newly created money and bank credit, and not savings. The process kick-starts with an engineered fall in interest rates. This makes investment appear attractive to the businessman, so he borrows to improve his business. But many other businessmen are attracted to the same idea.

Together, they are a growing herd, moving in the same direction. But cheap money also supports consumption, because saving money is made less attractive due to lower interest rates.

So our businessman has to bid up for labour, because it hasn't been released by a switch from consumption, and he is in competition with the other businesses also taking advantage of cheap credit. He has to pay up for raw materials, for the same reasons. The combination of industrial investors and consumers responding to cheap finance will drive the economy better. But with no extra resources available, prices rise – bottlenecks appear. And with prices rising, the central bank then has to raise interest rates to slow things down. Our businessman's plans are now in a mess. His return on investment calculations turn out to be wrong. He has been conned into an investment with none of the factors of production being available to him. His fellow entrepreneurs are in the same boat. Businesses start cutting back, and the whole business environment turns sour.

The essential point is false money and credit have created a business cycle which didn't exist before. It has turned the private sector into a crowd, surging in the same direction, instead of acting in a random and balanced fashion.

The central bank then compounds the problems it has created by again lowering interest rates to prevent the bust. It does not allow the distortions and false investments created as a result of the previous credit cycle to unwind, because it does not want businesses to go bust and unemployment to rise. But second time round, with the lesson of experience, the businessman is reluctant to burn his fingers again. He builds greater margins into his investment calculations. So the economy becomes slower to respond to a new round of interest rate cuts. The central planners at the central bank (who by the way have no business experience) have to act more aggressively to create yet more money and credit, to achieve the desired result.

These credit expansions work like a ratchet, becoming larger and larger over each credit cycle for less and less effect.

The businessman eventually wises up, and moves his manufacturing to somewhere where the factors of production are available. He needs to plan for ten, fifteen, twenty years. He cannot afford to ride credit-driven cycles of three or four years. It is unsound money that has driven him abroad more than any other factor. For this reason, over a number of these credit cycles the make-up of the economy in countries with falling savings, like the US and UK, becomes more and more dependent on consumption and ephemeral services, and less and less on manufacturing.

And finally, to encourage GDP growth, consumers are encouraged to actually borrow to spend and abandon saving altogether. So on every credit cycle, savings diminish and debt increases, finally accelerating to unsustainable levels of debt. Does this sound familiar?

This process came to an end with the credit crunch. Peoples' behaviour changed: they wised up, they no longer wished to borrow; they now wish to reduce their debt. The failure of this Keynesian experiment has left us all with acute financial insecurity. The banks switched from lending greed to fear of lending. History might view this watershed as the tipping point into accelerating inflation; the tipping point where hyper-inflation becomes a reality.

If the Authorities had let the banking system fail, as well as the businesses and people who were over-extended with debt or those that had money on deposit at the banks – pretty much all of us - it would have ended the politicians' pursuit of social objectives. Instead, they chose to rescue the banks, and everyone else, but the expense of depositors, by slashing interest rates to zero. It has required printing money in unprecedented quantities, at least for peace-time. From the Bear Sterns rescue in March 2008 to the present time, the Fed has increased the US monetary base by 220%, a similar rate to the Reichsbank in 1913-1917.

The Bank of England's balance sheet liabilities, which we can say equates to the money it has created, increased by 500% between 2007 and 2011. And where did this money go? It gave the banks liquidity and funded government spending not covered by taxes.

Having discouraged and destroyed savings over the years, the money does not now exist to cover today's budget deficits.

Central bankers tell us that printing money to offset stagnant bank lending will bring mild inflation to stimulate consumption and stop a slide into deflation. Not only is this wishful thinking, it is extremely inflationary. It ignores the fact that money and bank credit are used differently. Narrow money buys everyday items, while bank credit is required to sustain asset prices.

But without the support of newly printed money, the banks would be insolvent. Remember, they are geared ten to twenty times their core capital. It takes very little contraction of lending, very few bad debts, to wipe it out. This is the reason central banks have to keep shovelling in the money: to keep the banks solvent.

When governments and their central banks accelerated money printing to rescue the world from a bank collapse, it was intended as a stop-gap until the global economy recovered. Mainstream economists believed, or prayed, and certainly advised that the massive monetary stimulus would guarantee this recovery. They are wrong for entirely predictable reasons. As I said earlier, trying to engineer economic growth by injecting new money and credit into an economy has finally become totally ineffective. The credit crunch was the end of that illusion. All that the Fed and the Bank of England have achieved since then with negative real interest rates is more destruction of real savings. And it is only real savings that can guarantee a sustainable economic recovery, as we saw with Capital Theory.

The few savings that have survived the inflationary damage, are now commandeered by governments for their own spending. They are being diverted from the productive private sector into the inefficient government sector. There can be no economic recovery so long as this persists.

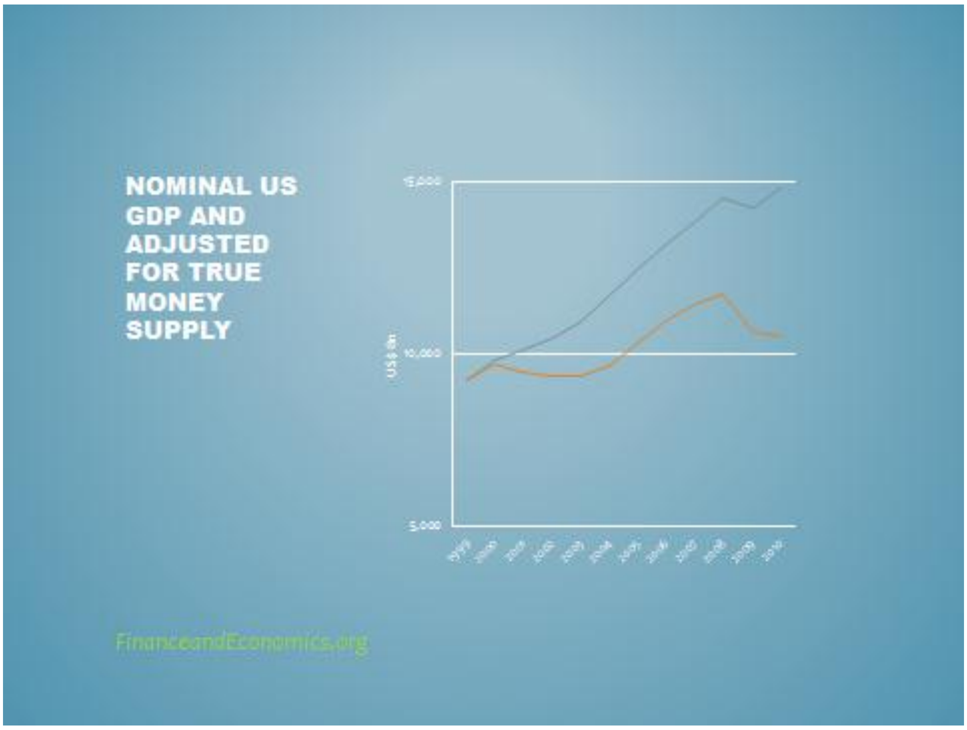
Yet governments are still firmly wedded to their social objectives. So the increase in claims for welfare services and other government spending continues. In real terms, these future liabilities are rising rapidly of their own accord; furthermore the inevitable slump in the private sector will add to government deficits through lower tax revenues and rising unemployment. In real terms, these deficits will skyrocket. So will the debt servicing costs – governments are stuck in a debt trap. In America a president needs to be re-elected. Votes have to be bought. And in paper money terms, these costs will rise even faster, because if you debased a currency yesterday, you need to debase it even further tomorrow because it buys less.

So these are the fundamental forces that are leading us into hyperinflation. Today, the chains of inflation are too weak to be felt, but believe me, they are already too strong to be broken.

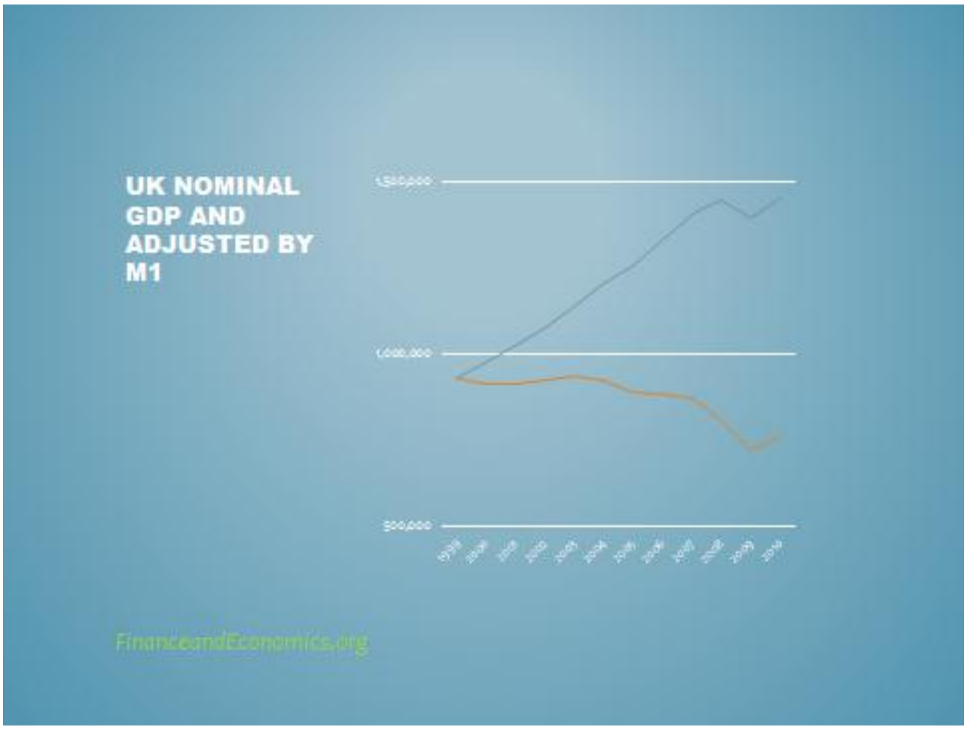
I have had a number of correspondents in the last year or two, who have woken up to the increasing dangers of a banking collapse, an economic collapse, or some huge cyclical event (Kondratieff is frequently mentioned), and they expect deflation, not inflation.

The first thing to say is that priced in sound money, I expect prices of all goods and assets to continue to fall very sharply.

This chart is of dollar prices converted into sound money. The correlation is not perfect, because sound money is not actually used for transactions. But you can deflate anything you like by the white exponential line. Bread, clothes, motor cars, energy. In real terms, prices are sliding at an increasing rate. I shall come back to this in a moment.



With respect to GDP, here is the US for the last ten years, deflated by True Money Supply. Note the slump since the credit crunch. The economy has contracted by about 12%.



And here is the UK GDP. If you take out the increase in cash and non-interest bearing deposits, Britain has been in recession since 2003/04. Since 2003 we are down over 20%.

I know this analysis is crude, but the message is clear. In real money terms, we are already in a deflationary slump, so I completely agree with the deflationists. What they seem to miss is that priced in paper money, prices can, have, and will rise. In Riechmarks between 1915 and 1922, the GDP statistics would have shown Germany was growing strongly. But adjusted properly for monetary inflation, the economy was actually collapsing.

At the end of the day, a paper currency is simply a zero-interest credit instrument, and to argue that its purchasing power will increase while it is being issued in accelerating quantities, without limitation, electronically or otherwise, is simply nonsense. Which brings me back to George Knapp.

At some stage, and I don't know when, the American people will wake up to George Knapp's fallacy. Their dollars are not worth what government says it is. The government is not, in the final analysis, free to do what it wants with money.

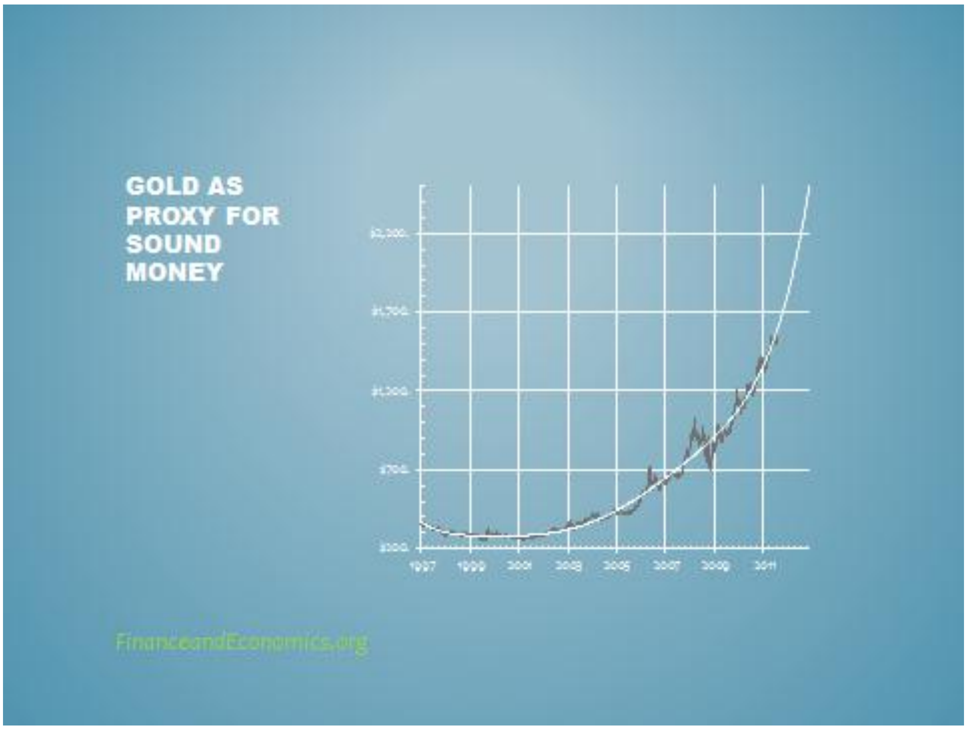
It is that recognition and the timing of it that are beyond anyone's control and anyone's guess. And when the dollar goes down the tubes, it will take the whole, global, paper-money pyramid with it.

The only way a collapse in purchasing power for paper money can be prevented is by the abandonment of all weak money policies, which is simply not going to happen for dollars and sterling. The situation for Euroland is different, because the ECB does not at the moment finance governments by money-printing. It only does it to keep the banking system going. This is why the PIGS are in crisis. The euro for them is a tough currency. But I expect the ECB will eventually give in and start printing more freely.

It's in recognition of the inflationary dangers we face, that gold and silver have performed so well for investors. Traditionally, these two metals have always been money. In all history they have survived every attempt, as they will this one, to replace them with paper money or inferior coinage.

But with the cumulative currency debasement which started before the First World War, the amount of paper currency in issue compared with gold held by the central banks is already simply enormous.

You may be wandering how I derived the chart of the price of absolutely everything in sound money, and extrapolated it with an exponential projection.



It is of course the dollar price of gold inverted. It shows the strength of the pull inflation exerts on us all. It is also visible confirmation for the hyper-inflation argument I have put before you today.

Thank you very much for listening to me.