

## Too Much Like 1929

By Bernard Ber

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*Ed. Note: The author compares global economic events of the late 1920's to contemporary economic activity. It is the author's intent to provide the reader with a set of 'signposts' to be watching for. There are many moving parts taking place under this scenario, so the reader may find it necessary to re-read a paragraph or two.*

As US real estate prices fall and depress US economic growth, private foreign investors begin to withdraw their capital from the US financial markets. This capital flow would by itself act to elevate the currency value of the country that it is returning to. However, the governments of developing foreign countries have policies in place to fix the exchange rate of their currencies. In order to maintain this fixed exchange rate, foreign central banks will print their own currency and exchange it for US dollars (which are then invested into US government debt). The amount of money printed and exchanged into US dollars by the foreign central bank will necessarily equate to the amount of private capital returning to the country. These central bank policies will act to artificially keep the value of the US dollar elevated and artificially keep US interest rates low.

The fixed exchange rate regime is put under great stress when private investment capital begins to leave the US, because it necessitates that the foreign central bank print much greater amounts of their own currency. This will act to boost their domestic money supply and cause their own economy and stock market to "overheat". Additionally, in the process of exchanging increasing amounts of their own currency for US dollars, the foreign central bank rapidly builds up the amount of foreign exchange reserves that they own. The increasingly large holdings of foreign exchange reserves represent a corresponding increasingly large risk of foreign exchange losses to the central bank (should the US dollar fall in value in the future).

When the central bank fixes the exchange rate, it effectively cedes control over the domestic money supply, as they are obligated to print whatever amount of currency is required in order to offset the amount of foreign currency being brought back to the country. The only tool that the central bank has left at its disposal is to change the level of the domestic short-term interest rate. However, even there its' hands are tied, because if they decide to increase the interest rate (should the economy "overheat"), then this will only serve to worsen the situation. This will cause even more investment capital to return to the country from the US because the interest rate differential between the two countries is made more favorable, drawing in capital in search of higher interest yield.

In the face of increasing private investment inflows (caused by a deteriorating US economy), the foreign central bank is faced with a tremendous dilemma. Its economy begins to overheat and yet increasing interest rates will only serve to worsen the situation. The only way to stop the rapid acceleration in domestic money supply growth is to finally abandon the fixed exchange rate regime altogether. This will negate the necessity of printing new currency with no control.

When the fixed exchange rate regime is terminated, then newly minted funds from the foreign central bank no longer act to support the value of the US dollar and maintain low US interest rates. In effect, there is nothing left to support the US consumer anymore. The value of the US

dollar collapses and US interest rates skyrocket. The skyrocketing interest rates cause a real estate crash. The collapsing value of the US dollar causes the price of gold to skyrocket. And needless to say, the stock market collapses.

At this time, the key foreign central bank that is artificially supporting the US economy at present is the central bank of China. Their current foreign exchange reserves now stand at \$1.2 trillion. The latest statistics indicate that their foreign exchange reserves grew by about \$135 billion in the first quarter of 2007, which equates to an annualized growth rate of \$540 billion. They are not alone in propping up the US economy, as total worldwide central bank reserve growth is running at an annualized rate of \$1 trillion (with current total reserves of \$5 trillion). Some people look at the data with puzzlement, but what it clearly reveals is that a great deal of private investment capital is being repatriated from the US. Economic growth in the US began to decelerate significantly in the fourth quarter of 2006. I don't see that as a coincidence.

The Chinese stock market began to rise in value dramatically starting in November 2006. It has literally doubled in value since then (over a period of 6 months), with the Shanghai composite index rising from 1800 to a present level of 3600. The over-inflated state of the Chinese stock market recently resulted in a one-day decline of 9% on February 27, 2007, which in turn caused global stock markets to sell off sharply. As well, the economic growth rate in China has accelerated to an annualized rate of 11.1% in the first quarter of 2007. The run-up in the Chinese stock market and the acceleration in economic growth at the same time that China's foreign exchange reserves rose sharply is also no coincidence.

The point is rapidly approaching when China's central bank will be forced to abandon their fixed exchange rate regime. On March 20, 2007, the governor of China's central bank stated for the first time that they "will not stockpile foreign exchange reserves any more" (an extraordinarily important comment that few people took note of). Given the present state of affairs, how could that possibly be accomplished without the abandonment of the fixed exchange rate system? They will realize that the alternative to this (keeping the policy in place) can only result in the destruction of the Chinese economy. When the peg on China's foreign exchange rate is dropped, the US economy (as well as the global economy) will implode.

The global economy is critically dependent right now on what happens in the Chinese economy. To that extent, it is very important to focus on three elements going forward: the growth of China's foreign exchange reserves, Chinese economic growth and the Chinese stock market. In turn, what happens in China will depend on the rate of deterioration in the US economy (which will determine the amount of private investment capital that returns back to China and causes their economy to overheat further). At this point, we are witnessing an extremely unusual relationship, whereby deterioration in US economic growth actually causes an acceleration in Chinese economic growth.

Further deterioration in US economic growth from this point onward will cause the US Federal Reserve to consider cutting the US short-term interest rate. While many participants in the US financial markets are conditioned to look at this outcome favorably, at this point such a decision would result in a repatriation of foreign capital (and rising longer term interest rates), because the interest rate differential versus other countries will become less favorable. An interest rate cut for a highly indebted country that is highly dependent on foreign capital will result in a completely opposite effect from that intended. The flight of private foreign capital back to China

would result in the termination of China's fixed exchange rate system, as the tremendous increase in their domestic money supply would necessitate it. Once that occurs, the foreign capital outflow would turn into a flood, given that there would be no foreign central bank intervention to offset it. Any benefit to debtors from a lower short-term interest rate will be negated by the tremendous offsetting cost of sharply higher longer-term interest rates (as US government debt is sold off in the US dollar liquidation). The US Federal Reserve is in a box. The Fed is now powerless to rescue the US economy, because of the threat of foreign capital flight. The emperor has no clothes.

The tension in the world financial system will continue to build as the system is stretched from two opposite ends (the US and China). Further acceleration in Chinese economic growth or further deterioration in US economic growth will increase this tension to the point that the system literally breaks (remembering again that these two trends are linked together). Any further increases in the Chinese short term interest rate or decreases in the US short-term interest rate will amplify these stresses and cause the cracks in the dam to widen (until the dam bursts).

The wild card in this situation is Iran. There has been a major escalation in the conflict between the US and Iran over the past few months regarding the development of Iran's nuclear program. The latest round of UN sanctions on Iran were imposed on March 24 and will be reassessed after 60 days (as of May 23<sup>rd</sup>) if Iran fails to comply with the UN Security Council resolution. Iran's leaders have recently indicated that they will retaliate in some unspecified manner if new sanctions are imposed upon them again. Their intent is clearly to escalate the conflict (in a "tit-for-tat" manner) to the point where a military conflict ensues. If Iran threatens in a more specific and tangible manner to attack the US directly, then you can rest assured that private foreign capital will flee from the US financial markets. When that capital flees back to China, the flow of capital will overwhelm their central bank and cause them to abandon their fixed exchange rate regime. As mentioned before, this in turn will cause the stream of money leaving the US to turn into a flood. Given Iran's deep hostility toward the US, they may very well recognize the acute vulnerability of their opponent and seek to exploit it by escalating the conflict (at least verbally) to the point of literally "scaring" foreign capital out of the US and destroying their economy.

Now I would like to draw a very important parallel. Let us return to the sequence of events that led to the stock market crash of 1929 and the Great Depression in the 1930s.

Back in 1966, the most esteemed Alan Greenspan himself wrote the following in an essay entitled "Gold and Economic Freedom":

"When business in the United States underwent a mild contraction in 1927, **the Federal Reserve created more paper reserves** in the hope of forestalling any possible bank reserve shortage. More disastrous, however, was the Federal Reserve's attempt to assist Great Britain who had been losing gold to us because the Bank of England refused to allow interest rates to rise when market forces dictated (it was politically unpalatable). The reasoning of the authorities involved was as follows: if the Federal Reserve pumped excessive paper reserves into American banks, interest rates in the United States would fall to a level comparable with those in Great Britain; this would act to stop Britain's gold loss and avoid the political embarrassment of having to raise interest rates.

The "Fed" succeeded; it stopped the gold loss, but **it nearly destroyed the economies of the world, in the process.** The excess credit, which the Fed pumped into the economy, spilled over into the stock market, triggering a fantastic speculative boom. Belatedly, Federal Reserve officials attempted to sop up the excess reserves and finally succeeded in braking the boom. But it was too late: by 1929 the speculative imbalances had become so overwhelming that the attempt precipitated a sharp retrenching and a consequent demoralizing of business confidence. As a result, the American economy collapsed. Great Britain fared even worse, and rather than absorb the full consequences of her previous folly, she abandoned the gold standard completely in 1931, tearing asunder what remained of the fabric of confidence and inducing a world-wide series of bank failures. The world economies plunged into the Great Depression of the 1930's." (end)

Do we see any parallels here?

The two major players in the world financial system at that time were the United States and Great Britain. The United States was the emerging industrial power, whereas Great Britain was the mature and stagnating industrial power. The central bank of the emerging industrial power (the US) printed money in an effort to prop up the economy of the mature industrial power (Great Britain). The inflation of the money supply resulted in the overheating of the economy and the stock market of the emerging industrial power. It was the crash in the stock market of the emerging industrial power (the US) that brought about the crash in all the world's stock markets and the Great Depression followed later.

Now fast forward to today, and what you see is China as the emerging industrial power and the United States as the mature and stagnating industrial power. China is printing money in an effort to prop up the economy of the mature industrial power (the US). The inflation of the money supply is resulting in the overheating of the Chinese economy and stock market. Very interestingly, on February 27, 2007, it was the sharp 9% one-day drop in the Chinese stock market that led to the sharp drop in stock markets worldwide, including the US. People may be conditioned to think that economic events in developing countries pale in significance to economic events in the US, and may fail to see how what happens "way over there" in China would have any significant impact on their economic well-being. But how different the truth really is. I think most people even now after the February 27<sup>th</sup> turn of events, fail to grasp why the US stock market sold off so sharply **after** the Chinese stock market sell off occurred first. The idea that a foreign stock market could dictate what happens in the US stock market almost offends the American sense of national pride (so the event is casually dismissed as "market irrationality"). A word of advice: you better get used to it, as there is much more of that to come. The crash is coming.

*Bernard Ber is an investment representative with CIBC in Toronto and is currently working towards the CMA management accounting designation. This article appeared on the Prudent Bear website and is reprinted with permission from the author.*