Chris Andrew
and Mustafa Zaidi
ca@clarmond.co.uk
+44 20 7060 1400

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Market Comment

CLARMOND

The Empire of Doldrums

At every iteration of the global monetary system the country that provides the world with its key collateral for trading and settlement has two roles. It is responsible not only for its own domestic economy but also for the global economy. Is the Fed about to relinquish this second role?

AT GENOA IN 1922 A DEBT-LADEN Europe attempted to resurrect the gold-based global collateral system, with the London Money Market, once again, at the centre of investment and commerce. The result was a compromise which saw the creation of a gold exchange standard in which key central banks would hold bonds of 'gold centre nations' (the British Empire and the USA) as liquid reserves, reducing the need for physical gold.

These collateral reserves would be used as currency for settling payments. Such an exchange system had been operated by the British at the India Office for the past two decades. British India's current account surplus had been invested in sterling bonds, providing liquidity to the London credit markets and alleviating the need for Britain to hold gold as a clearing mechanism; in this system sterling bills were as good a collateral as gold. The world was now put on the same standard; it was not to last.

Patchy Prosperity

This gold exchange standard succeeded in reviving international trade "ending the global slump", but replaced it with economic "doldrums." Growth did not return, and thus governments were unable to offset the domestic burden of debt. This became their main pre-occupation and, without growth, they needed "some degree of inflation as a necessary condition of solvency."

The rest of the world required the global collateral currency, pounds and dollars, to remain cheap in order to maintain liquid credit conditions. As long as Britain and the US tolerated an outflow of gold to accommodate countries that were joining, the system creaked on.

Domestic Precedence

The first vulnerability in monetary system was inadvertently exposed in 1925 by Churchill who, as Chancellor, took sterling back onto gold standard at the higher pre-WWI rate; this brought elevated UK interest rates and deflation. In 1928 the US Fed exacerbated the flaw by raising rates and actively attracting gold.

Others followed with the Banque de France selling their liquid reserve collateral for physical gold, applying further pressure on the global system. Sterling bills were no longer as good a collateral as gold. This hunger for gold was all consuming and credit became scarce.

Domestic trump International

By 1931 Britain's domestic needs were given priority over international co-operation and stability. America made that same decision in 1933, and thus three key currency and trading blocs emerged:

i) Sterling with Imperial Preference,
ii) A Gold bloc led by France and
iii) US Dollar led by the US.

The global collateral system lay shattered upon the needs of domestic growth and employment. Global economic doldrums had ended with another disastrous slump, the depression of the 1930s.

Calm before the storm?

International Stability

The current global collateral is the US Treasury; it is at the centre of the pricing of global credit and acts as the reserve currency for most nations; the US dollar is everyone's currency. Given the massive war-time-like increase in global debt of both government and central bank balance sheets over the last 7 years, and pedestrian growth rates, we are all once again "pre-occupied with debt, requiring some degree of inflation as a necessary condition for our solvency."

Long-term international stability, similar to seven decades ago, is counterposed to the short-term domestic needs of the US. By raising rates, the Fed has had its 'Churchill moment', as it has inadvertently declared that its short-term domestic agenda outweighs its implicit international obligations. This is at a time when its central bank compatriots are heading in the opposite direction.

Global systems require global responsibilities.