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Central banker: useful functionary, or Cockney rhyming slang ?

"Central bankers control the price of money and therefore indirectly influence every market in the world. Given this immense power, the ideal central banker would be humble, cautious and deferential to market signals. Instead, modern central bankers are both bold and arrogant in their efforts to bend markets to their will. Top-down central planning, dictating resource allocation and industrial output based on supposedly superior knowledge of needs and wants, is an impulse that has infected political players throughout history. It is both ironic and tragic that Western central banks have embraced central planning with gusto in the early twenty-first century, not long after the Soviet Union and Communist China abandoned it in the late twentieth. The Soviet Union and Communist China engaged in extreme central planning over the world's two largest countries and one-third of the world's population for more than one hundred years combined. The result was a conspicuous and dismal failure. Today's central planners, especially the Federal Reserve, will encounter the same failure in time. The open issues are, when and at what cost to society?"

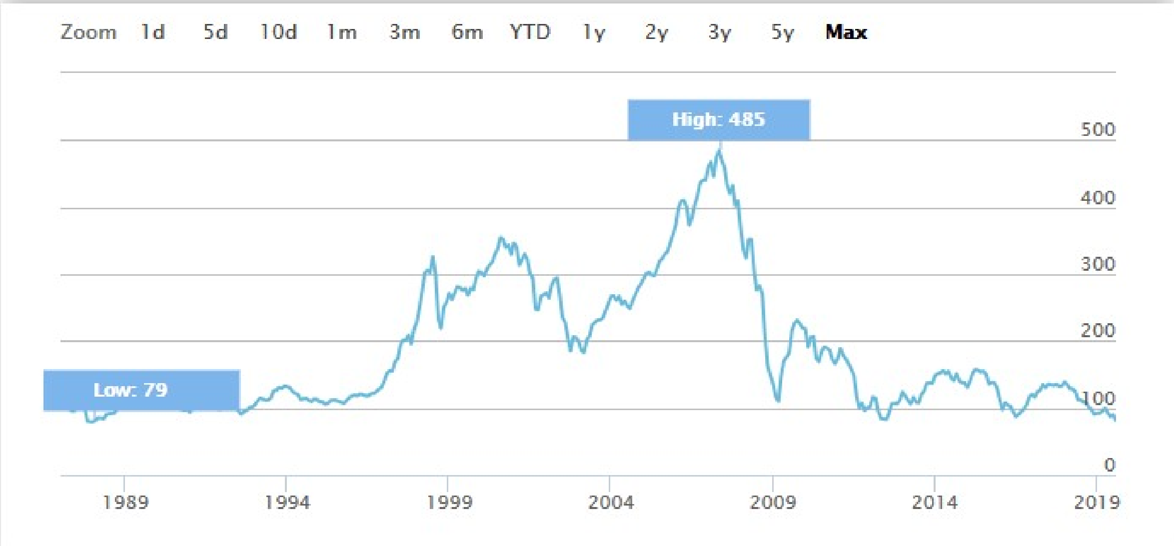
- James Rickards, *The Death of Money: The coming collapse of the International Monetary System*, 2014.

"Everyone loves an early inflation. The effects at the beginning of inflation are all good. There is steepened money expansion, rising government spending, increased government budget deficits, booming stock markets, and spectacular general prosperity, all in the midst of temporarily stable prices. Everyone benefits, and no one pays. That is the early part of the cycle. In the later inflation, on the other hand, the effects are all bad. The government may steadily increase the money inflation in order to stave off the latter effects, but the latter effects patiently wait. In the terminal inflation, there is faltering prosperity, tightness of money, falling stock markets, rising taxes, still larger government deficits, and still roaring money expansion, now accompanied by soaring prices and ineffectiveness of all traditional remedies. Everyone pays and no one benefits. That is the full cycle of every inflation."

- Jens O. Parsson, *Dying of Money: Lessons of the Great German and American Inflations*, 2011.

A number of financial market practitioners, including Russell Napier, Raoul Pal and Tim Parker have highlighted in the last few days the parlous state of the Eurostoxx Banks Index, whose price history is shown below:

Eurostoxx Banks Index 1987-2019



Source: Stoxx

Which banks make up the members of this index ?

Top 10 Components[5]

Company	Supersector	Country	Weight (%)
BCO SANTANDER	Banks	ES	16.97
BNP PARIBAS	Banks	FR	13.16
ING GRP	Banks	NL	10.62
INTESA SANPAOLO	Banks	IT	8.66
BCO BILBAO VIZCAYA ARGENTARIA	Banks	ES	8.30
UNICREDIT	Banks	IT	6.12
GRP SOCIETE GENERALE	Banks	FR	4.85
KBC GRP	Banks	BE	4.11
DEUTSCHE BANK	Banks	DE	3.94
CREDIT AGRICOLE	Banks	FR	3.66

[5] Based on the composition as of Jul. 31, 2019

Source: Stoxx

Russell Napier, in *The Solid Ground* newsletter of 8 August 2019 via the ERIC website:

The price of the equity of the following major European banks is now lower than when global equity markets bottomed in January 2019 – BBVA, Santander, Commerzbank, Danske, Nordea, ABN Amro, KBC Group, Deutsche Bank, ING, Societe Generale and Swedbank. Many others are close to their January lows and in many cases the January 2019 lows were the lowest prices seen since the 1990s ! The facts are that in the Eurozone bank balance sheets are contracting, key bank share prices are at all-time lows while interest rates are negative across the yield curve in most countries.

Investors can of course blissfully continue to ignore these facts and seek protection in 'cheap' European equities. Your analyst continues to recommend that they do not do so. ***We are living through the failure of the largest monetary experiment the world has ever seen – the creation of a new currency for Europe.*** The consequences of the failure of that experiment, now evident in Eurozone government bond yields, bodes a scale of economic disruption that is incredibly negative for Eurozone corporate earnings and equity prices.

[Our emphasis.]

Why are Euro zone banks in such bad shape ? Two specific things. As Russell points out, the passing of the Bank Resolution and Recovery Directive (BRRD) in 2014 established a precedent for the bail-ins of large institutional depositors at insolvent commercial banks. Large scale depositors in commercial banks have already lost money in Cyprus and Portugal, and investors in Italy have lost money in commercial bank mini-bonds they were led to believe were equivalent to deposits:

If the BRRD is enforced, large-scale Euro deposits bear risks that government bonds do not. While holders of government bonds do face the risk of a nominal decline in value, they do not face the risk of being bailed in and confronted with a scale of loss that is unquantifiable until well after the bail-in event. This structural shift, assuming that the BRRD is enforced, is a key reason why government bond yields in Europe can reach lows never seen before in the history of interest rates.

Secondly, by driving interest rates both down to the zero lower bound and subsequently below it, the ECB has knackered banks' business models:

In terms of banking practice we simply do not know what is possible because we have never been here before. In terms of theory things are very simple: banks borrow short and lend long, and they need a sufficient gap between those two rates to cover both their costs and the credit risk of the loan. Banks that try to pass on negative nominal deposit rates to their customers risk a flight to bank notes, historically known as a bank run, and without lower funding costs they find it very difficult to make profitable loans given current long-term interest rates. The ensuing negative nominal yield curve thus destroys the ability of commercial banks to expand their balance sheets and in that action create money. The greater the decline in long-term interest rates, the nearer we get to the time when commercial bank balance sheets begin to contract.. A contraction in broad money with interest rates already below zero is exactly the situation Ben Bernanke famously warned all central bankers that they must never allow themselves to get into in his famous address in 2002: "*Deflation: making sure "it" doesn't happen here*." "It" has not come to the US but it is coming like a bullet train to the Eurozone where the inability to create the full economic and political infrastructure to operate a single currency means that policy actions are exacerbating the risks of money destruction, and hence deflation.

To put it more bluntly, the ECB would appear to have concluded that to save the European banking system, it was necessary to destroy it.

For those in search of some light relief, consider this essay from Professor Richard Werner, Shifting from central planning to a decentralised economy. Short version: ***everything central bankers believe is wrong***. These unelected monetary technocrats have taken the Eurozone banking system to the brink and would appear to be close to pushing it over. Brexit in this context looks less like the UK "crashing out" over a "cliff edge", and more like escaping from a burning building before the roof falls in.

Well done to the mainstream media for completely ignoring the Eurozone banking crisis on the UK's doorstep. Well done to Kenneth Clarke in the recent Channel 5 documentary, *The Trouble with the Tories*, for describing Sterling's ethnic cleansing from the ERM in September 1992 as "a completely inconsequential moment". Not, perhaps, if you were a mortgage-holder contemplating UK interest rates at 15%, or an investor wondering what had just happened to Britain's foreign exchange reserves. A Chancellor with a modicum of intelligence or possessed of simple morality might question whether a half-baked currency union with no escape hatch is a prudent economic platform for a motley melange of disparate countries, given that the UK's economic recovery in the 1990s only began once we were violently ejected from the ERM.

We own virtually nothing by way of Eurozone stocks. We own virtually nothing by way of government bonds (although we concede some might make for a great ***short-term*** trade), before deflation morphs, via inevitable further central bank stimulus, into the real prospect of runaway inflation – or currency collapse. We do, however, have significant exposure to sensibly priced and profitable listed businesses outside the Eurozone (especially in Asia), and to systematic trend-following funds that performed admirably during the last financial crisis, and we maintain significant exposure to the monetary metals, gold and silver.

Investors have got used to the idea that central bankers somehow protect them against financial crises. Wait until they realise that central bankers are actually responsible for financial crises instead. Wouldn't want to have Mario Draghi's job when that penny drops.

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Price Value Partners manage investment portfolios for private clients. We also manage the VT Price Value Portfolio, an unconstrained global fund investing in Benjamin Graham-style value stocks and specialist managed funds.