# 150 Years Of Bank Credit Expansion Is Near Its End

## Description

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**The legal formalisation of the creation of bank credit commenced with England's 1844 Bank Charter Act. It has led to a regular cycle of expansion and collapse of outstanding bank credit.**

Erroneously attributed to business, the origin of the boom and bust cycle is found in bank credit. Monetary policy evolved with attempts to control the cycle with added intervention, leading to the abandonment of sound money.

**Today, we face infinite monetary inflation as a final solution to 150 years of monetary failures. The coming systemic and monetary collapse will probably mark the end of cycles of bank credit expansion as we know it, and the final collapse of fiat currencies.**

This article is based on a speech I gave on Monday to the Ludwig von Mises Institute Europe in Brussels.

## Introduction

So that we can understand the financial and banking challenges ahead of us, this article provides an historical and technical background. But we must first get an important definition right, and that is the cause of the periodic cycle of boom and bust. The cycle of economic activity is not a trade or business cycle, but a credit cycle. It is caused by fractional reserve banking and by banks loaning money into existence. The effect on business is then observed but is not the underlying cause.

Modern banking has its roots in England's Bank Charter Act of 1844, which led to the practice of loaning money into existence, commonly described as fractional reserve banking. Fractional reserve banking is defined as making loans and taking in customer deposits in quantities that are multiples of the bank's own capital. Case law in the wake of the 1844 Act, having more regard to the status quo as established precedent than the fundamentals of property law, ruled that irregular deposits (deposits for safekeeping) were no different from a loan. Judge Lord Cottenham's judgment in Foley v. Hill (1848) 2 HLC 28 is a judicial decision relating to the fundamental nature of a bank which held in effect that:

> "The money placed in the custody of the banker is to all intents and purposes, the money of the banker, to do with it as he pleases. He is guilty of no breach of trust in employing it. He is not answerable to the principal if he puts it into jeopardy, if he engages in haphazardous speculation…."

This was undoubtedly the most important ruling of the last two centuries over money. Today, we know of nothing else other than legally confirmed fractional reserve banking. However, sound or honest banking with banks acting as custodians had existed in the centuries before the 1844 Act and any corruption of the custody status was regarded as fraudulent.

This decision has shaped global banking to this day. It created a fundamental flaw in the gold-backed sound money system, whereby the Bank of England, as a prototype central bank, could only issue extra sterling backed entirely by gold. Meanwhile, a commercial bank could loan money into existence, the drawdown of which created deposit balances. The creation of these deposits on a system-wide basis meant that any excesses and deficiencies between banks were easily reconciled through interbank lending.

## Bankers' groupthink and the credit cycle

While an individual bank could expand its balance sheet, the implications of all banks doing the same may have escaped the early banking pioneers operating under the 1844 act. Thus, when their balance sheets expanded to a multiple of the bank's own capital, there was little cause for concern. After all, so long as a bank paid attention to its reputation it would always have access to the informal interbank market. And so long as it can call in its loans at short notice, the duration mismatch between funding by cash deposits and its loan book would be minimised.

Since the Bank Charter Act, experience has shown the expansion of bank credit leads to a cycle of credit expansion, over-expansion, and then sudden contraction. The scale of bank lending was determined by its management, with lenders tending to be as much influenced by their own crowd psychology as by a holistic view of risk. Of course, the expansion of bank credit inflates economic activity, spreading a warm feeling of improving economic prospects and feeding back into increasing the bankers' confidence even further. It then appears safe and reasonable to take on yet more lending business without increasing the bank's capital.

With profits rapidly increasing due to lending being a multiple of the bank's own capital, confident bankers begin to think strategically. They reduce their lending margins to attract business they believe to be important to their bank's long-term future, knowing they can expand credit further against a background of improving economic conditions to compensate for lower margins. They begin to protect margins by borrowing short from depositors and offering businesses term loans, reaping the benefits of a rising slope in the yield curve.

The availability of cheap finance encourages businesses in turn to enhance their profits by increasing the ratio of debt to equity in their businesses and by funding business expansion through debt. By now, a bank is likely to be raking in net interest on loan business amounting to eight or ten times its own capital. This means that an interest margin of a net two per cent is a 20% return to the bank's shareholders.

There is nothing like profitable success to boost confidence, and the line between it and overconfidence is naturally fuzzed by hubris. The crowd psychology fuelled by a successful banking business leads to an availability of credit too great for decent borrowers to avail for themselves, so inevitably credit expansion becomes a financing opportunity for poorly thought out loan propositions.

Having oversupplied the market with credit, banks begin to expand their interests in other directions. They finance businesses abroad, oblivious to the fact that they have less control over collateral and legal redress generally. They expand by entering other lines of banking-related business, assuming their skills as bankers can be extended into those other business lines profitably. A near-contemporary example was Deutsche Bank's failed expansion into global investment banking and principal trading in foreign securities and commodities. And who can forget Royal Bank of Scotland's bid for ABN-Amro, just as the credit cycle peaked before the last credit crisis.

At the time when their balance sheets have expanded to many multiples of their own capital, the banking crowd then finds itself with lending margins too low to compensate for risk. Bad debts arising from their more aggressive lending decisions begin to materialise. One bank beginning to draw in its horns, as it perceives it is out on a limb, can probably be weathered by the system. But other bankers will stop and think about their own risks, bearing in mind operational gearing works two ways.

It may be marked by an unexpected event, or just an apparent loss of bullish momentum. With bad debts beginning to have an impact, groupthink quickly takes bankers from being greedy for more business to fearful of it. Initially, banks stop offering circulating credit, the overdraft facility that lubricates business activity. But former lending decisions begin to be exposed as bad when the credit tap is turned off and investments in foreign lands begin to reflect their true risks. Lending in the interbank market dries up for the banks with poor or marginal reputations, and banks begin to report losses. Greed turns rapidly to fear.

The cycle of bank credit expansion then descends into a lending crisis with increasing numbers of banks exposed as having taken on bad loans and becoming insolvent. A slump in business activity ensues. With frightening rapidity, all the hope and hype created by monetary expansion is destroyed by its contraction.

Before central banking evolved into acting as the representative and regulator for licensed banks, the credit cycle described above threw up some classic examples. Overend Gurney was the largest discount house in the world, trading in bills of exchange before it made long-term investments and became illiquid. When the railway boom faltered in 1866 it collapsed. Bank rate rose to 10% and there were widespread failures. Then there was the Baring crisis in 1890. Poor investments in Argentina led to the bank's near bankruptcy. The Argentine economy slumped, as did the Brazilian which had its own credit bubble. This time, a consortium of other banks rescued Barings. Nathan Rothschild remarked that if Barings hadn't been rescued the entire banking system in London would have collapsed.

**Out of Barings came the action of a central bank acting as lender of last resort, famously foreseen and promoted by Walter Bagehot.**

In the nineteenth century it became clear that crowd psychology in the banks, the balance of greed and fear over lending, drove a repeating cycle of credit boom and slump. With the passage of time bankers recovering their poise from the previous slump forgot its lessons and rhymed the same mistakes all over again. Analysts promoting theories of stock market cycles and cycles of economic activity need look no further for the underlying cause.

In the absence of credit expansion, businesses would come and go in random fashion. The coordinated expansion of credit changed that, with businesses being bunched into being created at the same time, and then all failing at the same time. The process of creative destruction went from unnoticed market evolution to becoming a periodic violent event. Monetary institutions still ignore the benefits of events being random. Instead they double down, coordinating their interventions on a global scale with the inevitable consequence of making the credit cycle even more pronounced.

It is a huge mistake to call this repeating cycle a business cycle. It implies it is down to the failure of free markets, of capitalism, when in fact it is entirely due to monetary and credit inflation licensed and promoted by governments and central banks.

## The rise of central banking

Following the Barings crisis in 1890 the concept of a lender of last resort was widely seen to be a solution to the extremes of free markets. Initially, this meant that the bank nominated by the government to represent it in financial markets and to oversee the supply of bank notes took on a role of coordinating the rescue of a bank in difficulty, in order to stop it becoming a full-blown financial crisis. When the gold standard applied, this was the practical limitation of a central bank's role.

This was the general situation before the First World War. In fact, even under the gold standard there was significant inflation of base money in the background. Between 1850 and 1914 above ground gold stocks increased from about 5,000 tonnes to nearly 24,000 tonnes. Not all of it went into monetary gold, but the amount that did was decided by the economic actors that used money, not the monetary planners as is the case today.

It was against this background that the US Federal Reserve Bank was founded in December 1913. Following WW1, it became a powerful institution under the leadership of Benjamin Strong. Those early post-war years were turbulent times: due to war time inflationary financing, wholesale prices had doubled in the US between 1914-1920, while the UK's had trebled. This was followed by a post-war slump and by mid-1921 unemployment in the UK soared to 25%. In the US, the Fordney-McCumber tariffs of 1922 restricted European debtors from trading with America, necessary to pay down their dollar debts. A number of countries descended into hyperinflation, and the Dawes plan designed to bail out the Europeans followed in 1924.

While America remained on a gold standard, Britain had suspended it, only going back on to it in 1925. While the politicians decided overall policy, it was left to central bankers such as Strong at the Fed and Montague Norman at the Bank of England to manage the fallout. Their relationship was the most tangible evidence of central banks beginning to cooperate with each other in the interests of mutual financial stability.

With the backing of ample gold reserves, Strong was an advocate of price targeting through the management of money supply, particularly following the 1920-21 slump. His inflationary policies assisted the management of the dollar-sterling exchange rate, supporting sterling which at that time was not backed by gold. Strong also made attempts to develop a discount market in the US, which inflated credit markets further. One way and another, with the Fed following expansionary money policies and commercial bankers becoming more confident of lending prospects, monetary inflation fuelled what came to be known as the roaring twenties.

That came to a sharp halt in October 1929 when the credit cycle turned, and the stock market crashed. Top to bottom, that month saw the Dow fall 35%. The trigger was Congress agreeing to the Smoot-Hawley Tariff Act on 30 October, widely recognised at the time as a suicide note for the economy and markets, by raising trade tariffs to an average of 60% from the Fordney-McCumber average of 38%. President Hoover signed it into law the following June and by mid-1932 Wall Street had fallen 89%.

With such a clear signal to the bankers it is not surprising they drew in their horns, contracting credit, indiscriminatingly bankrupting their customers. All the expansion of bank credit since 1920 was reversed by 1934. Small banks went bankrupt in their thousands, overwhelmed by bad debts, particularly in the agricultural sector, as well as through loss of confidence among their depositors.

The depression of the 1930s overshadowed politics in the capitalist economies for the next forty years. Instead of learning the lessons of the destruction wrought through cycles of bank credit, economists doubled down arguing more monetary and credit inflation was the solution. To help economic sentiment recover, Keynes favoured deficit spending by governments to take up the slack. He recommended a move away from savers being the suppliers of capital for investment, with the state taking a more active role in managing the economy through deficit spending and monetary inflation.

The printing of money, particularly dollars, continued under the guise of gold convertibility during the post-war Bretton Woods system. America had enormous gold reserves; by 1957 they were over 20,000 tonnes – one third of estimated above-ground gold stocks at that time. It felt secure in financing first the Korean then the Vietnam wars by printing dollars for export. Unsurprisingly, this led to the failure of the London gold pool in the late 1960s and President Nixon suspending the fig-leaf of dollar convertibility into gold in August 1971.

Once the dollar was freed from the discipline of gold, the repeating cycle of bank credit was augmented by the unfettered inflation of base money, a process that has continued to this day.

## The current position

Since the turn of the millennium there have been two global bank credit crises: the first was the deflation of the dot-com bubble in 2001-02, and the second the 2008-09 financial crisis that wiped out Lehman. It was clear from these events that the debate over moral hazard was resolved in favour of supporting not just the banks, but big business and stock market valuations as well. Furthermore, America’s budget deficits were becoming a permanent feature.

The cyclical rhythm of bank credit expansion and crisis was taking place against a background of increasing wealth transfer from the productive sector by means of an underlying monetary inflation. The beneficiaries have been the government and non-productive finance as well as large speculators in the form of hedge funds. The evidence of this transfer of wealth through the effect on the general level of consumer prices was increasingly suppressed by statistical method. While the official consumer price inflation indicator has been pegged between one or two per cent, independent analysts (Shadowstats and Chapwood Index) reckon the true figure is closer to ten per cent.

That being the case, the use of a realistic price deflator tells us that the US economy, and presumably others, in recent years have been contracting in real terms. Furthermore, GDP, nominal or real, is an appalling indicator of economic progress, being no more than a measurement of the increasing quantities of government funny-money inflating the economy. It does not tell us how that money is used and the benefits that actually flow from it, nor the degree of price distortion it generates.

It is hard to avoid concluding that manipulating the statistics to hide the evidence is the last throw of the fiat currency dice, just as the Emperor Diocletian collapsed the Roman economy by suppressing evidence of rising prices through his edict on maximum prices in 301 AD.

This brings us to the current position, which is increasing looking like being on the edge of another cyclical crisis. If so, it marks the end of a period of far greater monetary and credit expansion than seen in previous cycles, coinciding with a Smoot-Hawley lookalike in the trade war between the two largest global economies.

The following big-picture factors are relevant to the likely timing for a credit crisis:

- Global debt has accumulated to an estimated $255 trillion, up from about $173 trillion at the time of the Lehman crisis An alarming proportion of it is unproductive, being government, consumer borrowing, and funding for financial speculation as well as owed by unviable businesses.
- With annual debt payments already accounting for most of the US budget deficit and that deficit getting larger, any rise in dollar interest rates would be ruinous for Federal government finances. Eurozone governments are in a similarly precarious financial position. Governments are ensnared in a classic debt trap.
- An estimated $17 trillion of global bonds are negative yielding, which is unprecedented. This is a market distortion so extreme that it cannot be normalised without widespread financial disruption and debtor destruction. There is no exit from this condition.
- The repo market crisis in New York indicates the banking system is in intensive care. The start of it coincided with the completion of the sale of Deutsche Bank’s prime dealership to BNP. It would be understandable if large deposits failed to transfer with the business and went to rivals instead.

The problem has continued, indicating senior bankers' groupthink is already turning from greed to fear.
- US bank exposure to collateralised loan obligations and the leveraged loan market, comprised mainly of junk loans and bonds, is the equivalent of most of the estimated $1.9 trillion sum of bank capital. It confirms this article's thesis that the level of ignorance over banking risk is late stage for the bank credit cycle and likely to be catastrophic.
- The share prices of Deutsche Bank and Commerzbank indicate they are not just insolvent but will need to be rescued – and soon. Banks in other Eurozone jurisdictions are in a similar situation. However, all Eurozone countries have passed bail-in laws and do not expect to bail out individual banks. The upshot is at the first sign of a bail-in being considered, a flight of large deposits will very likely be triggered and bank bond prices for all Eurozone issuers will collapse. The room for error in crisis management by central banks is considerably greater than at the time of the Lehman crisis eleven years ago.

## The forthcoming credit crisis could repeat 1929-32

An extreme amount of monetary creation over the last ten years and the US-China trade war over the last two is horribly reminiscent of late 1929, when the combination of the end of the credit cycle and escalating trade protectionism combined to wreak financial destruction on a global scale. We face a possible repeat of the 1929-32 experience and the depression that followed. The long-term expansion of global trade has already come to a halt. The secondary impact on economies such as Germany's is beyond question.

Even if a halt to the trade war between the US and China is agreed in the coming weeks, the crisis has been triggered and our empirical evidence suggests it will get worse. It appears that common sense on trade policies is unlikely to prevail, because the conflict is far deeper than just trade, with the Hong Kong riots as part of the overall picture.

The Chinese believe America has destabilised Hong Kong with good reason: the US Treasury has become dependent to receiving the lion's share of international portfolio flows to support the dollar and finance the US budget deficit, and China's own investment demands are a threat. With the dollar's hegemony under attack and China seeking those same portfolio flows to invest in her own infrastructure projects through the Hong Kong Shanghai Connect link, Hong Kong had to be destabilised.

For this and other reasons, trade tariffs are only part of a wider financial war, which is increasingly likely to escalate further rather than abate. With his trade policies having backfired badly, President Trump is now under pressure with time running out ahead of the election in a year's time. He is threatened with impeachment by Congress over the Ukraine affair, and his popularity ahead of an election year remains subdued. He has even appealed to Jay Powell, Chairman at the Fed, to introduce negative interest rates to boost the economy. Backing down over China is unlikely, because it would be a presidential policy failure.

## What will the developing crisis look like?

Clearly, central banks will respond to the next credit crisis with an even greater expansion of money quantity than at the time of the Lehman crisis eleven years ago. The consequence of this monetary inflation seems certain to lead to an even greater rate of loss of purchasing power for fiat currencies than currently indicated by independent assessments of price inflation.

Monetary inflation is likely to be directed at resolving two broad problems: providing a safety net for the banks and big businesses, as well as funding rising government deficits. Therefore, the amount of quantitative easing, which will be central to satisfying these objectives, will soar.

The effect on markets will differ from being a rerun of the 1929-32 example in one key respect. Ninety years ago, the two major currencies, the dollar and sterling, were on a gold exchange standard, which meant that during the crisis asset and commodity prices were effectively measured in gold. Today, there is no gold backing and prices will be measured in expanding quantities of fiat currency.

Prices measured in fiat currencies will be determined ultimately by the course of monetary policy. But in real terms, the outlook is for a repeat of the conditions that afflicted markets and economies during and following the 1929 Wall Street crash. A further difference from the depression years is that today western governments have extensive legal obligations to provide their citizens with welfare, the cost of which is escalating in real terms. Add to this the cost of rising unemployment and a decline in tax revenue and we can see that government deficits and debts will increase rapidly even in a moderate recession.

This brings us to an additional problem, likely to be evident in a secondary phase of the credit crisis. As it becomes obvious that the purchasing power of fiat currencies is being undermined at a rate which is impossible to conceal through statistical method, the discounted value of future money reflected in its time preference will rise irrespective of interest rate policy. Consequently, borrowers will be faced with rising interest rates to compensate for both increasing time preference and the additional loan risk faced by lending to different classes of borrowers.

Besides closing off virtually all debt financing for businesses and increasingly indebted consumers, this will play havoc with governments accustomed to borrowing at suppressed or even negative interest rates. Prices for existing bonds will collapse, and banks loaded up with government debt to benefit from Basle regulations will find their slender capital, if they have any left, will be quickly eroded.

The world of fiat currencies faces no less than its last hurrah. Indeed, some of the more prescient central bankers appear concerned the current system is running out of road, with the dollar as the world’s reserve currency no longer fit for this purpose. They want to find a means of resetting everything, exploring solutions such as digitising currency through blockchains, doing away with cash, and finding other avenues to try to control the vagaries of free markets.

None of them will work, because even a new form of money will be required to rescue government finances and prevent financial and economic failure through inflation. The accelerating pace of monetary creation to address these problems will remain the one problem central to the failure of a system of credit and monetary creation: the impossibility of resolving the debt trap that has ensnared us all.

Just as Germany found in 1923, monetary inflation as a means of funding government and other economic liabilities is a process that rapidly gets out of its control. Eventually, people understand the debasement fraud and begin to dispose of the fiat currency as rapidly as possible. It then has no value.

**The ending of the fiat currency regime is bound to terminate the repeating cycles of bank credit legitimised since 1844. The socialism of money through inflationary debasement will be exposed as a fraud perpetrated on ordinary people.**