Myrmikan Research Note

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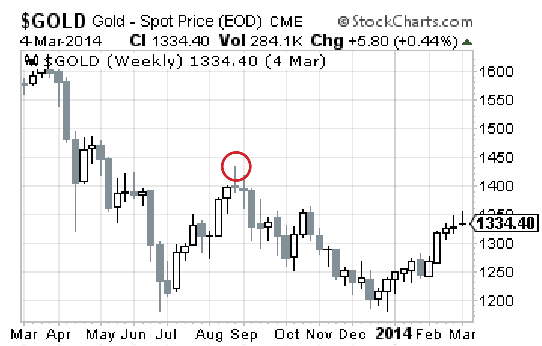
Ukrainian Conflict Bullish for Gold

Last weekend it became clear that Russia will effectively annex Crimea and possibly other eastern provinces of Ukraine. Gold surged higher. But, spikes in the gold price related to geopolitical events are often short lived, and rightly so. Contrary to wide opinion, gold is not a "fear trade"; it is a "money trade." Only events that threaten the integrity of a currency will cause gold to advance sustainably in that currency.

The most recent counterexample of this phenomenon was the conflict in Syria last summer. On August 28th, President Obama declared: "We have concluded that the Syrian government in fact carried out [the attack] and if that's so then there needs to be international consequences," as American military assets were ordered into place. Gold peaked that evening, capping a two month rise.



Military action is expensive, and the market correctly discounted that direct military confrontation in yet another Mideast country would strain the military and require huge expenditures that would widen the deficit, undermining the dollar. However, it quickly became clear what happens when a community organizer clashes with an officer of the KGB: surrender without a shot fired. Gold continued its descent.

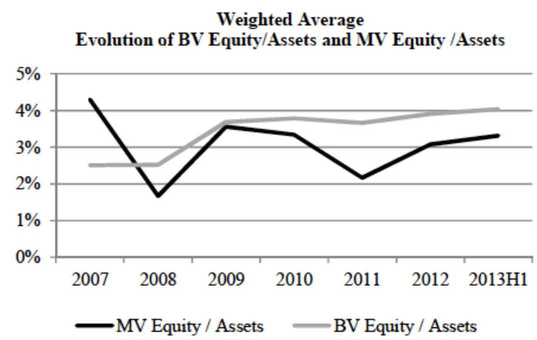
Having witnessed profound weakness last summer, Putin did not hesitate to deploy troops to a region geographically critical for Russia. All Obama has done is cancel a few meetings and announce that he will "stand with the international community in affirming that there will be costs for any military intervention in Ukraine," broadcasting total lack of leadership or will. After the West did nothing in response to Russian aggression in Chechnya and Georgia, it is hard to dispute Russian Senator Oleg Panteleyev's conclusion: "They talk and talk, and then they'll stop."

Yet, unlike with Syria, gold's gains will prove more tenacious not because the market is discounting the threat of American military action, but because of threats to the debt markets. Syria has less than $10 billion in total external debt, making it irrelevant to international finance. Ukraine has $138 billion in external debt, $26 billion of which is public debt. The eastern Ukraine, which borders Russia, is the more industrialized and essential for carrying this debt burden. If these regions are cleaved from Ukrainian political authority, there is no chance they will volunteer to maintain their share of the sovereign debt. Without the eastern regions, the west will inevitably default. Should a civil war erupt, the asset base supporting the private debt would become impaired as well, threatening lenders with total write-offs of their loans. Even in the absence of war, Ukraine's collapsing currency makes the external debt ever harder to maintain.

The question then becomes: who stands to lose if Ukraine defaults? Russian banks are the largest lenders to the country with $28 billion of exposure, but Russia is in the process of rather dramatically attaching their collateral, which will limit losses. Austrian banks are the second largest lenders, with $7 billion of exposure, followed by Italian banks with $5.9 billion and French banks with $5.3 billion of exposure (even Greek banks found $1.5 billion to lend to Ukraine). These figures record direct exposure – who knows how much money clients of these banks have lent: someone lent the other $90 billion, and it's a good bet whoever it was owes other people money, and so on.

Obama is right: Russian military action will have great costs . . . which will be imposed upon Western banks and the sovereigns that support them. Since European banks are conjoined with American banks through the Eurodollar market and derivatives books, the Fed and the dollar will become casualties as well.

In the context of trillions of dollars in QE by global central banks, a few tens of billions may not seem material for the global financial system. This view would ignore the effects of leverage. A recent OECD paper revealed that the top 22 banks in Europe were levered up 33 times as against the market value of their equity. This means a loss of a mere 3% of their assets would push them into insolvency.



These figures are a weighted average. The worst banks, Credit Agricole, Commerzbank, Royal Bank of Scotland, Deutsche Bank, and Société Générale all have leverage ratios of less than 2%. This means if these highly interconnected banks lose only 2% of their assets, they will need a bailout (or a bail-in) lest they pull their counterparties into insolvency as well. The bail-in option avoids the sovereign having to inject funds directly, but the destruction of credit would push the Eurozone deeper into a deflationary debt spiral that must lead either to a collapse of the banking system or massive printing by the ECB.

Even if Ukrainian losses prove too small to cause these existential threats, the loss of small amounts of capital can have dramatic affects in a fractionally reserved system. As is generally known, but not often appreciated, when a bank receives $1 of additional deposits the banking system can create a multiple of that figure in additional loans, depending on the reserve rate. Under a 10% reserve regime, $1 of additional capital can back $10 of additional loans. Under a 3% reserve scheme, the $1 is transmuted into $33 of additional credit. The flip side is that when that $1 is withdrawn or, worse, lost, the loan book must shrink by $33. With the European banking system highly levered and already struggling, a hit to balance sheets would cause outsized effects.

The banks claim they are healthy. For example, at the recent Davos conference, HSBC Chairman Douglas Flint said:

> I don't think there is any doubt the system is safer because the amount of time the board spends on regulatory matters, on oversight, on recovery and resolution, on dealing with the legacy issues [of the 2008 crisis] probably takes minimum of 50% of board time, more likely two-thirds of board time, and in some parts of the year 75% to 80% of board time. So when the board is spending two-thirds to three-quarters of its time dealing still five years after the crisis with the aftermath of the crisis and management is spending a majority of its time contributing to that debate, there is nobody in that room, I can assure you, that wants to take the risk of ever being in that space again.

Aside from the shocking revelation that banks are still spending over half of management time cleaning up the mess from 2008, Flint's response completely misunderstands the nature of the threat. He presupposes that as long as management is attentive and properly incentivized to manage risk properly, then the bank cannot fail. What his statement fails to appreciate is that the system itself is unstable, that the act of taking a $1 demand loan and converting it into $33 of term credit creates massive distortions in the economy that propel values higher as long as credit levels continue to rise, but then must lead to insolvency and depression when the debt pyramid collapses.

Irving Fisher penned one of the more elegant descriptions of the banking inspired boom / bust process. Famous for having lost his fortune through the belief that "stock prices have reached what looks like a permanently high plateau," expressed inopportunely three days before the 1929 market crash, Fisher developed the Chicago Plan in 1939 to abolish the fractional reserve system:

> Practically every period of economic hope and promise has been a mere inflationary boom, characterized by an expansion of the means of payment, and has been followed by a depression, characterized by a detrimental contraction of the means of payment. In boom times, the expansion of circulating medium accelerates the pace by raising prices, and creating speculative profits. Thus, with new money raising prices and rising prices conjuring up new money, the inflation proceeds in an upward spiral till a collapse occurs, after which the contraction of our supply of money and credit, with falling prices and losses in place of profits, produces a downward spiral generating bankruptcy, unemployment, and all the other evils of depression.
>
> Fractional reserves give our thousands of commercial banks power to increase or decrease the volume of our circulating medium by increasing or decreasing bank loans and investments. The banks thus exercise what has always, and justly, been considered a prerogative of sovereign power.

Economic booms and busts caused by surging then collapsing credit is a story that has repeated for centuries at least. Those interested in this history are advised to read Jesús Huerta de Soto's *Money, Bank Credit, and Economic Cycles* which explores fractional banking collapses from ancient Greece and Rome to the banks of Florence in the fourteenth century, Catalonia in the fifteenth, Seville, Venice, and Florence again in the sixteenth, England and France in the eighteenth, etc., etc., each striking at the region's prime.

Of course, it is in the bankers' interest to pretend that the 2008 credit crunch was some correctable accident of will rather than the result of an inherent design flaw, for the current system allows bankers to expropriate huge sums while the system expands, and socialize the losses when it fails. It was another critic who clearly expressed the motivation of the banks to engage in fractional reserve lending:

> In Germany there are only four very large private banks of national importance. In America there are only two. It is easier, more convenient, more profitable for the financial magnates of those banks to unite privately, surreptitiously, in a reactionary and not a revolutionary way, in a bureaucratic and not a democratic way, bribing government officials (this is the general rule both in America and in Germany), and preserving the private character of the banks in order to preserve secrecy of operations, to milk the state of millions upon millions in "super-profits", and to make financial frauds possible.

Vladimir Il′ich Lenin wrote these lines in 1917, and all that has changed since is the number of banks and the nature of the bribe: job offers post-government service as opposed to suitcases full of cash.

Lenin also saw clearly the usefulness of mega banks to the state:

> The big banks are the 'state apparatus' which we need to bring about socialism... A single State Bank, the biggest of the big, with a branch in every rural district, in every factory, will constitute as much as nine-tenths of the socialist apparatus. This will be countrywide book-keeping, country-wide accounting of the production and distribution of goods, this will be, so to speak, something in the nature of the skeleton of socialist society.

Given the recent history of the government forcing banks to extend credit to favored constituents of powerful politicians, and the expanded application of the Patriot Act to track each and every financial transaction, it is chilling rather than reassuring that, according to Flint, bank directors now spend three-quarters of their time with regulators.

It is the top bankers who should be most concerned. Public opinion will not countenance another bailout of the banking system, suggesting the next crisis will likely involve nationalization. This step is not as radical as it sounds. Large institutions such as Fannie Mae flit back and forth between public and private status without difficulty. As Lenin explained:

> The conversion of the bank, syndicate, commercial, etc., etc., rank-and-file employees into state employees is quite feasible both technically (thanks to the preliminary work performed for us by capitalism, including finance capitalism) and politically, provided the Soviets exercise control and supervision. As for the higher officials, of whom there are very few, but who gravitate towards the capitalists, they will have to be dealt with in the same way as the capitalists, i.e., "severely".

The next round of bank failures will not see capitalists carted off to prison camps, but it may well involve the bail-in of those with capital above a threshold à la Cyprus, stripping the non-connected rich of their capital. The regulatory authority for this confiscation has already been developed, and it is Obama who will choose when and how to implement it.

Putin is no communist. His strategy, shared by China, is a synthesis of 18th century mercantilism and 19th century imperialism. Ironically, it is the West that is following Lenin's program, and not just in banking.[1] While it is not in Putin's interest to bankrupt his primary customers for oil and gas, financial institutions designed for 20th century international capitalism cannot survive ascendant socialism at home and mercantilism abroad. History teaches that when credit systems implode, gold is the only asset to retain value.

Gold remains near historic lows in terms of monetary metrics, prime facie evidence of a financial bubble. As a bubble grows, ever smaller accidents become sufficient to pop it.

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1 Some may recall the central argument for Obamacare was expanded pools and capped corporate profits would lower premiums: "the simultaneous nationalisation of the insurance business, i.e., the amalgamation of all the insurance companies into one, the centralisation of their operations, and state control over them. . . . would lead to lower insurance premiums, would provide a host of facilities and conveniences for the insured and would make it possible to increase their number without increasing expenditure of effort and funds. Absolutely nothing but the inertia, routine and self-interest of a handful of holders of remunerative jobs are delaying this reform." This quotation, again from Lenin, reveals the source of this erroneous proposition being implemented in the United States.