the market NZZ

INTERVIEW

«We Will See the Return of Capital Investment on a Massive Scale»

Market strategist and historian Russell Napier warns of a 15- to 20-year phase of structurally elevated inflation and financial repression. He shares his views on how investors should prepare for this new world.

Mark Dittli

14.10.2022, 04.21 Uhr

Deutsche Version

Russell Napier has never been one of the eternal inflation warners. On the contrary: The market strategist and historian, who experienced the Asian Financial Crisis 25 years ago at first hand at the brokerage house CLSA in Hong Kong, wrote for years about the deflationary power of the globalised world economy.

Two years ago, the tide turned and Napier warned of a vicious return of inflation – and he hit the mark. In an in-depth conversation with The Market NZZ, which was lightly edited for clarity, he explains why most developed economies are undergoing a fundamental shift and why the system most investors have become accustomed to over the past 40 years is no longer valid.

According to Napier, financial repression will be the leitmotif for the next 15 to 20 years. But this environment will also bring opportunities for investors. «We will see a boom in capital investment and a reindustrialisation of Western economies,» says Napier. Many people will like it at first, before years of badly misallocated capital will lead to stagflation.

«Many investors today still pretend that we're in the system that we had from 1980 to 2020. We're not. We're going through fundamental, lasting changes on many levels»: Russell Napier.

In summer of 2020, you predicted that inflation was coming back and that we were looking at a prolonged period of financial repression. We currently experience 8+% inflation in Europe and the US. What's your assessment today?

> My forecast is unchanged: This is structural in nature, not cyclical. We are experiencing a fundamental shift in the inner workings of most Western economies. In the past four decades, we have become used to the idea that our economies are guided by free markets. But we are in the process of moving to a system where a large part of the allocation of resources is not left to markets anymore. Mind you, I'm not talking about a command economy or about Marxism, but about an economy where the government plays a significant role in the allocation of capital. The French would call this

system «dirigiste». This is nothing new, as it was the system that prevailed from 1939 to 1979. We have just forgotten how it works, because most economists are trained in free market economics, not in history.

Why is this shift happening?

The main reason is that our debt levels have simply grown too high. Total private and public sector debt in the US is at 290% of GDP. It's at a whopping 371% in France and above 250% in many other Western economies, including Japan. The Great Recession of 2008 has already made clear to us that this level of debt was way too high.

How so?

Back in 2008, the world economy came to the brink of a deflationary debt liquidation, where the entire system was at risk crashing down. We've known that for years. We can't stand normal, necessary recessions anymore without fearing a collapse of the system. So the level of debt – private and public – to GDP has to come down, and the easiest way to do that is by increasing the growth rate of nominal GDP. That was the way it was done in the decades after World War II.

What has triggered this process now?

My structural argument is that the power to control the creation of money has moved from central banks to governments. By issuing state guarantees on bank credit during the Covid crisis, governments have effectively taken over the levers to control the creation of money. Of course, the pushback to my prediction was that this was only a temporary emergency measure to combat the effects of the pandemic. But now we have another emergency, with the war in Ukraine and the energy crisis that comes with it.

You mean there is always going to be another emergency?

Exactly, which means governments won't retreat from these policies. Just to give you some statistics on bank loans to corporates within the European Union since February 2020: Out of all the new loans in Germany, 40% are guaranteed by the government. In France, it's 70% of all new loans, and in Italy it's over 100%, because they migrate old maturing credit to new, government-guaranteed schemes. Just recently, Germany has come up with a huge new guarantee scheme to cover the effects of the energy crisis. This is the new normal. For the government, credit guarantees are like the magic money tree: the closest thing to free money. They don't have to issue more government debt, they don't need to raise taxes, they just issue credit guarantees to the commercial banks.

And by controlling the growth of credit, governments gain an easy way to control and steer the economy?

It's easy for them in the way that credit guarantees are only a contingent liability on the balance sheet of the state. By telling banks how and where to grant guaranteed loans, governments can direct investment where they want it to, be it energy, projects aimed at reducing inequality, or general investments to combat climate change. By guiding the growth of credit and therefore the growth of money, they can control the nominal growth of the economy.

And given that nominal growth consists of real growth plus inflation, the easiest way to do this is through higher inflation?

Yes. Engineering a higher nominal GDP growth through a higher structural level of inflation is a proven way to get rid of high levels of debt. That's exactly how many countries, including the US and the UK, got rid of their debt after World War II. Of course nobody will ever say this officially, and most politicians are probably not even aware of this, but pushing nominal growth through a higher dose of inflation is the desired outcome here. Don't forget that in many Western economies, total debt to GDP is considerably higher today than it was even after World War II.

What level of inflation would do the trick?

I think we'll see consumer price inflation settling into a range between 4 and 6%. Without the energy shock, we would probably be there now. Why 4 to 6%? Because it has to be a level that the government can get away with. Financial repression means stealing money from savers and old people slowly. The slow part is important in order for the pain not to become too apparent. We're already seeing respected economists and central bankers arguing that inflation should indeed be allowed at a higher level than the 2% target they set in the past. Our frame of reference is already shifting up.

Yet at the same time, central banks have turned very hawkish in their fight against inflation. How does that square?

> We today have a disconnect between the hawkish rhetorics of central banks and the actions of governments. Monetary policy is trying to hit the brakes hard, while fiscal policy tries to mitigate the effects of rising prices through vast payouts. An example: When the German government introduced a €200 bn scheme to protect households and industry from rising energy prices, they're creating a fiscal stimulus at the same time as the ECB is trying to rein in their monetary policy.

Who wins?

> The government. Did Berlin ask the ECB whether they can create a rescue package? Did any other government ask? No. This is considered emergency finance. No government is asking for permission from the central bank to introduce loan guarantees. They just do it.

You're saying that central banks are powerless?

> They're impotent. This is a shift of power that cannot be underestimated. Our whole economic system of the past 40 years was built on the assumption that the growth of credit and therefore broad money in the economy was controlled through the level of interest rates – and that central banks controlled interest rates. But now, when governments take control of private credit creation through the banking system

by guaranteeing loans, central banks are pushed out of their role. There's another way of looking at today's loud, hawkish rhetoric by central banks: Teddy Roosevelt once said that, in terms of foreign policy, one should speak softly and carry a big stick. What does it tell you when central banks speak loudly? Perhaps that they're not carrying a big stick anymore.

Would that apply to all Western central banks?

Certainly to the ECB and definitely to the Bank of England and the Bank of Japan. These countries are already well on their path to financial repression. It will happen in the US, too, but we have a lag there – which is why the dollar is rising so sharply. Investment money flows from Europe and Japan towards America. But there will come a point where it will be too much for the US as well. Watch the level of bond yields. There is a level of bond yields that is just unacceptable for the US, because it would hurt the economy too much. My argument for the past two years was that Europe can't let rates go up, not even from current levels. The private sector debt service ratio in France is 20%, in Belgium and the Netherlands it's even higher. It's 11% in Germany and about 13% in the US. With rising interest rates, it won't take long until there will be serious pain. So it's just a matter of time before we all get there, but Europe is at the forefront.

Walk us through how this will play out.

First, governments directly interfere in the banking sector. By issuing credit guarantees, they effectively take control of the creation of broad money and steer investment where they want it to. Then, the government would aim for a consistently high growth rate of money, but not too high. Again, history shows us the pattern: The UK had five big banks after World War II, and at the beginning of each year the government would tell them by what percentage rate their balance sheet should grow that year. By doing this, you can set the growth rate of broad money and nominal GDP. And if you know that your economy is capable of, say, 2% real growth, you know the rest would be filled by inflation. As a third prerequisite you need a domestic investor base that is captured by the regulatory framework and has to buy your government bonds, regardless of their yield. This way, you prevent bond yields from rising above the rate of inflation. All this is in place today, as many insurance companies and pension funds have no choice but to buy government bonds.

You make it sound easy: The government just has to engineer a level of nominal growth and of inflation that is consistently somewhat higher than interest rates in order to shrink the debt to GDP ratio.

Again, this is how it was done after World War II. The crucial thing is that we are moving from a mechanism where bank credit is controlled by interest rates to a quantitative mechanism that is politicised. This is the politicisation of credit.

What tells you that this is in fact happening today?

When I see that we are headed into a significant growth slowdown, even a recession, and bank credit is still growing.

The classic definition of a banker used to be that he lends you an umbrella but would take it away at the first sight of rain. Not this time. Banks keep lending, they even reduce their provisions for bad debt. The CFO of Commerzbank was asked about this fact in July, and she said that the government would not allow large debtors to fail. That, to me, was a transformational statement. If you are a banker who believes in private sector credit risk, you stop lending when the economy is headed into a recession. But if you are a banker who believes in government guarantees, you keep lending. This is happening today. Banks keep lending, and nominal GDP will keep growing. That's why, in nominal terms, we won't see an economic contraction.

Won't there come a point where the famed bond market vigilantes would step in and demand significantly higher yields on government bonds?

I doubt it. First, we already have a captured investor base that just has to buy government bonds. And if push comes to shove, the central bank would step in and prevent yields from rising higher, with the ultimate policy being overt or covert yield curve control.

What if central banks don't want to play along and try to regain control over the creation of money?

They could, but in order to do that, they would really have to go to war with their own government. This will be very hard, because the politicians in government will say they are elected to pursue these policies. They are elected to keep energy prices down, elected to fight climate change, elected to invest in defence and to reduce inequality. Arthur Burns, who was the Fed chairman during the Seventies, explained in a speech in 1979 why he lost control of inflation. There was an elected government, he said, elected to fight a war in Vietnam, elected to reduce inequality through Lyndon B. Johnson's Great Society programs. Burns said it wasn't his job to stop the war or the Great Society programs. These were political choices.

And you say it's similar today?

Yes. People are screaming for energy relief, they want defence from Putin, they want to do something against climate change. People want that, and elected governments claim to follow the will of the people. No central banker will oppose that. After all, many of the things that are associated with financial repression will be quite popular.

How do you mean that?

Remember I said that financial repression means engineering an inflation rate in the area of 4 to 6% and thereby achieving a nominal GDP growth rate of, say, 6 to 8%, while interest rates are kept at a lower level. Savers won't like it, but debtors and young people will. People's wages will rise. Financial repression moves wealth from savers to debtors, and from old to young people. It will allow a lot of investment directed into things that people care about. Just imagine what will happen when we decide to break free from our one-sided addiction of having pretty much everything we consume produced in

China. This will mean a huge homeshoring or friendshoring boom, capital investment on a massive scale into the reindustrialisation of our own economies. Well, maybe not so much in Switzerland, but a lot of production could move back to Europe, to Mexico, to the US, even to the UK. We have not had a capex boom since 1994, when China devalued its currency.

So we're only at the start of this process?

Absolutely. I think we'll need at least 15 years of government-directed investment and financial repression. Average total debt to GDP is at 300% today. You'll want to see it down to 200% or less.

What's the endgame of this process, then?

We saw the endgame before, and that was the stagflation of the 1970s, when we had high inflation in combination with high unemployment.

People are already talking about stagflation today.

That's utter nonsense. They see high inflation and a slowing economy and think that's stagflation. This is wrong. Stagflation is the combination of high inflation and high unemployment. That's not what we have today, as we have record low unemployment. You get stagflation after years of badly misallocated capital, which tends to happen when the government interferes for too long in the allocation of capital.

When the UK government did this in the 1950s and 60s, they allocated a lot of capital into coal mining, automobile production and the Concorde. It turned out that the UK didn't have a future in any of those industries, so it was wasted and we ended up with high unemployment.

So the endgame will be a 1970s style stagflation, but we're not there yet?

No, not by a long shot. First comes the seemingly benign part, which is driven by a boom in capital investment and high growth in nominal GDP. Many people will like that. Only much later, when we get high inflation and high unemployment, when the scale of misallocated capital manifests itself in a high misery index, will people vote to change the system again. In 1979 and 1980 they voted for Thatcher and Reagan, and they accepted the hard monetary policy of Paul Volcker. But there is a journey to be travelled to get to that point. And don't forget, by the time Thatcher and Reagan came in, debt to GDP had already come down to new lows. That enabled them to introduce their free market policies, which would probably not have been possible if debt to GDP were much higher. So that's why we're in for a long social and political journey. What you have learned in market economics in the past forty years will be useless in the new world. For the next twenty years, you need to get familiar with the concepts of political economy.

What would have to happen for you to conclude that we'll avoid this path?

If governments went out of interfering with the banking system, reinstated private sector credit risk and handed back control over the growth of money to central bankers. Also, if we had a huge productivity revolution that would make real GDP grow at 4%. This would allow us to keep inflation at 2% in order to get nominal growth of 6%. We can't forecast productivity, and I never want to underestimate human ingenuity, so we'll see about that. A third possibility would be voters telling their governments to stop these policies by voting them out of office. But this is not likely because, as mentioned, most people will like this environment at first.

What will this new world mean for investors?

First of all: avoid government bonds. Investors in government debt are the ones who will be robbed slowly. Within equities, there are sectors that will do very well. The great problems we have – energy, climate change, defence, inequality, our dependence on production from China – will all be solved by massive investment. This capex boom could last for a long time. Companies that are geared to this renaissance of capital spending will do well. Gold will do well once people realise that inflation won't come down to pre-2020 levels but will settle between 4 and 6%. The disappointing performance of gold this year is somewhat clouded by the strong dollar. In yen, euro or sterling, gold has done pretty well already.

What about countries that don't follow the path of financial repression?

That's going to be tricky. Switzerland, for example, will probably stay away from these policies, but it will see continued inflows of capital, creating upward pressure on the franc. Sooner or later, Switzerland will have to bring back some forms of capital controls. That will be a feature worldwide. We have gotten used to sitting in Zurich or London and investing money in the US, in China, in Malaysia or Mexico. There are some emerging markets that are attractive today, as they have low levels of debt. But in a world where large parts of the global economy are in a system of financial repression, there will be all sorts of capital controls. That means that as an investor, you best invest in jurisdictions where you plan to spend your retirement. To me, that means I don't want to be invested in China at all, for example. The risks of getting stuck there are way too high, as the example of Russia has shown. Many investors today still pretend that we're in the system that we had from 1980 to 2020. We're not. We're going through fundamental, lasting changes on many levels.

Russell Napier

Solid Ground investment Report and co-founder of the investment research portal ERIC. He has written macroeconomic strategy papers for institutional investors since 1995. Russell is founder and director of the Practical History of Financial Markets course at Edinburgh Business School and initiator of the Library of Mistakes, a library of financial markets history in Edinburgh.

INTERVIEW

«It Will Turn Out to be Largely Impossible to Normalize Interest Rates Without Collapsing the Economy»

Historian and author Edward Chancellor in an in-depth interview about the failed monetary policy of central banks and the difficult path to a healthier and more robust economic and financial system.

Mark Dittli 21.07.2022

INTERVIEW

«The Period of Abundance Is Over»

Jeffrey Gundlach, CEO of DoubleLine, worries that the Federal Reserve is overreacting in the fight against inflation. He expects a severe slowdown of the economy and says how investors can navigate today's challenging market environment. A conversation with the Bond King.

Christoph Gisiger 05.09.2022

INTERVIEW

Russell Napier: «We Are Entering a Time of Financial Repression»

Market strategist Russell Napier talks about why he sees structurally rising inflation coming, why central banks are impotent - and what that means for investors.

Mark Dittli 14.07.2021