When Money Becomes Worthless

- by Martin Hutchinson
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The Financial Times last Tuesday noted a disturbing new trend – hedge fund and other investors are increasingly seeking to invest in physical commodities themselves, rather than in futures. Given the excess of global liquidity, this is not entirely surprising. It does, however, raise an ominous possibility of a supply shortage in one or more commodities, caused by investor demand that exceeds available mine output and inventory. That could potentially produce a collapse in economic activity similar to that from the 1837-41 and 1929-33 liquidity busts, but with the opposite cause.

The problem arises because of the size of the world's capital pools in relation to its volume of trade. The total assets of U.S. hedge funds in September 2009 were $1.95 trillion (down from almost $3 trillion a year earlier). That compares with total U.S. imports of goods and services in 2008 of $2.1 trillion. However, in addition to the hedge funds, there are other huge pools of money available for deployment in commodities markets. For example China and Japan each have around $2 trillion of foreign exchange reserves, while Saudi Arabia and the Gulf states have comparable sized pools of liquid assets available for investment. Since the available inventory of commodities is a fraction of their annual production, we could potentially end up with an extreme case of too much money chasing too few goods.

This would not matter much if investment were concentrated in futures markets. The open interest in such markets is controlled by the traders, who arbitrage to close positions as the settlement date nears. Thus when huge speculative money flows pour into futures markets, they drive up the price of the commodity concerned, but do not significantly interfere with the production of that commodity, nor with the flow of the commodity from producer to consumer.

Normally, commodity investment is confined to futures markets because it is much more convenient. The cost to a hedge fund or other financial investor of holding stocks of a commodity is quite high, normally sufficient to deter investors from attempting to buy commodities directly. They will only buy commodities directly if they are afraid that the normal arbitrage mechanisms between the futures markets and the commodity markets will be overwhelmed by the volume of demand, so that investment in futures will prove less profitable than it "should."

When investment moves to physical commodities, as it may now be doing, it potentially disrupts trade flows. A ship laden with copper ore that would normally have sailed from Chile to a smelter on the U.S. West Coast is instead parked in a holding area in order that investors can profit from the rise in value of that copper. That reduces the amount of ore available to smelters. Since the balance between supply and demand of most commodities is quite delicate, and supply cannot be ramped up by more than a modest percentage at short notice, that could result in a physical shortage of the commodity at the smelter, shutting down the smelter for a period and depriving its customers of the copper products they need for their own operations.

Disruptions of commodity flows of this kind can potentially cause both hyperinflation and a major recession. The value of copper to the smelter and its customers is much higher in a shortage than if it is available normally, because the cost of closing their own operations is large – hence the price of any spare copper that might be available locally zooms upwards. Equally, the economic cost of shutting down the smelter and its customers far exceeds the value of the copper ore shipment. Products containing copper are suddenly in short supply, while workers lose their paychecks and so are forced to stop consuming at the same level.

The effect of a gross liquidity surplus is thus quite similar to that of a sudden shortage. In the shortage case, as in 1837-41 and 1929-33, prices decline sharply – in those two cases by as much as 20-25% – economic activity is hugely reduced as businesses are unable to obtain financing and workers are laid off. The resultant decrease in demand causes producers to lose money, eventually closing their doors, as well as bankrupting the financial system.

In a gross liquidity surplus, in which investment capital disrupts commodity trade flows, inflation rather than deflation results, probably very rapid inflation rather than the moderate 5% to 10% inflation we became used to in the 1970s. That inflation still further increases demand for commodities, worsening the problem. Businesses unable to obtain raw materials close their doors, workers' real incomes decline sharply (even when they keep their jobs) and Gross Domestic Product declines similarly to the deflationary case.

We have never experienced a global hyperinflation, in which money is unable to purchase goods, so it becomes worthless. In particular countries, wars have produced this effect, notably in the Revolutionary wars in both the United States and France, when the "continentals" and "assignats" became of no value. Similar effects have been produced by excess money printing in Latin America; in hyperinflationary periods citizens of Argentina have starved, even though the country is one of the world's greatest food producers. However, globally we have experienced nothing worse than the moderate worldwide inflation of the 1970s, in which trade flows were disrupted and incomes and assets affected, but commodities generally remained available in the market and output weakened but did not decline sharply.

The fascination of adding another chapter to economic historians' textbooks is not sufficient to make global hyperinflation anything other than an event to be avoided at all costs. It might help the Ben Bernanke of 2080 to make better monetary policy decisions than the current incumbent, since he would have the chance to be the world's greatest expert on the hyperinflationary crash of 2011. However, as far as this column is concerned, future generations can take their chances – we need to avoid hyperinflation happening to this generation.

The cost of avoiding this disaster appears to be steadily increasing. Once articles start appearing in the Financial Times about investors choosing to buy physical commodities rather than futures, many more such investors will be drawn into this activity. A moderate tightening of monetary policy that might well have deflected the forces of hyperinflation if it had been instituted several months ago may well prove ineffectual at this stage.

In determining the necessary monetary policy, the gold price provides a very useful signaling device (and its definitive breakout through previous highs last week provides a stern warning.) It does not matter one whit whether investors demand physical gold rather than futures, because gold has only insignificant industrial uses and the stocks of gold available in "inventories" such as Fort Knox are far more than sufficient to supply those uses for a decade if necessary. However, the commodity investment impulse is closely tied to the gold investment impulse; both reflect a well warranted distrust of fiat money and a desire to hold items of secure long-term value. Hence the gold price is available to show policymakers whether their monetary policy is appropriate.

If, following last week's breakthrough, the gold price continues to increase, heading for $2,400 per ounce, the equivalent in today's money of the 1980 high, that will be an excellent signal that monetary policy urgently needs tightening.

If, after a first monetary tightening, the gold price retreats for a few weeks and then breaks through its recent highs, that development will be a signal that monetary policy must be tightened further, as the flight to commodities has not halted.

Only when the gold price breaks definitively downwards, dropping 25% or more from its high, will policymakers know that they have succeeded in breaking the commodity investment mania. Such a development is however likely to occur only after a definitive crack in government bond markets, forcing policymakers to address their gigantic budget deficits as a matter of urgency.

Given the predilections of today's policymakers, it is unfortunately unlikely that they will tighten monetary policy sufficiently to break the commodity flight, whatever the gold price does. Instead, led by the determined Keynesians of the International Monetary Fund, they are much more likely to attempt to control the gold price itself, either surreptitiously by selling off massive quantities of the world's gold reserves, or openly by imposing limits on gold futures trading and possibly, like Franklin Roosevelt in 1933, making it illegal for ordinary individuals to own gold or to buy gold futures.

That will of course only make matters worse; it would be equivalent to trying to avoid a speeding ticket by smashing the car's speedometer. Manipulating the gold price to pretend that liquidity is not excessive does not stop liquidity from being excessive. Nor does it lead any but the stupidest institutional investor to believe that his urge to invest in physical commodities is misguided. Rather, it will cause commodities investment to be carried out through shell companies in tax havens, away from regulators' radar screens. The effect on global supply chains will be equally damaging, but policymakers will no longer have a straightforward way of determining how to avoid the resulting economic depression.

I wrote last week that tightening liquidity directly by entering into a central bank "exit strategy" is dangerous. However , the Financial Time's story itself and the gold price breakthrough have significantly increased the size of the hike in interest rates necessary to halt the flight to commodities.

Time is short, and the probability of disaster is rising.

The Bears Lair is a weekly column that is intended to appear each Monday, an appropriately gloomy day of the week. Its rationale is that, in the long '90s boom, the proportion of "sell" recommendations put out by Wall Street houses declined from 9 percent of all research reports to 1 percent and has only modestly rebounded since. Accordingly, investors have an excess of positive information and very little negative information. The column thus takes the ursine view of life and the market, in the hope that it may be usefully different from what investors see elsewhere.

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