

Interest Rates Are Going Higher

It is gradually dawning on markets that lower dollar interest rates are a fantasy. But higher rates will destabilise fiat currencies.

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Global Research, April 19, 2024

[LewRockwell.com](#)

Region: [USA](#)

Theme: [Global Economy](#)

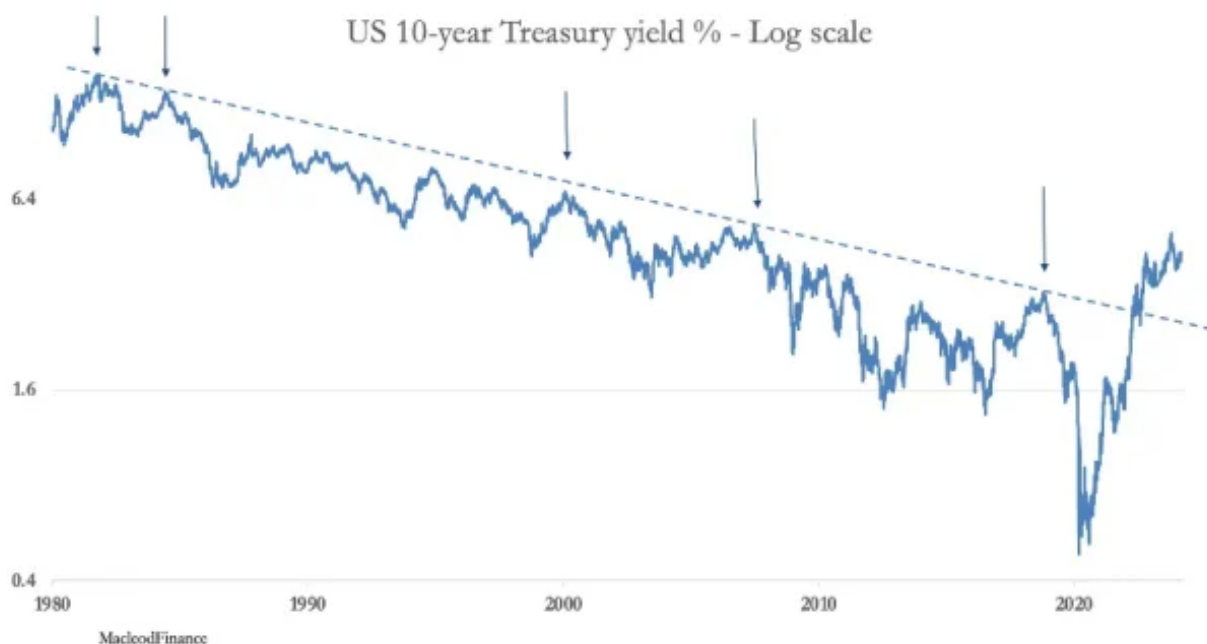
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If a chart speaks a thousand words, this is it:



From its peak at about 15% in the early eighties, the trend for US bond yields was down for forty years. When the yield soared through 2.8% in April 2022 (yes, only 2.8%) alarm bells

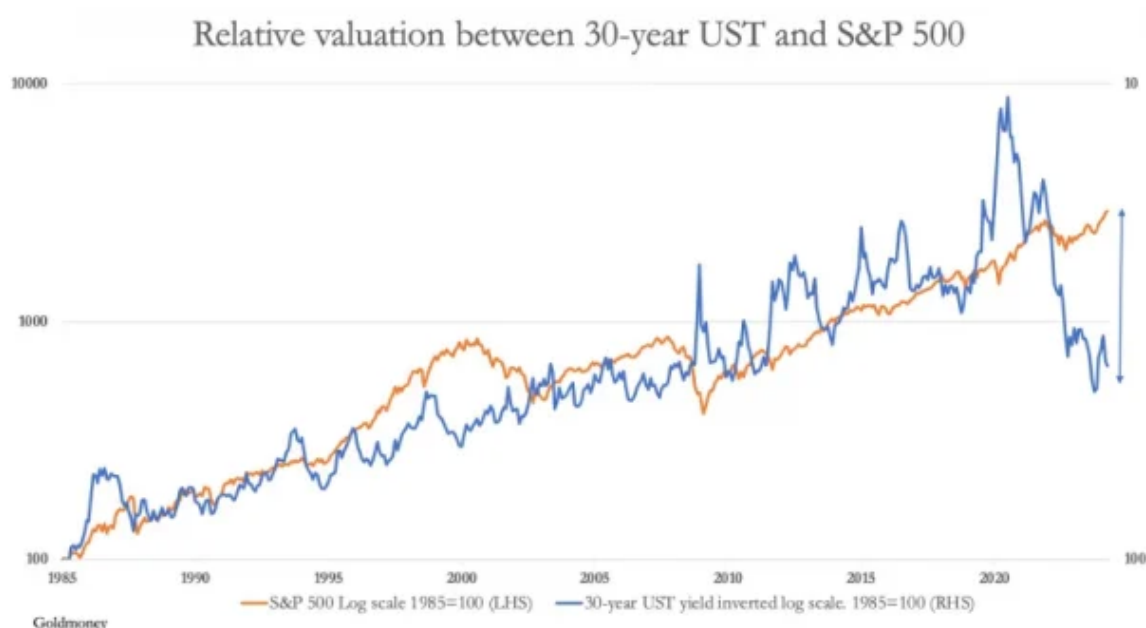
should have been ringing. When it turned down from 5% last October, investors heaved a sigh of relief and then expected interest rates and bond yields to decline: inflation was over.

However, between October and February the monthly inflation rate continually increased (it paused in March at the February rate). Importantly, last month Larry Summers headlined a joint report between Harvard and the IMF which came out with a CPI recalculation to include financing costs, stating that in 2022 CPI inflation hit 18%. Those financing costs are still there, so the current official estimates of 3.4% understate it massively.

Of course, if the Fed cut its funds rate and the banking system followed, the inflation rate based on Summers' calculation would fall. But that's not what the Fed is watching. It sees commodity and energy prices rising again. Gasoline, a significant CPI component is rising particularly strongly up 14% this year. But as a mutual friend in the IMF who knows Summers well observed to me, it is amazing how he is ahead of the curve when a change in policy is about to happen. And he is saying that inflation is still a problem, contradicting markets.

So yes, the chart above of a thousand words is not to be ignored, and we are seeing that the super-tanker determining global interest rates is on the turn towards higher rates. Expectations of lower rates are being continually deferred and might not even happen. And Summers has been ramming the message home that the Fed should not reduce interest rates in a series of Bloomberg interviews.

US interest rates and bond yields will rise. The consequences for US bond prices and equity values will be extremely bearish, given that prospective valuations of the former will decline materially, and that the relationship with equities is already very stretched. This is illustrated in my next chart.



The negative correlation between the Treasury long bond and the S&P index is normally very tight, the exceptions being during the dot-com bubble, the Lehman crisis, and in the

wake of the covid crisis when the Fed suppressed rates to the zero bound and bond yields with it. More recently, the long bond yield has risen significantly, without undermining equities. It is now becoming clear that interest rates are not going to fall as they are optimistically discounted, and equities will surely fall significantly.

The Impact on Japan Will be Devastating



This week has seen the yen fall through the Bank of Japan's last-ditch line at Y152 as bond yields rose strongly. There's little doubt that the Bank of Japan will have to raise rates and stop monetising debt.

The losses on QE have become incredible. Since the peak of prices in July 2019, the value of the Bank of Japan's bond holdings has fallen by over Y400 trillion, which is over 400,000 times its paltry equity capital of 100 million yen. It raises the question: will the BOJ need to be recapitalised?

Doubtless, as dollar rates increase forcing Japanese rates higher its losses will eventually

catch the public's attention. And the plight of Japan's over 20 times highly leveraged banks will as well, because if the central bank is busy saving the commercial banking system becomes no longer credible and has the potential to collapse the currency.

The ECB Has Its Own Difficulties

Similarly to the Bank of Japan, the ECB faces a potentially lethal combination of higher interest rates, bond yields, and a falling exchange rate against the US dollar. And having made the error of imposing negative interest rates combined with quantitative easing, it has undermined the purchasing power of the euro. Furthermore, the eurozone includes some of the most indebted of the advanced nations, so further increases in bond yields from current overvalued levels will hit them hard.

Greece has a debt to GDP estimated at 150%, Italy 140%, France 112%, Portugal 112%, and Spain 110%. All these eurozone nations are running budget deficits as well, ranging as high as 8% to GDP for Italy.

These budget deficit estimates assume no recession, which with higher interest rates is virtually guaranteed. They are likely to be significantly higher due to lower tax revenues, higher welfare costs, and higher financing rates. In the past, the ECB has bought off most of these problems through a combination of interest rate suppression and QE — these will no longer be possible in a rising global interest rate environment which is beyond the ECB's control.

The ECB and the national central banks in the Eurosystem have losses on QE which in many cases wipes out their capital entirely. Without their recapitalisation, like that of the Bank of Japan they will lack the credibility to rescue their commercial banks from failure. Similarly to the Japanese banking system, eurozone banks became exceptionally leveraged due to margin compression under negative interest rates, so they are extremely vulnerable to rising interest rates and bond yields.

Recapitalising the Eurosystem is a nightmare at best. It will require unanimous approval from many member parliaments, not just to recapitalise individual national central banks, but to subscribe for their key commitments at the ECB as well. To get unanimity will be difficult enough, when TARGET2 imbalances are so significant. When the Bundesbank is owed over a trillion euros by the ECB and other members of the Eurosystem, convincing politicians in Berlin to agree to the Bundesbank's recapitalisation will be difficult. And that's assuming the Federal Constitutional Court doesn't get involved as well.

We should be aware that higher interest rates could destroy the Eurosystem entirely. And with its failure, the future of the Brussels project itself will be in doubt. I have mentioned this possibility many times over the last ten years, but this outcome is now shifting from possible towards being probable.

Other Nations Are Ill-prepared for Higher Rates

Other nations with their own currencies will have to raise their interest rates to keep pace with those of the US dollar, or risk seeing them decline relative to the dollar. And higher rates will impact government and private sector debt accordingly. Some nations which have managed their public affairs responsibly have highly indebted private sectors, with mortgage debt that will become unaffordable, destroying residential property values. There

is no escape from the financial holocaust about to hit everyone, brought about by the US Government's abuse of its fiscal responsibilities, particularly in recent years, and the monetary authority's mismanagement of credit.

As well as the demise of fiat currencies, we are seeing the end of the socialising welfare model. The only escape from total economic collapse is to return to credible gold standards, which Russia, China, and Saudi Arabia can do.

The Restitution of Gold

It is becoming clear that the era of fiat currencies is drawing to a close, and that the return of gold as the international anchor for all credit will return. This outcome will not be embraced by America, the EU, Japan, and many other nations hooked on non-productive credit inflation and economic management by the state. The longer they delay accepting this reality, the worse it will be for their currencies.

We know that China and Russia have accumulated large amounts of bullion as insurance against this possibility. Before the last financial crisis, China was even exhorting its own citizens to buy gold. And in addition to her official reserves, informed opinion is that Russia has a further 10,000 tonnes or so in two other state funds. Between them, Russia and China are the golden centre for their rapidly developing sphere of influence, fully 60% of the world's population and already over 30% of its nominal GDP.

It is increasingly fashionable for geopolitical analysts to talk about the rising power of the two Asian hegemonies. So far, they haven't debated the demise of the dollar-based fiat currency system. Its principal features are its instability, its loss of purchasing power since the end of Bretton Woods in 1971, and the necessity to raise interest rates from time to time in an attempt to stabilise currency values. And now, by China and Japan simply withholding further purchases of dollars and dollar denominated debt, the dollar is sinking relative to gold. A funding crisis looms, which will need far higher interest rates, undermining the value of the dollar measured in gold even further.

This contrasts with credible gold standards, which anchor currency values to international legal money. It leads to stable interest rates at low base levels, typically two or three per cent. The caveat is that central banks should use interest rates to manage their gold reserves, not to manage economic outcomes. And the government must always run a balanced budget.

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