Cyprus: Fear, deflation and a strong US$

There is perhaps nothing which changes human behaviour more than the arbitrary and unfair acts of authority. Economists may argue that a levy on bank deposits is just as fair a way to bail out a banking system as raising taxes and cutting public spending. A citizen of Cyprus will simply ask why are his/her deposits have been sequestered when nobody else's have? While we can all debate whether the Eurosystem works economically this startling inequality of treatment raises a much more important question- does it work politically? That is the most important question as the Euro is the progeny of political desire and is succoured by the political elite. If however the people of the system believe that the Euros sustenance necessitates the use of arbitrary power resulting in unequal treatment then they will conclude that the Euro system is not worth having. The loss of democracy and the rule of law will outweigh whatever economic benefits Euro membership may bring. The citizens of the PIIGS have shown incredible resilience to the economic sacrifices they have been asked to make but will they be as resilient to the loss of democracy which the creation of the Euro necessitates and the Cypriot bank levy clearly illustrates? The Euro cannot fail economically but the bending of the rule of law to prevent its economic collapse brings arbitrary and unfair outcomes which peoples have always rebelled against. There will clearly be short term economic consequences from the sequestration in Cyprus but the key impact will be long term as the citizens of the Euro, like the citizens of the Soviet Union or the American colonies before them, eventually reject the sacrifice of political rights necessary to support the system. When the history books are written the Brussels imposed sequestration in Cyprus will be seen as the tipping point when the citizens of the Euro system realised that the socio-political sacrifice needed to sustain a single currency was just too great.

The owners of capital have advantages which other citizens do not have in expressing their dissatisfaction with arbitrary and unfair actions by government. Capital will leave but of course capital has been exiting southern Europe for many years. As the stability of the Euro shows it has largely been exiting southern Europe for northern Europe. This will now change with very negative impacts for the Euro's value on the international exchanges. With the long arm of Brussels now seen as so powerful is it safe for an Italian citizen to have bank deposits in Germany? It might be but it might not and as there is neither a nominal or likely real return from holding Euro deposits in Germany then why take the risk. The conundrum for the Euro is that one bought it to make money from its dissolution. Owning German Euro deposits and German government debt was likely to produce material profits for any investor in a post Euro world. Now such a bet is incredibly dangerous for a southern European and perhaps even for any foreign investor as sequestration of deposits becomes a tool of fiscal policy. Events in Cyprus are a game changer for the Euro as all capital now realises that, within the Euro system, it is subjected to whatever arbitrary powers government will need to save the system. The decline of the Euro is now particularly important because of its impact on the US, Switzerland and the Emerging Markets.

The US$ is already turning into a strong currency and the reasons behind this are elaborated upon in a new Solid Ground report issued today (Pop Goes The Weasel). The rise of the US$ is now given a further impetus as some capitalists will conclude that private property rights are likely to be more closely adhered to the USA than in the Eurozone. While this might not be the case in the long term the relative protection of private wealth in the US, following the sequestration of Euro bank deposits by the dictat of an unelected regime in Brussels, is without question. The ever strengthening US$ does not have particularly negative implications for the USA but as outlined in How The Yield Bubble Bursts and Pop Goes The Weasel it will have crushing impacts on Emerging Markets. A marked tightening of liquidity will now be exacerbated in EM as the US$ rises.

All of this creates huge problems for the Swiss. The SNB foolishly thought that its commitment to print an infinite amount of francs, thus prevent its appreciation against the Euro, would deter capital inflows. That bluff has worked in recent months as Swiss foreign reserves have plateaued since September 2012 but it will now fail. There are many reasons why capital may enter a country and fear of sequestration elsewhere has always been a key driver of wealth into Switzerland and that flow will now accelerate. The Swiss authorities simply cannot respond to this by printing more money as it could encourage further capital inflows as others bet on the asset price inflation such a silly monetary policy will engender. Within weeks or months the Swiss will have to start charging a fee, like the Brazilians, on certain capital inflows into the Swiss Franc. For many Switzerland will not be far enough away from the long arm of Brussels and Singapore may also find itself subjected to excessive capital inflows.

Deflation follows when money hides. A seemingly small arbitrary act in Brussels is likely to trigger a rush by capital for the safest and therefore most sterile of assets. This rush to sterility will defeat the search for birth and growth and the seemingly impossible outcome of deflation in a fiat currency world comes one major step nearer.