Warsh Options: GLOBAL FINANCIAL CRISIS 2.0 OR GLOBAL CURRENCY CRISIS 1.0?

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Warsh has spoken extensively in the last 2 months about his intent to control "Price Inflation". And he was very specific about his goal as being below 2.0%. If talking could have controlled consumer prices, we would be well below 2% by now. Unfortunately, apart from the fleeting seconds during the Warsh speeches when futures prices seemingly declined, they continue to remain at elevated levels.

For context, in the last 10 years, we have had a CPI reading below 2% on only two occasions – at 1.8% in 2019 and 1.2% in 2020. The average for the last 10 years has been well above 3%, indicating that monetary policy has been lax for an extended period. Now Warsh also mentioned that he does not have a magic wand. And he is very correct about that. Perhaps even more than he realizes.

In the broad scheme of things, there are only two economic outcomes possible for the US today. & neither of them is palatable. Again, as Warsh quite correctly mentioned, Inflation is a choice. Unfortunately, he is going to end up choosing the less palatable, but the more politically expedient, of the two options.

The Monetary Options and their Outcomes - GFC 2.0 and GCC 1.0

I. **GFC 2.0** - If Warsh does a Volcker and follows through with his hawkish talk about controlling price inflation, then what lies ahead is a repeat of GFC 2008 – or what I have referred to as Global Financial Crisis 2.0. The consequences would be far more devastating than GFC 2008, as the size and nature of the bubbles today are far bigger than the Housing Bubble of 2008.

II. **GCC 1.0** - If the primary price-inflation-controlling mechanism happens to be "speaking tough and doing nothing" (and this has been the case under Warsh so far), then what lies ahead is a Global Currency Crisis 1.0. This would be substantively worse than the GFC 2.0. The US dollar would lose substantial purchasing power even when measured against other currencies, with the DXY losing at least 50% if not more. Unquestionably, gold would witness massive "Reserve Asset" buying from central banks as well as individuals around the world, and prices would be well into 5 digits where the first digit is unlikely to be "1".

There is no proverbial middle-ground between these two options. A crisis is certain in either scenario (or even with some unfathomable third option), with an economic recession that is likely to rival The Great Depression of 1929-1946. As Austrian Economists would like to point out, the recession/depression is a necessary cure to purge the malinvestments of the preceding decades.

The only choice in front of Warsh today is whether he can protect the purchasing power of the US Dollar, at least in part. A summary of the monetary policy options in front of Warsh that would lead to the GFC Vs GCC scenarios, along with the economic outcomes, is given below. Warsh is again correct about the Magic Wand, and there is nothing in sight.

Monetary Policy	Effect on Asset Classes	Economic Scenario
Global Currency Crisis 1.0		
Dovish Monetary Policy* i. The US Fed funds rate is around 5% (current rate is 3.5 to 3.75%), while the 30-year Treasury may stop attracting external buyers. ii. Massive QE's and expansion of the Fed Balance Sheet to $10 trillion by 2028 (current Fed BS is $6.7 trillion) iii. US National debt to be around $50 trillion by 2028 (near $40 trillion today)	Stocks and Housing down by 50% or more. Bonds, especially long-term bonds, to lose more than 90% DXY to decline to under 50 from the current 100+. Gold to go well above $24,000/oz over the next 5 years.	Inflationary Depression with annual double-digit Price Inflation and cumulative GDP contractions well above 25% (for comparison, the US GDP contracted nearly 30% between 1929 and 1933). In the worst-case scenario within the playbook of GCC 1.0, the US could well witness hyperinflation similar to that of the Weimar Republic.
Global Financial Crisis 2.0		
Hawkish Monetary Policy* i. US Fed funds rate to be well above 8%. ii. Fed stops/reduces substantially the monetization of US Govt deficits	Stocks, housing, and bonds to lose 75% or more. DXY to remain relatively strong at around 75. Gold to be around $10,000/oz	A repeat of the stagflationary 1970s with both the price inflation and GDP contractions worse than what the US experienced in the 1970s.
*** - Hawkish / Dovish Monetary policy is not decided on the basis of changes to fed funds rates from the current levels, but in the context of the prevailing Price Inflation and the ability to restrain government debt relative to the GDP.**		

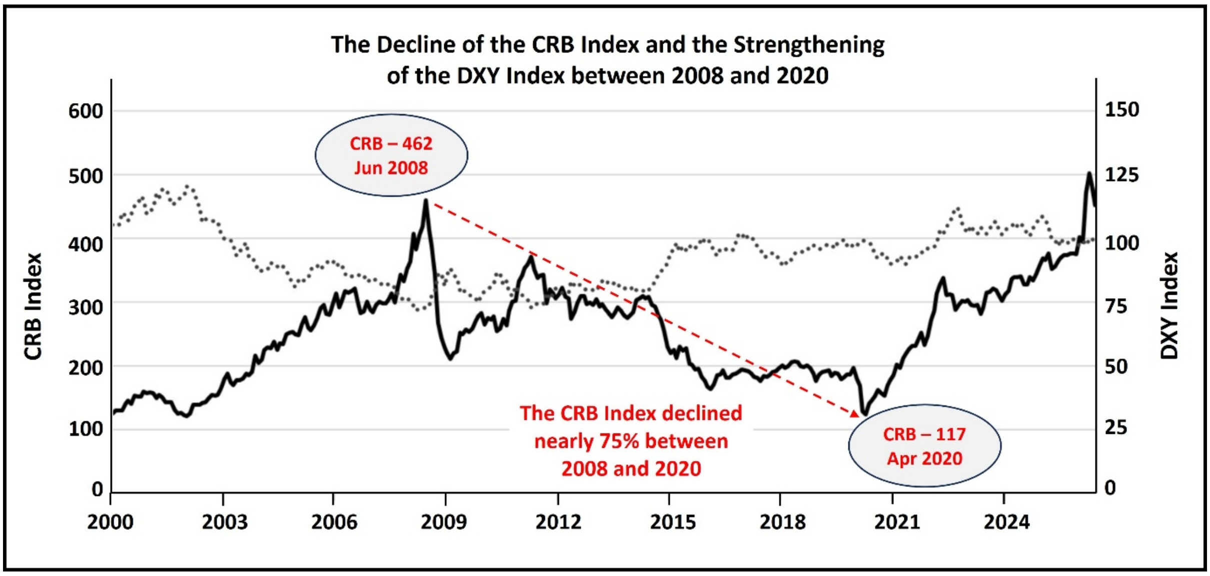
The Difference between 2008 and 2026

This ought to be a very logical question in the minds of the reader now: The GFC 2008 was caused by the bursting of the housing bubble. The subsequent decade witnessed unprecedented monetary policy, with more than a decade of ZIRP and QE. If this did not lead to a GCC, why should a relatively more hawkish monetary policy, as outlined in the table above under GCC 1.0, lead to a currency crisis?

The answer lies in the non-neutrality of money and a little known/studied phenomenon known as the "Cantillon Effects". A one-line definition would be that newly created money flows disproportionately into different asset classes at different points in time and not uniformly across assets. For example, let us say that we double the quantity of money in the system overnight. This will not mean that every asset would double in price the next day or even over time. A few assets would of course double, and some would even go up a lot more than that. It's even possible that some prices would decline in the face of the above-mentioned monetary inflation.

To understand the consequences of the Cantillon effects, let us look into what happened between 2008 and 2020. This was the period that witnessed a growth in US Money Supply (M2) from $7 trillion to $20 trillion, the Fed Balance Sheet exploding from less than $1 trillion to nearly $8 trillion, and the National Debt growing from less than $10 trillion to nearly $30 trillion.

Stocks, housing, and bonds went on a tear. But the interesting part is to see what happened to commodities. In the face of massive monetary inflation in which the Fed was literally creating trillions from thin air, the CRB Index of commodities declined nearly 75% over a decade.



2022 was the decisive turning point in this cycle. It is now the turn for commodity prices to catch up with the monetary inflation. Not only the historical monetary inflation, but the one that lies ahead, which could indeed dwarf the numbers mentioned above.

So not only does Warsh not have any magic winds, he faces insurmountable headwinds in the form of rising commodity prices. We have a decade of high price inflation ahead merely on account of the historical sins of massive deficit spending and artificially low interest rates. Of course, depending on what Warsh does in the months ahead, this high inflation could well end up becoming hyperinflation.

Will Warsh Walk His Talk?

The evidence so far that he will do so is ZERO. But to be fair, it is still early days to pass a definitive judgment.

The "moment of truth" will come when the "Lehman Moment," i.e., asset bubbles burst, happens in the current cycle. This time around, it is not just one asset class as was the case in 2008, but multiple ones in the form of the AI Bubble, Housing Bubble, and Private Credit Bubble. Each bubble on its own is much larger than the housing bubble of 2008.

The US economy is going to be plunged into a severe recession, much worse than what we witnessed post the Lehman crash of 2008. The pressures to repeat what seemingly worked, i.e., ZIRP and QE, would be immense. Notwithstanding Bernanke's Nobel Prize in 2022, what the US faces today is exactly a consequence of those loose monetary policies, which should be obvious to Warsh.

Under those circumstances, whether Warsh has the intellectual fortitude to do the correct things – raise interest rates, continue the QT, and force the US Govt to move towards balancing the budget – will be the real indicator. My own bet is that the probability of that happening is abysmally low. Perhaps even almost zero.

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About the Author: Shanmuganathan Nagasundaram (aka Shan) is an Economist based in India. He has published more than 100 columns in Newsletters worldwide on the topic of Lassiez Faire Economics and the Gold Standard. Shan published his first book "RIP USD: 1971-202X ...and the Way Forward" in July 2024 where he forecasts an imminent Inflationary Depression for the US that will last a decade or longer. He also outlines the prognosis wherein the world's monetary system would revert to a Gold standard before the end of this decade as compared to the Paper currency standard that has prevailed since 1971.