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INVESTMENT RESEARCH

Britcoin – the ugly truth:

how to protect your wealth from central bank digital currencies

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Central bank digital currencies are the ultimate tool for government control

Nigel Farage, Editor, Southbank Investment Research

Government encroachment onto our lives reached a peak during the pandemic. Lockdowns, lockouts, lockups and lockins all featured in the name of control. Not control of the virus, but of the people.

That is because governments believe they know better. We must not be allowed to make choices for ourselves, despite being individuals with individual risk profiles and facing individual situations which no government mandate can sufficiently adapt to. As far as Westminster bureaucrats are concerned, we are a homogenous blob, there to be channelled into the correct behaviour.

The pandemic revealed this is true in more dramatic fashion than usual, but that belief was always there, underlying every new policy to come out of Parliament. It dominated the Brexit debate and the response to the Global Financial Crisis too.

Today, it is tempting to believe that, as the pandemic fades, things can only get better. Government control of our lives will recede. And those hopes may be proven right, for a while.

But government interference may be about to get worse in a very important way. The *ability* of governments to impose their control on our lives is about to take a sizeable leap.

To be clear, this is very different from saying that governments will impose more dramatic measures on us soon. Although Climate Lockdowns, a recession, and the War in Ukraine do loom large.

But the point of this report is not to warn you that governments will impose new policies on our lives. It is to warn that their ability to do so will change dramatically.

I believe that, given such new powers, it is only a matter of time before governments will use them. It'll be in response to some sort of crisis, of course. But consider something I believe to be more important in the grand scheme of things – and there are grand schemes, believe you and me.

What'll really change is that your compliance with the policies cooked up by the Treasury, nudge units and the Cabinet will be automatic and absolute. This means you won't be asked to behave in a certain way or to respond by doing something. You won't even be forced to comply, as we were during the pandemic.

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The policy will simply be done to you at the push of a button somewhere in Westminster. There will be no choice whether or not to comply.

Imagine what the pandemic would've looked like if governments could have enforced their pandemic policies "from home", as it were. If they didn't need police to patrol the streets to keep people locked in their homes, politicians merely needed to click their computer mouse. What if they didn't need vaccine mandates, just a piece of software code which is automatically uploaded and can't be avoided?

If politicians didn't need your compliance, what else would they have imposed on us over the past three years?

I shudder to think.

But, again, we don't know what the policy will be, although plenty of suggestions have already been made. What makes this report so crucial is that the nature of the government's game has changed. The government's policies won't be made and then enforced imperfectly. They will simply happen to you.

To find out how you can protect yourself, read this report by our investment director John Butler. John first wrote about the threat of CBDCs way back in 2014 and he's been following their development ever since. He's also developed investment strategies to help households avoid the greatest risks to their wealth implied by a possible future "Britcoin".

Nigel Farage
Editor, Southbank Investment Research

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Protecting your wealth from a digital wolf in sheep's clothing

John Butler, Investment Director, Southbank Investment Research

There are those who believe that governments foster innovation, during wartime for example. They also like to ignore the slaughter of millions which is sometimes part of this process. That is not to mention the innovators we missed out on as a result.

The latest government "innovation," which follows in a long tradition of borrowing ideas from the private sector intended to improve our lives and using them for other means instead, is central bank digital currencies (CBDCs).

Designed not to exist in any physical form whatsoever, CBDCs would give their central bank issuers entirely new powers. Indeed, much of the manoeuvring that was required in 2008-9 to rescue the financial system with taxpayer-funded bailouts would have been so much easier had CBDCs been in existence. But if easier, is that necessarily a good thing for the economy as a whole?

To answer this question, it is important to differentiate between CBDCs and the concept of private, distributed digital currencies, including those such as bitcoin, that are built using distributed ledger technology (DLT). Rather than offer an alternative currency, CBDCs are mostly aimed at making monetary policy easier to implement and, potentially, far more powerful.

As monetary officials have repeatedly made clear, they have no interest in replacing their policy discretion with algorithms, blockchains or any other form of private-sector solution. Recently, Pablo Hernández de Cos, the chairman of the Basel Committee on Bank Supervision – the regulatory branch of the Bank for International Settlements in Basel, the "central bank of central banks" – made the following comments with respect to DLT:

> *DLT could, in principle, allow for cheaper, faster and more customised financial intermediation. But, here again, such benefits must be weighed against the risks if not properly regulated and managed. These include potential threats to banks' operational resilience, a lack of legal clarity with regard to assets transacted on DLTs, and concerns with regard to anti-money laundering and the financing of terrorism.*

Financial system regulators have a bad habit of associating everything that is unregulated with money laundering and terrorism, when in fact the vast bulk of such activity takes place within the incumbent banking and payments system. Such invidious associations should be seen as primarily self-serving rather than anything necessarily in the public interest.

The Bank of England appears to share these sentiments. In December 2022, that central bank published the following comment:

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> *In the traditional financial system, critical financial infrastructure is regulated to deliver an appropriate level of responsibility, accountability, and control. In the future, critical third parties providing material services to the UK financial sector (eg cloud service providers) may also be subject to regulatory requirements. So, there is a question as to what appropriate regulatory oversight of a blockchain could entail, were it to become a more critical piece of infrastructure in the financial system.*
>
> *Blockchains do not constitute critical financial infrastructure (yet). But they could conceivably become so in the future if crypto-asset activity and its interconnectedness with the wider financial system continue to develop. So, it is important that relevant authorities find legal mechanisms and means of co-ordinated action to ensure that an equivalent regulatory outcome is delivered.*

Hence CBDCs, once introduced, are not intended to displace, but to migrate existing, centralised, regulated monetary systems from paper-based to wholly digital. There will still be legal tender laws requiring their acceptance for payment, and penalties for counterfeiting or other forms of fraud. Money laundering will still be a crime. And central banks will still control monetary policy. Indeed, their control of monetary and financial power will grow.

As it stands today, while central banks set interest rates and conduct open-market operations (e.g. quantitative easing) *these actions only have a direct impact on the reserves of the banking system* which, for many years now, have been essentially digital. Yes, banks hold some physical cash in reserve, but it is such a tiny portion of their overall balance sheet as to be practically irrelevant.

The broader money supply, including the amount of physical cash in circulation, various types and amounts of bank deposits and credit, fluctuates along with economic activity and liquidity preferences. Thus, when the Global Financial Crisis arrived in 2008, central bankers slashed interest rates and created huge amounts of reserves, but this did not prevent a general contraction in credit. Liquidity preferences spiked, including a desire to hold larger amounts of physical cash.

Given that multiple banks failed or had to be rescued, and that interest rates had declined to essentially zero, holding physical cash seemed an entirely reasonable thing to do. But it did have the effect of limiting central banks' ability to add further monetary stimulus to their economies.

As one central bank after another began to consider lowering interest rates to outright negative levels, one immediate and obvious complication was that savers would seek to avoid negative rates by reducing their bank deposits in favour of physical cash hoards. Such a run on to deposits would not only negate the proposed further stimulus, but would have the counterproductive effect of reducing banks' normally stable depositor base.

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CBDCs expand central bank power, for better or worse

CBDCs provide economic officials with a solution to this perceived problem: Once introduced, a purely digital currency cannot be physically withdrawn. No matter if central banks cut interest rates to below zero, even dramatically so, in an effort to get savers to spend more. The digital currency must remain in the banking system. It may circulate more as households and businesses seek to pass the depreciating "hot potato" around, but there is no other option. A bank run on the system as a whole becomes impossible.

CBDCs thus also give central bankers the de facto power to "tax" deposits, or to supplement them with stimulus cash, as they did during the pandemic. But they would also give them the ability to easily track and trace every transaction, no matter how tiny, and perhaps embed some sort of sales, VAT or transactions tax, depending on the type of transaction involved.

To what extent these new powers would be used or abused is unclear, and a merging of monetary and fiscal policy in this way would no doubt be political, but CBDCs would enable a complete fusion of monetary and fiscal policy, if desired, and would make any form of avoidance or evasion of their use on the part of households or businesses all but impossible outside of direct barter.

The end of financial privacy?

Financial privacy, something that has been eroding for many years, would vanish entirely. That is not to say that there could not be safeguards to protect personal data. But here, too, to what extent or for whatever reason individuals' transaction histories would be visible to the authorities would need to be decided as a political matter.

This latter point helps to explain why there is much public disagreement amongst economic officials about how best to regulate private digital currencies and prevent their use for money laundering, tax evasion or other illicit economic activities. Whether public or private, purely digital currencies leave the ultimate "paper trail" that can be followed back to inception. Yes, individuals can use cryptography to protect their privacy on a public blockchain, which is why bitcoin is frequently referred to as a "cryptocurrency".

In a 2021 article, former acting director of the CIA, Mike Morell, made precisely this point, calling bitcoin a "boon for surveillance," and that "concern over bitcoin's use for illicit finance is significantly overstated."

He should know. The CIA is known to monitor international financial transactions as it seeks to discover the source of all manner of activity, illicit or otherwise, that is considered a threat – real or potential, distant or immediate – to the national security of the United States. The agency uses the insights to draw connections between both state and non-state actors whenever possible.

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CBDCs as international reserves

The international arena is an interesting one for CBDCs, not only in that they would facilitate the ability of authorities to monitor cross-border transactions, but also because they could potentially disrupt the existing international monetary order.

Currently centred around the US dollar, it is worth considering whether another country's CBDC, once successfully implemented domestically, could displace the dollar and provide the new global reserve.

The fact that international reserve balances are already, in effect, digital in nature, suggests that the introduction of CBDCs doesn't fundamentally change the game in this respect. Reserves remain within the banking system and are not "spent" in the way that domestic physical currencies are. Rather, as they are accumulated, they are sometimes sold to purchase securities of some sort, such as government bonds, or they are exchanged for other currencies, or sometimes gold.

Whether or not the dollar eventually loses its exclusive international reserve status will be down to other factors. It could be that China, Russia, Japan, Germany or the big oil exporters eventually tire of accumulating dollars that seem destined to lose value to inflation over time.

The war in Ukraine and associated economic sanctions might also catalyse some changes in international monetary behaviour. Dollar-dependent trade is a relatively easy target for sanctions, but if other currencies are used instead, sanctions become far harder to enforce. It should surprise no one that Russia, China, India, Turkey and others have all made recent public statements to the effect that they have been actively seeking alternatives to the dollar even since Washington imposed war-related sanctions.

Were the above and other countries to indeed find a means to avoid the dollar in trade entirely, this would imply a severe reduction in the dollar's global monetary role. Could the weaponisation of the dollar have, in fact, been counterproductive? Imagine Messrs Putin, Xi, Modi and Erdogan channelling Napoleon: "Never interrupt the Americans when they are making a mistake!"

Dollar dominance on the wane, but NOT due to CBDCs

Having written extensively on the topic of global monetary regime change, in my opinion there is currently no national currency alternative to the dollar. Each of the various possibilities has problems of its own. Should the primary candidates migrate to CBDCs in future, with the United States opting for whatever reason to be left behind, doesn't necessarily imply that the dollar would not remain the dominant reserve.

Of course the US government might opt not to be left behind at all, but rather to place itself in the vanguard of the thrust to introduce a universal CBDC serving all

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modern monetary roles, including that of provide for the bulk of the international monetary reserve base. In a project of Napoleonic ambition, the US could simply explain that all existing dollar balances be converted into a purely digital dollar and that, over some period of months, all physical currency would need to be redeemed for digital dollar balances in an account or would simply expire worthless.

However, what if, subsequent to such a move, multiple major countries in the world pushed back? For example, what if they shared some of the concerns mentioned above, including, perhaps, that the United States would abuse its dominant reserve position by not providing for a fair market interest rate or, perhaps, implementing an outright negative dollar interest rate as a de facto tax on foreign-held dollar balances?

In a way not dissimilar to Napoleon's sense of near-invulnerability when he set about invading Russia, the United States might find the rest of the world pursuing a form of defence in depth, finding ways to reduce reliance on the dollar. Perhaps some countries would even engage in a form of "scorched-earth" policy in which they required domestic economic agents to transact internationally in non-dollar currencies only.

Certainly such policies would be disruptive, but perhaps some actors would perceive their cost of their implementation to be less than to remain dependent not only on the dollar, but on a new-fangled dollar CBDC which, paradoxically, gave the US Federal Reserve more power over global monetary conditions than it had ever had, yet at a time when relative US global economic power had slipped to its lowest ebb since the 19th century.

What about digital gold?

If the dollar's role continues to decline, rather than any particular CBDC, there is a more likely candidate to replace it: gold. Gold is the only truly international money, accepted everywhere as a reliable store of value, and one with the strongest possible historical track record providing the de facto global monetary base and, under the classical gold standard, the de jure one. As I argue in my book, *The Golden Revolution, Revisited*, gold provides the game-theoretic monetary solution to a globalised, multipolar world.

So, while I don't see CBDCs changing the international monetary regime on their own, it would be a real game-changer indeed if one or more CBDCs were to be linked to gold in some way. That would introduce real, tangible, perhaps irresistible competition for the dollar as the dominant global reserve.

As it stands now, however, it seems a more immediate concern that CBDCs will not only make it easier for central banks to implement negative interest rates, if desired, but that they will acquire a range of new, implied powers. Thus they bring with them broad implications for tax and fiscal policy, financial privacy and the ability for households to preserve their wealth in what has already become a highly challenging economic environment.

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Protecting your wealth from CBDCs

Bad economic policies, fiscal and monetary, always create a challenging environment for investors. CBDCs could, however, amplify the negative effects. For one, they would threaten to all but eliminate the traditional, safe-haven savings option of keeping some of one's wealth in the bank.

In a CBDC world, savers should see banks as nothing more than payments and liquidity providers, rather than a home for savings. CBDCs would enable cash-strapped governments to confiscate savers' wealth directly via negative interest rates.

Moreover, any cash-linked investment would be at risk, and not only bank deposits. Certificates of Deposit (CDs), money-market funds and even bond funds would be affected, if indirectly, by the underlying negative interest rate charged by the central bank – a de facto "tax" on savings.

There is also the risk of currency devaluation, which grows all the greater as interest rates decline, or go outright negative. A double-whammy of artificially low or negative CBDC rates on fixed income investments, combined with the indirect effects of imported inflation via currency devaluation, would wreak havoc on the real purchasing power of pensioners' savings.

Building a CBDC-defensive portfolio

With CBDCs increasing the risk that cash and bonds all but guaranteed to lose a substantial part of their real purchasing power in future, what is the defensive investor to do? Is it even possible to grow real wealth in such an environment?

I believe that it is, but it requires that investors greatly re-orient their portfolios, in particular by reducing holdings of cash and bonds and overweighting six stock market sectors, which are:

- Energy and Utilities
- Mining and Materials
- Chemicals
- Consumer Non-Discretionary
- Waste Disposal and Recycling
- Transportation and Logistics

Why these six? Well, all of them currently trade at valuations that are not far out of line with historical averages, which in a historically overvalued market implies that they are not currently overweighted by the investment "herd", but rather the opposite.

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They are light on so-called "intangible" assets and as such their valuations do not rely on highly uncertain long-term growth assumptions. They are comprised of relatively mature firms with experienced management teams.

Most important, they tend to have relatively stable margins and pricing power, be cash-generative, and pay dividends that can keep up with inflation over time. That means that they share some of the characteristics of bonds – relatively stable earnings and dividends, or "coupons" if you prefer – and yet aren't subject to the possible negative effects of CBDCs on cash and fixed-income investments.

Some of these sectors are cyclical, some less so, but there is nothing wrong with exposure to cyclicality when one is not attempting to time the market but rather construct a portfolio for an economically challenging environment. Indeed, one reason why some of these sectors trade at relatively low valuations is due to institutional investors' preference to reduce cyclicality in their funds, which happens to be a "herd" investing style best avoided.

Several of these sectors are comprised of just a few leading firms. Others are more dispersed, meaning that firm selection is more important. However, all of them are tracked by exchange-traded funds (ETFs) from major fund providers, enabling investors to get broad sector access for low management fees.

Investors preferring to do their own stock picking are encouraged to do so. They should pay particular attention to the specific management teams' experience and background, rather than merely on select firms by relative valuation multiples alone. Industry leaders, other factors being equal, tend to trade at higher multiples.

One simple way to diversify within a sector is to purchase the leading firm, which by definition has been consistently successful in the past, and then to select a second, rival firm, determined to have a particularly good management team, one capable of dealing with particularly challenging economic environments such that they have a fighting chance to outperform or even displace the industry leader over the long term.

Beyond shares: thoughts on precious metals

As discussed above, CBDCs increase the risk that cash and bonds fail to preserve real purchasing power. Normally a defensive investor would have a large allocation to both.

But with CBDCs making it easier than ever for the government to implement artificially low or outright negative interest rates, adding cash and bonds to a portfolio does not necessarily provide much in the way of defensive or diversification benefits. Indeed, they are practically guaranteed to lose real purchasing power.

But then, what do you do to diversify the stock portfolio, if not with bonds?

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The answer is: buy precious metals instead. Gold and other precious metals pay no coupon, but they do tend to retain their purchasing power in challenging economic environments, including inflationary ones. Precious metals acquire bond-like characteristics in a low- or negative-rate environment. Consider: a bond may pay a coupon, but if that coupon is at or below the rate of inflation, then it is, in effect, a negative coupon.

Precious metals, on the other hand, do not pay a negative coupon, but do tend to retain purchasing power. Precious metals are thus the better "bonds" in a low- or negative-rate environment. And so, if constructing a typical 60/40 shares/bonds portfolio, consider using gold and other precious metals to comprise some of that 40%.

Conclusion

Whether directly or indirectly, CBDCs place nearly all financial assets at greater risk than otherwise. A conservative, CBDC-defensive portfolio as described above is one to which occasional, more speculative positions might be added. Economic progress would not just come to a halt with the introduction of CBDCs. Businesses can still grow, if more slowly on average. New technologies and possibly entire industries can still emerge and outperform.

There is thus no reason not to seek out such opportunities. Indeed, finding particularly attractive new investments, if risky ones, should occupy the bulk of an investors time. He/she shouldn't be constantly preoccupied with the "core" portfolio, say comprising some 80% of the assets, which should more or less run itself according to a conservative investment process such as that described above.

Rather, most time should be engaged in finding particularly attractive new opportunities for the other 20%, which can be placed at some risk, in the search for outside returns. At present, I'm evaluating several such opportunities from areas that range from: a revolutionary clean air technology; AI-driven smart meter software designed to optimise energy consumption; a Black Sea port expansion; and an East European craft brewing operation.

Southbank Investment Research remains dedicated to providing practical, actionable advice on how to best preserve wealth in good times and bad. But even in the bad times, we always do our utmost to present our subscribers with fresh opportunities for capital appreciation.

John Butler
Investment Director, Southbank Investment Research