Notes…from people way smarter than us

SEPT 2020 · Diego Tremiterra

From the following:

"The End of Alchemy: Money, Banking, and Future of the Global Economy"

By Mervyn King

Having recently read Lord Mervyn King's book, The End of Alchemy, we thought it would make sense to share some of his ideas given the relevance of his thinking. The book covers much more ground than what we discuss in this piece, but we purposefully focused on a small section of the book given the current macroeconomic landscape. Whenever we write in italics, we're quoting him (we would not be able to come up with those insights, unfortunately, but that you already know).

BACKGROUND FOR REFERENCE

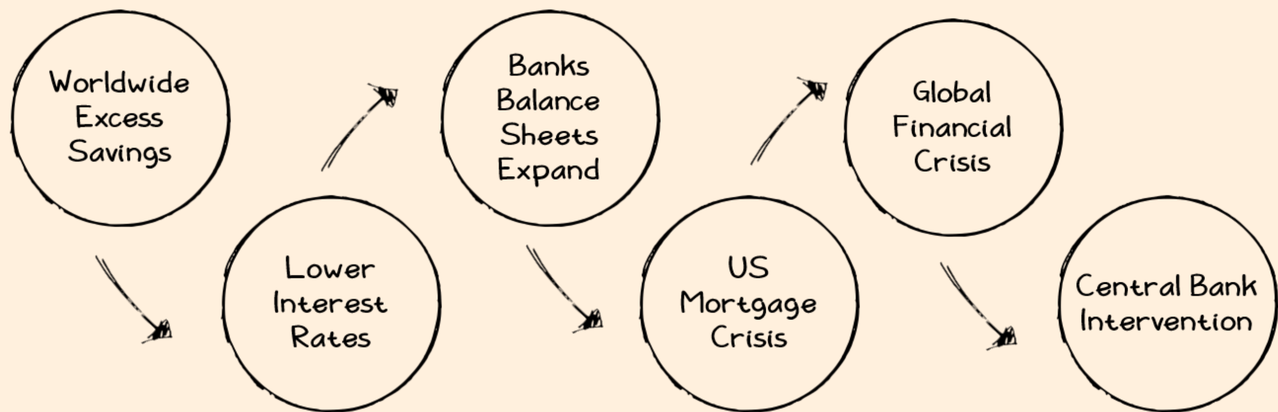
- *"The role of central banks is extremely simple: to ensure that the* ***right*** *amount of money is created in both good times and bad times".*

- *"Confidence in paper money rests on the ability and willingness of governments not to* ***abuse*** *their power to print money".*

- *"Before the great depression of the early 1930s, central banks and governments saw their role as* ***stabilising the financial system and balancing the budget****. After the Great Depression, attention turned to policies aimed at* ***full employment****. But post-war confidence that Keynesian ideas – the use of public spending to expand total demand in the economy – would prevent us from repeating the errors of the past was to prove touchingly naïve. The use of expansionary policies during the 1960s, exacerbated by the Vietnam War, led to the great inflation of the 1970s, accompanied by slow growth and rising unemployment – the combination known as 'stagflation'. The direct consequence was that central banks were reborn as independent institutions committed to* ***price*** *stability".*

- Albeit highly successful for the following two decades, the price stability mandate of Central Banks created huge imbalances. Policy makers, instead of targeting the disease (those imbalances), focused on solving the symptoms (the inevitable crisis). Let's look at the structural imbalances pre-2008.

STRUCTURAL IMBALANCES PRE-2008 & THE GFC



1. *"After the demise of the socialist model of a planned economy, China, countries of the former Soviet Union and India embraced the international trading system"*. This led China to add 70 million manufacturing jobs from 2000-2012, compared to 42 million in the US and Europe. This manufacturing surge in China led to an influx of cheap consumer goods (remember the explosion of "Made in China"?) at the expense of manufacturing jobs and depressed real wages.

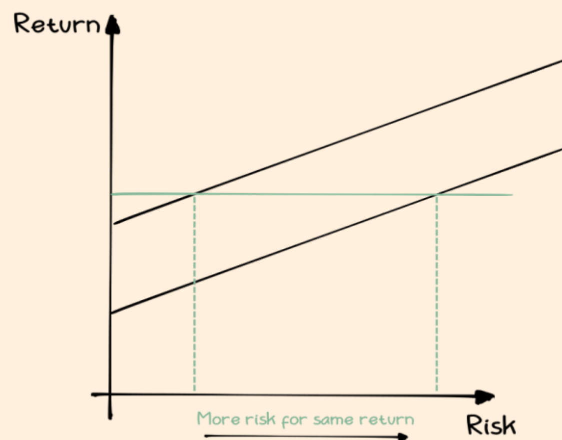
2. Export-led growth strategies worked marvels for China, as well as for many Asian economies. Given their lack of trust in the national currency and the absence of a social safety net, households developed a strong desire for savings. Combine high savings with export led economic growth, and China created lasting **trade surpluses against trading counterparts**. These surpluses generated excess savings worldwide as Asian households desire to save was not matched by western desire to spend (despite the majority of those economies running deficits).

3. **High savings rate across the world depressed general interest rates**. Central banks in the US and the UK lowered short-term interest rates in order to compensate for the drag on total demand (domestic demand minus trade deficit) caused by the increasing trade deficit (more things were being imported than exported). In economic terms, by lowering short-term interest rates, the US and the UK were trying to boost total demand by bringing forward future demand. Boosting total demand was instrumental to keep the economies growing and to avoid deflationary pressures (which is an economist's worst nightmare).

4. Lower interest rates meant asset prices (whose values is the Present Value of discounted future cashflows, or DCFs) inflated, as the discount rate (the denominator) used in DCF models decreased. This meant that:

a. In order to buy assets, investors had to incur incremental debt given the higher asset price. **This led to an increase in leverage.**

b. If you were awake for even a few hours in your intro econ class you'll remember the Security Market Line (SML), which is a graphical representation of systemic risk (market risk) of a security (or multiple securities) vs. its (or their) expected return. The lower interest rates incentivized higher-risk behavior to squeeze out higher-returns, which pushed the SML downwards, forcing investors to look for more risk in order to maintain the level of return. **This also led to an increase in leverage and risk.**



5. This all led, as we already know, to negligent behavior in the financial industry, as loose regulation and cheap capital allowed leverage of financial institution to soar. (According to The Atlantic, financial industry leverage ratios grew from 12-1 in 2004 to 33-1 in 2008).

6. We were left with two main problems: **unsustainable spending levels** (boosted by low interest rates, a monetary response to the structural trade deficits and savings glut) and **the excessive trust in the soundness of the financial system** (whose leverage was reaching astronomical levels with little regulatory oversight and a willful negligence of the risk profile of the banks' balance sheets).

7. What came next is well documented history (thanks to the $10b+ content spend budget of Netflix we've got to watch and re-watch multiple documentaries telling the same story): a subprime mortgage crisis that, through (*insert preferred adjective describing size*) mortgage-backed securities exposure, became a systemic event for the entire financial sector. Liquidity dried up and *"governments ended up guaranteeing all private creditors of the banks, imposing on future taxpayers a burden of unknown magnitude"*.

LESSON NOT LEARNED

1. Despite this sequence of events, and if we fast forward more than a decade, **we do not seem to have learned our lessons**:

    a. The inertia before the crisis was evident once again, with countries like the US running budget deficits 11 years into an economic expansion with interest rates near historic lows. We've now had simultaneous expansionary fiscal and monetary policy for several years, and the global pandemic has put on steroids this already existing trend. **We continue to run our governments on a reactive way, meaning that we respond to crisis rather than prepare for them.** For more on this, read Roger's last piece.

    b. *"Nothing has really changed in terms of either the fundamental structure of banking or the reliance on central banks to restore macroeconomic prosperity"*. Yes, the banking system has de-levered and we now have better and cleaner balance sheets. But risk (and leverage) has just moved to other parts of the economy (i.e. corporate and government debt), and the deleveraging process doesn't look like it will be any less painful than it was for the financial institutions.

    c. *"Why then, and in sharp contrast to the 1930s, was there so little enthusiasm* [post GFC] *for radical reform to our economic system and institutions?"*. **How did the system change, and how did it make us better prepared for the next crisis? I'm not sure how to answer that question.**

2. **The headwinds we're facing today are not derived by temporary shocks, but rather from an underlying weakness caused by the earlier bringing forward of demand** (debt driven consumption and multi-decade trade deficits). The post 2008-9 measures of encouraging consumer spending and borrowing (after 20 years of unsustainable domestic spending which in turn led to great economic growth) *"were the absolute opposite of what we needed to do – encourage saving and exports – to correct the underlying equilibrium"*. And so, a decade later, here we are again, with weak demand, challenging inflation outlook (potentially even deflation), with debt levels at historical highs and, this time, with the added challenge of a global pandemic which prioritizes public health to economic or political performance. We're facing new challenges on top of the chronic ones, which we have purposefully avoided for the better part of the last two decades. And whilst the day of reckoning is not necessarily around the corner, we can certainly assume that the hole we're digging is deeper than yesterday. But at least, we still got Susan and Derek...