

Monday, December 22, 2014



## Global Macro Themes – Exit Strategies: Pandora’s Box

*Ever since central banks were forced by events<sup>1</sup> to embark on quantitative easing (QE), the same monetary institutions were quick to outline their exit plans. Given that the success of these reflationary policies crucially relies upon their credibility to overcome the*

*deflationary forces unleashed by the Great Recession we were always bemused as to why central banks focussed on exit strategies so early in their implementation; it was always going to make the task of reflation more difficult. Indeed, as it has transpired quantitative easing programmes have been more prolonged and greater in magnitude than most financial market participants initially envisaged. Not only that, but the purported exit strategies always appeared to us to be highly unlikely to be implemented based on economic history. In this research note we explore the topic of exit strategies in greater detail and consider what the impact on the global economic and financial landscape will be; crucially we draw on the experiences from the 1940s.*

### Outlining The Toolbox

We have been pondering the issue of central bank exit strategies ever since QE programmes were first announced in 2009 as a last ditch attempt to ward off the depressionary forces that were being unleashed on the global economy; an episode that has subsequently become known as the Great Recession. As mentioned in the introduction, central banks were very keen to outline their exit plans almost from the word go, but we were sceptical (as is our nature) that what they were promising to do would be, in reality, either effective or implemented.

In July 2009 former Fed Chairman Bernanke wrote an op-ed for the Wall Street Journal (WSJ) specifically on the subject of exit strategies<sup>2</sup>. In his article Bernanke makes it clear that the central bank’s exit strategy is closely tied to the management of the Fed’s balance sheet, specifically the reserve balances.

Tightening monetary policy therefore requires either a reduction in reserve balances (excess money market liquidity) or a neutralising of their effect. Two

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<sup>1</sup> We are reminded of UK PM Harold Macmillian’s famous quote in reply to a question about what he feared, “Events, dear boy, events”; it is however, like many quotes, contested as to the exact circumstances of its delivery.

<sup>2</sup> For the full article See:

<http://online.wsj.com/articles/SB10001424052970203946904574300050657897992>

main avenues were identified: direct measures to reduce the stock of excess reserves and the newly acquired ability by the Fed to pay interest on excess reserves<sup>3</sup>.

The former involves directly managing the size of the Fed's balance sheet and there are several ways in which a reduction can be achieved. Bernanke listed them as:

- Large scale reverse repos with financial market participants
- Treasury issuance of bills and depositing the proceeds with the Fed
- Offering term deposits (as opposed to overnight reserves) to commercial banks
- Selling part of the Fed's long-term securities portfolio accumulated during QE via the open market

The latter – paying interest on excess reserves - conversely has a neutralising effect as it relies on the reluctance of commercial banks to lend out money to the private sector at an interest rate below that which could be earned by leaving the money with the Fed. After all, why engage in riskier borrowing for a lower rate of return?

As Bernanke concluded in the WSJ article the Fed has several tools at its disposal to tighten monetary policy as and when the economic environment was deemed to have improved sufficiently. Some of these tools are clearly more effective than others – we have grave doubts, for example, about the ability of the Fed to sell long-term securities back into the open market as it would be a very brave primary dealer indeed that makes an offer to purchase the first Treasury bond being offered to the market given how many bonds the Fed has accumulated on its balance sheet via its QE programme - but overall the impression given is that the exit strategy has been well thought out. We disagree with this notion.

### **Exiting What Exactly?**

Our greatest issue with the exit strategies described above is the lack of clarity over what the term “exit” applies to. Strictly speaking, it describes the central bank no longer having to deploy unorthodox policy tools and beginning the process of withdrawing monetary policy accommodation. However, this definition has been extrapolated by many financial market participants to mean something stronger; namely to signal that the global economy has finally overcome the economic headwinds that first became apparent in 2008.

While we agree there are (probably) tools at the disposal of the central banks to tighten monetary policy as and when the economy recovers on a self-

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<sup>3</sup> The Fed was only granted the authority to pay interest on excess reserves in 2011, a decision that brought them into line with the operational guidelines of most other central banks in the advanced economies.

sustaining basis, this goal has yet to be achieved. In fact, as we have written about previously<sup>4</sup>, neither the US nor the global economies have responded as expected to the Keynesian demand-side stimulus that has been injected over recent years; the lack of a robust pick-up in business investment being the clearest indication of failure.

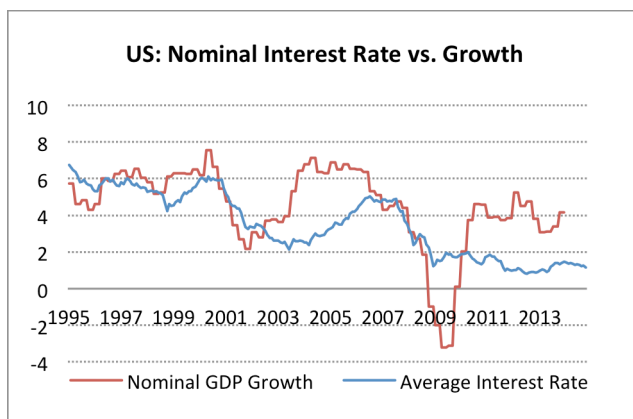
## The Golden Rule Of Investing

After such a grand subtitle our readers might be tempted to think we are about to outline the Holy Grail that investors have been seeking for centuries. Unfortunately, it is something much more mundane but nevertheless profound.

The decision as to whether to make an investment – any investment – depends upon two variables: the cost of capital, whether an actual cost of raising the requisite funds or the opportunity cost of foregoing other uses of the funds, and the expected return from the investment. If the latter exceeds the former then the rationale decision is to invest and if not then refrain; simple really!

At the economy-wide level the two pertinent variables are the nominal interest rate and the nominal GDP growth rate. The chart below shows how these two variables have evolved over the past two decades in the US. For much of the period shown the US nominal GDP growth has been at, or very close to, the level of the nominal interest rate.

Interestingly, (no pun intended) as a direct result of the Fed's actions in 2009 the US nominal interest rate has been significantly lower than the US nominal of GDP growth<sup>5</sup>.



The subsequent failure of investment to recover strongly is, consequently and rather obviously, a bit of a mystery to the Keynesian policy tinkerers, not to mention a significant intellectual challenge.

<sup>4</sup> See "GMT – Keynesian Failure", 10 March 2014.

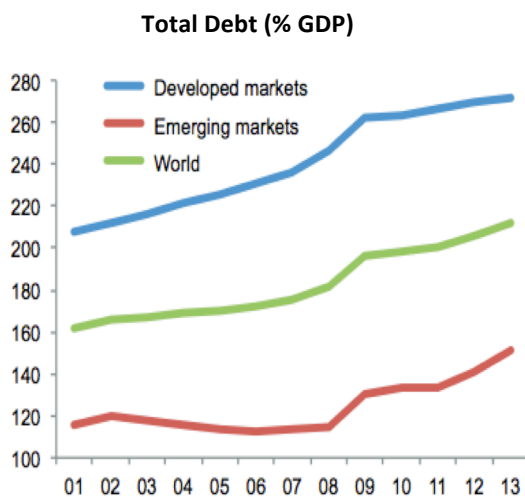
<sup>5</sup> Another notable exception was the period 2002-6 when, as has been the case recently, US nominal interest rates were significantly lower than the contemporaneous nominal GDP growth rate; an important observation but more on that later in this research note. Ed. Note: We have calculated the nominal interest as an equally weighted average of the 3-month US Treasury bill and the 10-year US nominal government bond yield. Obviously this is an imperfect proxy for interest rates available to the private sector (it ignores, for example, credit/liquidity premia, which can, at times, be significant – such as during the Great Recession). We have chosen this definition due to the availability of a long-run data set but also because interest rates available to the government and to the private sector are, in the language of economists, highly cointegrated. Hence, the inferences we draw are applicable.

The most likely explanation for the failure of investment to pick-up over recent years relates to the fact that investment decisions are not made on the basis of *ex post*, or realised, nominal GDP growth – the economy-wide proxy for the investment return – but on the *ex ante* expectation of future nominal GDP growth.

## Deadly Debt Dynamics

In our view the failure of the post-Great Recession upswing to bolster private sector expectations of sustained future GDP growth stems from the fact that the economic recovery is (still) heavily dependent upon rising levels of indebtedness.

Despite all of the chatter about deleveraging there is no support for this hypothesis in the hard economic data. There has, without doubt, been deleveraging within some sectors of the economy – most notably in the financial sector – nevertheless, total debt levels continue to rise. As can be seen in the chart below, which comes from a report entitled “*Deleveraging? What deleveraging?*” published by the International Center for Monetary and Banking Studies, total debt (namely, both public and private) has continued to rise not only in developed economies, but also in the emerging markets, to levels that have rarely been seen in peace-time economies.



Source: Buttiglione, Lane, Reichlin and Reinhart

Such debt dynamics are highly problematic because it suggests that future economic growth possibilities – globally – will be lower. This reflects the intertemporal substitution of demand that debt implies; funds borrowed to invest today – which as all economic students know adds to current GDP - must be paid back (including the associated interest rate) in the future, subtracting from GDP.

Advocates of Keynesian economic stimulus argue that increased government investment, importantly financed via budget deficits, kicks start economic growth both directly and indirectly by invigorating depressed private-sector “animal spirits”, encouraging further investment. This investment is assumed to raise future economic growth above and beyond that necessary to repay the debt. However, this conclusion is true only if the investment is “productive”, something that cannot be determined *ex ante*.

*Ex post*, however, we can draw some tentative conclusions because prior productive investment should – by definition – have raised nominal GDP. Combined with the repayment of the loan principle, this would contribute to reducing debt/GDP ratios (the effect comes via both the denominator and numerator). As the chart above clearly illustrates there is no evidence of such reversion in debt/GDP ratios, suggesting that prior investments have, at an aggregate level, not been sufficiently productive<sup>6</sup>.

### **Policy Actions – Promised Vs. Probable**

Eradicating the debt load that is, in our view, impeding a self-sustaining global economic recovery is therefore of paramount importance. Governments have promised to engage in fiscal consolidation but such efforts are likely to prove toxic to economic growth. Indeed as we showed in “*GMT – Fiscal Consolidation: A Sisyphean Task*”, 27 August 2014, the magnitude of fiscal tightening required to bring debt levels in the advanced economies back towards the more acceptable 60% level is considerable, at more than 10 percentage points for the G20 average.

Such a degree of fiscal tightening, especially occurring simultaneously, (generating negative spill over effects via external trade) would significantly undermine economic growth. It would effectively mirror recent experiences in the periphery of the Euro zone, whose economies have been subjected to their own Great Depressions.

One could argue that the above comparison is not exact because the advanced economies have their own central banks and hence have the ability to provide monetary support via currency devaluations of the kind that has not been possible in the Euro zone periphery, despite President Draghi’s best efforts. Unfortunately, however, due to the zero-sum nature of exchange rates it is simply infeasible for all the countries to devalue their way to prosperity. So, even if the analogy is not entirely exact, a critical channel for providing monetary stimulus is simply not available.

Former UK FSA Chairman Adair Turner made this important point in a recent blog describing the use of exchange rate devaluation to generate economic growth as “collectively impossible”<sup>7</sup>. In fact, as we noted in previous research, it is likely to not only be collectively impossible but will almost certainly contribute to a worsening in the global economic situation as beggar-thy-neighbour

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<sup>6</sup> This conclusion should be caveated by the phrase “at least not yet”. It is always possible that one expects a GDP growth boost from prior investments to materialise in the not too distant future, implying the world is poised to reap the benefits in the form of what would be an unprecedented surge in economic growth. This is a topic we intend to cover in a future BSEC research note to be published early in the New Year.

<sup>7</sup> See: <https://forumblog.org/2014/11/how-to-escape-the-debt-trap/>

exchange rate policies<sup>8</sup> are very corrosive in terms of international cooperation; encouraging protectionism policies to the (further) detriment of global trade.

So if a proposed fiscal solution is impractical, what does that imply for the monetary policy outlook?

### **Low For Really, Really, Long**

As mentioned at the outset, central banks have already signalled their intent to start raising interest rates next year in an attempt to maintain their inflation fighting credentials. We strongly suspect if this were to occur then it will not take financial market participants very long to extrapolate a trend, especially with interest rates coming from such historically low levels.

In addition to the direct damping effect the resultant increase in borrowing costs would have on economic growth – especially given such elevated debt levels – it would also probably be associated with a dramatic reversal in the wealth effect. The reason being that at current valuations global asset markets only look anywhere near reasonable if, and only if, interest rates remain at rock bottom levels<sup>9</sup> (and even that is at a stretch).

Any attempt on the part of the world's central banks to raise interest rates next year<sup>10</sup> would echo the situation that occurred in 1937/8 when central banks, encouraged by the upswing in economic activity following the Great Depression, began to tighten monetary policy; the upshot of which was a double-dip recession.

So, while we cannot rule out the possibility of policymaker error (and let's face it there have been some spectacular ones over the past decade) what is the more probable outcome?

In short, we view – and have done for some time – the only viable policy solution to the crisis to be one where monetary stimulus is increased further, completely contrary to the signals being sent out. Central bankers need to shift radically, moving away from the low inflation-targeting regimes presently in place until such time as the total debt load is significantly reduced.

The most effective way that such a policy can be implemented is via an interest rate cap. Such policy measures might seem extreme, and for many market

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<sup>8</sup> Or in the modern sexed up vernacular “currency wars”.

<sup>9</sup> See “GMT – Pause For Thought”, 25 June 2014.

<sup>10</sup> On the margin, the substantial slide in crude oil prices seen over the past six months reduces the risk of what we would describe as misguided monetary tightening occurring next year. Partly based on our analysis (see: <http://www.blackswaneconomics.com/in-the-news/oil-prices-plunge-opec-meeting-661.html>) and following subsequent discussions with some of our clients who are more knowledgeable in this field, we suspect the move lower in crude oil prices will prove to be quite protracted.



participants unprecedented, but this is far from true. Such policies have been adopted before, although it was admittedly a long time ago.

To those aware of their existence interest rate caps are considered to be the result of “war-time” financing of huge government budget deficits between 1939-1945. In fact, their birth was prior to the onset of WWII.

As noted by Eichengreen and Garber in *“Before The Accord: US Monetary – Financial Policy, 1945-1951”* to wit,

*“The low interest rate regime is portrayed as a logical extension of wartime debt-management policies. In fact, the origins of US policy in the period 1945-50 go back further, specifically to the monetary policies and problems of the 1930s”.*

*“Two developments in the 1930s that encouraged the Fed to intervene to stabilize securities prices were rising interest rates and the problem of excess reserves”.*

*“Though mopping up excess reserves might enhance monetary control, the higher interest rates it produced might prompt a recession. To acquire reserves, banks would liquidate a portion of their bond portfolios, and the consequent rise in long-term interest rates might abort the recovery. If the fall in bond prices was sufficiently severe, the solvency of banks which had invested heavily in bonds might be threatened”.*

If these dual concerns – monetary tightening heralding in a recession and undermining financial stability – sound eerily familiar, they should. Irrespective of all the chatter from the leading lights at the Fed and other central banks contemplating reining in monetary accommodation, these concerns are very much front and centre.

### **A History Lesson**

The Fed did not accede to initial requests from US Treasury officials, who were concerned that any back-up in government bond yields would undermine their debt-management objectives, to cap interest rates in 1935. However, for the first time ever, the Fed purchased government bonds with the deliberate intention to stabilize fluctuations in Treasury yields<sup>11</sup>.

It was not until the US entered WWII, April 1942 that the Fed explicitly announced a cap interest rate at  $\frac{3}{8}\%$ , for Treasury bills, with the Reserve banks

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<sup>11</sup> It is not widely known, even in financial circles, but the Fed does not just have a dual mandate, namely full employment and low inflation (now formalized at 2%) but there is a third objective: moderate long-term interest rates as detailed here: [http://www.federalreserve.gov/faqs/money\\_12848.htm](http://www.federalreserve.gov/faqs/money_12848.htm). Hence, we would argue that if (when?) the Fed announces an explicit bond yield cap, it would be able to do so within its existing mandate as established in the Federal Reserve Act.

required to purchase all bills offered to them at this price. In practice, the Fed also established an upper limit on Treasury bond yields of 2 ½%.

Aside from an increase in the Treasury bill rate target (which saw it drift up towards 1%), the interest rate caps remained in place until March 1951, when it was abolished via the Treasury/Fed Accord, which saw the central bank regain operational independence of monetary policy. The Accord simply stated that,

*"The Treasury and the Federal Reserve System have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure the successful financing of the Government's requirements and, at the same time, to minimize monetization of the public debt."*

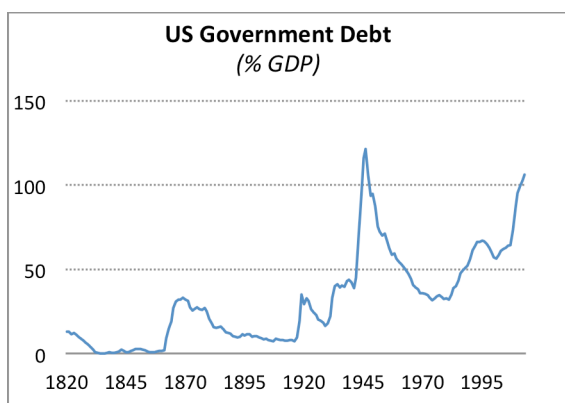
(Federal Reserve Bulletin, March 1951, p. 267).

The Accord was motivated by the Fed's concern that the interest rate peg was fuelling credit creation and hence inflationary pressures, which they considered to be of paramount importance. By contrast, President Truman and Treasury Secretary Snyder viewed maintaining the interest rate cap as imperative to securing government funding with the Korea war intensifying.

Narrative accounts of how the accord came into being show that significant disagreement between the Fed and the Treasury came as early as 1949. Yet, it was not until a full two years later that it became a public and very messy dispute, prompting President Truman to call the entire FOMC to the White House on 31 January 1951 – yet another first for the Fed<sup>12</sup>.

### Why Now?

The Treasury/Fed Accord is interesting for economists and financial market participants alike for numerous reasons.



Source: Reinhart and Rogoff and IMF database

First and foremost, it provides a timely reminder to guard against complacency in thinking that what we have become accustomed to, even over a relatively long period like the past 30 years, will always prevail. Second, it illustrates just how interventionist policymakers – even those supposed to hail from the country that considers itself to be the leader of the free world - if the macroeconomic situation is deemed

<sup>12</sup> For further information on this fascinating dispute between the US administration and top Fed officials see:

[https://www.richmondfed.org/publications/research/economic\\_quarterly/2001/winter/pdf/hetzel.pdf](https://www.richmondfed.org/publications/research/economic_quarterly/2001/winter/pdf/hetzel.pdf)



serious enough. Finally, it raises an interesting question: why was the Accord not agreed until a full five years after the ending of WWII?

As outlined above, the primary motive for Fed officials forcing the President and the Treasury to end the interest rate cap was inflation concerns. While it is true that in 1951 CPI inflation had accelerated to 7.9% y/y up from 1.3% y/y in the preceding year, in the late 1940s CPI inflation had been considerably higher, peaking at 14.4% in 1947. Admittedly, CPI inflation was boosted by the abolition of wartime price controls, but why did the Fed not act then? In our view, the reason is that the Truman administration's commitment to the interest rate cap was robust because of the very high levels of US government debt. As can be seen in the above chart, which is based on data provided by Reinhart and Rogoff, US government debt peaked at 121% of nominal GDP in 1946; the highest level ever recorded (but scarily similar to today's level of 106% of nominal GDP).

Reducing the burden from such a high debt load was clearly a top priority for US policymakers. As a result, the goal of maintaining a low inflation environment was subordinated. By 1951 US government debt had been lowered to 75% of nominal GDP; still relatively high, but considerably lower than it had been just five years earlier. As such, the focus of US policymakers naturally shifted back in favour of the price stability objective and the Fed started to win the public debate against the bond yield peg.

What the above experience also clearly illustrates is the power of using inflation to eradicate debt in an economy (almost 50 percentage points in just five years!). Certainly, it is unimaginable that such a drastic debt reduction could occur via the policy mix being promised by the present crop of politicians, both in the US and in other advanced economies, namely monetary accommodation (subject to CPI inflation remaining close to mandated targets) and fiscal consolidation.

### **The Fischer Effect And More**

Objections to central banks using the printing press to shed the debt load are numerous. One of the most cited is that it would completely undermine the hard-won inflation fighting credibility of independent central banks. We agree, but counter with the following: how credible are these monetary institutions given the levels of debt in the advanced economies?

Central banks always have been, are, and always will be, monetary servants of the government. First, they act as the bank to the government, such that if the government draws on the monetary resources of central bank it must honour the payment or the whole financial system would collapse instantaneously; perhaps the clearest breach of financial stability that could occur. Indeed, one of the primary motivations for the establishment of central banks was the need for the governments to finance war campaigns<sup>13</sup>.

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<sup>13</sup> "Plus ça change, plus c'est la même chose" eh!

Additionally, central banks heads are government appointed, so inflation hawks can always be eventually replaced, as shown by recent events in Japan. Former BoJ governor Shirakawa was reticent to engage in large-scale JGB purchases, but following the election of PM Abe – whose economic revival plan (Abenomics) relied, in large part, on additional substantial monetary stimulus - he was replaced by a former MoF official and staunch critic of the BoJ, Kuroda; monetary stimulus (via increased QE) quickly followed<sup>14</sup>.

Finally, *in extremis* central banks can always be nationalised and formally brought under the direct control of the government, as occurred to the Bank of England in 1946<sup>15</sup>. In short, only fools and madman consider central banks to be truly independent institutions.

A further objection, we hear cited against inflating debt loads away is that it would be self-defeating as investors would simply respond by increasing the required interest rate premium, keeping or even potentially forcing real interest rates higher. Essentially, this is an appeal to the Fischer effect. We completely share such concerns, and this is why, as and when central banks are forced to deploy the printing press it must be accompanied by an explicit yield cap on government bonds.

### **Balance Sheet Constraints**

Clearly, for the policy to work, the yield cap must be lower than the nominal GDP growth rate, and hence must also be lower than the level that would be set in a freely traded market. Hence, it naturally raises concerns as to how many government bonds central banks would be required to purchase in support a bond yield target. Indeed, former Fed Governor Bernanke has privately expressed just this concern when discussing the option of bond yield caps<sup>16</sup>.

We strongly suspect that central banks would not witness a massive increase in their balance sheets if such a policy were to be adopted. First, because the central bank would be buying government debt financed by issuing reserves, they have essentially unlimited buying fire-power; as such, even the largest investors would be unable to “take on” the central bank in the way that George Soros famously did with the BoE in 1992. Moreover, credibility is likely to be further enhanced if the bond yield cap is publically – and explicitly - announced, so as to remove any doubt as to what the central bank is aiming to achieve.

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<sup>14</sup> See “GMT – Abenomics: One Year On”, 13 February 2014.

<sup>15</sup> The Bank of England was not privatized until 1997; one of the few policies former Labour Chancellor Gordon Brown managed to implement that proved not to be economically damaging. His fiscal golden-rule would have been another notable success if he had not deliberately chosen to breach it! And, let’s not even mention his disastrous 1999 gold sale decision.

<sup>16</sup> Interestingly, however, Bernanke did not consider this objection sufficient to rule out the possibility of such a policy. Given his closeness to his successor, Yellen, we would be highly surprised if this policy option is no longer on the table.

Finally, the government could also employ various forms of financial repression to ensure there was not a wholesale exodus by investors (either private or foreign official<sup>17</sup>) from their government bond market. Commercial banks, insurance and pension funds, could be compelled to hold a certain percentage of their assets in the form of government bonds (to make such legislation more palatable they can describe such captured bond holdings as representing a financially prudent sounding “liquidity buffer”).

### Remaining Objections

A final, and more serious, objection to such a policy proposal is that it might not actually work; a criticism that is based on Japan’s recent experience with Abenomics. This argument has been most clearly enunciated by GMO’s James Montier. To quote:

*“To me, there is no evidence that inflation is actually coming back in Japan. The sequencing that Abe has to achieve in order to get inflation back is so difficult. He starts by devaluing the Yen, okay, but what that does is raise import prices, which means the average Japanese person just had a wage cut. That’s deflationary, not inflationary. You may raise the CPI headline, but you are stripping out the ability of the consumer to spend.”*

This is a very fair and well-founded argument, but it does not turn out to be a deal breaker for the following reason. As we alluded to in (*“GMT – JPY: To Infinity And Beyond”*, 18 November 2014) we consider:

*“this “problem” [to be] simply a first-order problem, one that will get corrected in due course for the simple reason that Japanese consumers will not tolerate a sustained drop in their real living standards; a reaction will, in time, occur.”*

Two reactions seem to us possible – we readily admit that neither are especially palatable to anyone with a capitalist bone in their body, but this reflects the severity of the current macroeconomic situation<sup>18</sup> - but whichever occurs the

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<sup>17</sup> Amongst the various forms of financial repression that will most likely be required, capital controls have got to be towards the top of the list, as the international dimension cannot be ignored given the degree of foreign ownership in many government bond markets. Such measures would clearly result in a further deterioration in international relations, as foreign official holders of government bonds, such as central banks and sovereign wealth funds, would view such actions as odious. However, no matter how unfavourably they might be viewed, consider the alternative: currency wars. It seems to us, given the significant disequilibrium evident in the world economy at present, whatever policy route is adopted the outcome is likely to trigger increased international tension.

<sup>18</sup> We feel at this point we need to make the following defensive statement: we are wholeheartedly in favour of a capitalist system. The dramatic shift in monetary policy objectives we have outlined in this research note, runs contrary to this position, but this is what we predict will happen and probably needs to happen; essentially it is pressing the reset button on the global

result would be higher wages, both nominal and real. The first reaction could be increased unionisation of the labour force, where hard-pressed workers revisit the model of the 1970s and collectively demand higher wages to compensate for declining living standards under the threat of industrial action. Alternatively, the government could directly intervene and announce an incomes policy.

Of the two we consider the former to be the more likely, especially as private sector inflation expectations would be certain to rise in the event of the central bank adopting an explicit goal to inflate away the debt load.

Whichever of the two routes to higher wage and price inflation<sup>19</sup> transpire, it would also have a positive distributional impact. This is a subject we have already covered in *“GMT – The Identity Crisis: Part 2”*, 14 May 2014, and as this research note is already quite long we would direct our readers to this.

### **Asset Market Implications**

We have outlined in this research note what we consider to be the only viable “exit strategy” from the macroeconomic challenges facing the world economy, most importantly eradicating the high levels of indebtedness observed in most major economies.

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economy. Once economy-wide debt levels are inflated away we would very much welcome a return to more prudent monetary policy and the embracing of a truly capitalist system. Crucially, this must allow for greater failure, something that be sorely missing in the past few decades. Or, as Seth Godin has astutely observed, *“If failure is not an option, then neither is success”*.

In our view, at some undefined point in the prior two decades policymakers, confident that they had the tools and the ability to control the economy with demand-side measures, decided that recessions were not to be tolerated and should be avoided at all costs. While such a policy objective seems to be admirable at first glance the reality is that not only were policymakers overly confident in their abilities to control the economy but, by effectively ruling out the possibility of failure, they sowed the seeds of the crisis that began in 2007.

Nowhere is this problem greatest than in the banking sector. Moreover, by flooding global financial markets with very cheap liquidity central banks have actively encouraged financial institutions to continue to engage in carry trades (as evidenced by the huge contraction in interest rate spreads); a process aided by their forward rate guidance policies.

Even though there is recognition that by their size and degree of interconnectedness these financial institutions are Too-Big-To-Fail there has been very little progress made in trying to reduce their size. As such failure of a financial institution, as we saw clearly following the collapse of Lehman Brothers, leads to a catastrophic outcome. A key prerequisite for allowing failure, which forms the basis for a properly functioning capitalist system, is to break-up the banks. Therefore, in our view, another key indicator policymakers are – finally, albeit belatedly- moving down the correct path would be decisive action to reduce the size of individual banks. We live in hope, or in keeping with the title of this research note perhaps we should refer to Elpis.

<sup>19</sup> There could well be more that we have not considered and we would invite readers to contact us with any their suggestions.

Central banks use the phrase “exit strategy” to describe how they intend to move away from very accommodative monetary stances, but as we have argued, the more likely outcome is more, not less, monetary stimulus; ultimately taking the form of explicit interest rate caps on government bonds. This would be associated with CPI inflation rates in the developed economies much higher than is consistent with the current inflation objectives of central banks.

To-date there is scant evidence that the global monetary guardians are contemplating such a bold change of direction. However, given that the promised mix of fiscal consolidation and growth supportive monetary stances seems extremely unlikely to tackle the debt issue, we expect such a change will occur, eventually.

Indeed, it would not surprise us in the least if central bankers, assuming a more optimistic economic view than us, attempt to reduce the amount of monetary accommodation over the coming 12 months; both the Fed and the BoE seem to be on such paths. If our less optimistic assessment of the global situation is correct, then economic growth will quickly falter after what many investors will consider to be only a moderate interest rate increase. Amid concern that they are repeating the errors of 1937, we envisage that policymakers would quickly reverse direction and start to consider more extreme policy measures.

Any resultant asset price market wobble would, nevertheless, present investors with significant alpha generating opportunities as it would provide good entry points for trades that would benefit from the introduction of an explicit interest rate cap such as: long equities, long bonds (initially) but to be replaced by short nominal bond volatility, long index-linked bonds and long FX volatility. These trades are all consistent with the long-term outlook we have described in this research note, and which we suggest represents an investment blueprint for the coming decade<sup>20</sup>.

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<sup>20</sup> In order to give our readers time to digest this lengthy research note we have decided this will be the last publication for 2014. We would like to thank all our readers for the support shown in this the first year of BSEC and we wish you a very happy holiday season and a prosperous 2015.