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THE ROAD TO NOWHERE

The Cobden Centre

HINDESIGHT LETTERS

An Interview with William White, Part I:

The former Economic Adviser for the Bank of International Settlements (BIS), speaks with Sean Corrigan, Cobden Centre contributor and its Editor Max Rangeley

At Hinde Capital, investors know we consistently strive to provide an intellectually honest source of information on the role of money in markets and its implications in both an economic and social context. Our role as fiduciaries is to grow and preserve our client's wealth using absolute return and diversification strategies.

Dynamic risk and money management define our strategies not economic ideals. However to understand the risks associated with the global economic system, today, one must fully comprehend that the credit cycle is the business cycle. Policymakers' forward guidance, control of money and credit transmissions pose the single greatest threat to achieving a stable and sustainable economic future. We do not have such stability today.

We find ourselves sharing the same values as the Cobden Centre (TCC) which was established to promote social progress through honest money, free trade and peace. Myself as a contributor and member of the advisory board support their desire articulated here:

"Our vision is of a peaceful, open and free society based on sustainable economy in which everyone has the opportunity to participate in constantly growing real prosperity."

Based on sound scholarship, (primarily the Austrian School) they argue that such a society must be built on honest money; of which we at Hinde are also advocates.

Honest money means an end to credit expansion and false booms followed by financial crises with appalling human cost. It means an end to inflation of the money supply and hence prices. Honest money is the key to social progress in the 21st century.

Therefore:

• TCC believe that social progress comes when private property is secure and all people enjoy an increase in their real income. They believe that the reduction of relative poverty and the increase of general prosperity will make society more orderly, stable and free.

• TCC believe that, today, the first condition to secure private property, to diminish widening wealth inequality and to establish a stable, sustainable economy for the benefit of all is honest money.

• TCC believe that the method of increasing real income for all people is a social system of independence, interdependence and mutual cooperation: the free market.

I am delighted to share the transcript of a truly fascinating and revealing interview between a former global central bank adviser on the state of monetary policy, its economic and market implications and members of the Cobden Centre. Thank you to the Cobden Centre for an insightful dialogue and sharing this through Hinde Capital.

Ben Davies,

Co-Founder & CEO Hinde Capital

William White is currently Chairman of the Economic and Development Review Committee of the OECD which provides policy recommendations to governments of member and aspiring member countries. Mr White was one of four members of the Issing Committee which, from 2009 to 2013, advised Chancellor Merkel of Germany on matters pertaining to international financial stability.

He continues to do research on issues pertaining to monetary and financial stability. He has published both academic papers and shorter articles of interest to the serious press in many countries. As well, Mr White regularly makes associated presentations, tailored to a wide variety of audiences, worldwide. More information can be found at www.williamwhite.ca

Mr White held the position of Economic Adviser at the Bank for International Settlements (BIS) in Basel for 14 years before retiring in 2008. Prior to joining the BIS, he spent three years at the Bank of England followed by 22 years with the Bank of Canada. He left the latter as Deputy Governor for International Affairs.

The Cobden Centre contributor Sean Corrigan and Editor Max Rangeley interviewed Dr White on recent developments in Europe and around the world.

Max Rangeley: Well, thank you very much for being on the call today, Bill. That's really great. So I've got a few questions here, which I thought we could go through. First, now that QE has started in Europe is this likely to cause further distortions rather than stimulate the economies of Europe, especially will it favour large corporations at the expense of small businesses, do you think?

William White: To be honest, I'm not sure it's going to do anything - certainly, anything that's good. The fundamental problem here, as I see it anyway, is that the European banking system is still broken. As you know, the European economy is heavily reliant on small and medium-sized enterprises, and they are reliant in turn on bank financing. Unfortunately, it is these firms that are not getting the bank financing that they need. Until that gets fixed, we will continue to have a huge problem in Europe.

It also needs to be remembered that, while the first round of QE everywhere was intended to deal with liquidity problems in financial markets, QE2 and QE3 in the United States were designed to spur increases in aggregate demand through lower term spreads and credit spreads. The idea that QE will work in Europe, which has a much greater dependency on bank financing, seems a little farfetched to me.

In any event, here in the euro zone bond yields are incredibly low already although one cannot rule out that this was in anticipation of QE. So my general sense is that I don't think QE was

needed and I am dubious that it will work in stimulating aggregate demand as intended. Moreover I remain worried that its implementation might bring with it other unintended and undesirable consequences that we haven't even thought about. All that said, I think the ECB was under such pressure to act further that it had little choice but to do what it did. And that, in itself, I think, is really unfortunate, because it just drags another important central bank still deeper and deeper into this malaise of central bank over extension.

Sean Corrigan: As you say, I couldn't agree more. It's a question of dysfunctional banking and also of the debt hangover, which we haven't addressed. And to me, QE is self-deceiving in that the liquidity issue, as you say, was the first rationale in the aftermath of the Lehman collapse was one thing, but to then try and use it as a macro tool when what you're trying to do is make borrowing more attractive for people who have just been burnt by overborrowing seems--

William White: Mad. It's mad here and it's mad everywhere. It's more of what got us into trouble in the first place.

Sean Corrigan: We're trying to fix banks but now we're destroying their net interest rate margins, by trying to work this way as well. We're also destroying all the other financial institutions like insurance and pension companies that must be bleeding everywhere.

William White: I'm working on a piece for the G30 which basically deals with the future of central banking and the future of monetary policy. I sense from talking to many of the members, many of whom are previous central bankers, that they are very concerned about the direction this has taken, in particular the continued over reliance on stimulative monetary policy to get us out of the predicament we are in. It has turned into a kind of Pandora's box. Swiss Re has recently published a paper called "Financial Repression: Quantifying the Cost" which looks at the cost of these unusually low interest rates for the insurance industry. Clearly, they are really, really worried about it and I don't blame them.

As for your other point Sean, I also agree. I guess in the early days when they started lowering the interests rates, the thought was that the deposit rates would go down before the loan rates and the banks would get a short-term benefit from the change. But in the fullness of time, however, margins are getting squeezed more and more so that even the banks are being hurt. If broken banks are a big chunk of current problems, particularly in Europe, it is a bit odd that policy is actually making the future of banks and other financial institutions still more dodgy.

As both of you may know, I've written a lot about this stuff, not least of which a paper that was published by the Dallas Fed in 2012 . It was called "Ultra Easy Monetary Policy And The

Law Of Unintended Consequences." It contained page after page of all the things that might go wrong. Moreover, knowing that even my imagination might be inadequate, I treated that paper as a kind of work in progress. So every time I opened up The Financial Times or something else and I saw something unpleasant that wasn't in my paper, I clipped it out and added it to the pile. Unfortunately, the pile is getting bigger and bigger. There is a possibility at least that this whole exercise could end very badly.

Sean Corrigan: This kind of brings us on to one of the other points I think we had on the sketch of the ideas we'd like to discuss with Bill. The bigger issue to me is that the central bank has become the go-to place in lieu of the sheer incapability of politicians to address the problems in front of them. So everything is now, "Let's ask the central bank do something. Let's ask the central bank." Of course, like all public choice issues, the central banks themselves, while perhaps a little reluctant at first, have come to enjoy their role as the world's superheroes and saviours of the universe. How are we ever going to get them back to doing the job that they should have been doing, which is just providing a back stop to a functioning financial system?

William White: The answer is I don't know. I think, increasingly, they are discomforted more than anything else. I think it's not just the ex central bankers but increasingly the people that are still holding the levers. They are starting to ask whether they have somehow been backed into a place where they don't really want to be. Now, I agree with you, Sean, that there's an element in everybody, although some more than others, where they're glad to be looked upon as the saviours of the day. But I rather sense that an increasingly large number of central banks are actually looking at what is going on and saying "We are being asked to do something that is effectively impossible." In a nutshell, most central bankers know that our economies do not face a liquidity problem but a solvency problem linked to excessive debt accumulation. If it's a solvency problem, central banks can't fix it. The only way they can fix it is by inflation which, with the debt levels being the way they are, could very quickly get out of hand.

The point is that, if the debt problem is to be sorted out in any meaningful way, the governments have got to get involved. The hardest thing will be to admit that in many cases the debts cannot be serviced and must be written off, at least in part. This will be painful but the effects of living with crippled financial institutions for many years would be worse. There's a great line from John Kenneth Galbraith that I used in a paper a while back. You remember Rab Butler whose autobiography was called "Politics: the art of the possible" . Galbraith denies this saying "Politics is not the art of the possible. It is choosing between the unpalatable and the disastrous" . That is where we are at.

Sean Corrigan: I am sure there are sensible voices talking this way, Bill, but then we have Madame Lagarde and her coterie who have rushed to welcome all these things and to offer praise unto the heavens the minute that somebody somewhere is printing some money or borrowing some more money. It doesn't really help, does it?

William White: No, it certainly doesn't and I have to say the IMF has not always got it right in the past, as recorded by their own Independent Evaluation Office. This was set up in 1999, I think, around the time we set up the Financial Stability Forum at the BIS. The Independent Evaluation Office looked back at the Funds advice prior to the Asian crisis and basically said the IMF just got it wrong. They ignored the rapid expansion of credit and the rising stock of debt and all the other imbalances that the BIS had been concerned about.

And then around 2011, the IEO did another report on whether the Fund had adequately foreseen the current crisis and warned about it. Again the answer was no. And still more recently, Olivier Blanchard has come out, on at least two occasions, recommending higher inflation as a preventive measure for future crises. His logic is that if you had higher inflation, you'd have higher nominal rates. And if you had higher nominal rates, when you get into one of these crises, you'd have more room for manoeuvre by lowering nominal rates. My initial reaction and that of many central bankers was very negative. Where do you think the higher inflation is going to come from without the kind of monetary and credit easing that is going to create even more of the problems we've got already?

Sean Corrigan: Yes. Well, we now come back to 'secular stagnation' business as well, don't we, that's now become something of a norm even though we have already had this discussion. If you go back, it's not hard to find. At the back end of the Great Depression, Alvin Hansen - the man more Keynesian than Keynes - started this nonsense off that we were never ever going to grow again, that we were never ever going to find any business that wasn't blighted with overcapacity. We were never going to employ any more people. And look at what the world economy has done in the last 80 years! I know we've messed it up in the last ten or so but, still, great progress is being made on a global scale. We've just managed to retard it in our economies. And yet, here we go. We're recycling the same nonsense that we need to have bubbles and negative interest rates in order to allow anybody to have the hope of finding a job in the morning. I mean, how can you believe that? The madness of it.

William White: Larry Summers argues that the Wicksellian natural rate is now below zero, and the financial rate can't go below zero, so therefore we have a real problem. Well, my reaction is to suggest we try through policy to get the natural rate back up again The way that you do that is to raise expected profit rates for viable companies that are being held down by

all the zombie companies bring supported by banks or governments in one form or another. It will be painful, absolutely no question. There will be a lot of vested interests, which will be hurt. But the way out of this thing is to get rid of the excess capacity and give people an opportunity to make an honest dollar. Now a real complication is that the Chinese, as you know, have got immense amount of excess capacity in all sorts of different areas. Much of the excess capacity is in the hands of the SOEs - the state-owned enterprises. And the problem is it then becomes a fundamental political problem whether that excess capacity can be wound down or not. If it cannot be done, than the Chinese will likely try to export the excess production as an alternative.

Sean Corrigan: Dealing with China, I think that's absolutely right. They were the go-to people to drive growth so we had this sort of wilful blindness. You know that there's never been any genuine accounting - even if the books themselves aren't deliberately cooked - because there's never been any realistic concept of return on capital there. The SOEs have been social and political instruments. And it does seem like the regime is trying to back out of this, but of course, it can only take baby steps out. If and when unemployment starts to rise out there, this becomes problematical since, as we've clearly been told by everybody at the top, this is the main issue from the political-social stability side. The SOEs are the only bodies left to be the reservoirs and the shock absorbers. And as you say, that has implications for the rest of the world. The question here is, does this mean they're going to try to export their way out and does that mean they have to let the yuan go. But remember we have this pyramid of whatever it was the BIS estimated - $1 trillion in bank loans alone? – certainly, an enormous amount of money – on top of which rests the partly illicit foreign finance smuggled into China via commodities and notional trade. If we let the yuan go, all of that now presents us with a classic, Third World, Thailand, Argentinian-type issue and we end up with not just a competitive devaluation, but possibly a collapse. Is this the next instability that we're going to face?

William White: I wouldn't be surprised. If everyone else is trying to devalue against the US dollar, can the Chinese be far behind? I mean you said they certainly must have been watching what the Japanese did and the fact that G20 never said a word about competitive devaluation. The new wrinkle-- I'm not sure whether this was the reference you were making to the BIS, Sean - but the BIS estimates that over the last four or five years corporates from emerging market countries have issued 6 trillion dollars worth of bonds, mostly denominated in dollars. If the dollar goes up against all these other currencies, including the Yuan, there's going to be a lot of people that are going to be on the short end of that currency mismatching.

Sean Corrigan: Well this is '97, '98 all over again potentially.

William White: It is not impossible. I haven't looked closely at the numbers but 6 trillion sounds like a sizable amount of money to me..

Sean Corrigan: It is noticeable that the Chinese press has started in the last month or so to carry articles about this whereas they've never really said anything until now. They never said too much about Japan before even though the contention between the two sides there is more deep seated than the simply economic one. But they have started to talk about a world in which the Europeans devalue. This is our second biggest or sometimes our biggest export destination and they devalue, they say. What does this mean for the yuan? For the moment they may feel no need to adjust, but they are talking about the yuan-euro rate. I have not seen that at all up until the last few weeks and since QE was announced in Europe.

William White: The argument being used is that this is not a competitive devaluation because all we're trying to do is stimulate our own domestic economy. It is only a side effect that the currency goes down. But as we all know, if you're in a world where you are debt constrained or in a liquidity trap, then the only thing that really is available to you is a lower currency. So these people must know in the back of their minds that that's basically what they're doing. Anyway, it seems to me that if everybody is doing what they're doing on the basis of what everybody else is doing, you might not call it competitive devaluation but it sure looks that way. Who knows? I mean maybe the next step will be the kind of open trade protectionism that we' saw in the 1930’s. Fortunately, I don’t see many signs of it so far but it's not impossible.

Sean Corrigan: Indeed, and that would be certainly one way to push the natural rate through the negative, if such a concept means anything! I mean that would be a disaster for world wealth creation, wouldn't it?

William White: For sure. It should also be noted that many fringe political parties in Europe are already talking about leaving the Eurozone. There's a very strong protectionist kind of element that seems to be part of what they're talking about.

Sean Corrigan: Everyone is a Listian or a Mercantilist at heart, Bill. I think local populist politicians find it particularly hard to resist. If they're appealing to the disenfranchised urban working man, it's very hard to make an argument for free trade at the same time unfortunately.

William White: It's a quick fix. One of the things that I've been increasingly worried about, as I look at the mistakes that the politicians are making, is that they are doing so to satisfy the guy in the street who wants a quick fix. Ultimately, it is a political thing. I'm currently back to reflecting on a very old issue; namely, whether we need a new international monetary system with rules to impose some discipline. Otherwise, we are going to wind up doing some really

dumb stuff.

Max Rangeley: Relating to that with the new monetary system, Bill. At the Cobden Centre, we're very partial to Friedrich von Hayek. And I was just wondering-- we've discussed a lot of the distortions that can be caused by very low interest rates. But do you have sympathies with the idea that actually central banks should not set interest rates at all? They should be set by markets, just like all other prices.

William White: Well, I'm not sure that I'm prepared to go that far at this point. However, I can remember having a conversation more than 20 years ago with the then governor of the Bank of Canada, John Crow. We had, at the time, come to exert such a strong influence on the Treasury Bill rate that it basically belonged to us. And I thought that was wrong because I figured that there should be at least a band out there where the interest rate, the longer term rates in particular, could move of their own accord. That could tell us something about what the market thought about where the economy was going, and in turn what policy needed to do. And I'll be honest. I haven't really thought this thing through. But the idea of a complimentarity between the central bank that basically sets a very short-term rate and the market, which sets all the others, strikes me as being not an inappropriate way to run the system.

At the moment, the problem is that central banks, either through forward guidance about where the short-term rate is going to go, or through QE that actually exploits the substitution effect to drive the spreads down, are basically responsible for setting all the rates. That I think is wrong. However, my concerns are a little bit like the old joke about the guy who goes in the museum, and says, "I may not know much about art but I know what I don't like. My comments fall far short of an explicit statement of what I would like to see done as an alternative.

Sean Corrigan: And again, the problem with the central banks has been building. Ever since we moved to floating exchange rates in the first place, of course, but it's accelerated clearly since the Tequila crisis 20 years ago. Every successive blow-up is bigger and the infamous Greenspan Put -- it's a bit unfair to blame just him for this since everybody followed him in offering one! -- but the infamous Greenspan Put has become a bigger and bigger option every time. And now, we're in a situation where we it’s not just too big to fail banks, but we tried to make the whole system too big to fail, so we also have too big to fail governments. As you say, it's now all pervasive. Even from the perspective of the screen jockey of financial markets, you can see there's nobody cares really about analyzing an economy or even a company anymore. It's all about what's going to be the central bank's response to the newsflow.

William White: It's crazy, crazy. A number of years ago, Mervyn King reminded us of that old line of John Maynard Keynes, which was - I'm not going to get it exactly right – "If central bankers could get themselves thought of as just ordinary working men, like dentists, wouldn't that be splendid? "And my reaction, even at the time was not dentists but doctors. Above all, do no harm, and that's where we are at.

I wrote a paper around 2004 which was called "Are Changes in Financial Structure, Increasing Safety Nets?" The whole paper, although it was written in a very polite way, was essentially about the Greenspan Put and moral hazard. It pointed out that the Greenspan Put worked in the sense that, when the economy went down, the Greenspan Put brought it back up again. But the problem is that, as debt levels increased in response to successive bouts of monetary easing, each new bout of easing had to be more vigorous than the one before. The logic of this progression is that at a certain point, monetary easing would no longer deliver the goods. However, the Americans in particular have never seen that. They've always said, "Basically, it worked in the past. It will work in the future. As we know from the book "The Black Swan" this logic is just wrong.

Max Rangeley: So it's like a ratchet effect where every time you need stimulus, you need even lower, lower interest rates and more and more cheap credit, and eventually, you get to the lower bound.

William White: We wrote papers about these issues over a decade ago basically, saying, "If you ratchet down, time after time, you're going to hit the zero lower bound and what are you going to do then?" I remember a meeting in 2002 or maybe 2003 at the BIS. It was mostly the deputy governors in charge of monetary policy and I was in the chair. The Representative from the Fed had already written a couple of papers with Ben Bernanke on this topic. He concluded that there was no problem with the zero lower bound because there were many other things a central bank could do and he outlined them However, the next person to speak was Masaaki Shirakawa, before he became Governor, who responded by saying We've already done all of this stuff in Japan and it didn't work."

Sean Corrigan: That's the tragedy. It is. It seems to me, again the smartest minds in the world don't seem to notice that they keep allowing over-borrowing to occur and/or they actively promote it. Whichever way, whether it's a sin of omission or commission, we know this is where the cycle always stops. So then, when the structure fails, there is no will, as you say, to allow the bankruptcies and to cut the deadwood out and so restore the natural rate – even though this is what we did throughout recorded history, all the way up to the New Deal. Then we typically had a two or three year, short, sharp recession before everybody was either back on their feet and merrily building way above the old peak shortly or else they at least had before them the prospect that this was going to be the case.

William White: And even more recently what happened in the Scandinavian banking crisis in the early 1990s.

Sean Corrigan: And in the Asian countries in 1998, of course. We always forget that. They had a huge collapse but they came back stronger than ever, didn't they?

William White: Yeah. Absolutely.

Sean Corrigan: We try to smooth the cycle out and all we do is perpetuate the debt. But most people don't look at the balance sheet. The ordinary man has been conditioned not to look too closely at how much he has to pay back. He looks at what the debt costs him to service out of his income – it's a lessee's or a tenant's mentality. So we got into this trap that because there's ever more debt, we have to continually force the burden down. And so therefore, we push interest rates lower and lower in every cycle. And we preserve too many of the old dead fossilized layers of lending, which have now no economic benefit whatsoever, and this is where we're ratcheting down. So, the debt level goes up every cycle. The officials at the central banks, however, whether they explicitly think about it this way or not, seem to be focused on trying to keep the overall debt burden at the same level, regardless. And the issue is here is that while they're doing that on one side with lowered interest rates, on the other side, financial innovation has increased the maturity range for everybody.
The idea that the ordinary man of my father's generation might be offered an eight-year car loan would have been laughed out of court. It's a bit of an exaggeration , but you could barely get an eight-year housing loan – not without having saved long and hard to let someone else go before you in the queue at your mutual society! Now, you can get an eight-year car loan. You can get a 50-year mortgage and a non-amortizing mortgage and so on and so forth. But, the people to whom this facility is being extended are lower and lower in the scale of creditworthiness if we're honest about it. And so, we have enhanced the effects of lower interest rates in more extended payment terms, which means that the monthly take is lower, so we can build a bigger debt mountain. And with that comes all the instability and all the problems of micromanaging the cycle.

William White: Absolutely. It is notable that in the course of the last couple of years, the BIS in its Annual Reports has repeatedly used the phrase the 'debt trap'. Very low interest rates encourage so much debt increase that central banks fear raising them again because you will bankrupt everybody. That is the debt trap. Similarly, Robert Pringle wrote a book in 2012 called "The Money Trap", which is about the international side of this over extension. Hans-Werner Sinn has just published "The Euro Trap", and Eswar Prasad recently published "The Dollar Trap". There is something going on here with these dynamic processes that is being

increasingly recognized as dangerous.

Sean Corrigan: Well, we hear this line from Mr. Carney. Without getting to personalities, of course since I don't know him – he may well be a very worthy individual - but I can't read any of his pronouncements without shuddering. He explicitly says this, doesn't he? "We need more borrowing. We need more borrowing," and then, "Oh, we will only put up interest rates gently, because with all this borrowing, we will just shock the system again the minute we do anything."

William White: Who is that you're talking about?......

We pick up on Bill's response to who, next week, in Part II of Road to Nowhere.

The Cobden Centre
For honest money and social progress

Max Rangeley - Editor of the Cobden Centre

He is the CEO of ReboundTAG Ltd, which produces microchip luggage tags and has been showcased by Lufthansa and featured on BBC World among other media outlets. Max has a Master's in economics, following this he was given a scholarship to do a PhD at the London School of Economics, but decided instead to go straight into business.

Sean Corrigan - Contributor Cobden Centre

With nearly 30 years' experience of markets, Sean has spent a lifetime proving Hayek's dictum that 'the curious task of economics is to demonstrate to men how little they really know about what they imagine they can design'. Starting out life as a trader in the City, he then switched to formulating strategy as head of Developed Markets at a major third party provider before forming his own consultancy, Capital Insight, at the height of the (first) Tech Bubble. He later moved to Switzerland, first working at a Zurich-based family office, then at one of the larger commodity asset managers. He now blogs at trueSinews.com while also acting as consultant for Hinde Capital and a contributor to hindesightletters.com.

ABOUT US

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Our principle aims are to help investors achieve real adjusted returns and provide long-term wealth protection. We offer funds and strategies that both grow capital and accrue income. This are run in Managed Accounts, Off Shore Funds and as Exchange Traded Products.

Established in 2007, Hinde Capital launched its first fund the same year specialising in the precious metals sector, Hinde Gold Fund,BVI Ltd. Hinde Gold Fund's primary aim is to provide our investors with exposure to the precious metals market through a highly liquid, actively managed fund with low leverage and security of assets.

Hinde Dividend Products were introduced in 2014 to provide a series of equity income strategies run by both strategy and geography, based on our proprietary valuation models the Hinde Dividend Value Matrix®. The SG Hinde UK Dynamic Equity ETN (50% Hedge) was the first of a series of equity traded products. We run European, US and MSCI Asian versions.

The strategies range from long only, 50% hedged to market neutral, enabling investors to switch between more or less exposure to stock markets but without negating the reinvestment of their dividends in the stocks held.

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