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The Cobden Centre

HINDESIGHT
LETTERS

An Interview with William White, Part II:

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.

Continued from PART I...

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?.....

PART II

Sean Corrigan: Mark Carney.

William White: Well I have had fundamental doubts about the merits of full transparency for at least a decade. Moreover, I've never spoken to a market person who's disagreed with me. Transparency on the part of a central bank has disadvantages as well as benefits.

Sean Corrigan: The old Bundesbank used to be the ones. You made your play and if the Bundesbank didn't like it come a Thursday lunchtime - Bang! - they moved interest rates in your face. You always had to be wary of it, and it was a much better system.

William White: We at the BIS first started reflecting on this issue around 2004 when the Fed started talking about "measured" increases in interest rates, which was code for 25 basis points per meeting. if you think about a Sharpe ratio ,where the differential between the borrowing rate and the lending rate are going down, but the variance is basically going to zero, then transparency of this sort is really an invitation to take on leverage and that is precisely what people did. And I think it's the kind of stuff they're doing today.

Sean Corrigan: I absolutely concur and I've written about this in the past as well. The central bank should be inscrutable. You should have to consult the oracle and if the oracle decides that it doesn't like what you're doing, you have to make a sacrifice then and there. Otherwise, there's no discipline.

William White: Absolutely. I go back to my early days of the Bank of Canada when we brought in inflation targeting, about three months after New Zealand. Subsequently, and only gradually, the mantra of transparency became more fully firmly embedded. And I can remember talking to John Crow who was then the Governor and saying to him that it was a huge step to go from "Trust me to do the right thing" to "Now I am going to tell you what I intend to do in the future". Moreover, I remember saying to him I did not recall ever having a discussion of this issue at the Bank of Canada. We just morphed into it. Basically, I think it had its roots in all the academic stuff about economic agents having rational expectations. And that assumption too is, I think, fundamentally flawed.

Similarly, I fear that central bankers may have been inadvertently drawn into what they are currently doing.. The first set of really radical policies - the zero lower bound and the QE1 and the intervention in the interbank markets and all that stuff – was done for reasons of financial stability. My own belief is that it was absolutely the right thing to do. But then, as time wore on and as government did not do what they should have done to help resolve the crisis, central bankers got drawn into QE2 and all the rest of this stuff. But it has now got a totally different objective, one of stimulating aggregate demand. And, as I said before, my feeling is that it won't work and may have many undesired side effects that will build up over time. Many of the central bankers at Davos this year said explicitly that they were only buying time for governments to act but, seven years into the crisis, it already seems we have been waiting forever.

One way to describe the dangers of waiting is that the effectiveness of monetary policy in terms of stimulating aggregate demand goes down with time, because you're constantly bringing spending forward from the future. As the future becomes today, then you have to pay it back. So just by definition, this thing only works for a short time period. Unfortunately, the side effects, not least the further accumulation of debt and excessive asset prices, go up with time. And, at a certain point, those two time lines cross. Logically, at that point, central bankers should say, "We are doing more harm than good. This policy must be reversed." But I don't see anybody actually doing it.

Sean Corrigan: Well, I have this sort of aphorism that the central banks are patting themselves on the back that they had their 1933 moment early - massive intervention, a flood of liquidity, and so on - but they've all been paralyzed ever since with what they think happened in 1937, when, supposedly, the tightening on both the monetary and fiscal side triggered a seriously adverse reaction in an economy which was still weak. In fact, there are also some compelling arguments that this was not the decisive factor, that it was more to do with Roosevelt's labour laws and union policy and the like, destroying entrepreneurial hopes again. But, nonetheless, this is how the central banks read it. In 1933, after three or four wasted years, the central banks got brave and did all the big monetary things, and we had a short-lived burn. But then, in ’37, we tried to pull the plug too soon and it was horrible again. And they're paralyzed still by this Ghost of ‘37.

And as you say, this is what this whole transparency/ forward guidance thing is all about: "Let's not frighten the market." They forget the financial market should be a reflection of what's going on in the real business of wealth creation, but the market has become so big that any shock in there feeds back much more strongly on the real side. But every time they mollycoddle the market, it gives the market its head so it becomes even bigger and even more disproportionate. So again, we're in one of these vicious cycles.

William White: Well, I think there has been a growing recognition that a major explanation for market volatility having been so low, until very recently, was that the actions of the central banks were reducing that volatility, as indeed they did prior to 2007. I think a lot of people have been looking at the Swiss Franc - what happened after the peg was dropped - not just because the experience is interesting in itself , but for what it might tell us about prospective global developments when central banks begin to reverse the suppression of volatility that we've had up until now. Personally, I could give you a dozen reasons why the reversal of rates, once begun, might move an

awful lot faster than anybody is currently anticipating.

Sean Corrigan: Well, there are no buffers, are there? We know the banking system doesn't now offer a buffer.

William White: No.

Sean Corrigan: We also know that nobody in their right mind really wants to buy long-term debt down here for any prospect of income, which, of course, gives the lie to the fact that the real natural interest rate is sub-zero – and also, incidentally to Keynes' whole 'college bursar' nonsense about 'anchoring' effects preventing rate declines and so shutting us in a what his followers called a 'liquidity trap'. The rate can never really be sub-zero because we all prefer to have things now, not tomorrow. But the point is they're only here because everybody again is chasing the fact that there's a committed buyer in town with unlimited capability to buy and one which seems to be increasing its appetite at every stage. As the central bank pushes interest rates one way - whether as a deliberate policy or as a by-product - everybody else becomes a momentum chaser. While you get the capital gains in the short run to outweigh the lack of income, this is all hunky-dory, but when it turns…

William White: You are closer than I am to the markets, but I suspect some people are doing momentum trading. I think I read in the paper yesterday that, if you bought 30-year bonds at the beginning of 2014, you have already earned a mean 6% or 7% or something like that, largely in capital appreciation. My point is that--

Sean Corrigan: A couple of basis points matter here because the durations are so long. It means a nice fat market-to-market gain. So while the trend continues, total returns on bonds look pretty good but more, and more, and more of that return is simply that we're squeezing out an extra couple of basis points, pushing the price to a higher and higher premium. And as you say, bonds could-- if we're willing to pay the government to borrow from us, as in some cases we are - actually go a lot further than we ever thought possible. But again, as I think you said earlier, if it's unsustainable, ultimately, it must end.

William White: Yes. Sadly, I don't think anybody's capable of telling you precisely how and when the whole thing will come unstuck. Nevertheless, you know that at some point, it has to. It's like all of these complex systems. What we know from studying them over time is that they fall apart on a regular basis, and it's impossible to say precisely where or what the trigger will be. That raises the obvious question of what investors can do to protect themselves.

Sean Corrigan: In all inflationary episodes - and this **is** one whether or not it's having an effect on final goods prices in a manner that people want to see, since we clearly have enormous influx of money and credit flooding into the world above and beyond the productive needs of industry on the one hand and the urge to saving on the other – in all these inflationary episodes we eventually make even the poorest person and the oldest person into speculators. That’s been the lesson of history. And as we were saying among ourselves earlier, even we ‘experts’ are not necessarily very good at that game. But we're all forced to become players, regardless. This is a tragedy of a wholly different order.

William White: As I said before, I sense a growing sense of unease about where this will all end up.

Max Rangeley: Relating to this is the concern with deflation at the moment as well. Is this justified, do you think? Do you think deflation is necessarily detrimental to an economy or perhaps even often beneficial to an economy?

William White: Well, there is actually a big pre-war literature about what they used to call the productivity norm. In a nutshell, if you've got an economy that's got positive productivity growth, then real wages should be going up. Now, the question is, if the real wage is defined as the nominal wage divided by the price level, should the real wage rise through higher nominal wages or lower prices? In the post War period, we’ve just basically assumed that the prices should be constant and wages should go up in nominal terms. But the pre-War literature basically said, "Well, maybe that's not true. Maybe it ought to be the other way around." Actually, I have in my files two more recent papers on this. One of them was written by George Selgin and is called “Less Than Zero”. Another one written by David Beckworth is called ‘Aggregate Supply-driven Deflation and Its Implications for Macroeconomic Stability’. I must say, I think there's a very reasonable case for saying that if you had moderate deflation, it would benefit everybody as opposed to the wage driven approach in which some people get the benefit and some don’t. So there would be a benefit here too on the income distribution side, which has become a source of particular concern in almost every country in recent years. I think that might be a good idea.

But your question is also relevant to how we got into the current mess in the first place. I would contend that central banks were too focused on avoiding deflation at a time when productivity increases coming out of China and elsewhere were causing prices to fall. This was a “good” deflation like many others seen throughout history. By resisting these trends through monetary and credit creation, we have actually turned a “good” deflation into a “bad” deflation of the sort described in the 1930’s by

Irving Fisher. Allowing deflation at this point could seriously exacerbate the debt servicing capacity of many borrowers, including sovereigns. Part of the solution must be to have the courage to write some of this stuff off.

Sean Corrigan: But I think you should go back to your earlier quote that it's the unpalatable or the impossible. There are lots of ways to do it but, as always, reforms only ever come in a crisis and the central banks in their own way have been trying to avoid us having one. Let's not blame them exclusively, but the policy makers as a group are happy enough to risk an inflationary crisis to reduce the debt whereas, in fact, the quickest way to get through it would be a deflationary crisis because we would then have no choice but to deal with the debt issue immediately. We'd have to get together tomorrow and say, “I can't pay this on the original terms. This is what I can offer you instead." And next, "Certainly, if we don't agree, let's go to arbitration and then let’s start over again and let bygones be bygones." Instead we have this fear that we have too much debt so we cannot ever afford to let prices go down, but to push process up we need to encourage more indebtedness. And because we're so worried about growth, we don’t notice we're suppressing it through our own policy. The deflationary crisis would be truly horrible but at least it would be over in a matter of months!

William White: It is worth looking back at the banking crises of the early 1990s in the Nordic countries and Japan respectively. The Nordics faced up to their problems and resolved them and growth quickly returned. The Japanese did not and the return to growth took a lot longer.

Sean Corrigan: I can't remember if it's was Juncker or Barosso. I think the former, very early on in 2008 said, "We will not allow any systemically important bank to fail." Then he paused and added: "And, yes, all the banks are systemically important." That’s where we went wrong, that's where we've been ever since, and that's why we're in so much trouble. In fact, it's now “all borrowers are systemically important. All debt is systemically important. We cannot have a failure anywhere.” But by trying to prevent any failure, you ultimately make it more likely that everyone will fail.

William White: No, absolutely. It's the Japanese model from 30 years ago. It's the Japanese convoy system, where everybody is sort of in everybody else's back pocket. That is, everyone is supporting everybody else. And it works like a charm, until it doesn't. And when it doesn't, it can take everybody down. It's as simple as that. What can I say other than that I share your concerns. Unfortunately, the current belief system is very likely to be maintained until some crisis shows that it is a system of false beliefs, and perhaps not even then. Daniel Kahneman suggests that it is human nature,

when our beliefs are sorely tested by events, to retreat further into those beliefs rather than to reassess them. Something very similar has been going on with policy since the crisis began. On the monetary and regulatory fronts, policy has essentially been "more of the same" and "still more of the same"

Sean Corrigan: there is a perfect example of this, Bill, of retreating to a belief rather than relying on something which is proven and known. I'm referring to the fact that, suddenly, no matter which economy you are considering, or what financial structure, or institutional framework, 2% inflation has become the absolute golden ratio of all modern economics. If we do not have 2% a year price increases, the economy cannot function, we're always being told. Where did THIS ever come from?

William White: It came from nowhere. I remember many years ago when I was at the Bank of Canada and we introduced inflation targeting. What was the target number, or band, to be? Clearly the path down to where we wanted to be had to reflect where we started from, and the price in terms of lost output of the transition. However, the final destination should have reflected work on the distortions and welfare losses associated with that target, not least distributional implications, and that work was never done. Similarly, I remember when the Bank of Canada introduced monetary targeting in the 1970s, when again a target had to be chosen The Governor and the Senior Deputy Governor made it up in the car on the short journey to a Parliamentary Committee to discuss the new policy regime. Perhaps the underlying logic was, and is, that the numbers chosen have to be "not obviously unreasonable". That does not of course set the bar very high.

Talking about belief systems, I did a lecture for OMFIF in 2013 which is up on my website and deals in large part with such issues. I contend that one important reason why we got into this mess was that the behaviour of each set of relevant actors was being driven by a set of false beliefs. That includes the lenders, the borrowers, the central bankers, the regulators and the politicians. In each case, the false belief was "comforting" and thus easy to hold onto. For borrowers, by way of example, the false belief was that you could borrow without ever having to pay it back, using your house as an ATM.. For lenders, the false belief was that lower lending standards were acceptable because the economy had become inherently less risky. For central bankers, the false belief was that, if inflation was under control, nothing could go wrong. Note that this central banking belief essentially morphed out of a much less extreme belief that low inflation was better than high inflation. I have no idea how this

transformation took place, but it was certainly not based on any careful reading of either economic history or the history of economic thought.? Of course, speculating about such issues belongs more to the realm of psychology, or even anthropology, than it does to the realm of economics

Max Rangeley: Bill, I have just one more major question actually, which is last November our Founder, Member of Parliament Steve Baker, led the first debate in Parliament for 170 years on monetary reform. So what are your thoughts on, for instance, the Chicago plan or Martin Wolf's article in the Financial Times last year discussing endogenously created money; do you have a perspective on any of those themes?

William White: I find it extraordinary that some economists still do not recognize that we have a fiat money system. Banks do not lend money that has been saved. They create money by making loans and simply writing up both sides of their balance sheet. This system clearly greases the wheels of commerce, but it can also get badly out of control as we have seen in recent years. There really is an issue here. Do we want to go back to 100% reserve banking, or something of that nature, as suggested by the Chicago school and Irving Fisher in the 1920's. While I have not thought enough about it to say where I'd come out on this debate, it certainly is an issue that we should be thinking about. This has also been suggested quite recently by Martin Wolf and John Kay of the Financial Times. These are serious people whose suggestions should be treated equally seriously. And, in a similar vein, I repeat what I said a few moments ago. We also need to go back and look at the whole International Monetary System, or Non System as I and others have called it.

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

Hinde Capital is a London based Investment Manager, specialising in developing world-class investment solutions for institutions, family offices, trustees, as well as high net worth private clients and their advisers. Hinde Capital offers investors a range of disciplined investment strategies that draw on the founders' real-world trading and risk management experience attained from previous senior trading and money managing roles at some of the largest global financial institutions.

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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