The Debt Bomb Will Leave a Crater in Your Bank Account

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Most things you can learn from **economics** are wrong. Figuring out why they're wrong has plenty of value though. It allows you to predict things that others don't see.

The neutrality of money is a great example. Most people who've studied economics believe that you can fiddle about with the supply of money without affecting the real economy unevenly. The metaphor used to explain this is pouring water into a bathtub – it doesn't matter where the water is poured in. Water, like money, is more or less the same and mixes in seamlessly.

The problem is that **central banks** don't pour in money, they buy specific things with freshly created funds. Usually they buy government bonds. These days they also buy stocks, exchange-traded funds, and more. That means the economic effect of an increase or decrease in the money supply is felt first in financial markets and last in the real economy. Hence the concern that monetary policy benefits the rich, who are closely tied to financial markets.

Booms and busts

Some economists blame the non-neutrality of money for the booms and busts of our time. New money in our economy looks like savings at first. This encourages debt-financed investment. But when it turns out that no actually saved the money, it was just created by the central bank, then the new investments struggle. That's why booms and busts are most prevalent in industries using debt – housing especially.

But back to **how you can profit from a better understanding** of all this.

Owning what central bankers have added to their buy list certainly worked well as an investment strategy these last few years. Whenever central bankers were busy buying, stockmarkets surged. Whenever they stopped, threatened to stop or spoke about doing slightly less, stocks went into a tailspin.

Central bankers quickly learned to walk the tightrope. But they didn't think through where it leads. The global stockmarket is now worth 102% of global GDP. At the end of 2007 we hit a high of 120% before the routs of 2008.

Analysts are worried about overvaluation. Both Deutsche Bank and Goldman Sachs published reports about how central banks have pushed markets to odd-looking levels of overvaluation.

Now that central banks are looking to normalise monetary policy, they've realised where they've taken us.

The tide of central banking will turn on you

Not many people care about central banking for the sake of it. But while they happen to be running the stockmarket, these all-powerful institutions are suddenly front-page news to no end.

The question is, **where does this lead us**?

On the one side, we have the argument that the global economy is looking up. Central bankers no longer need to intervene as much. In fact, they're looking to tighten monetary policy in coming years. We're almost back to normality.

That narrative has taken a beating these last few days. The US inflation rate missed expectations and the target again last month for the fourth month in a row. The Bank of England's Monetary Policy Committee is in a broad state of disagreement about where to go from here. And the Japanese are still focusing on quantitative easing.

Which brings up the other side of the argument. Can central bankers reverse monetary policy without causing a crash? If they bought stocks, bonds and more to push the economy into expansion, what will stocks, bonds and other assets do as the central bankers start to sell? They'll tumble.

Usually, central bankers argue, all these questions are closely related. The economy, unemployment, stockmarkets, banks, bonds and of course inflation are all interdependent. A one-size-fits-all monetary policy works because none of the things the central bank cares about can go haywire independently.

In one world, the economy does badly, unemployment rises, stockmarkets fall, banks get into trouble, bonds get bid and inflation falls. Then the central bank prints money to solve all the problems in one fell swoop.

In the other world, the economy does well, unemployment falls, stockmarkets surge, banks are stable, bonds slowly fall, and inflation goes up. The central bank tightens.

The problem is, the world is not binary. There are other possible combinations of the above indicators. Stagflation in the 70s taught us this. The tech bubble and the global financial crisis did too.

But still we haven't learned.

Which mandate is prioritised?

If you want to know which indicator will go haywire this time – stocks, bonds, inflation, unemployment, banks and so on – the question to ask yourself is which mandate a central bank prioritises.

For example, in the 70s they valued unemployment over inflation. And so inflation went out of control until the priorities were reversed.

Before 2008 central bankers ignored the housing bubble in favour of stable inflation and unemployment. This worked so well it was called the Great Moderation. Bank stability was what suffered and eventually blew up.

This time around, stockmarkets are the focus of central bankers. They want to stimulate the economy with the wealth effect. Unemployment and inflation have responded well so far. But we're at a crossroads now that policy must be normalised.

The question is, which indicators will the central bankers of the world decide to focus on while others go haywire? If inflation rises, but unemployment does too, will central bankers raise rates? If the stockmarket falls each time they do raise rates, will they continue to? And if inflation remains low, will they continue to stimulate the economy and financial markets at the risk of inflating bubbles even further?

At some point, monetary policy will become a trade-off. What will central bankers decide to sacrifice?

We don't know yet

But one good sign is that the **central bankers are aware of these questions**. They know they have to make choices.

Five days ago, Federal Reserve chair Janet Yellen said this:

> *So in looking at asset prices and valuations, we try not to opine on whether they are correct or not correct. But as you asked what the potential spillovers or impacts on financial stability could be of asset price revaluations — my assessment of that is that as assets prices have moved up, we have not seen a substantial increase in borrowing based on those asset price movements. We have a financial system and banking system that is well capitalised and strong and I believe it is resilient.*

She's speaking about the links between stockmarket prices, bank stability and debt. More recently she's focused on inflation and the lack of it. As well as the link between unemployment and the non-accelerating inflation rate of unemployment (NAIRU) – the point at which unemployment is so low inflation starts to rise due to the increased spending. She also told American lawmakers their budget is unsustainable and she couldn't and wouldn't finance their bonds forever.

That's a lot of balls for a central banker to juggle at once.

The challenge of numbers juggling is exponential. Numbers juggling refers to trying to juggle many objects, rather than doing snazzy tricks with the same number of balls.

The inflation ball

Central bankers usually have one ball to juggle – inflation. The American central bank is supposed to have two – inflation and unemployment. The Australians have three – they added welfare and national interest. The British system prioritises price stability, but adds growth and unemployment as secondary concerns.

At the moment, **central bankers have added a lot of things** to their list. It's enough to make any juggler very worried.

In numbers juggling, going from three to four balls is relatively easy, as four balls is just two balls juggled separately in each hand. But adding a fifth ball returns the pattern to a criss-crossing figure of eight. And that makes life very difficult because it's very hard to adjust or correct as you go.

By the time you've spotted a ball on the wrong trajectory, you've already thrown the one that will collide with it, creating total chaos instantly. In other words, the relationships between the balls become too complex to control. You're more of an observer than a policymaker.

In fact, adjusting the throw based on what you see happening above you, which works for three balls, is precisely the wrong thing to do for five. It's too late and will only cause a cascade of worsening errors.

By adding so many mandates to its list, central bankers have put themselves at the mercy of inter-relationships it doesn't understand and can't control.

Monetary mission creep

If you don't spend your weekends and evenings teaching people to juggle while they wait for their go on the flying trapeze, you might like a different metaphor. Central bankers are making the mistake militaries know as "mission creep". The goals are developing as the campaign against the financial crisis and its consequences develop.

Central bankers are trying to solve the problems their last effort created.

Your brokerage account could end up looking like Aleppo.

Until next time,

Nick Hubble
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