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Q&A with Dr. Brendan Brown **Apr 07, 2020**

Q1: Some say that monetary conservatives are making the same mistake as they did in the Great Depression - if implemented, calls for sound money would make a bad situation worse, and plunge the world into endless Depression and Darkness?

A: The best time for a sound money revolution is evidently not in the midst of a pandemic. Even so a further lurching into new dimensions of unsoundness harms the prospects for the return of economic prosperity once the pandemic is over. High inflation, enhanced monopoly power and crony capitalism are all long-run dangers from unsoundness now.

As a historical matter, monetary conservatives were not responsible for the Great Depression. Quite the opposite. The culprits were the monetary radicals who presided over the great US monetary inflation of 1922-8 and the resulting global credit bubble and bust with its epicentre in the Weimar Republic. The Federal Reserve in 1930-2 ignored the conventional prescriptions (originally made famous by the British nineteenth century commentator Walter Bagehot) of lending in a crisis and pumping up temporarily the supply of high-powered money. In Summer/Autumn 1931, the Fed pushed up interest rates to defend the gold standard for the dollar, as a gold drain had been triggered by Sterling's devaluation; still ample gold reserves did not justify that step in the midst and aftermath of the German banking collapse (Summer 1931) and a temporary suspension of gold convertibility in emergency would have been in full conformity with historical practice and endorsed by monetary conservatives.

Q2: I feel that governments should warn citizens that standards of living will fall; given the unavoidable reduction in supply of goods and services, there seems no way round this. Yet they are kind of pretending that with all the support measures and by pumping in trillions of dollars or euros we can somehow carry on as usual. This is misleading. Would you agree?

A: During the pandemic the supply shock does go along with decreased spending. Contamination by disease risk means a big fall (and in some cases shuttering) in the supply of disease-free goods and services – and demand is simultaneously curtailed by a whole range of influences (in many cases forced saving, as no scope to buy usual disease-free supplies; in other cases by financial and income stress).

Private savings, sustained by public income support and physical constraints on consumption, have a counterpart in massive government deficits, as private capital spending collapses.

Once some combination of disease receding and drug therapy/vaccine advance occurs, the supply side starts to recover and demand alongside. Demand then tends to run ahead of supply, much of which remains financially crippled or beset by mal-investment. (**Definition: mal-investment** refers to capital spending which occurred in response to distorted price-signaling in capital markets during the bubble and subsequently turns out to be excessive and even non-productive). Also boosting demand is pent-up purchases supported by the overhang of money printing and income transfer payments made during the pandemic. A big swing factor in demand is business capital spending; this collapses during the pandemic, and rebounds in the aftermath.

So, as demand recovers – stimulated by households and businesses catching up on spending which had been delayed during the pandemic - there will indeed be pressure on supply. Interest rates would normally rise as part of the process of balancing supply and demand under these circumstances; also, long-run budget consolidation measures (increased taxation and spending cuts) would kick in. But none of this will happen. The Fed and other central banks will continue with zero or negative rate policies and QE. Rising inflation tax will balance supply and demand.

Q3: In geo-political terms, looking ahead do you feel our response will merely highlight the superiority of authoritarian regimes such as that of China in managing a "complex adaptive system" such as a modern economy? Or will democracies in the end prove to be superior in their response?

A: The Chinese authoritarian regime was at the origin of this pandemic – hiding its emergence during crucial weeks when the West could have taken action to prevent the virus spread. Its surveillance state may have done a superficially efficient job of containing the pandemic spread once under way, but that is no model for the West. Who can measure the economic and human cost of the Chinese surveillance and enforcement?

As regards China, the answer is for the West to demand an end to its wild animal eating practices from which the virus emanated and to insist on permanent inspections and access of western experts to the medical situation in China – these should be conditions of future trade relationships (and should have been part of previous trade negotiations including the most recent). There is no justification in any of this for the West implementing any part of the Chinese surveillance state apparatus, though unfortunately this is what we might see happening.

Also, we might reasonably hope that Western democracies will hold their own leaders accountable who were blatantly negligent in their response to the threat of pandemic. Democratic pressures should bring about much higher safety margins of equipment and beds in the health sector, together with a reining in of monopoly rents there for doctors and suppliers.

Q4: Turning to monetary and financial market aspects: the central banks seem to have killed off the "bond vigilantes", so the markets are unable to penalise governments for monetising debt on a massive scale: do you agree and how do you interpret recent market movements?

A: Some commentators justify the very low level of long-term interest rates as reflecting an "endemic" huge savings surplus relative to investment

opportunity in the aftermath of pandemic. They argue that many households and businesses will be re-building their balance sheets after the damage of the pandemic and that investment spending will be correspondingly feeble. And non-monetary disinflation from digitalization and super-cheap energy prices will continue to exert force. This is all quite implausible. Explosions of government debt (with US debt to GDP as high as 150% by end 2021) will mean that governments are in need of much taxation revenue from their central banks – in the form of monetary repression tax. (**Definition: Monetary Repression Tax (MRT)** stems from the central bank holding interest rates at far below their natural level, thereby cutting the interest paid on public debt; the central bank is able to do this in the situation where it is targeting a 2 per cent inflation rate at a time when there are strong non-monetary disinflationary forces).

We should also expect once the health emergency is fully over a surge in spending, some of which will be pent-up, and some of which will be capital spending driven by perceptions of new investment opportunity as the economy re-structures. Central banks, by rigorous pinning of short-term rates at zero, management of expectations regarding short-term rates in the future, and massive QE operations, will be able to hold down long-term rates as in the aftermath of the Second World War.

Q5: Is there any way back to a sound money regime? What should investors look out for in terms of hopeful indicators?

A: The most hopeful path to sound money now goes through high inflation in the long aftermath of pandemic. Popular outrage against high goods and services inflation is much greater than against asset inflation – although whether this leads back to sound money depends on the response of political forces. In the high inflation of the late 1960s and 1970s it was the right wing of social democratic parties in Germany which led the way to hard money; in the US it was the right wing of the Democratic Party under President Carter which riled against Republic monetary policies leading to high inflation. It is too early to tell whether such forces would re-emerge in a new era of high inflation.

Q6: If unlimited monetary financing, "QE infinity", helicopter money and MMT etc are disastrous, yet every nation state is following the herd, will the system collapse or rather continue as it has been? Relative currency values will not change much, they will all be worth just a fraction of their present purchasing power - such a process has been ongoing for decades! Linked to this, will the US dollar remain dominant or are its fundamentals too weak?

A: Answering your last question first, the dollar is likely to remain dominant, in part because the euro is plagued by existential risk which has increased as a result of the pandemic. But high inflation everywhere will challenge dollar hegemony in some degree.

More broadly, there is no system. We have a bunch of fiat monies with any tie to anchors (whether gold or high-powered money) long since cut. The dollar hegemon has never had a reputation for soundness. Briefly in the 1970s and early 1980s the Deutsch mark and Swiss franc were perceived as hard based on their central banks pursuing monetarist policies.

In the last quarter century, the full brunt of monetary inflation has not been apparent in goods and services markets due to powerful disinflationary forces. With globalization now in reverse or stagnant at best and government debts sharply higher in consequence of pandemic, the likelihood is now for an acceleration of goods and services inflation, meaning an end to the "low inflation" era.

If indeed we are heading for a high inflation era in the aftermath of the pandemic this will be general across the globe, including the US, Europe, Japan, China and a host of smaller countries – all for the same reasons (explosion of government debts, weak debtors, political power of the debtors etc). Exchange rates between the dollar and other currencies may well become much more volatile as the path of inflation diverges over substantial periods (albeit at high rates), with fear of high inflation at various degrees of intensity. This heightened exchange rate volatility and uncertainty to some degree gives greater scope for "monetary independence" in countries outside the US. Small changes in monetary policy have less of an exchange rate effect, and in any case exchange rate swings encounter a greater degree of immunity (as businesses become more adept at coping with these). And with inflation rates more volatile and less correlated globally there could be some resumed benefits for international investors to partly diversify out of the dollar. So yes, in some degree dollar hegemony could diminish for some time.

A key issue is where does political revulsion against high inflation and a move to sound money start if anywhere. In the late 1960s and early 1970s it was Germany and Switzerland; the birth of the hard DM lessened dollar hegemony. If Europe again were to be the birthplace of monetary revolution (say Germany and a group of small countries floating off from monetary union) that would diminish dollar hegemony. If by contrast the US were to be where the sound money revolution were to start, that could bring dollar monetary hegemony to a new pitch. We should not neglect the scenario of euro-collapse going along with hyperinflation in Europe, including Great Britain. For example, growing signs that the euro-zone is going down the route of high inflation towards tackling existential dangers would lead to a plunge in the euro before the journey had got far under way.

Q7: How would you structure the portfolio of a risk averse investor between sovereign bonds, corporate bonds, gold, equities and cash - and what changes would you make as a result of the current crisis?

A: There are huge uncertainties in the present situation and some greater degree of cash holding than normal is justified so as to be able to take advantage of speculative and more fundamental opportunities ahead. But cash in general should not be with fragile banking systems; stick to liquid 2 to 3-year maturity top grade bonds (supranational, corporate, treasuries) in US dollars. Particular attention should be given to dollar issues of Japanese government guaranteed institutions whose spreads are based on A spreads, but in fact the quality of dollar paper from Japan could be seen as better than that. The A spread for the Japanese government is based on domestic debt in yen where there is considerable risk of default in real terms via inflation; but that risk does not apply to dollar denominated debt. 3-year dollar paper issued by Japanese government guaranteed agencies at 1 per cent yield have a place in near-cash portfolios.

Gold holdings in a portfolio should be elevated to reflect the high likelihood of an age of high inflation ahead – though we should not lose sight of the adage that by the time the bad news era starts (in this case high inflation, say in 2022), gold in real terms might already be at its peak.

Within the equity space, the best prescription could be to avoid everything which depends highly on the present financial status quo (oil, commercial real estate, passive investing), as a global debt crisis most likely lies ahead including a blow-up of the private equity space. Big Tech monopolies and tech which is based on the "next big thing" should be sought, albeit that these will not be immune to a second big dive of asset markets ahead, perhaps after a summer re-bound, based on expectations of a strong economic upturn into the late months of this year.

Q8: You have suggested that a market-based solution would involve massive "equity for debt swaps". Could you explain this and how much scope is there for them in current conditions?

A: Pandemic shock, or any supply shock, hits the overall market value of firms (debt and equity combined), in view of the plunge of earnings (often into big loss) and emergence of huge economic obsolescence. As equity values fall the protection (from the equity cushion) for debt holders diminishes: the same debt is now riskier (meaning increased likelihood of bankruptcy). The spectre of bankruptcy and all its deadweight costs can seriously lame the business prospects of the given firm. So, in principle, both debt and equity holders can gain from financial reconstruction that diminishes bankruptcy risk. A debt equity swap involves bond holders agreeing to convert a part of their existing paper (bonds) into equity – meaning that the overall leverage of the firm at present market values falls back. Correspondingly, the price of their remaining bonds rises. The equity holders lose through some dilution, but this should be more than offset by gains related to reduced bankruptcy risk and the business opportunities that can be forged. Evidently negotiations are far from simple – as there is the issue as to how the overall gains from reducing bankruptcy risks are to be divided between existing holders (of debt and equity) with all the bluff and counter-bluff that this involves.

Q9: Do you see any hope that either of the prospective candidates for the US presidency - Joe Biden and Donald Trump - leading the US and world towards a better economic and monetary regime?

A: I am not at all hopeful that either candidate would even partly embrace a road towards free markets and sound money. Both, for different reasons, would lean towards big government solutions with enhanced regulations and favouring albeit distinct groups of cronies. In some respects, the dangers of high inflation are greater under Trump, given the sheer extent of his monetary populism and fondness for private equity barons and big business cronies. Perhaps Joe Biden would assemble advisors more adept at following a hard-line policy with respect to China; Trump's policy was fatally flawed by his closeness to cronies in Wall Street and more broadly in US business who were looking for huge personal business opportunities from a "China deal". Also, a Biden administration might be more deliberate in the huge issue of how to tackle big monopoly power in the US, though this is far from certain (remember how the Obama Administration caved over prosecuting Google for anti-trust violation).

Q10: About 80 developing countries are calling for aid in the crisis and face a dire outflow of capital; how should the IMF respond?

A: The cupboard is bare at the IMF. The Obama Administration presided over massive loans by that institution (well beyond the legal maximum) to Europe during its sovereign debt crisis. It is hard to see why the US should now approve vast new funding for the IMF towards lending to the emerging market world. Market borrowing is in most cases possible where lending should be part of the response to the present crisis (together with loan modifications by existing creditors). For many emerging market economies, the problem is that they allowed themselves to become part of the epicentre of the global credit bubble as led by the dollar hegemon. Losses should now be taken by the participants in that asset inflation process – with no obvious rationale for being bailed out.

Q11: When the immediate medical concerns of the pandemic start to wane, and assuming that there will likely be a host of social/societal problems to follow, what should investors be considering in this regard?

A: Let's look at the social/societal problems. Liberty is most likely a loser. Governments will gradually relinquish emergency powers – but until the pandemic is fully over (meaning most likely a vaccine plus cure widely available), these will continue in many serious forms. New powers gained during the emergency will never be relinquished totally. Crony capitalism and monopoly power will be enhanced. Competition from bricks and mortar-based activity has been seriously lamed – most of all by legacy financial paralysis (conventional stores in many cases will have taken on huge further debts during the pandemic, with the resulting raised menace of bankruptcy laming their ability to compete with enterprises which are purely online). And there is the key issue of a high "natural" unemployment rate. The areas most hit by the pandemic often overlapped sectors of low wage employment. Then there is the huge issue of ageing populations with pension provision now demonstrated as totally inadequate. How will society channel more funding to alleviate poverty amongst the aged?

Q12: What's the probability that the EU recession will lead to a financial crisis given fragile balance sheets for EU commercial banks and what could the ECB do to prevent it?

A: Probability of financial crisis is very high within EMU. The central scenario is that the ECB will "do whatever it takes"; but this time there is no help from the IMF and US. So, doing whatever it takes gets paid for by high inflation and financial repression on an unprecedented scale. The European economy becomes more like the Chinese economy (banks and many enterprises on state support – including access to funds available at cheap or zero rates due to financial repression). One big difference: Europe is not a federal or unified state and Northern Europe may seek an exit.

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Q13: Is the political reaction to the Pandemic economically more damaging than the Pandemic itself? And what is your central scenario for how the command economy under emergency decree will evolve?

A: Let's look at the concept of letting the pandemic run wild. This is a misleading counterfactual. Even without lockdowns there would surely have been a plunge in economic activity as so much of supply became "contaminated" (liable to spread infection). Shops were closing down, as were cafes, restaurants, hotels and airlines, without emergency decrees. The added emergency actions have added to the supply reductions. Their effectiveness in "flattening the curve of infection" is surely open to discussion; would this have flattened anyhow? That is an issue for debate amongst the experts. If there is high level of optimism that there will be widely available effective drug therapy for people ill with COVID by the autumn - then surely flattening the curve makes a lot of sense – and some of this would have occurred without emergency decree.

No doubt the response of medical systems – the effective refusal of treatment to many non-COVID ill people who thereby suffered, and in some cases, died – to avoid the politically damaging spectacle of treatment rationed to COVID ill will be subject to widespread examination and criticism. A key issue is whether governments could have done more to incentivize cures and vaccines – the benefits of doing so at a fraction of the potential cost of extended lockdowns are so immense.

Q14: In addition to the initial Covid-19 pandemic, and the political reaction to it (lockdown etc.) there is another set of factors to consider: Social reaction. The Euro is a much-talked about candidate because the Greek-crisis of the last decade might now resurface as the Italian crisis. When will this issue hit the news? and depress the Euro? So far it seems untouched? What about the US Dollar which might lose some of its "safe-haven" status if President Trump continues to blunder through this crisis as he has done so far? What about Japan? - Highly indebted, postponed the Olympics, and now will probably also have to bear the cost of a partial lockdown?

A: Much depends on the path of this pandemic.

The central scenario in the market-place is also the most optimistic, and is pricing in that lockdowns so far, combined with summer approaching in the Northern hemisphere, mean that the disease will go into at least partial remission from early summer, with peaking already having taken place in Europe and soon in the US. Another wave of pandemic could occur later in this year but by that time health systems will be better prepared (equipment and capacity, health workers protected) and effective drug therapy widely available (this will differ very much amongst countries). Effective vaccines become widely available by mid-2021. In the meantime, there will be an ending of most restrictions, except for strong advisories that vulnerable people continue to largely stay at home and regulations that supermarkets and drugstores continue with social distancing so that the vulnerable need not become subject to risk there. In this central scenario, we could expect big economic rebound – analogous in some respects to the rebound following war. There, the demobilized military (who were forced into inactivity regarding production of butter, producing guns and fighting instead) return to civilian occupation.

Here the forced inactive (at home not in the battlefield) can now return to economic activity. And this will be amidst much pent-up demand fueled by money printing and a return from depression lows of capital spending.

As regards the geographic divergence of experience following the pandemic, there is severe credit deterioration everywhere. Europe is least able to bear this without crisis given its ailing banks and weak (in terms of credit-rating) sovereigns. And European business activity is highly focused on China. That will be highly problematic as in the post-pandemic world the Cold War between China and the US emerges.

As to prospects between the major currencies, the euro is highly vulnerable in view of its existential risks and intense debt concerns; the dollar could be in between, with the yen the strongest.

Q15: How will all the social and political consequences of the Crisis feed back into politics and geopolitics?

A: In all countries a big question at the political level is how did our elites fail to prevent the pandemic and why were the health services so ill prepared for anything like this? It will be a test of democratic soundness how far and open are these investigations. In the US one might well imagine that the Democrats in the House will try to get this underway ahead of the elections, but the Trump Administration will use every effective delaying tactic. There will be leaks and leaks. Much will depend on whether there is a relief in the pandemic by the autumn allowing a full entry of these issues into the election campaign.

At the level of geo-politics, in the eyes of many, China is now a pariah state, having hid the spread of the virus at a time when the rest of the world could have taken effective action. But the US and European elites in their own way were engaged through cronyist links with the elites in China. There is huge economic interdependency (not least in pharmaceutical drug chains). So, expect the China-US hostility to simmer rather than develop early on into Cold War. But that will follow. And Beijing, well attuned to that likelihood, could start quietly and pre-emptively moving reserves out of dollars into gold, in anticipation. Europe, on the other hand, may well go down the path of indefinite appeasement of China. Japan as usual will try to play both – sustain its vital alliance with the US whilst deriving economic advantage from its high degree of integration with China.

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