

How to Protect Your Savings
from the
Coming Crisis

CODE RED

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Bestselling Authors of *Endgame*

WILEY

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This book is dedicated to

our mothers.

Mildred Duke Mauldin (1917–and still going)

No matter what life throws at her, she perseveres with grace and a smile. One can grow up with no greater example of the importance of showing up no matter what. She makes life better for everyone who has ever known her.

Mary Prevatt Tepper (1945–2012)

She was a wonderful mother and a saint who helped thousands of poor and needy through Betel International.

This debilitating spiral has spurred our government to take massive action. In poker terms, the Treasury and the Fed have gone “all in.” Economic medicine that was previously meted out by the cupful has recently been dispensed by the barrel. These once-unthinkable dosages will almost certainly bring on unwelcome aftereffects. Their precise nature is anyone’s guess, though one likely consequence is an onslaught of inflation. Moreover, major industries have become dependent on Federal assistance, and they will be followed by cities and states bearing mind-boggling requests. Weaning these entities from the public teat will be a political challenge. They won’t leave willingly.

—Warren Buffett
*Berkshire Hathaway 2008
Letter to Shareholders*

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Any faults and omissions from the book, and we are sure there are many, are exclusively our own.

Introduction: Code Red

When Lehman Brothers went bankrupt and AIG was taken over by the U.S. government in the fall of 2008, the world almost came to an end. Over the next few weeks, stock markets went into free fall and trillions of dollars of wealth were wiped out. However, even more disturbing were the real-world effects on trade and businesses. A strange silence descended on the hubs of global commerce. As international trade froze, ships stood empty near ports around the world because banks would no longer issue letters of credit. Factories shut as millions of workers were laid off as commercial paper and money market funds used to pay wages froze. Major banks in the United States and the United Kingdom were literally hours away from shutting down and ATMs were on the verge of running out of cash. Banks stopped issuing letters of credit to former trusted partners worldwide. The interbank market simply froze, as no one knew who was bankrupt and who wasn't. Banks could look at their own balance sheets and see how bad things were and knew that their counterparties were also loaded up with too much bad debt.

The world was threatened with a big deflationary collapse. A crisis that big only comes around twice a century. Families and governments were swamped with too much debt and not enough money to pay them off. But central banks and governments saved the day by printing money, providing almost unlimited amounts of liquidity to the financial system. Like a doctor putting a large jolt of electricity on a dying man's chest, the extreme measures brought the patient back to life.

The money printing that central bankers did after the failure of Lehman Brothers was entirely appropriate in order to avoid a Great Depression II. The Fed and central banks were merely creating some money and credit that only partially offset the contraction in bank lending.

The initial crisis is long gone, but the unconventional measures have stayed with us. Once the crisis was over, it was clear that the world was saddled with high debt and low growth. In order to fight the monsters of deflation and depression, central bankers have gone wild. Central bankers kept on creating money. Quantitative easing was a shocking development when it was first trotted out, but these days the markets just shrug. Now, the markets are worried about losing their regular injections of monetary drugs. What will withdrawal be like?

The amount of money central banks have created is simply staggering. Under quantitative easing, central banks have been buying every government bond in sight and have expanded their balance sheets by over nine trillion dollars. Yes, that's \$9,000,000,000,000—12 zeros to be exact. (By the time you read this book, the number will probably be a few trillion higher, but who's counting?) Numbers so large are difficult for ordinary humans to understand. As Senator Everett M. Dirksen once probably didn't say, "A billion here, a billion there, and soon you're talking about real money." To put it in everyday terms, if you had a credit limit of \$9 trillion on your credit card, you could buy a MacBook Air for every single person in the world. You could fly everyone in the world on a round-trip ticket from New York to London. You could do that twice without blinking. We could go on, but you get the point: it's a big number.

In the four years since the Lehman Brothers bankruptcy, central bankers have torn up the rulebook and are trying things they have never tried before. Usually, interest rates move up or down depending on growth and inflation. Higher growth and inflation normally means higher rates, and lower growth means lower rates. Those were the good old days when things were normal. But now central bankers in the United States, Japan, and Europe have pinned interest rates close to zero and promised to leave

them there for years. Rates can't go lower, so some central bankers have decided to get creative. Normally, central banks pay interest on the cash banks deposit with them overnight. Not anymore. Some banks like the Swiss National Bank and the Danish National Bank have even created *negative* deposit rates. We now live in an upside-down world. Money is effectively taxed (by central bankers, not representative governments!) to get people to spend instead of save.

These unconventional policies are generally good for big banks, governments, and borrowers (who doesn't like to borrow money for free?), but they are very bad for savers. Near-zero interest rates and heavily subsidized government lending programs help the banks to make money the old-fashioned way: borrow cheaply and lend at higher rates. They also help insolvent governments, allowing them to borrow at very low costs. The flip side is that near-zero rates punish savers, providing almost no income to pensioners and the elderly. Everyone who thought their life's savings might carry them through their retirement has to come up with a Plan B when rates are near zero.

In the bizarre world we now inhabit, central banks and governments try to induce consumers to spend to help the economy, while they take money away from savers who would like to be able to profitably invest. Rather than inducing them to consume more, they are forcing them to spend less in order to make their savings last through their final years!

Savers and investors in the developed world are the guinea pigs in an unprecedented monetary experiment. There are clear winners and losers as prudent savers are called upon to bail out reckless borrowers. In the United States, United Kingdom, Japan, and most of Europe, savers receive close to zero percent interest on their savings, while they watch the price of gasoline, groceries, and rents go up. Standards of living are falling for many and economic growth is elusive. Today is a time of financial repression, where central banks keep interest rates below inflation. This means that the interest savers receive on their deposits cannot keep up with the rising cost of living. Big banks are bailed out and continue paying large bonuses, while older savers are punished.

In the film *A Few Good Men*, Jack Nicholson plays Colonel Nathan Jessup. He subjects his troops to an unconventional and extreme approach to discipline by ordering a Code Red. Toward the end of the film, Colonel Jessup explains to a court-martial proceeding that while his methods are grotesque and abnormal, they are necessary for the defense of the nation and the preservation of freedom.

While central bank Code Red policies are certainly unorthodox and even distasteful, many economists believe they are necessary to kick-start the global economy and counteract the crushing burden of debt. David Zervos, chief market strategist at Jefferies & Co., humorously observes that "Colonel" Ben Bernanke, chairman of the Fed, is likewise brutally honest and just as insistent that his extreme policies are absolutely necessary.

We began to wonder what Colonel Jessup's speech might sound like if the colonel were a central banker. Perhaps it would go something like this (cue Jack Nicholson):

You want the truth? *You can't handle the truth!* Son, we live in a world that has unfathomably intricate economies, and those economies and the banks that are at their center have to be guarded by men with complex models and printing presses. Who's gonna do it? You? You, Lieutenant Mauldin? Can you even begin to grasp the resources we have to use in order to maintain balance in a system on the brink?

I have a greater responsibility than you can possibly fathom! You weep for savers and creditors, and you curse the central bankers and quantitative easing. You have that luxury. You have the luxury of not knowing what I know: that the destruction of savers with inflation and low rates, while tragic, probably saved lives. And my existence, while grotesque and incomprehensible to

you, saves jobs and banks and businesses and whole economies!

You don't want the truth, because deep down in places you don't talk about at parties, you want me on that central bank! You need me on that committee! Without our willingness to silently serve, deflation would come storming over our economic walls and wreak far worse havoc on an entire nation and the world. I will not let the 1930s and that devastating unemployment and loss of lives repeat themselves on my watch.

We use words like *full employment, inflation, stability*. We use these words as the backbone of a life spent defending something. You use them as a punchline!

I have neither the time nor the inclination to explain myself to a man who rises and sleeps under the blanket of the very prosperity that I provide, and then questions the manner in which I provide it! I would rather you just said "thank you" and went on your way.

Central bankers must hide the truth in order to do their job. Jean-Claude Juncker, the Prime Minister of Luxembourg and head of the European Union at one point, told us, "**When it becomes serious, you have to lie.**" We may dislike what they are doing, but if politicians want to avoid large-scale default, the world needs loose money and money printing.

Ben Bernanke and his colleagues worldwide have effectively issued and enforced a Code Red monetary policy. Their economic theories and experience told them it was the correct and necessary thing to do—in fact, they were convinced it was the only thing to do!

Chairman Ben Bernanke could not be further from Colonel Nathaniel Jessup, but they are both men on a mission. Colonel Jessup is maniacally obsessed with enforcing discipline on his base at Guantanamo. He has seen war and does not take it lightly. He is a tough Marine who would not hesitate to kill his enemies. He is not loved, but he's happy to be feared and respected. Ben Bernanke, by contrast, is a soft-spoken academic. You can't find anyone with anything bad to say about him personally. His story is inspiring. He grew up as one of the few Jews in the Southern town of Dillon, South Carolina, and through his natural genius and hard work, he was admitted to Harvard, graduated with distinction, and soon he embarked on a brilliant academic career at MIT and Princeton. Sometimes, when Bernanke gives a speech, his voice cracks slightly, and it is certain he would much prefer to be writing academic papers or lecturing to a class of graduate students than dealing with large skeptical audiences of senators. But Bernanke is one of the world's foremost experts on the Great Depression. He has learned from history and knows that too much debt can be lethal. He genuinely believes that without Code Red-type policies, he would condemn America to a decade of breadlines and bankruptcies. He promised he would not let deflation and another Great Depression descend on America. In his own way, he's our Colonel Jessup, standing on the wall fighting for us. And he gets too little respect.

Bernanke understands that the world has far too much debt that it can't pay back. Sadly, debt can get away via only: (1) defaults (and there are so many ways to default without having to actually use the word!), (2) paying down debt through economic growth, or (3) eroding the burden of debt through inflation or currency devaluations. In our grandparents' age, we would have seen defaults. But defaults are painful, and no one wants them. We've grown fat and comfortable. We don't like pain.

Growing our way out of our problems would be ideal, but it isn't an option. Economic growth is elusive everywhere you look. Central bankers are left with no other option but to create inflation and devalue their currencies.

No one wants to hear that we'll suffer from higher inflation. It is grotesque and not what centr

bankers are meant to do. But people can't handle the truth, and inflation is exactly what the central bankers are preparing for us. ~~They're sparing some the pain of defaults while others bear the pain~~ low returns. But a world in which big banks and governments default is almost by definition a world of not just low but (sometimes steeply) negative investment returns. As we said in *Endgame*, we are left with no good choices, only choices that range from the merely very difficult to the downright disastrous. The global situation reminds us very much of Woody Allen's quote, "More than any other time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. The other, to total extinction. Let us pray we have the wisdom to choose correctly." The choice now left to some countries is only between Disaster A and Disaster B.

Today's battle with deflation requires a constant vigilance and use of Code Red procedures. Unfortunately, just like in *A Few Good Men*, Code Reds are not standard operating procedures or conventional policies. Ben Bernanke, Mario Draghi, Haruhiko Kuroda, and other central bankers are manning their battle stations using ugly weapons to get the job done. They are punishing savers and encouraging people to borrow more, providing lots of liquidity, and weakening their currencies.

This unprecedented global monetary experiment has only just begun, and every central bank is trying to get in on the act. It is a monetary arms race, and no one wants to be left behind. The Bank of England has devalued the pound to improve exports by allowing creeping inflation and keeping interest rates at zero. The Federal Reserve has tried to weaken the dollar in order to boost manufacturing and exports. The Bank of Japan, not to be outdone, is now trying to radically depreciate the yen. By weakening their currencies, these central banks hope to boost their countries' exports and get a leg up on their competitors. In the race to debase currencies, no one wins. But lots of people lose.

Emerging-market countries like Brazil, Russia, Malaysia, and Indonesia will not sit idly by while the developed central banks of the world weaken their currencies. They, too, are fighting to keep their currencies from appreciating. They are imposing taxes on investments and savings in their currencies. All countries are inherently protectionist if pushed too far. The battles have only begun in what promises to be an enormous, ugly currency war. If the currency wars of the 1930s and 1970s are any guide, we will see knife fights ahead. Governments will fight dirty—they will impose tariffs and restrictions and capital controls. It is already happening, and we will see a lot more of it.

If only they were just armed with knives. We are reminded of that amusing scene in *Raiders of the Lost Ark* where Indiana Jones, confronted with a very large man wielding an even larger scimitar, simply pulls out his gun, shoots him, and walks away. Some central banks are better armed than others. Indeed, you might say that the four biggest central banks—the Fed, Bank of England (BoE), European Central Bank (ECB), and Bank of Japan (BoJ)—have nuclear arsenals. In a fight for national survival, which is what a crisis this major will feel like, will central bankers resort to the nuclear option; will they double down on Code Red policies? The conflict could get very messy for those in the neighborhood.

Providing more debt and more credit after a bust that was caused by too much credit is like suggesting whiskey after a hangover. Paradoxical as the cure may be, many economists and investors think that it is just what the doctor ordered. At the star-studded World Economic Forum retreat in Davos, Switzerland, the billionaire George Soros pointed out the contradiction policy makers now face. The global financial crisis happened because of too much debt and too much money floating around. However, according to many economists and investors, the solution may in fact be more money and more debt. As he said, "When a car is skidding, you first have to turn the wheel in the same direction as the skid to regain control because if you don't, then you have the car rolling over."

Only after the global economy has recovered can the car begin to right itself. Before central banks can be responsible and conventional, they must first be irresponsible and unconventional.

The arsonists are now running the fire brigade. Central bankers contributed to the economic crisis the world now faces. They kept interest rates too low for too long. They fixated on controlling inflation, even as they stood by and watched investment banks party in an orgy of credit. Central bankers were completely incompetent and failed to see the Great Financial Crisis coming. They couldn't spot housing bubbles, and even when the crisis had started and banks were failing, they insisted that the banks they supervised were well regulated and healthy. They failed at their job and should have been fired. Yet governments now need central banks to erode the mountain of debt by printing money and creating inflation.

Investors should ask themselves: *if central bankers couldn't manage conventional monetary policy well in the good times, what makes us think that they will be able to manage unconventional monetary policies in the bad times?*

And if they don't do a perfect job of winding down condition Code Red, what will be the consequences?

Economists know that there are no free lunches. Creating tons of new money and credit out of thin air is not without cost. Massively increasing the size of a central bank's balance sheet is risky and stores up extremely difficult problems for the future. Central bank policies may succeed in creating growth, or they may fail. It is too soon to call the outcome, but what is clear (at least to us) is that the experiment is unlikely to end well.

The endgame for the current crisis is not difficult to foresee; in fact, it's already under way. Central banks think they can swell the size of their balance sheet, print money to finance government deficits, and keep rates at zero with no consequences. Bernanke and other bankers think they have the foresight to reverse their unconventional policies at the right time. They've been wrong in the past, and they will get the timing wrong in the future. They will keep interest rates too low for too long and cause inflation and bubbles in real estate, stock markets, and bonds. What they are doing will destroy savers who rely on interest payments and fixed coupons from their bonds. They will also harm lenders who have lent money and will be repaid in devalued dollars, if they are repaid at all.

We are already seeing the unintended consequences of this Great Monetary Experiment. Many emerging-market stock markets have skyrocketed, only to fall back to Earth at the mere hint of an end to Code Red policies. Junk bonds and risky commercial mortgage-backed securities are offering investors the lowest rates they have ever seen. Investors are reaching for riskier and riskier investments to get some small return. They're picking up dimes in front of a steamroller. It is fun for a while, but the end is always ugly. Older people who are relying on pension funds to pay for their retirement are getting screwed (that is a technical economic term that we will define in detail later). In normal times, retirees could buy bonds and live on the coupons. Not anymore. Government bond yields are now trading below the level of inflation, guaranteeing that any investor who holds the bonds until maturity will lose money in real terms.

We live in extraordinary times.

When investors convince themselves central bankers have their backs, they feel encouraged to bid up prices for everything, accepting more risk with less return. Excesses and bubbles are not a mere side effect. As crazy as it seems, reckless investor behavior is, in fact, the planned objective. William McChesney Martin, one of the great heads of the Federal Reserve, said the job of a central banker was to take away the punch bowl before the party gets started. Now, central bankers are spiking the punch

bowl with triple sec and absinthe and egging on the revelers to jump in the pool. One day the party ~~low rates and money printing will come to an end, and investors will make their way home from the~~ party in the early hours of sunlight half dressed, with a hangover and a thumping headache.

The coming upheaval will affect everyone. No one will be spared the consequences: from savers who are planning for retirement to professional traders looking for opportunities to profit in financial markets. Inflation will eat away at savings, government bonds will be destroyed as a supposedly safe asset class, and assets that benefit from inflation and money printing will do well.

This book will provide a road map and a playbook for retail savers and professional traders alike. This book will shine a light on the path ahead. *Code Red* will explain in plain English complicated things like zero interest rate policies (ZIRPs), nominal gross domestic product (GDP) targeting, quantitative easing, money printing, and currency wars. But much more importantly, it will explain how it will affect your savings and offer insights on how to protect your wealth. It is our hope that *Code Red* will be an invaluable guide for you for the road ahead.

PART ONE

In the first part of this book, we will show you how we arrived where we are, what central banks are doing, how they are storing problems for the future, and how the current policies will end badly. In Part II of the book, we will show you how to protect your savings from the bad consequences of central bank policies.

Let's dive right in!

Chapter One

The Great Experiment

Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent) that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services.

—Ben Bernanke

Chairman of the Board of Governors of the Federal Reserve Bank of the United States. President Lyndon B. Johnson once summed up the general feeling about economists when he asked his advisers, “Did you ever think that making a speech on economics is a lot like pissing down your leg? It seems hot to you, but it never does to anyone else.” Reading a book about monetary policy and central banking can seem equally unexciting. It doesn’t have to be.

Central banking and monetary policy may seem technical and boring; but whether we like it or not, the decisions of the Federal Reserve, the Bank of Japan (BoJ), the European Central Bank (ECB), and the Bank of England (BoE) affect us all. Over the next few years they are going to have profound impacts on each of us, touching our lives in every way. They influence the value of the dollar bills in our wallets, the price of the groceries we buy, how much it costs to fill up the gas tank, the wages we earn at work, the interest we get on our savings accounts, and the health of our pension funds. You may not care about monetary policy, but it will have an impact on whether you can retire comfortably, whether you can send your children to college with ease, or whether you will be able to afford your house. It is difficult to overstate how profoundly monetary policy influences our lives. If you care about your quality of life, the possibility of retirement, and the future of your children, you should care about monetary policy.

Despite the importance of central bankers in our lives, outside of trading floors on Wall Street and the City of London, most people have no idea what central bankers do or how they do it. Central bankers are like the Wizard of Oz, moving the levers of money behind the scenes, but remaining a mystery to the general public.

It is about time to pull the curtains back on monetary policy making.

Even though they are separated by oceans, borders, cultures, and languages, all the major central bankers have known each other for decades and share similar beliefs about what monetary policy should do. Three of the world’s most powerful central bankers started their careers at the Massachusetts Institute of Technology (MIT) economics department. Fed chairman Ben Bernanke and ECB president Mario Draghi earned their doctorates there in the late 1970s. Bank of England governor Mervyn King taught there briefly in the 1980s. He even shared an office with Bernanke. Many economists came out of MIT with a belief that government could (and, even more important, should) soften economic downturns. Central banks play a particularly important role, not only by changing

interest rates but also by manipulating the public's expectations of what the central bank might do.

We are living through one watershed moment after another in the greatest monetary experiment of all time. We are all guinea pigs in a risky trial run by central bankers: it's Code Red time.

Those of us who are of a certain age remember the great Dallas Cowboys coach Tom Landry. He would stalk the sidelines in his fedora, holding a sheet of paper he would consult many times. On the plays he would run, worked out well in advance. Third down and long and behind 10 points. He had a play for that.

The Code Red policies that central bankers are coming up with more closely resemble Hail Mary passes than they do Landry's carefully worked out playbook: they are not in any manual, and they are certainly not normal. The head coaches of our financial world are sending in one novel play after another, really mixing things up to see what might work: "Let's send zero interest rate policy (ZIRP) up the middle while quantitative easing (QE) runs a slant, large-scale asset purchases (LSAPs) go deep, and negative real interest rates, financial repression, nominal gross domestic product (GDP) targeting, and foreign exchange intervention hold the line."

The acronym alphabet soup of the playmakers is incomprehensible to the average person, but all these programs are fancy, technical ways to hide very simple truths.

In *Through the Looking Glass*, Humpty Dumpty says, "When I use a word, it means just what I choose it to mean—neither more nor less." When central bankers give us words to describe the financial policies, they tell us exactly what they want their words to mean, but rarely do they tell us exactly the truth in plain English. They think we can't handle the truth.

The Great Financial Crisis of 2008 marked the turning point from conventional monetary policies to Code Red type unconventional policies.

Before the crisis, central bankers were known as boring, conservative people who did everything by the book. They were generally disliked for being party poopers. They would take away the punch bowl just when the party got going. When the economy was overheating, central bankers were supposed to raise interest rates, cool down growth, and tighten monetary policy. Sometimes, doing so caused recessions. Taking away the punch bowl could hardly make everyone happy. In fact, at the start of the 1980s, former chairman Paul Volcker was burnt in effigy by a mob on the steps of the capitol for hiking short-term interest rates to 19 percent as he struggled to fight inflation. Central bankers like Volcker believed in sound money, low inflation, and a strong currency.

In the throes of the Great Financial Crisis, however, central bankers went from using interest rates to cool down the party to spiking the punch with as many exotic liqueurs as possible. Ben Bernanke, the chairman of the Federal Reserve, was the boldest, most creative, and unconventional of them all. With his Harvard, MIT, and Princeton background, he is undoubtedly one of the savviest central bankers of his generations. When Lehman Brothers went bust, he invented dozens of programs that had never existed before to finance banks, money market funds, commercial paper markets, and so on. Bernanke took the Federal Funds rate down almost to zero, and the Fed bought trillions of dollars of government treasuries and mortgage-backed securities. Bernanke promised that the Federal Reserve would act boldly and creatively and would not withdraw the punch bowl until the party was really rolling. Foreign central bankers like Haruhiko Kuroda (BoJ); Mervyn King and his replacement from Canada Mark Carney (BoE); and Mario Draghi (ECB) have also promised to do whatever it takes to achieve their objectives. We have no doubt that whoever replaces Bernanke will be in the same mold.

These are the days of a new breed of central banker who believes in the prescription of ultra-easy money, higher rates of inflation, and a weaker currency to cure today's ills. Their experiment

medicine may have saved the patient in the short term, but it is addictive; withdrawal is ugly; and because long-term side effects are devastating, it can be prescribed only for short-term use. The problem is, they can't openly admit any of that.

Central bankers hope that unconventional policies will do the trick. If everything goes as planned, inflation will quietly eat away at debt, stock markets will go up, house prices will go up, everyone will feel wealthier and spend the newfound wealth, banks will earn lots of money and become solvent, and government debts will shrink as taxes rise and deficits evaporate. And after all is well again, central banks can go back to the good old days of conventional policies. There is no guarantee that will happen, but that's the game plan.

So far, Code Red policies have lifted stock markets, but they have not worked at reviving growth. But Code Red-type policies are like a religion or communism. If they don't work, it is only proof that they were not tried in sufficient size or with enough vigor. So we're guaranteed to see a lot more unconventional policies in the coming months and years.

How I Learned to Stop Worrying and Love Inflation

The Great Financial Crisis was a story of a huge mountain of debt that was piled too high, reached criticality, and then collapsed. For decades, families, companies, and governments had accumulated every kind of debt imaginable: credit card bills, student loans, mortgages, corporate and municipal bonds, and so on. Once the mountain rumbled, broke, and started to collapse, the landslides spread everywhere. The epicenter of the crisis was the U.S. subprime mortgage market (in fact, many foreign leaders still think it was fat, suburban, Big Mac-eating Americans who caused the global crisis), but the United States was just a small part of a much bigger problem. Countries such as Ireland, Spain, Iceland, and Latvia also had very large real estate bubbles that burst. Other countries, including Australia, Canada, and China, have housing bubbles that are still in the process of bursting. It's the same problem everywhere: too much debt that cannot be paid back in full.

(We certainly would not minimize the role of the Federal Reserve in failing to supervise the banks and especially subprime debt. By holding interest rates too low for too long and by willfully ignoring the developing bubble in the U.S. housing market, they certainly played a central role.)

When a person has too much debt, the sensible thing to do is to spend less and pay down the mortgage or credit card bills. However, what is true for one person isn't true for the economy as a whole. Economists call this principle the *paradox of thrift*. Imagine if everyone decided overnight to stop spending beyond what was absolutely necessary, save more, and pay down their debts. That would mean fewer dinners out, fewer visits to Starbucks, fewer Christmas presents, fewer new cars, and so on. You get the picture. The economy as a whole would contract dramatically if everyone spent less in order to pay down debts. But, in fact, that is exactly what happened during the Great Financial Crisis. Economists call this process *deleveraging*. And the last thing central banks want is for everyone to stop spending money and reduce their debts at the same time. That leads to recessions and depressions.

At least that was the theory proposed by John Maynard Keynes, the father of one of the most influential economic schools of thought, and it has become the reigning paradigm. It's all about encouraging consumption and reviving "animal spirits." If the economy is in the doldrums

(recession), it is up to the government to run deficits, even massive ones, in order to “prime the pump.” Put plenty of money into people’s hands so they will go out and spend, encouraging businesses to expand and hire more workers, who will then consume yet more goods, and so on. Wash, rinse, and repeat.

Another solution if you have too much debt is to declare bankruptcy. In many countries that can be an effective way of starting over again. You put behind you debts you can’t pay, offer to pay what you can, and start anew. Once again, what is good for the individual isn’t necessarily good for the economy as a whole. Imagine what would happen if millions of people declared bankruptcy at the same time. Banks would all go bust, and the government would probably have to pick up the tab and recapitalize the banks. And then, before long, the government would find itself going bust.

The difference between what is right for one person and what is right for society is paradoxical. It is what logicians call the *fallacy of composition*. What is true for a part is not true for the whole. If you drive to work 10 minutes early, you might avoid traffic. If everyone drives to work 10 minutes early, the traffic jam will happen 10 minutes earlier. Central banks don’t want everyone to be prudent or go bankrupt at the same time. They would simply prefer everyone to remain calm and carry on spending.

If you want to avoid everyone’s ceasing to spend—or, worse yet, everyone’s going bankrupt at the same time—the only way to make the debt go away in real terms is through inflation. Inflation is the Ghostbusters of debt. It wipes debt out over time. For the sake of simplicity, imagine that you owe \$100,000. If inflation is 2 percent, it will take about 30 years to cut the value of the loan in half. But if the rate of inflation doubles to 4 percent, it will take just 18 years to halve the value of the loan. And if inflation doubles again to 8 percent, you will halve the loan in 8 years!

Inflation is just what the doctor ordered for an economy with too much debt. By ratcheting up inflation, central bankers can erode debt quickly and quietly. But while inflation is the friend of debtors, it is the enemy of savers; so for central bankers to come out and say they’re in favor of inflation would be like the pope’s announcing one day that he’s not Catholic. That isn’t going to happen.

Inflation is a subject that divides economists because it means different things to different people. Not all inflation is bad. Inflation is generally considered to be problematic when the broad price level of most goods and services starts to go up because too much money is chasing too few goods. The increase in the price of a haircut is bad inflation. The method of cutting hair is no different than it was in the 1930s or the 1950s, yet it is vastly more expensive to get your hair cut today. (I [John] pay 20 times more for a haircut today than I did when I was a kid.) However, an increase in the price of Picasso or de Kooning is considered to be normal, or “good,” inflation. The higher prices are merely a reflection of more wealthy people in the world chasing fine art. They reflect the scarcity of the goods for sale and the laws of supply and demand at work. And who complains about the asset inflation of a rising stock market or rising home values?

Then there is good deflation and bad deflation. The deflation of falling telegraph, telephone, and Internet prices is viewed as good. Better technology means that prices fall because we can do the same things more cheaply or even nearly for free. For example, in *Money, Markets & Sovereignty*, Ben Steil and Manuel Hinds describe the second phase of the Industrial Revolution in the United States between 1870 and 1896. Prices fell by 32 percent over the period, but real income soared 110 percent amid robust economic growth, expanded trade, and enormous innovation in telecommunications and other industries.

The bad kind of deflation is different. When demand drops because people have too much debt and not enough money to spend, prices fall, too, though the cost of production does not. Jobs dry up leaving people with even less to spend. That is the kind of deflation central bankers fear today.

Alphabet Soup: ZIRP, QE, LSAP

Let's look at how central bankers attempt to create inflation and how they help households, companies, and governments burdened with too much debt. We'll go through the main acronyms and technical terms and explain what they mean and how they affect you.

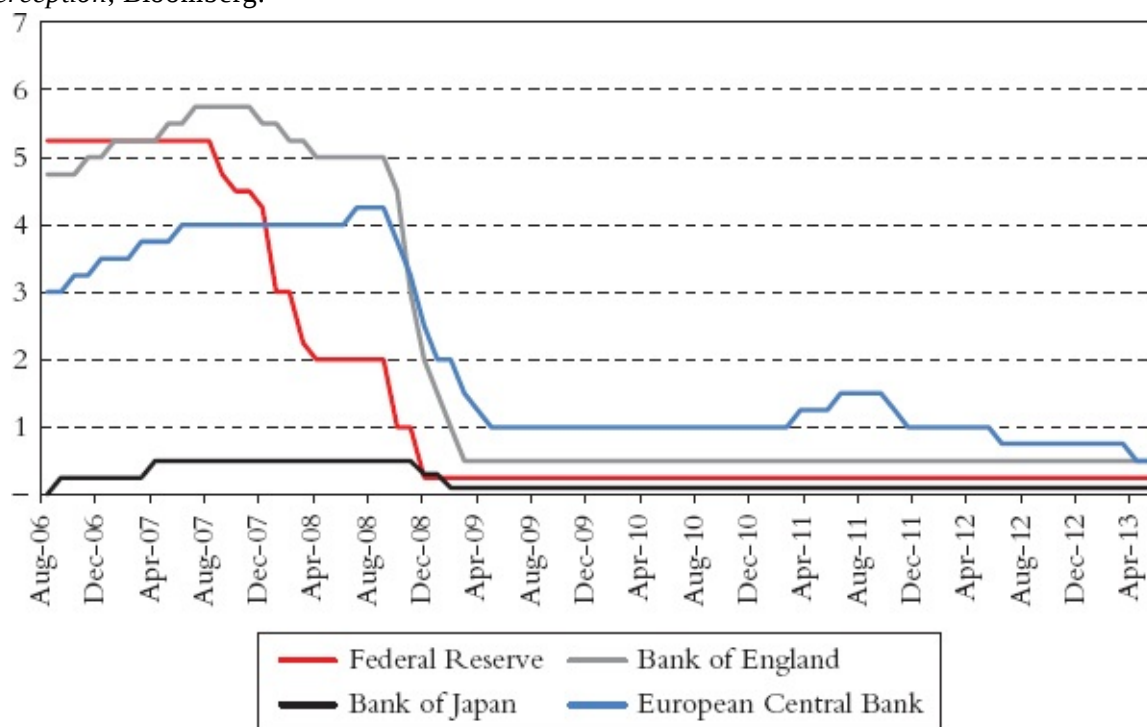
The main way monetary authorities have an impact on the economy is by setting interest rates. Interest rates determine the price at which people will borrow and lend. In the old days, when the economy was growing quickly, central banks would raise rates. When the economy was slowing down, they'd cut rates, which meant that financing got cheaper, credit was easier, and money was looser.

The reason the Fed cut interest rates was to stimulate the economy. Lower rates mean lower mortgage, credit card, and car payments. They give businesses access to cheaper capital and hopefully spur profits and thus hiring. This puts more money into the hands of consumers. As an example, U.S. 30-year mortgage rates recently hit a record low of 3.66 percent, down from 4.5 percent the same time last year. A number of mortgage holders will refinance, given the much lower rates, increasing their disposable income. That almost makes us want to buy a house or two. Who can complain about a free lunch?

Cutting rates can only go so far until you hit zero. You can see this in [Figure 1.1](#). Then you're stuck with a floor. In fact, central banks cut rates during the financial crisis, and then left them near zero and have not raised them since. Leaving rates at or near zero is what central banks refer to as *zero interest rate policy* (ZIRP). Currently, the United States, United Kingdom, Japan, Switzerland, and, arguably, the Euro area are all engaging in ZIRP.

Figure 1.1 Global Interest Rates

Source: *Variant Perception*, Bloomberg.



In a ZIRP world, debtors are overjoyed and savers are screwed. Imagine borrowing at 5 or 10 percent and then suddenly seeing your borrowing costs fall to a little above zero. No matter how much debt you had before, paying very little interest every month is a lifesaver. Low borrowing costs make it easier for struggling businesses to roll over their debt and reduce the real value of debt payments. If you reduce the coupon payment on a loan, that is economically the same thing as forgiving part of the principal amount, but this forgiveness is hidden. The low rates effectively allow “zombie” households and businesses to limp along without going bankrupt.

Near-zero interest rates are, however, terrible for savers, investors, and lenders. Imagine you're a retiree, and you've been responsible and saved all your life; you've put money in the bank that you expect to pay you interest every month. You probably bought some bonds as well so you could collect coupons every quarter. In a ZIRP world, you would be getting very little every month from interest and coupon payments. You would live your retirement years with far less income than you had planned for, or you would need to work far longer in order to save more.

This is happening to retirees all over the world—it's why more and more people over 60 are still working. The Federal Reserve and central bankers are not particularly worried about savers. More Americans are struggling with debt. In an indebted society, helping debtors beats helping savers.

Inflation is the opposite of a gift that keeps on giving. Higher inflation allows the Federal Reserve and other central banks to take real interest rates below zero. *Nominal interest rates* are the actual interest rate you get. *Real interest rates* are nominal rates minus the inflation rate. If your bank offers you 2 percent on your bank account, the nominal rate is 2 percent. So far, so simple. If inflation is 2 percent, then the real interest rate is 0 ($2 - 2 = 0$). The interest rate is only just keeping up with inflation. If inflation is 4 percent, then the interest you are getting on your bank account isn't even keeping pace with inflation. Your real interest rate would be negative 2 ($2 - 4 = -2$). As you can see, with rates near zero, as long as inflation is positive, central banks can create negative real rates. Even though nominal rates can be trapped at zero, real interest rates can go below zero.

When real rates are negative, cash is trash. Negative real rates act like a tax on savings. Inflation eats away at your money, and is in effect a tax by the (unelected!) central bankers on your hard-earned money. Leaving money in the bank when real rates are negative guarantees that you will lose purchasing power. Negative real rates force savers and investors to seek out riskier and riskier investments merely to tread water. It almost guarantees people don't save and stop spending. In fact, Bernanke openly acknowledges that his low interest-rate policy is designed to get savers and investors to take more chances with riskier investments. The fact that this is precisely the wrong thing for retirees and savers seems to be lost in their pursuit of market and economic gains.

Simply by opening their mouths, central bankers can affect not only today's interest rate, but tomorrow's *expected* interest rate as well. If Bernanke (and his successors) or Mario Draghi of the ECB promise to keep interest rates near zero until kingdom come, investors will generally take them at their word. By promising to keep rates low, central banks have crushed bond yields. The bond yield curve tells the story. The yield curve is the structure of interest rates for bonds for today, tomorrow, and the day after tomorrow. By plotting a line for each bond maturity, you can see what expected rates are out into the future: 2 years, 5 years, 10 years, and 30 years. The U.S. government can now issue 10-year debt for less than 2 percent yield. This is below the rate of inflation. It implies the Fed has been successful at keeping rates below inflation all the way out to 10 years.

Lots of big economists such as Paul Krugman, Ben Bernanke, Gauti Eggertsson, and Michael Woodford, have provided the intellectual underpinnings that justify Code Red policies (the list of

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