How to Protect Your Savings

from the

Coming Crisis

CODE RED

JOHN MAULDIN and

JONATHAN TEPPER

Bestselling Authors of *Endgame*

WILEY

Contents

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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 almos 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 Buffe
Berkshire Hathaway 200
Letter to Shareholde

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Let me finally say that finishing this book would not have been possible before the end of the decad without the work and continual prodding of Jonathan Tepper. He is the best co-author any writer coul have, especially one that is already overcommitted.

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

The world was threatened with a big deflationary collapse. A crisis that big only comes around twic a century. Families and governments were swamped with too much debt and not enough money to pa them off. But central banks and governments saved the day by printing money, providing almo unlimited amounts of liquidity to the financial system. Like a doctor putting a large jolt of electrici 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 entire appropriate in order to avoid a Great Depression II. The Fed and central banks were merely creatin 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 cris was over, it was clear that the world was saddled with high debt and low growth. In order to fight th monsters of deflation and depression, central bankers have gone wild. Central bankers kept on creatin money. Quantitative easing was a shocking development when it was first trotted out, but these day the markets just shrug. Now, the markets are worried about losing their regular injections of monetar drugs. What will withdrawal be like?

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

In the four years since the Lehman Brothers bankruptcy, central bankers have torn up the rulebo and are trying things they have never tried before. Usually, interest rates move up or down dependin on growth and inflation. Higher growth and inflation normally means higher rates, and lower grow means lower rates. Those were the good old days when things were normal. But now central bankers the United States, Japan, and Europe have pinned interest rates close to zero and promised to lea them there for years. Rates can’t go lower, so some central bankers have decided to get creativ ~~Normally, central banks pay interest on the cash banks deposit with them overnight.~~ Not anymor Some banks like the Swiss National Bank and the Danish National Bank have even created *negati* deposit rates. We now live in an upside-down world. Money is effectively taxed (by central banker not representative governments!) to get people to spend instead of save.

These unconventional policies are generally good for big banks, governments, and borrowers (wh doesn’t like to borrow money for free?), but they are very bad for savers. Near-zero interest rates ar heavily subsidized government lending programs help the banks to make money the old-fashione way: borrow cheaply and lend at higher rates. They also help insolvent governments, allowing them borrow at very low costs. The flip side is that near-zero rates punish savers, providing almost n income to pensioners and the elderly. Everyone who thought their life’s savings might carry then 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 spend to help the economy, while they take money away from savers who would like to be able profitably invest. Rather than inducing them to consume more, they are forcing them to spend less order to make their savings last through their final years!

Savers and investors in the developed world are the guinea pigs in an unprecedented moneta experiment. There are clear winners and losers as prudent savers are called upon to bail out reckle borrowers. In the United States, United Kingdom, Japan, and most of Europe, savers receive close zero percent interest on their savings, while they watch the price of gasoline, groceries, and rents g up. Standards of living are falling for many and economic growth is elusive. Today is a time c financial repression, where central banks keep interest rates below inflation. This means that th interest savers receive on their deposits cannot keep up with the rising cost of living. Big banks a 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 an unconventional and extreme approach to discipline by ordering a Code Red. Toward the end of th film, Colonel Jessup explains to a court-martial proceeding that while his methods are grotesque an 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, man economists believe they are necessary to kick-start the global economy and counteract the crushin burden of debt. David Zervos, chief market strategist at Jefferies & Co., humorously observes th “Colonel” Ben Bernanke, chairman of the Fed, is likewise brutally honest and just as insistent that h extreme policies are absolutely necessary.

We began to wonder what Colonel Jessup’s speech might sound like if the colonel were a centra 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 guardec 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 Minist of Luxembourg and head of the European Union at one point, told us, **"When it becomes serious, yo 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 Re monetary policy. Their economic theories and experience told them it was the correct and necessa 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 me on a mission. Colonel Jessup is maniacally obsessed with enforcing discipline on his base Guantanamo. He has seen war and does not take it lightly. He is a tough Marine who would n hesitate to kill his enemies. He is not loved, but he's happy to be feared and respected. Ben Bernank by contrast, is a soft-spoken academic. You can't find anyone with anything bad to say about hi personally. His story is inspiring. He grew up as one of the few Jews in the Southern town of Dillo South Carolina, and through his natural genius and hard work, he was admitted to Harvard, graduat with distinction, and soon he embarked on a brilliant academic career at MIT and Princeto Sometimes, when Bernanke gives a speech, his voice cracks slightly, and it is certain he would muc prefer to be writing academic papers or lecturing to a class of graduate students than dealing wi large skeptical audiences of senators. But Bernanke is one of the world's foremost experts on th Great Depression. He has learned from history and knows that too much debt can be lethal. H genuinely believes that without Code Red–type policies, he would condemn America to a decade breadlines and bankruptcies. He promised he would not let deflation and another Great Depressio descend on America. In his own way, he's our Colonel Jessup, standing on the wall fighting for u 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 away via only: (1) defaults (and there are so many ways to default without having to actually use th word!), (2) paying down debt through economic growth, or (3) eroding the burden of debt throug inflation or currency devaluations. In our grandparents' age, we would have seen defaults. But defaul 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 elusive everywhere you look. Central bankers are left with no other option but to create inflation a 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 centr ~~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 wor of not just low but (sometimes steeply) negative investment returns. As we said in *Endgame*, we a left with no good choices, only choices that range from the merely very difficult to the downrig disastrous. The global situation reminds us very much of Woody Allen’s quote, “More than any othe time in history, mankind faces a crossroads. One path leads to despair and utter hopelessness. Th other, to total extinction. Let us pray we have the wisdom to choose correctly.” The choice now left t some countries is only between Disaster A and Disaster B.

Today’s battle with deflation requires a constant vigilance and use of Code Red procedure Unfortunately, just like in *A Few Good Men*, Code Reds are not standard operating procedures conventional policies. Ben Bernanke, Mario Draghi, Haruhiko Kuroda, and other central bankers a manning their battle stations using ugly weapons to get the job done. They are punishing saver 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 trying to get in on the act. It is a monetary arms race, and no one wants to be left behind. The Bank England has devalued the pound to improve exports by allowing creeping inflation and keepin interest rates at zero. The Federal Reserve has tried to weaken the dollar in order to boo manufacturing and exports. The Bank of Japan, not to be outdone, is now trying to radically deprecia the yen. By weakening their currencies, these central banks hope to boost their countries’ exports an get a leg up on their competitors. In the race to debase currencies, no one wins. But lots of people los

Emerging-market countries like Brazil, Russia, Malaysia, and Indonesia will not sit idly by whi the developed central banks of the world weaken their currencies. They, too, are fighting to keep the currencies from appreciating. They are imposing taxes on investments and savings in their currencie All countries are inherently protectionist if pushed too far. The battles have only begun in wh promises to be an enormous, ugly currency war. If the currency wars of the 1930s and 1970s are an guide, we will see knife fights ahead. Governments will fight dirty—they will impose tariffs an 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 th Lost Ark* where Indiana Jones, confronted with a very large man wielding an even larger scimita simply pulls out his gun, shoots him, and walks away. Some central banks are better armed tha 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 nation survival, which is what a crisis this major will feel like, will central bankers resort to the nucle option; will they double down on Code Red policies? The conflict could get very messy for those the neighborhood.

Providing more debt and more credit after a bust that was caused by too much credit is lik suggesting whiskey after a hangover. Paradoxical as the cure may be, many economists and investo think that it is just what the doctor ordered. At the star-studded World Economic Forum retreat i Davos, Switzerland, the billionaire George Soros pointed out the contradiction policy makers no face. The global financial crisis happened because of too much debt and too much money floatin around. However, according to many economists and investors, the solution may in fact be mo money and more debt. As he said, “When a car is skidding, you first have to turn the wheel in th 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 ca 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 cris the world now faces. They kept interest rates too low for too long. They fixated on controllin inflation, even as they stood by and watched investment banks party in an orgy of credit. Centr bankers were completely incompetent and failed to see the Great Financial Crisis coming. The couldn't spot housing bubbles, and even when the crisis had started and banks were failing, the insisted that the banks they supervised were well regulated and healthy. They failed at their job an should have been fired. Yet governments now need central banks to erode the mountain of debt b printing money and creating inflation.

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

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

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

The endgame for the current crisis is not difficult to foresee; in fact, it's already under way. Centr banks think they can swell the size of their balance sheet, print money to finance government deficit and keep rates at zero with no consequences. Bernanke and other bankers think they have the foresig to reverse their unconventional policies at the right time. They've been wrong in the past, and the will get the timing wrong in the future. They will keep interest rates too low for too long and cau inflation and bubbles in real estate, stock markets, and bonds. What they are doing will destroy save who rely on interest payments and fixed coupons from their bonds. They will also harm lenders wh 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. Man 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 offerin investors the lowest rates they have ever seen. Investors are reaching for riskier and riski investments to get some small return. They're picking up dimes in front of a steamroller. It is fun fo a while, but the end is always ugly. Older people who are relying on pension funds to pay for the retirement are getting screwed (that is a technical economic term that we will define in detail later). normal times, retirees could buy bonds and live on the coupons. Not anymore. Government bon yields are now trading below the level of inflation, guaranteeing that any investor who holds the bon 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 b up prices for everything, accepting more risk with less return. Excesses and bubbles are not a me side effect. As crazy as it seems, reckless investor behavior is, in fact, the planned objective. Willian McChesney Martin, one of the great heads of the Federal Reserve, said the job of a central banker w to take away the punch bowl before the party gets started. Now, central bankers are spiking the punc 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 th 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 save who are planning for retirement to professional traders looking for opportunities to profit in financi markets. Inflation will eat away at savings, government bonds will be destroyed as a supposedly sa 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 alik This book will shine a light on the path ahead. *Code Red* will explain in plain English complicate things like zero interest rate policies (ZIRPs), nominal gross domestic product (GDP) targetin quantitative easing, money printing, and currency wars. But much more importantly, it will expla how it will affect your savings and offer insights on how to protect your wealth. It is our hope th *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 a doing, how they are storing problems for the future, and how the current policies will end badly. Part II of the book, we will show you how to protect your savings from the bad consequences 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 Bernank*
>
> Chairman of the Board of Governors of the Federal Reserve Bank of the United Stat

President Lyndon B. Johnson once summed up the general feeling about economists when he asked h 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 ar 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 no the decisions of the Federal Reserve, the Bank of Japan (BoJ), the European Central Bank (ECB), ar the Bank of England (BoE) affect us all. Over the next few years they are going to have profour impacts on each of us, touching our lives in every way. They influence the value of the dollar bills our wallets, the price of the groceries we buy, how much it costs to fill up the gas tank, the wages w earn at work, the interest we get on our savings accounts, and the health of our pension funds. Yo may not care about monetary policy, but it will have an impact on whether you can retire comfortabl whether you can send your children to college with ease, or whether you will be able to afford yo house. It is difficult to overstate how profoundly monetary policy influences our lives. If you ca about your quality of life, the possibility of retirement, and the future of your children, you shou care about monetary policy.

Despite the importance of central bankers in our lives, outside of trading floors on Wall Street ar the City of London, most people have no idea what central bankers do or how they do it. Centr bankers are like the Wizard of Oz, moving the levers of money behind the scenes, but remaining 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 centr bankers have known each other for decades and share similar beliefs about what monetary polic should do. Three of the world's most powerful central bankers started their careers at th Massachusetts Institute of Technology (MIT) economics department. Fed chairman Ben Bernanke ar ECB president Mario Draghi earned their doctorates there in the late 1970s. Bank of England govern Mervyn King taught there briefly in the 1980s. He even shared an office with Bernanke. Man economists came out of MIT with a belief that government could (and, even more important, shoul soften economic downturns. Central banks play a particularly important role, not only by changin 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 c 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. H would stalk the sidelines in his fedora, holding a sheet of paper he would consult many times. On were the plays he would run, worked out well in advance. Third down and long and behind 10 point He had a play for that.

The Code Red policies that central bankers are coming up with more closely resemble Hail Ma passes than they do Landry's carefully worked out playbook: they are not in any manual, and they a certainly not normal. The head coaches of our financial world are sending in one novel play aft another, really mixing things up to see what might work: "Let's send zero interest rate policy (ZIRI 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 (GD 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 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 u 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 Code Red type unconventional policies.

Before the crisis, central bankers were known as boring, conservative people who did everything b the book. They were generally disliked for being party poopers. They would take away the punch bov just when the party got going. When the economy was overheating, central bankers were supposed raise interest rates, cool down growth, and tighten monetary policy. Sometimes, doing so cause recessions. Taking away the punch bowl could hardly make everyone happy. In fact, at the start of th 1980s, former chairman Paul Volcker was burnt in effigy by a mob on the steps of the capitol fo hiking short-term interest rates to 19 percent as he struggled to fight inflation. Central bankers lil 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 cool down the party to spiking the punch with as many exotic liqueurs as possible. Ben Bernanke, th chairman of the Federal Reserve, was the boldest, most creative, and unconventional of them all. Wi his Harvard, MIT, and Princeton background, he is undoubtedly one of the savviest central bankers generations. When Lehman Brothers went bust, he invented dozens of programs that had never existe before to finance banks, money market funds, commercial paper markets, and so on. Bernanke too the Federal Funds rate down almost to zero, and the Fed bought trillions of dollars of governme treasuries and mortgage-backed securities. Bernanke promised that the Federal Reserve would a boldly and creatively and would not withdraw the punch bowl until the party was really rollin Foreign central bankers like Haruhiko Kuroda (BoJ); Mervyn King and his replacement from Canad Mark Carney (BoE); and Mario Draghi (ECB) have also promised to do whatever it takes to achie 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-eas 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; ar because long-term side effects are devastating, it can be prescribed only for short-term use. Th problem is, they can’t openly admit any of that.

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

So far, Code Red policies have lifted stock markets, but they have not worked at reviving growt But Code Red–type policies are like a religion or communism. If they don’t work, it is only proof th they were not tried in sufficient size or with enough vigor. So we’re guaranteed to see a lot mo 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, reache criticality, and then collapsed. For decades, families, companies, and governments had accumulate every kind of debt imaginable: credit card bills, student loans, mortgages, corporate and municip bonds, and so on. Once the mountain rumbled, broke, and started to collapse, the landslides sprea everywhere. The epicenter of the crisis was the U.S. subprime mortgage market (in fact, many forei leaders still think it was fat, suburban, Big Mac–eating Americans who caused the global crisis), b the United States was just a small part of a much bigger problem. Countries such as Ireland, Spai Iceland, and Latvia also had very large real estate bubbles that burst. Other countries, includi Australia, Canada, and China, have housing bubbles that are still in the process of bursting. It’s t 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 bank and especially subprime debt. By holding interest rates too low for too long and by willfully ignori 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 t mortgage or credit card bills. However, what is true for one person isn’t true for the economy as whole. Economists call this principle the *paradox of thrift*. Imagine if everyone decided overnight stop spending beyond what was absolutely necessary, save more, and pay down their debts. Th would mean fewer dinners out, fewer visits to Starbucks, fewer Christmas presents, fewer new ca and so on. You get the picture. The economy as a whole would contract dramatically if everyone spe less in order to pay down debts. But, in fact, that is exactly what happened during the Great Financi Crisis. Economists call this process *deleveraging*. And the last thing central banks want is f everyone to stop spending money and reduce their debts at the same time. That leads to recessions ar depressions.

At least that was the theory proposed by John Maynard Keynes, the father of one of the mo influential economic schools of thought, and it has become the reigning paradigm. It’s all abo encouraging consumption and reviving “animal spirits.” If the economy is in the doldrur (recession), it is up to the government to run deficits, even massive ones, in order to “prime th pump.” ~~Put plenty of money into people’s hands so they will go out and spend, encouraging business~~ to expand and hire more workers, who will then consume yet more goods, and so on. Wash, rinse, ar repeat.

Another solution if you have too much debt is to declare bankruptcy. In many countries that can b an effective way of starting over again. You put behind you debts you can’t pay, offer to pay what yo can, and start anew. Once again, what is good for the individual isn’t necessarily good for th economy as a whole. Imagine what would happen if millions of people declared bankruptcy at th same time. Banks would all go bust, and the government would probably have to pick up the tab ar 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 what logicians call the *fallacy of composition*. What is true for a part is not true for the whole. If yo drive to work 10 minutes early, you might avoid traffic. If everyone drives to work 10 minutes earl 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 spending.

If you want to avoid everyone’s ceasing to spend—or, worse yet, everyone’s going bankrupt at th same time—the only way to make the debt go away in real terms is through inflation. Inflation is th Ghostbusters of debt. It wipes debt out over time. For the sake of simplicity, imagine that you ov $100,000. If inflation is 2 percent, it will take about 30 years to cut the value of the loan in half. But the rate of inflation doubles to 4 percent, it will take just 18 years to halve the value of the loan. And 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 u inflation, central bankers can erode debt quickly and quietly. But while inflation is the friend debtors, it is the enemy of savers; so for central bankers to come out and say they’re in favor inflation would be like the pope’s announcing one day that he’s not Catholic. That isn’t going happen.

Inflation is a subject that divides economists because it means different things to different peopl Not all inflation is bad. Inflation is generally considered to be problematic when the broad price lev of most goods and services starts to go up because too much money is chasing too few goods. Th increase in the price of a haircut is bad inflation. The method of cutting hair is no different than it w 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 reflection of more wealthy people in the world chasing fine art. They reflect the scarcity of the good for sale and the laws of supply and demand at work. And who complains about the asset inflation of rising stock market or rising home values?

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

The bad kind of deflation is different. When demand drops because people have too much debt an not ~~enough money to spend, prices fall, too, though the cost of production does not. Jobs dry~~ u 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 household companies, and governments burdened with too much debt. We’ll go through the main acronyms an technical terms and explain what they mean and how they affect you.

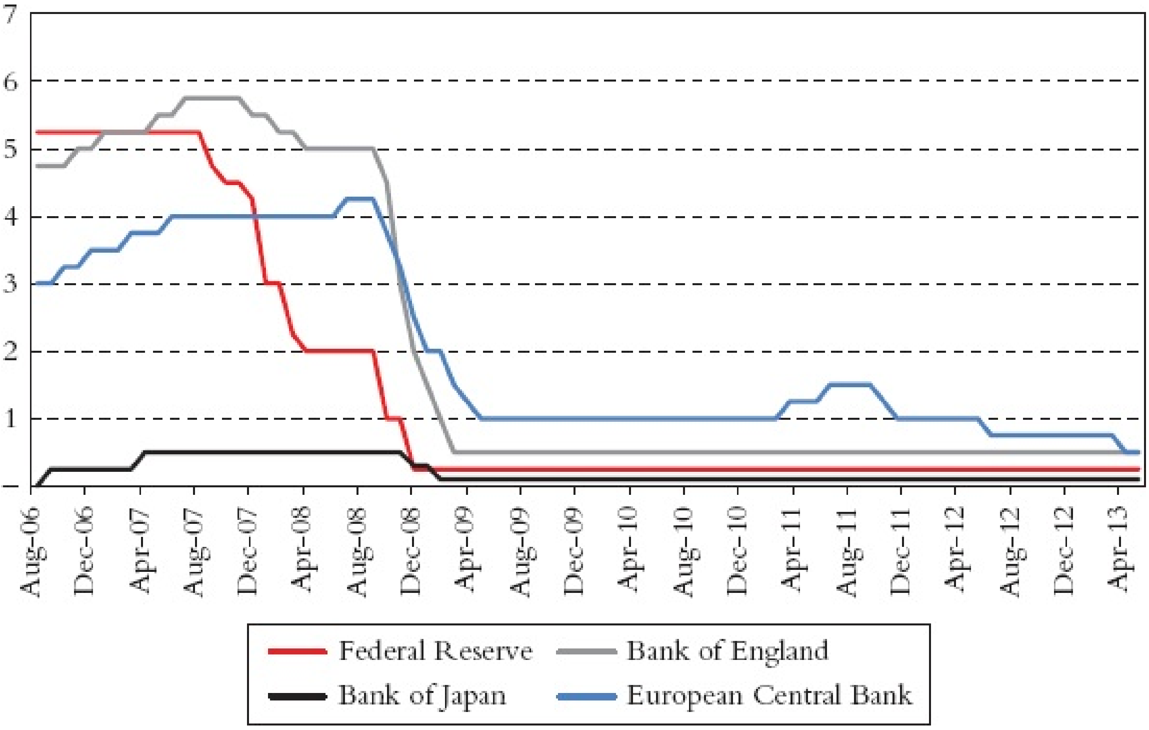
The main way monetary authorities have an impact on the economy is by setting interest rate Interest rates determine the price at which people will borrow and lend. In the old days, when th economy was growing quickly, central banks would raise rates. When the economy was slowin they’d cut rates, which 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 low mortgage, credit card, and car payments. They give businesses access to cheaper capital and hopeful spur profits and thus hiring. This puts more money into the hands of consumers. As an example, U. 30-year mortgage rates recently hit a record low of 3.66 percent, down from 4.5 percent the same tim last year. A number of mortgage holders will refinance, given the much lower rates, increasing the disposable income. That almost makes us want to buy a house or two. Who can complain about a fre lunch?

Cutting rates can only go so far until you hit zero. You can see this in Figure 1.1. Then you’re stuc with a floor. In fact, central banks cut rates during the financial crisis, and then left them near zero an have not raised them since. Leaving rates at or near zero is what central banks refer to as *zero intere rate policy* (ZIRP). Currently, the United States, United Kingdom, Japan, Switzerland, and, arguabl 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 1 ~~percent and then suddenly seeing your borrowing costs fall to a little above zero. No matter how muc~~ debt you had before, paying very little interest every month is a lifesaver. Low borrowing costs mak it easier for struggling businesses to roll over their debt and reduce the real value of debt payments. you reduce the coupon payment on a loan, that is economically the same thing as forgiving part of th principal amount, but this forgiveness is hidden. The low rates effectively allow “zombie” househol and businesses to limp along without going bankrupt.

Near-zero interest rates are, however, terrible for savers, investors, and lenders. Imagine you’re retiree, and you’ve been responsible and saved all your life; you’ve put money in the bank that yo expect to pay you interest every month. You probably bought some bonds as well so you could collec coupons every quarter. In a ZIRP world, you would be getting very little every month from intere and coupon payments. You would live your retirement years with far less income than you ha 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 sti working. The Federal Reserve and central bankers are not particularly worried about savers. Mo 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 Reser and other central banks to take real interest rates below zero. *Nominal interest rates* are the actu interest rate you get. *Real interest rates* are nominal rates minus the inflation rate. If your bank offe you 2 percent on your bank account, the nominal rate is 2 percent. So far, so simple. If inflation is percent, then the real interest rate is 0 (2 − 2 = 0). The interest rate is only just keeping up wi inflation. If inflation is 4 percent, then the interest you are getting on your bank account isn’t eve keeping pace with inflation. Your real interest rate would be negative 2 (2 − 4 = −2). As you can se with rates near zero, as long as inflation is positive, central banks can create negative real rates. Eve 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. Inflatio eats away at your money, and is in effect a tax by the (unelected!) central bankers on your hard-earne money. Leaving money in the bank when real rates are negative guarantees that you will los purchasing power. Negative real rates force savers and investors to seek out riskier and riski investments merely to tread water. It almost guarantees people don’t save and stop spending. In fac Bernanke openly acknowledges that his low interest-rate policy is designed to get savers and investo to take more chances with riskier investments. The fact that this is precisely the wrong thing f 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, b tomorrow’s *expected* interest rate as well. If Bernanke (and his successors) or Mario Draghi of th ECB promise to keep interest rates near zero until kingdom come, investors will generally take the at their word. By promising to keep rates low, central banks have crushed bond yields. The bond yie curve tells the story. The yield curve is the structure of interest rates for bonds for today, tomorrov and the day after tomorrow. By plotting a line for each bond maturity, you can see what expected rate are out into the future: 2 years, 5 years, 10 years, and 30 years. The U.S. government can now issu 10-year debt for less than 2 percent yield. This is below the rate of inflation. It implies the Fed h 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 Micha Woodford, have provided the intellectual underpinnings that justify Code Red policies (the list