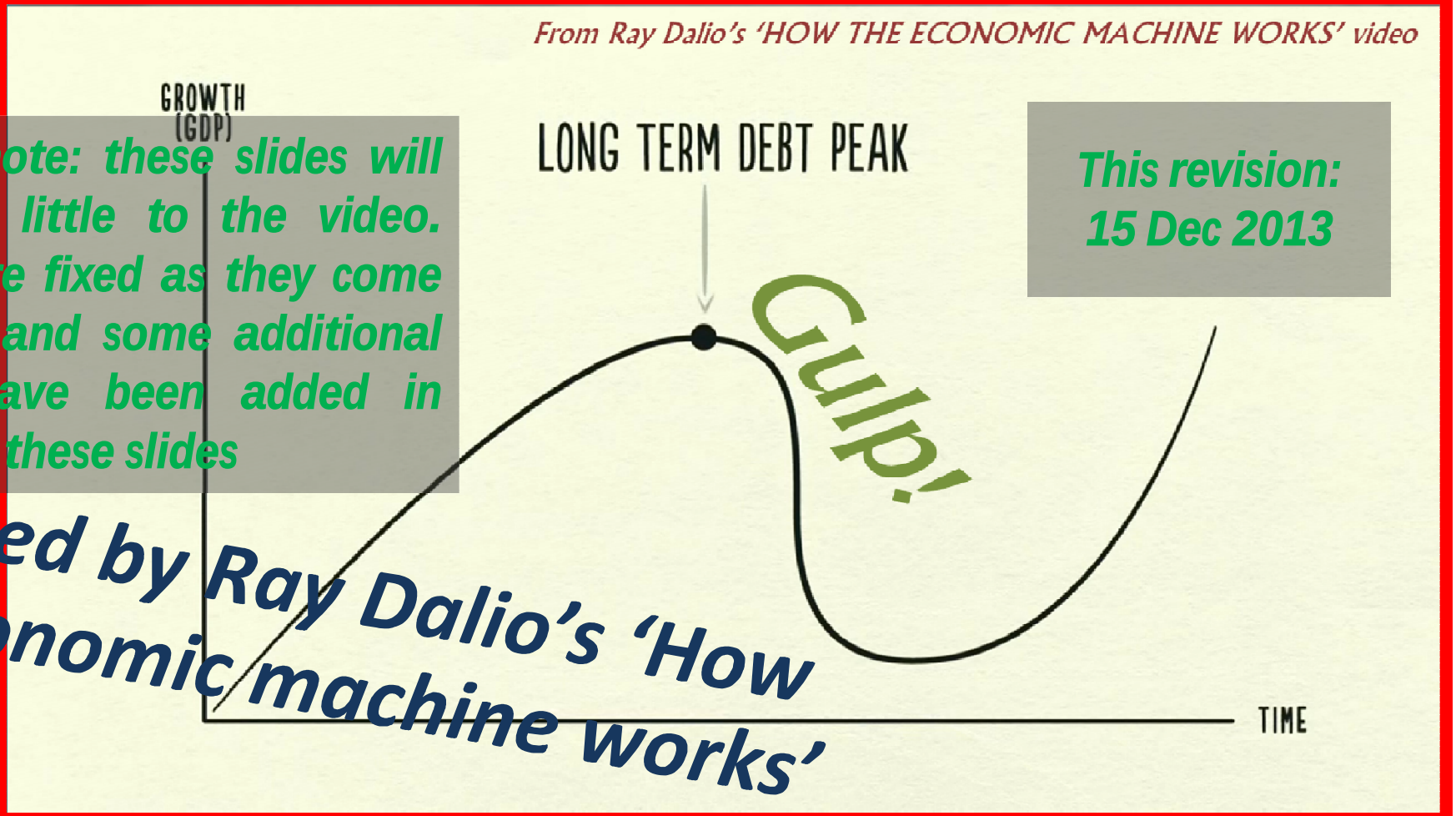
A short comment on the risks & intergenerational inequity due to current economic & monetary policy



Please note: these slides will differ a little to the video. Typos are fixed as they come to light and some additional notes have been added in green to these slides

This revision: 15 Dec 2013

Inspired by Ray Dalio's 'How the economic machine works'

My site: www.barenakedeconomist.com

What is the most clear and present intergenerational issue of our time?

A. Global warming?

At least young people get this and there is action!

B. Economic Debt loads?

If we are one hour to midnight on global warming, we are 5 min past midnight on economic debt loads.

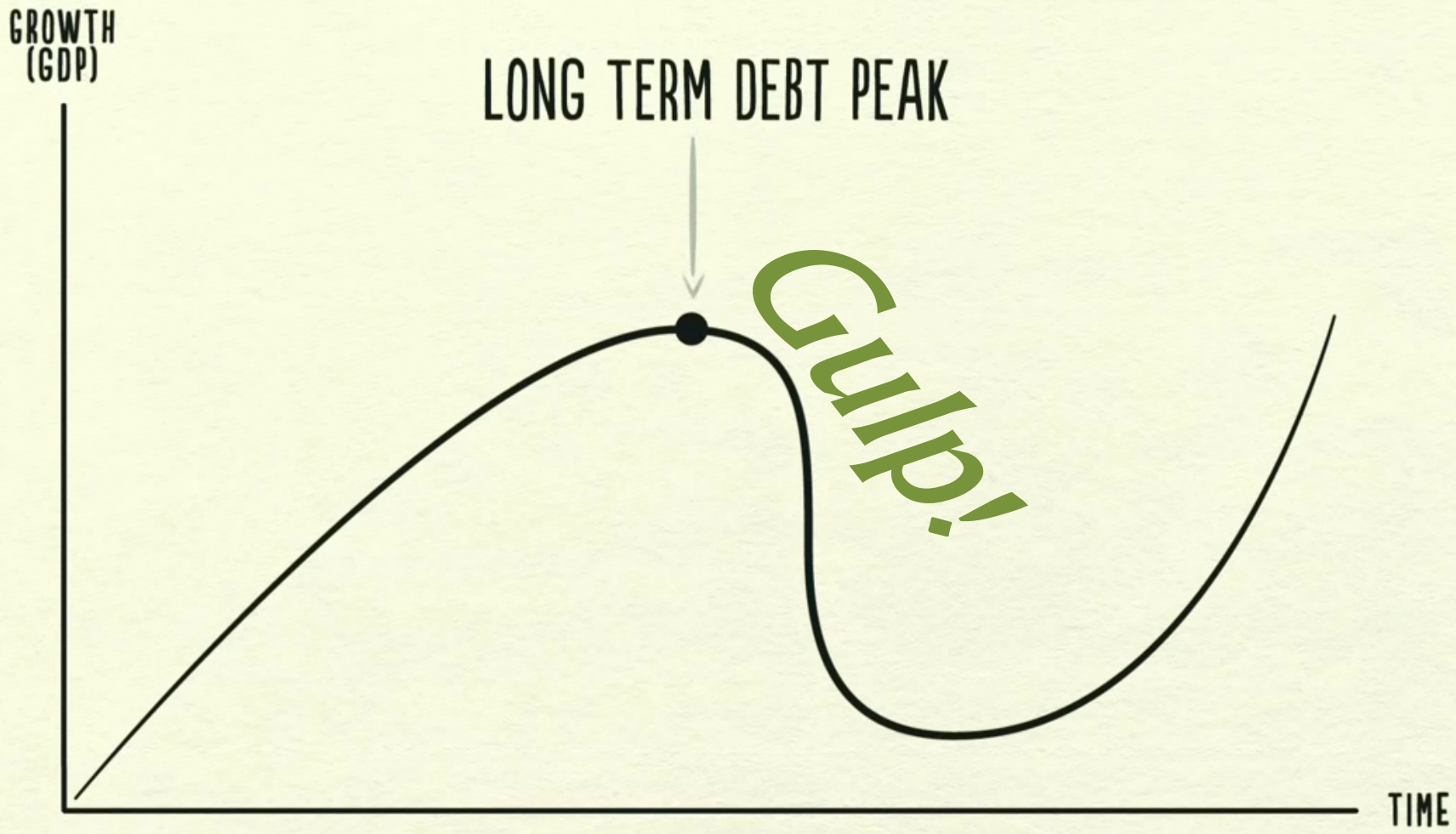
And the 'fix' being tried is more of the same.

If young people don't speak up people will keep shoving the load onto them.

From Ray Dalio's 'HOW THE ECONOMIC MACHINE WORKS' video

One of the best, most successful investors in the world is pointing out that debt levels now are twice what they were before the great depression

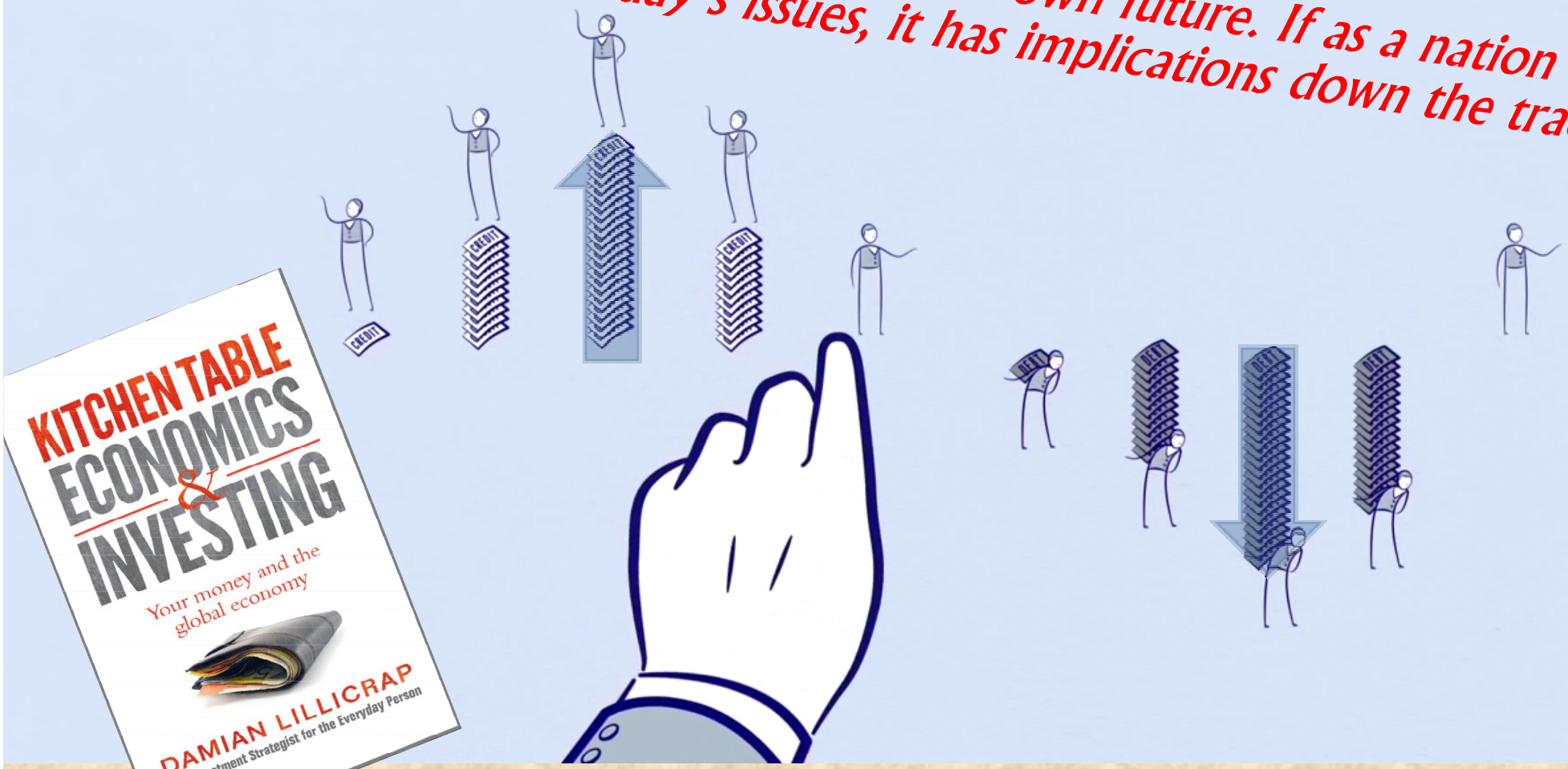
From Ray Dalio's 'HOW THE ECONOMIC MACHINE WORKS' video

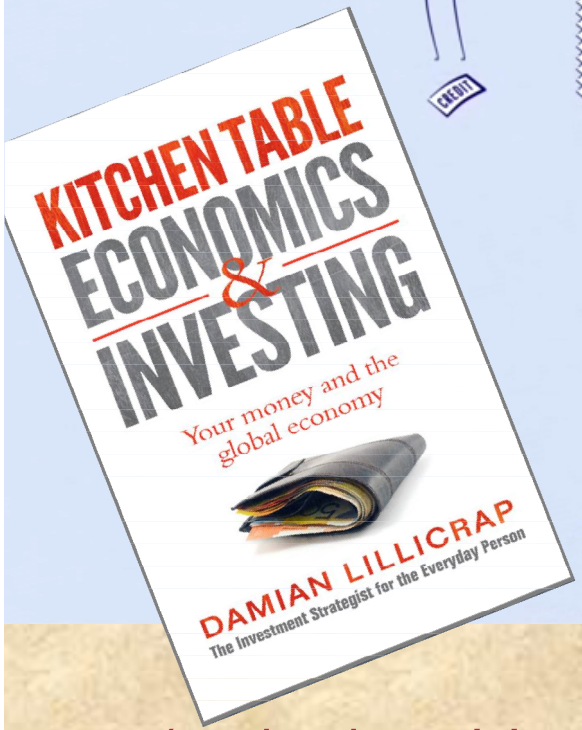


Ray also explains that his considered view is that things typically get ugly from such a point

From Ray Dalio's 'HOW THE ECONOMIC MACHINE WORKS' video

Remember: Debt is borrowing from your own future. If as a nation we borrow to smooth today's issues, it has implications down the track.

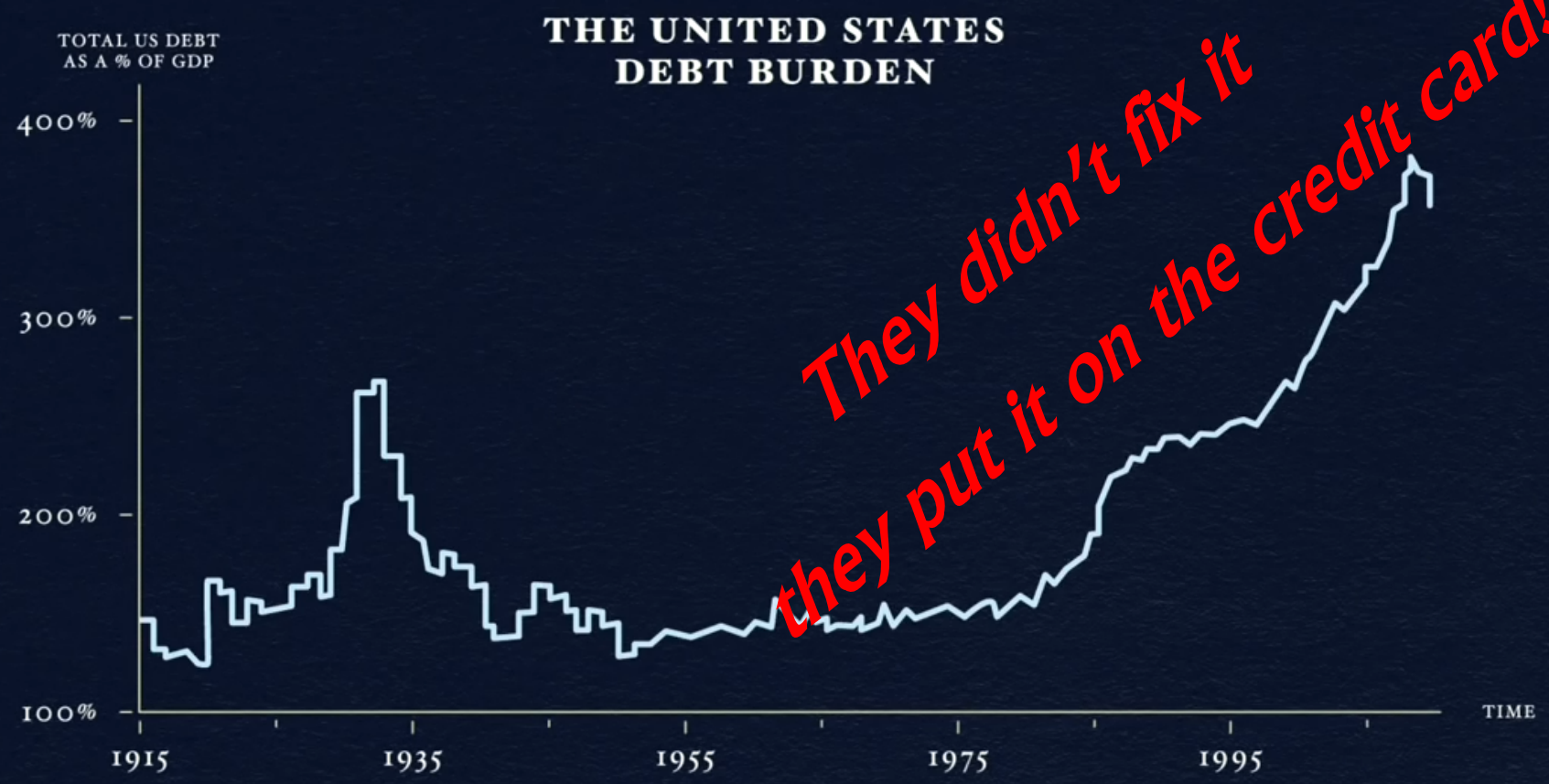




(my book explains why borrowing from the future is generally a better concept to think about than borrower countries and debtor countries)

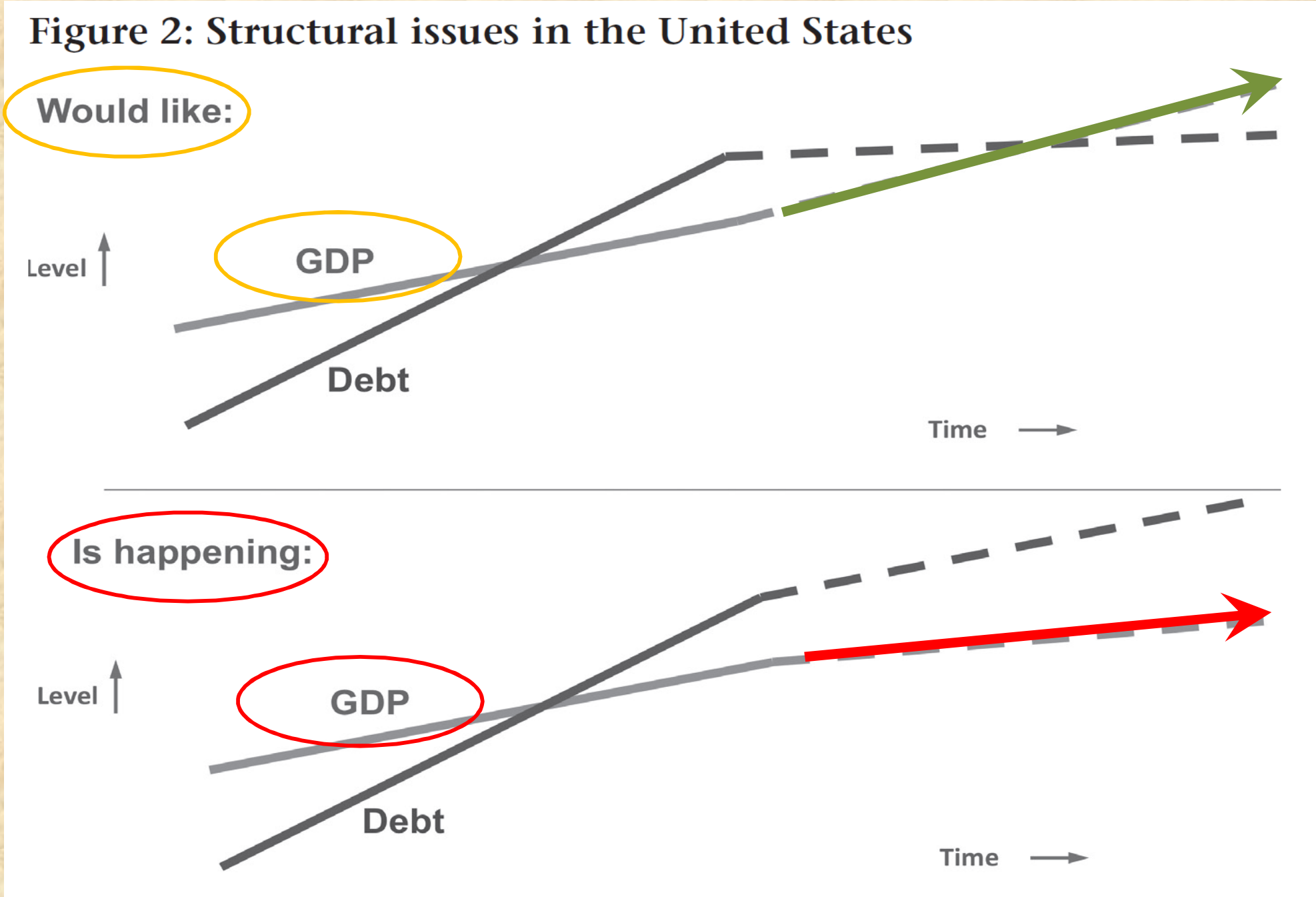
Our experience counts for little
They didn't fix things over the last 30 years

From Ray Dalio's 'HOW THE ECONOMIC MACHINE WORKS' video



Hope is not a strategy!

From my book: Kitchen Table Economics & Investing



Hope is not a strategy!

We appear to be on an unsustainable path.

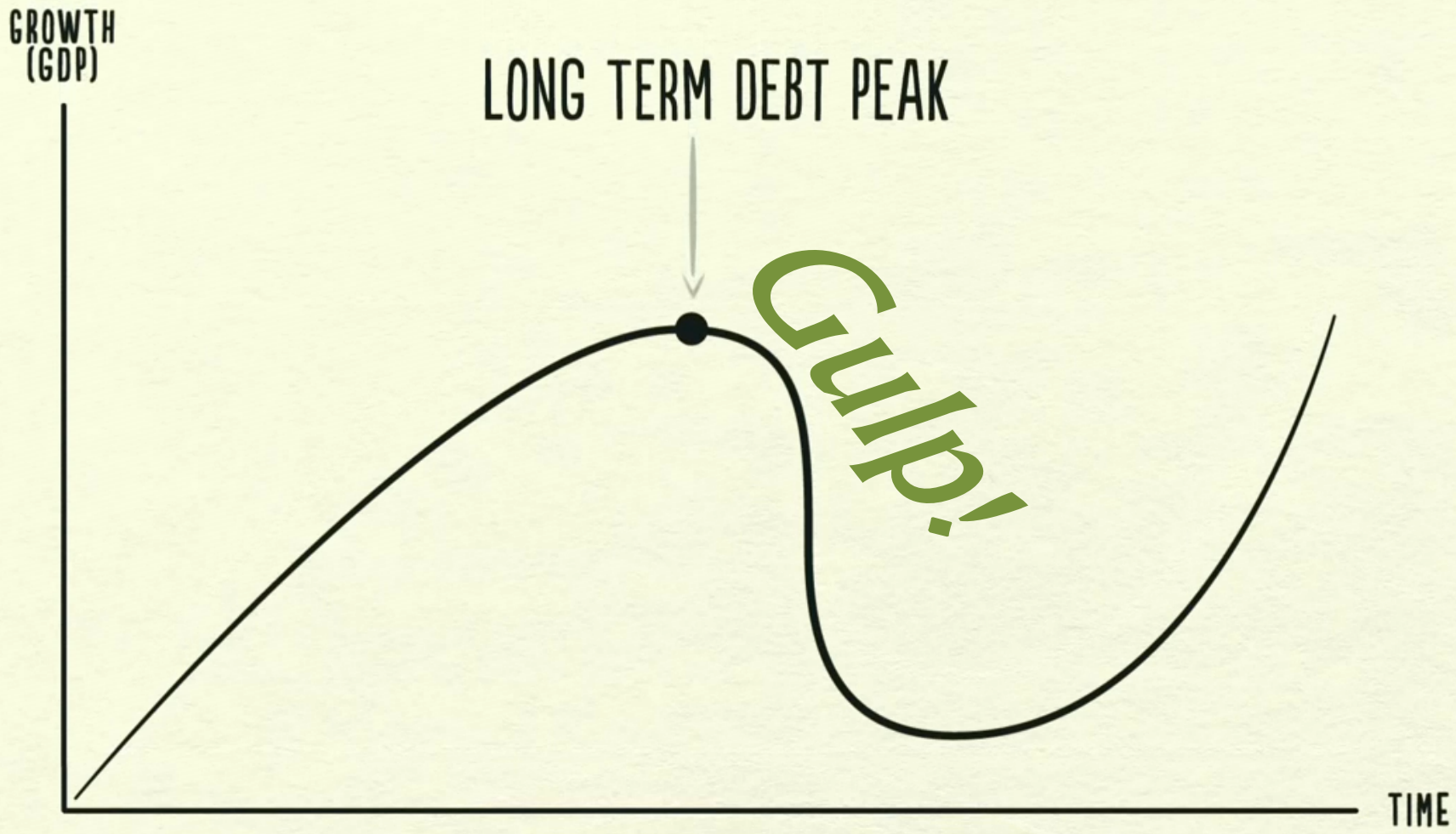
Interest rates can't go much lower, so we can't juice more growth from lower rates.

We could try other things like extreme money printing, or negative interest rates -

but do we really want to experiment with the economy – and frankly these probably won't work long term.

The incentive for authorities (in the absence of your voice), is to boost short term and hope long term isn't a problem.

From Ray Dalio's 'HOW THE ECONOMIC MACHINE WORKS' video



Ray also explains that his considered view is that things typically get ugly from such a point

Ray's three rules

- First, ***don't have debt rise faster than income*** because your debt burdens will eventually crush you.
- Second, ***don't have income rise faster than productivity*** because you'll eventually become uncompetitive.
- Third, ***do all that you can to raise your productivity*** because in the long run, that's what matters most.

1. **Great for not getting us into trouble.**
2. **Theoretical – doesn't change incentives**
3. **Doesn't get us down from our high ledge**

Ray's mechanism for his 'beautiful deleveraging'

Deflationary:

To get us down from the ledge

1. Cut Spending - sometimes referred to as Austerity
2. Reduce debt - for example writing off debt
3. Redistribute wealth - from the haves to the have nots

Inflationary

4. Print Money – from thin air

First point: Reducing debt and inflation are also forms of redistributing wealth.

I go into more detail in my YouTube critique of Ray's video:

In short:

1. Printing money is mainly interest rate policy, encouraging more debt.
2. It favours the haves over the have nots
3. Most of these are redistributions: democracies have ways of doing redistributions – no back door measures please.

My site: www.barenakedeconomist.com

Borrowing and not paying back means we have been living beyond our means.

If we have been living beyond our means the natural level of GDP is lower than what we have become accustomed to

i.e. the natural level of spending (the lifestyle we have become accustomed to) needs to be a little lower to be sustainable.

Something needs to change. This isn't a rabid political view, this is just maths.

Either we get a different framework or we can hope for growth (and get deeper into a hole and eventually have to redistribute if it doesn't come).

If we change things you can either be aware and be part of the process or you will likely wear the cost.

Lower rates allows debtors to service more debt!

Even if too much was lent??

From Ray Dalio's 'HOW THE ECONOMIC MACHINE WORKS' video

A person who received more credit than they should have!

A person who lent more than they should have!

He would experience losses if rates hadn't moved lower.

So lower rates aren't all positive:

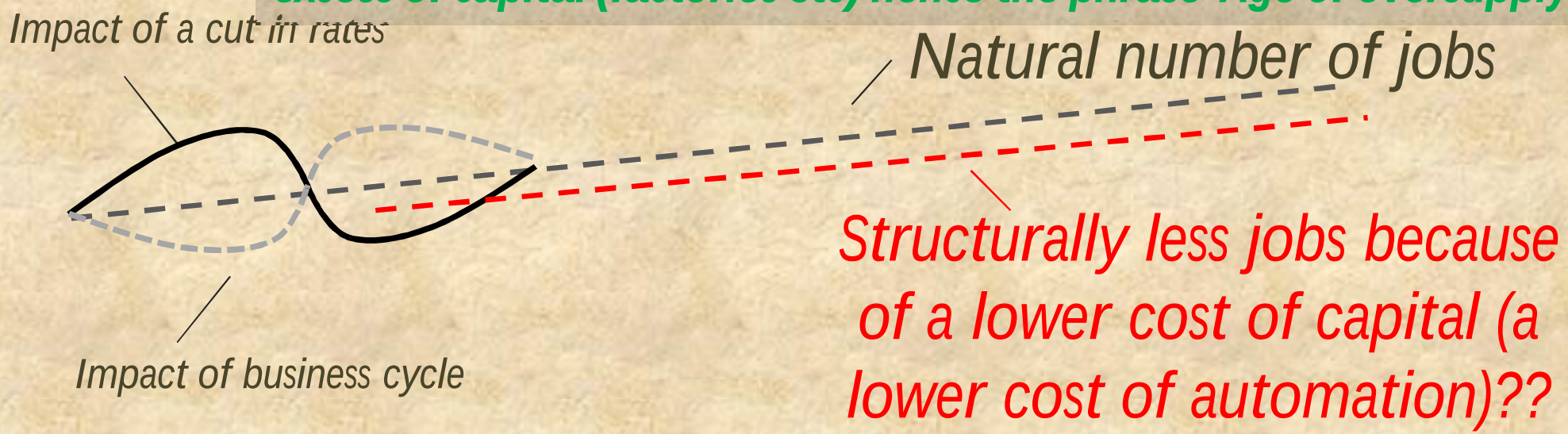
- This encourages bad lending discipline – 'moral hazard'
- Savers and those trying to live off their savings get lower rates of returns.
- Change playing field for countries trying to import to a country.
- Low rates also impact asset prices:
    - Harder for young people to buy houses
    - Asset prices become more volatile – increased risk.

Does lower rates (including QE) = less jobs and less wage inflation in the longer term?

Cheaper to borrow to buy machines to replace people??

Is this why wage growth has been so low??

A low cost of capital has promoted not just cheap capital but an excess of capital (factories etc) hence the phrase 'Age of oversupply'



Higher rates should mirror lower rates, over a cycle – to be fair!

But 30 years of falling rates!!

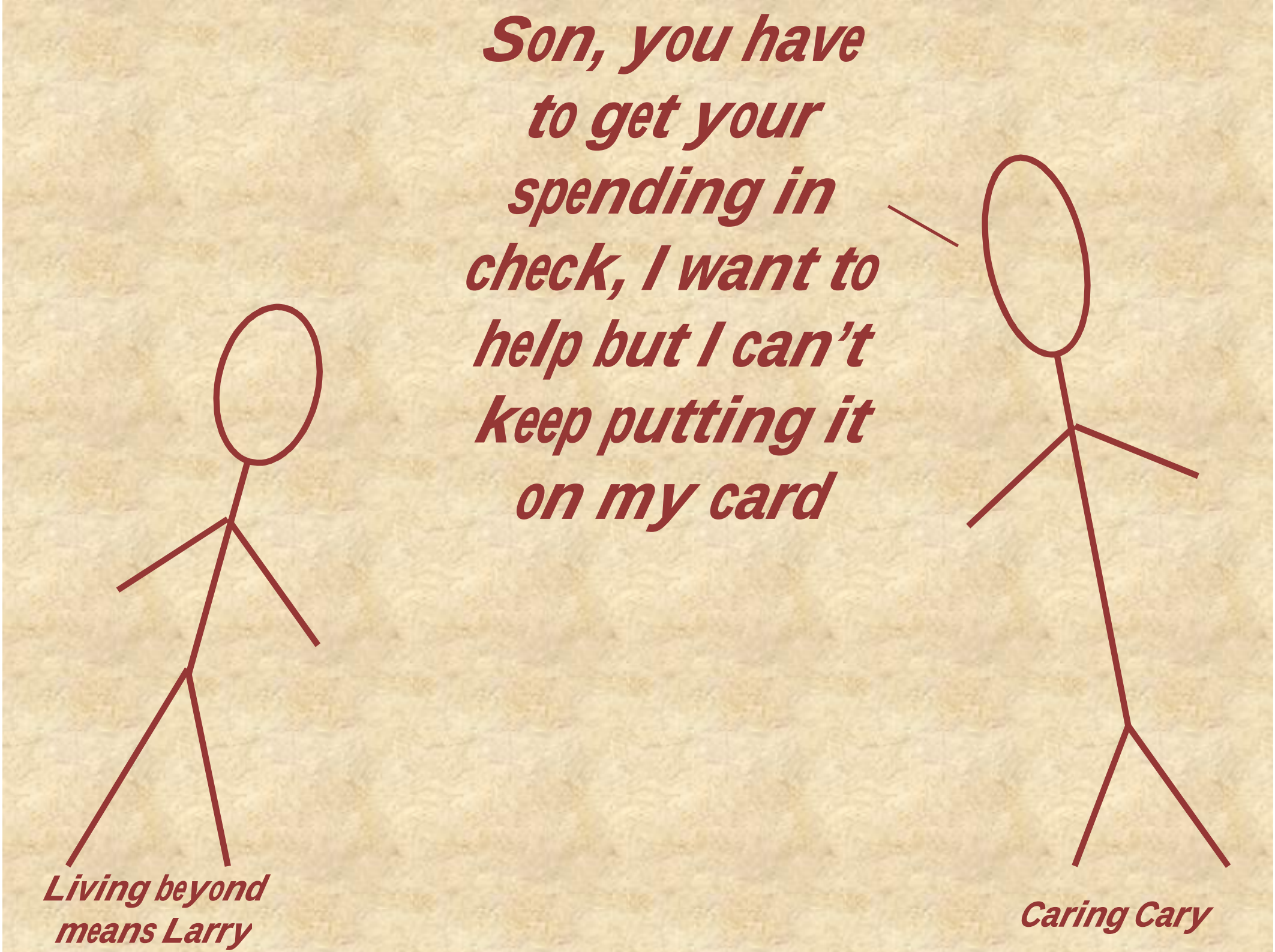
From my book: Kitchen Table Economics & Investing

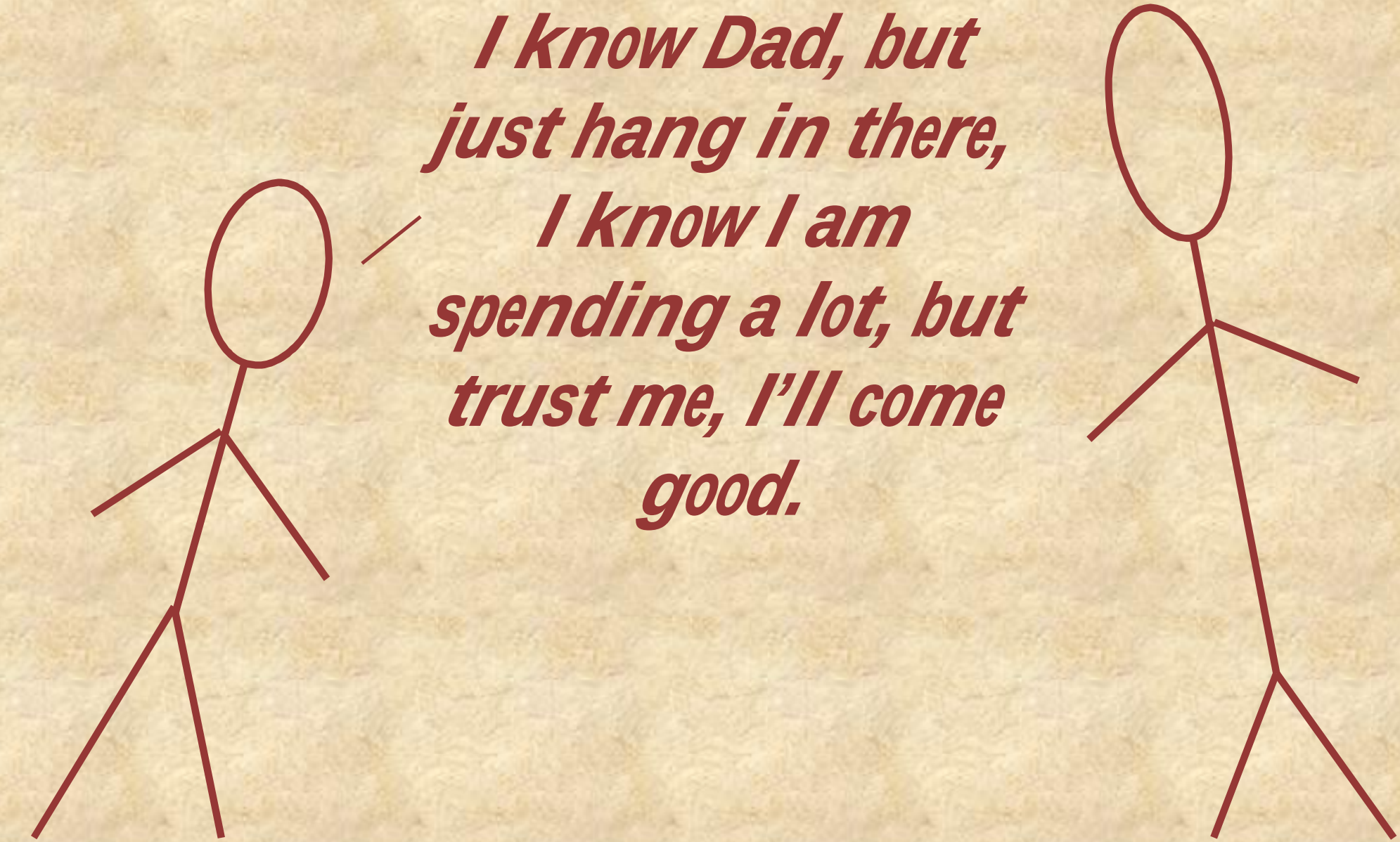
So monetary policy is and should be a cyclical tool, to make its impacts fair.

We have been winding rates lower, on the assumption that stronger growth kicks in.

Are we being responsible in our assumptions.

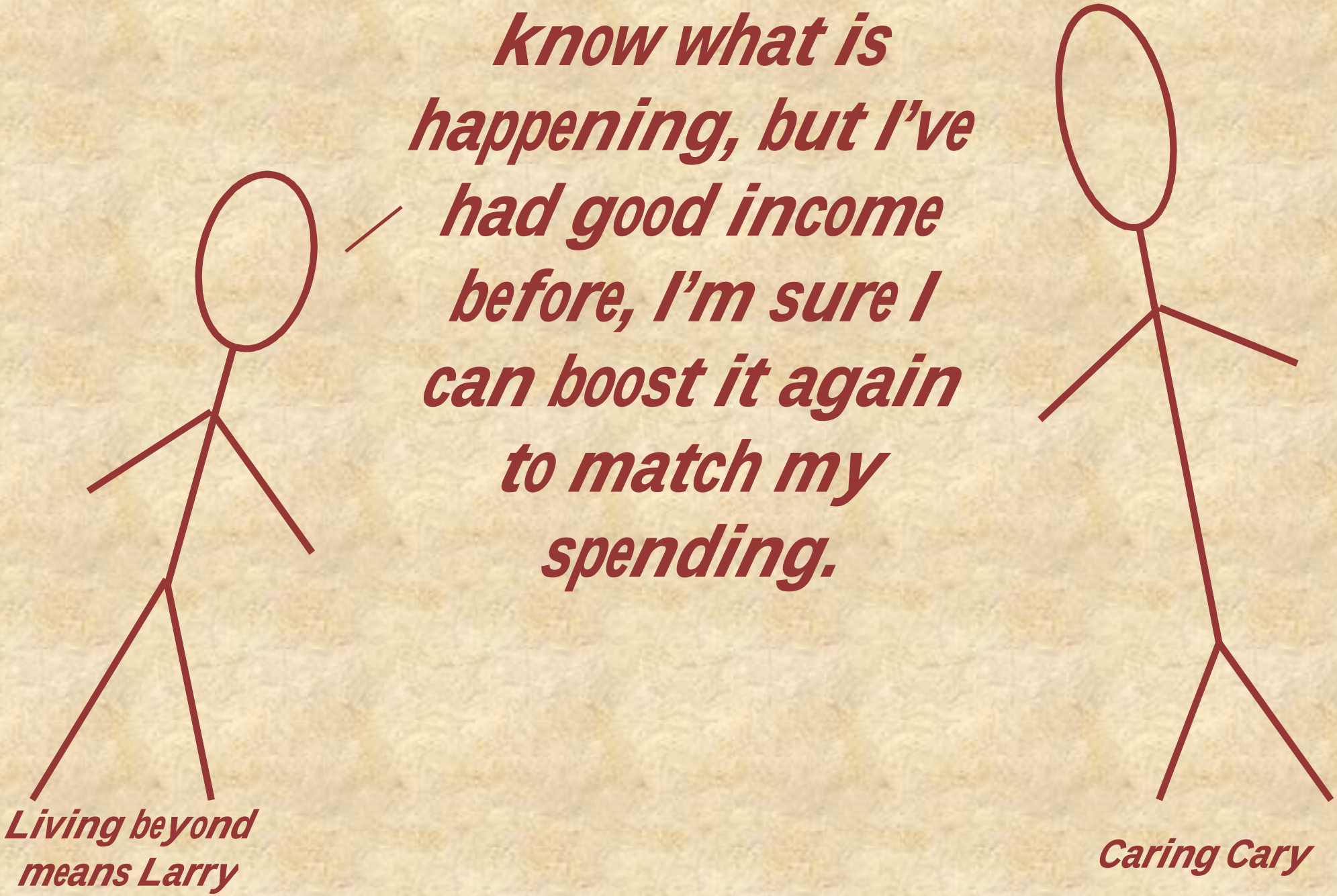
What if the economy was a 20 year old son??

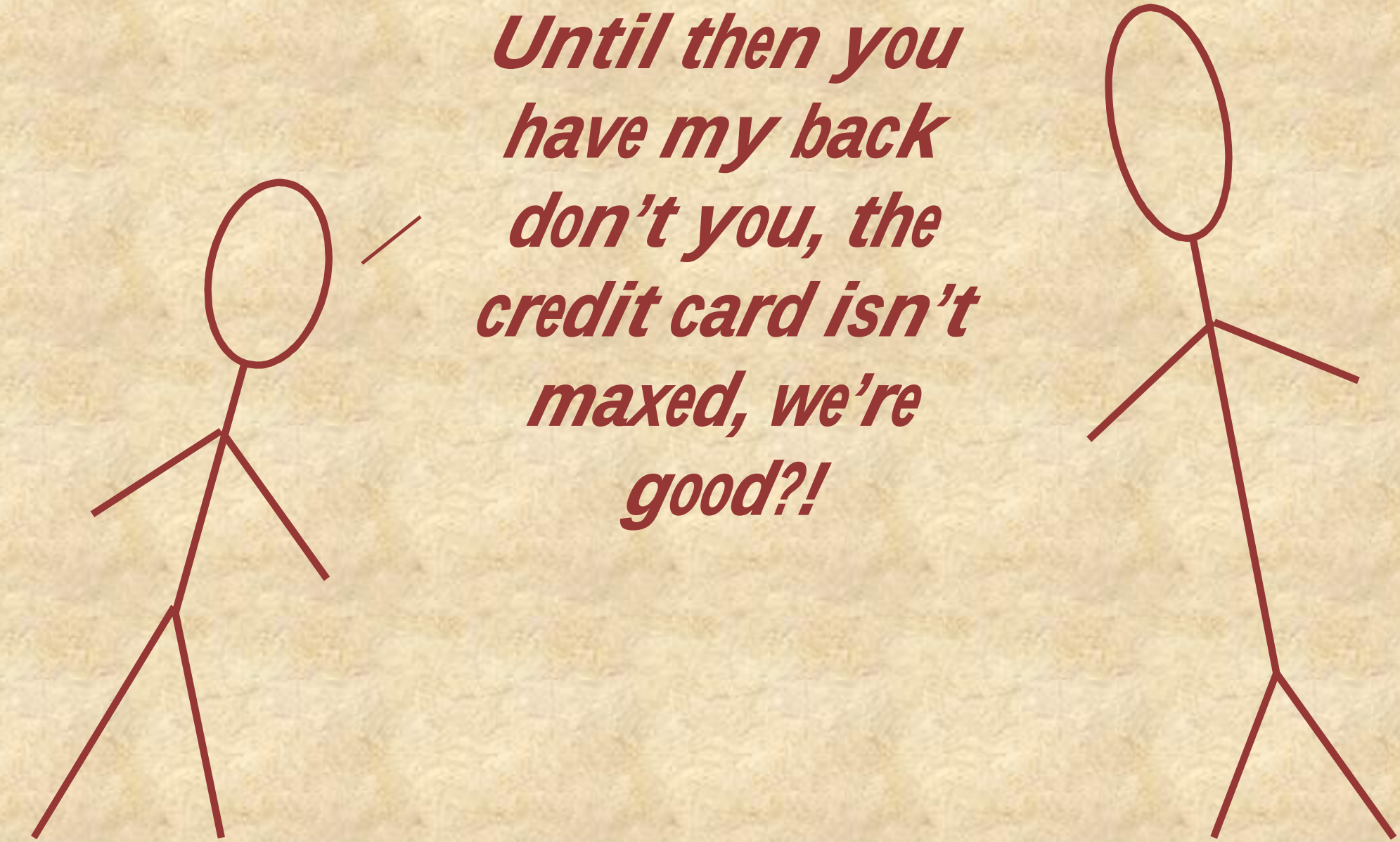

Son, you have to get your spending in check, I want to help but I can't keep putting it on my card
Living beyond means Larry
Caring Cary



Living beyond means Larry

Caring Cary


I don't exactly know what is happening, but I've had good income before, I'm sure I can boost it again to match my spending.
Living beyond means Larry
Caring Cary



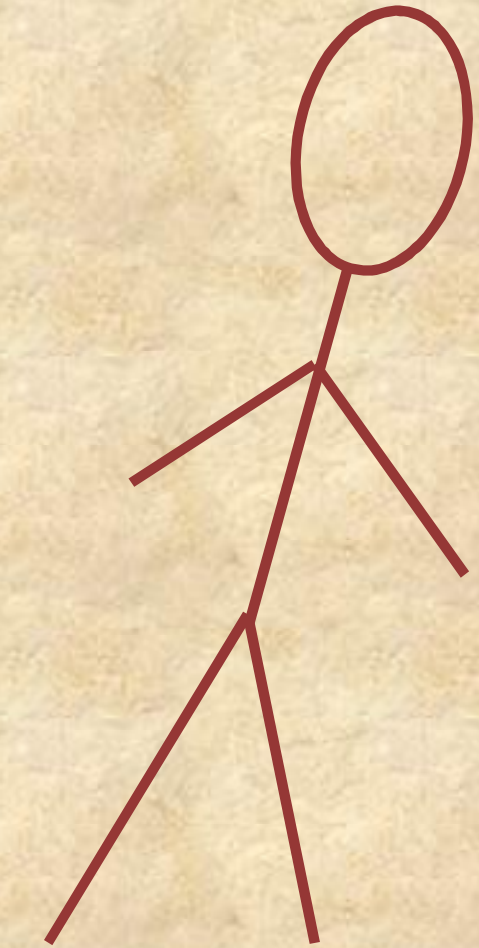
Living beyond means Larry

Caring Cary

What's a good Dad to do:

a) Keep lending (moral hazard)?

b) Cut back his lending, encouraging his son to spend within his current means?



Living beyond means Larry

Caring Cary

Important concept!!

GDP Growth ≠ Healthy Economy

*Using GDP as a measure of financial health is like looking at **Living-beyond-his-means-Larry's** spending as a measure of his financial health.*

*If **Larry** is **borrowing** to support his lifestyle his **spending** is a poor measure of health.*

These intergenerational issues are global

Here's some themes I hear regularly from professional investors on some of the biggest economies in the world.

On US money printing:
The US is engaged in the biggest economic science experiment of all time

On the Eurozone:
It can't work in its current form but it is hard to see how it makes the changes it needs to make.

On the Japan:
They have twice as much debt to GDP as the US, growth problems and demographic problems

And on China

From the locals

The Chinese economy is like the movie Speed.

You know about the bus that couldn't slow down without blowing up.

It can't go on forever like this but can't slow down.

Borrowing (stealing??) from the future

US, Japan, Part of Europe: Excess debt

China: Overbuilding - doing world today that would otherwise be done in the future – typically funded by debt

Scorecard on addressing issues:

US – some recognition, some denial

Japan – some recognition, some efforts but very tough situation now

China – large imbalances but significant efforts to try to change

Eurozone – On average might be in the best shape, but the structure of the Eurozone makes issues hard to resolve.

Common theme: efforts aimed at slowing, not stopping using the credit card.

A Global Village!

With all adults in the village spending beyond their means .

And putting on their kids credit cards.

We are hoping for growth but wouldn’t it be prudent to have another plan.

QE primarily acts via interest rates, lower rates encouraging less saving, more borrowing and spending.

This isn't fixing the problem it is supporting it.

Support (preventing issues) is ok provided a fix is on the way, but central banks can't provide the fix.

The fix either needs to comes from productivity (the hope), or from governments restructuring things.

People tend to act on incentives

The incentive for authorities and central banks:

- ***keep doing the same things***
- ***unless we demand they do things differently.***

The incentive for us:

- ***to act is to restore equity,***
- ***and to restore certainty,***
- ***because if our hope of growth don't eventuate***
- ***we are further in the hole with bigger problems.***

Some standard recipes from authorities:

1. *Keep pushing for growth, even if it is pulling growth from the future.*
2. *If things get bad, blame others, including other countries, start wars.*

Say no to both of these!

My belief is that we should take out insurance, set-up a framework that works if growth doesn't come.

All may be okay, growth may come.

I hope & pray it does!

But if it doesn't we are deeper in the hole!

The longer we delay the worse the possible outcomes

(a bigger bill for the next generation)!

My framework

I believe:

1.

That we should set things up with stabilises such that budgets automatically come back into balance, and debts brought under control

For example, taxes that automatically increase (say 1%) each year until debts are brought back, or clearly on the way to being brought back to a predefined limit – to say of 60% of GDP.

I believe: 2.

That central banks need processes to ensure that interest rates average more natural (fair for all) levels over time.

It is somewhat of a reversion to previous approaches, but perhaps they should aim to constrain the ratio of 'total credit to GDP' in the economy.

This would prevent excessive debt burdens (in line with Ray's rules) which then require ever lower interest rates.

If interest rates don't get back to normal, we don't have the ability to cut interest rates if we have negative shocks. This makes the system very risky!

I believe:

3.

That a right of a modern society is that the government provides a climate for jobs or supports the unemployed

If we don't, increased interest rates, and taxes necessary for a sustainable system (my first two points), could send the economy into a depression like spiral as described by Ray.

This means more sharing between haves and have nots.

I would argue pure free market conditions have favoured the cost of capital over labour for decades, so this is just capping free market outcomes not discarding them.

(btw there is more on this in the talk to camera video I am making 'Fine Tuning the Economic Machine')

I also believe:

Such a framework gets us out of the current situation.

That if growth was destined to come that it would come anyway under this framework

Low interest rates (money printing, QE) etc, might help the pain of transition under such a framework, but without such a framework this is anaesthetic without the operation.

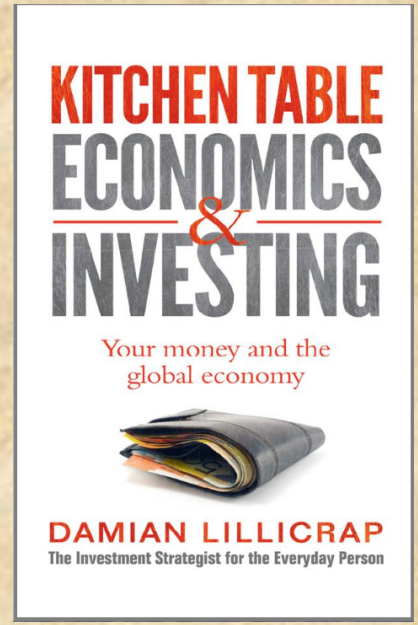
What do you value?

Are you worried that we are relying to much on the hope for growth?

Do you think we should at least be considering another path??

If so share the link to this video!

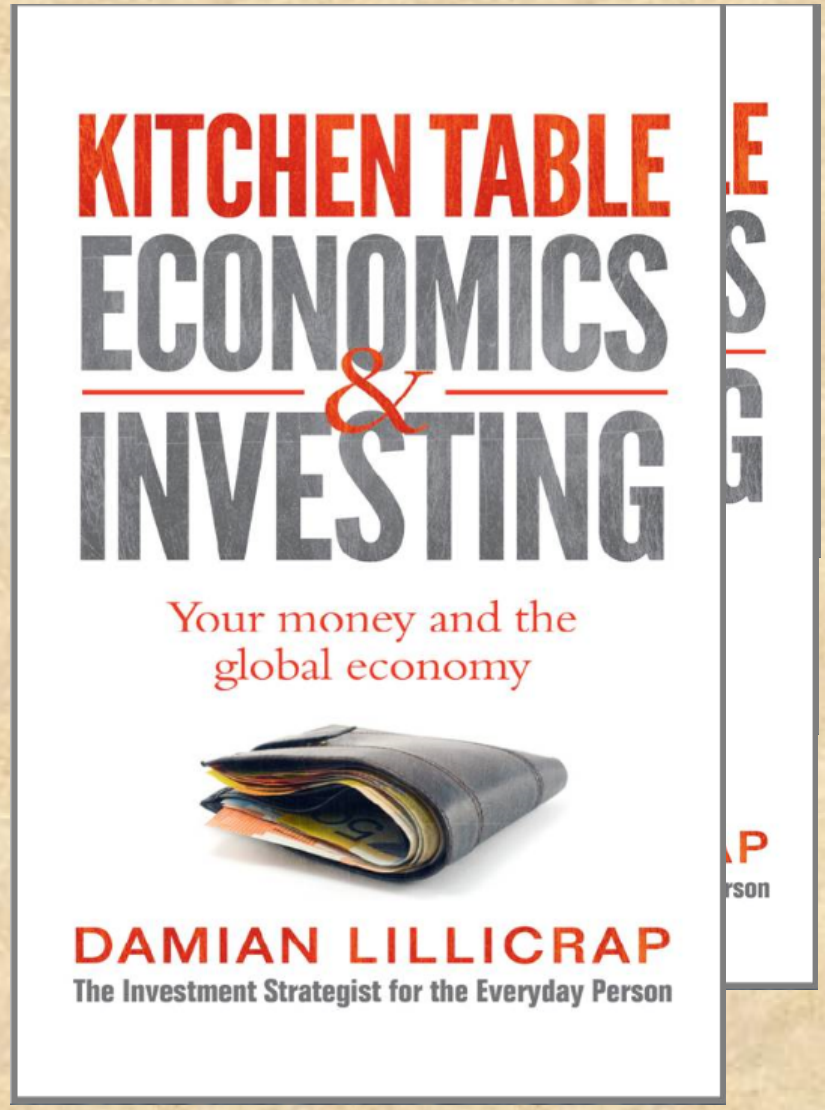
Do you want to know more? If so download and read my book, or tap any source, but please do understand the risks we face.



Particularly if you are young: 20, 30, 40, 50...
Or if you care about the next generation!

This is not just about the US, think about the next biggest economies, there intergenerational issues (debt and over building) in China, Japan, Europe..

Thanks again to Ray Dalio for his video trying to promote an understanding of the economy and where things are at.



Also check out my talk to camera video 'Fine Tuning the Economic Machine', or my longer critique of Ray's video.

Damian Lillicrap B.E (Chem), Grad. Dip of Atg, CPA

www.barenakedeconomist.com

By the way, the site explains that I am not an economist (nude one degree!), although I have been in finance for nearly 20 years.