The Consequences of Serial Quantitative Easing, QE3, 4, 5…

Painkillers are addictive. People follow the path of least resistance. Principles are always compromised. The prudent are the few. And often made to pay.

When unconventional policy was deployed to rescue a global financial system in crisis in 2008, we went down a slippery slope from which we have not recovered.

This time is different in that we have financial tools at our disposal that we had not in previous financial crises. This time is still the same in that we are human and we will repeat ourselves, and there are certain immutable laws of economics.

The most remarkable thing about policy response in 2008 was its intention to avoid any and all pain, its aim to bail out every investor, institution, company and country. Was not the idea of capitalism that the free market punishes in equal measure that it rewards? Has the culture of entitlement pervaded the human psyche to the extent that we expect no one and never to lose? Have we uploaded the 'cheat codes' (to use PC game jargon) so that all may use them? It is well known that players who use 'cheat codes' simply cannot survive when these codes are withdrawn. And what if everyone uses 'cheat codes'? If one person uses them, then there is an incentive for everyone to use them. The result is a simultaneously chaotic and boring game.

One cannot help but feel that capitalism has failed. And that its death knell was sounded by the death of communism, its great nemesis. Without communism as a foil, capitalism evolved in a cancerous and uncontrolled fashion, resulting in the perverse form that rules us today.

One cannot help but suspect that a new system will emerge to challenge capitalism as an economic philosophy. But economic philosophies are born out of necessity. It is hard to see how the world will wean itself off our morphine induced dream.

Debt is being created even as it is being repaid, a self evident observation were it not for that the crisis was born in excessive debt, and the solution to its precipitation seems to be the creation of more debt. As debt is repaid, nominal output must fall, all other things being held constant. This accounts for the economic weakness observed across the world. Central banks only available response to stoking economic growth has been to apply more debt in the hope of igniting self sustaining growth. So far it has obtained limited success.

It is certainly possible that our debt creation has outpaced equilibrium growth rates ex debt to the extent that the mean reversion cannot be adequately compensated for by conventional policy, or unconventional policy for that matter. If so, then our prospects are to wait for time and the natural cycle of recovery to stabilize output growth, once it has reached its negative extremities, and have it mean revert to positive territory. Given the extent of the debt fueled overshoot, this could take a long time.

In the meantime central banks have decided to act. Their efforts are aimed at staving off any kind of default or slowdown. They intend that the market must punish no one. What they may achieve, is an event or phenomenon that punishes everyone. Without the guiding torch of principle, capitalism has been distorted to a form of socialism.

Every central bank which can is monetizing its sovereign’s debt, or expanding its balance sheet, or trying to debase its own currency. Mutual and universal success must be evidenced by invariance of relative prices. Failure is likely to produce discontinuous price actions, which are not addressed by current option pricing models.

In theory, no country need default in the debt denominated in its own currency. In theory, a government cannot be obliged to pay back its debt. It can be compelled to do so by martial force (Britain has an excellent track record in this regard. Call it foreclosure with extreme prejudice.)

The l
argest creditors of national debt are the respective central banks. This presents an interesting discussion as a country drifts towards insolvency. Certainly it is the intention of each central bank to engineer inflation at least to the extent it

erodes the value of the stock of debt. In the case of a reorganization, however, it is not clear what the objectives of the central bank will be as regards the claim it holds. This has implications for other claim holders who will almost surely be in the minority. Will their interests be aligned? For almost all investors, this question is academic and far off. But as this point approaches, it could crowd out private demand for government bonds.

In the meantime, controlled and moderately high inflation appears to be the plan for debt management. The risk is that the inflation becomes less controlled than planned. With a money base as large as has been created by the central banks, any pick up in the velocity of money or the money multiplier, is quickly multiplied through this money base resulting in the potential for some very interesting inflation levels.