

I want to revisit Chernobyl. Disclaimer... I only know what I saw in the TV series with the same name and secondly I only use it as an analogy to what is happening in the global financial "plumbing" system.

Chernobyl was a relatively old reactor which worked perfectly in all but extremely rare events. The appearance of robustness led to systemic complacency that eventually led to disaster when the reactor blew up.

The most important variable in a reactor seems to be its temperature. If it gets too hot, the uranium rods lift out of the reactor stopping the atomic reaction, too cool and the rods go in further thus enhancing the nuclear reaction creating heat which in turn generates power.

The temperature of the reactor is measured by a sensor which transmits the data to the control room.

Analogous to Chernobyl, in finance the central banks are the control room, interest rates are the temperature of the financial system (reactor) and the GDP is the power output by the reactor.

In the old financial reactor, government and investors alike always clamour for more power (money creation) which in turn drives GDP. Central banks, being independent, could oblige but in the process of generation would create more heat in the financial system and interest rates (temperature gauge) would rise thus creating an automatic reduction in the demand for power thus causing the financial system to cool down automatically. If central banks felt the GDP was running too hot and drawing too much power, they could raise interest rates causing a drop in demand for power as well. It was self-protecting.

Today the central banks have spent the last 30 years systematically dismantling the temperature warning system by dragging interest rates to zero. They are saying that the reactor can produce infinite power because they are willing to do "whatever it takes" to generate whatever power (GDP) is needed. The core is starting to run very hot... how hot? We don't know because we don't have a temperature gauge!

This works because to look at Chernobyl at any time until 10 seconds before it blew up it looked stable. The financial system is seemingly stable and will look that way right up until the day it doesn't.

Like Chernobyl are we mistaking calm for safe? Which incidentally is similar to the premise of finance using volatility as the primary risk measure.

In September 2008 we came extremely close to a systemic meltdown in the financial system. One would have thought we would have shed our complacency and pulled ourselves back from the brink. But what doesn't kill you makes you stronger? Thus emboldened, the central bank control room simply created MUCH MORE "power" i.e. money to help the economy.

The central bank complacency on the face of it is simply too staggering to comprehend. It is no wonder that investors are rushing to buy "invisible art" and 16 digit numbers as an attempt to get off this "power" grid.

But wait a second. The analogy doesn't hold I am wrong! Central banks CAN create infinite power and the reactor will never blow up?

It can run infinitely hot. It can by definition because the potential supply of money is infinite.

This was the skip of faith taken in 1987, 1994, the jump taken in 1997/98 and 2000, the lunge taken in 2008 and the Rubicon leap taken in 2020.

My critical analysis assumption error is that no central bank would ever want to risk running the reactor hot never mind infinitely hot. It was an assumption written into every economics book in my day.

Ever since central banks and governments cosied up the pros of this idea become clearer.

Inflation of money is a hidden tax.

It helps devalue debt owed by government.

Governments have broken the link between the responsibility and accountability of their projects. Huge deficits without regard for the financing is the result.

Governments cannot afford high interest rates.

It has worked often in the past. Probably because there were big deflation drivers counteracting the inflation drivers. i.e. the internet disintermediation, developing nation labour and deregulation.

It becomes someone else's problem down the road.

It generates GDP albeit at a slower rate thus promoting employment.

Any inflation it creates will be transitory.

It begs the question then ... why, pre 1987, was central bank independence, limits to money supply growth and price stability assumed to be so important as to be inviolate?

It can only be that history has shown that price stability is in society's long term interest. Extreme inflation or deflation is undesirable.

Why then risk extreme inflation? They either fear extreme deflation more or are underestimating the likelihood benign inflation will morph into hyper-inflation (or both).

I think it boils down to one critical assumption. ... money supply growth leads to higher GDP which in turn leads to employment. We can always grow out of the problem. ...

Over the last few years this has been true to a lesser and lesser extent. More money being required to produce less and less GDP and employment.

But here's a hypothesis gleaned from developing nations' experiences.

What if money supply creation/employment assumption flips and after a certain point more money creation leads to LESS employment?

What if money supply creation after a certain point leads to real world DEFLATION and financial world INFLATION.

And what if the authorities do not recognise this and simply do what the Chernobyl control room did and carry on with more of the same thing until the inevitable happens?

Certainly recent experiences in hyperinflation in Venezuela and Zimbabwe seem to bear this out as, after a certain point, inflation went exponential and the real economy simultaneously imploded in both cases leading to massive unemployment.

If this happens on a global scale we will have high inflation coexisting with high unemployment at a level that we cannot even conceive of yet.

In addition, there could be the worst kind of inflation where what you want in the future goes up in price and what you have saved for the future goes down in price.

I don't lay claim to be any sort of economist or clear macro thinker, I am just trying to boil down to the assumptions that underlie our economic and financial framework and ask...

What if we are wrong in our core assumptions?

I suspect whilst we are assuming the Newton laws of physics apply we are about to get a quantum physics lesson!

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