TILL DEBT US DO PART
Deglobalisation, debt and the decisions we make – a millennial perspective

Dr Bob Swarup
AUTHOR, Money Mania
(Bloomsbury Press, 2014)
DECONSTRUCTING THE GRUFFALO
OF MEN, MONEY AND COMPLEXITY

PART 1
Why bother?

The only point of economic forecasting is to make astrology look respectable.

J.K. Galbraith

History may not repeat, but it does rhyme.

Mark Twain

Logic: The art of thinking and reasoning in strict accordance with the limitations and incapacities of the human misunderstanding.

Ambrose Bierce
A perspective on Europe

Source: Swarup & Perkins
Another perspective...

Source: Bob Swarup & Dario Perkins, *Till Debt Do Us Part*, Lombard Street Research, Camdor Global
An uncertain world

• An environment dominated by uncertainty
• Questions abound:
  • What does a Trump presidency look like?
  • Where does Brexit take the UK?
  • Can Europe survive?
  • Will Abenomics rescue Japan?
  • What does a Chinese debt hangover look like?
  • How do we exit quantitative easing?
  • How big can a central bank or sovereign balance sheet get?
  • The challenge of regulation
  • Social tensions and inequality
It’s all rather complicated…

Source: Swarup & Eich, 2008
Or is it?
The world is a complex place but our brains are only about three pounds
It’s the same old story

• None of this is new or unique
• One example:
  • 377BC: 13 Greek city states default on their loans to the Temple of Apollo
  • 2012: The modern nation of Greece defaults on its sovereign debt
• Another example:
  • 33AD: Rome suffers a real estate bust. The Emperor Tiberius sets up a bad bank that floods the system with money and takes parchment back by property as collateral.
  • 2008 to today: The US suffers a series of subprime defaults and contagion spreads through the economy. The Fed pumps in ‘unprecedented’ amounts of stimulus and begins to large amounts of structured credit as collateral.
A pinch of bounded rationality

Would you believe me if I told you A and B are the same colour?

We are all intendedly rational

Source: Edward H Adelson
A little short-termism...

- The Stanford Marshmallow Experiment
- The torture of time: urgency vs importance
A large helping of trust…

- Stanford revisited
- Homebuyers, investors, politicians: The dynamics of inconsistency
Some shortcuts…

- Trust as a heuristic
- How do you choose a restaurant on holiday?
- The importance of shortcuts
- But what happens when rationality is replaced by rules?
  - The alphabet of ratings
  - Models
  - ‘Experts’
- How do geese fly in formation?
The nature of risk

• Risk vs uncertainty
• Everything is an exercise in uncertainty
• The fallacy of probability
  • Unknown unknowns and picking balls from jars
A few more biases into the mix...

<table>
<thead>
<tr>
<th>Cognitive bias</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Extrapolation</td>
<td>Placing more weight on recent events to predict future outcomes</td>
</tr>
<tr>
<td>Confirmation</td>
<td>The propensity to emphasise information that supports pre-conceived opinions.</td>
</tr>
<tr>
<td>Framing</td>
<td>Interpreting events differently depending on context and emotional state.</td>
</tr>
<tr>
<td>Overconfidence</td>
<td>Overestimating the likelihood of positive outcomes and accuracy of predictions</td>
</tr>
<tr>
<td>Hedonic</td>
<td>Needing to demonstrate growth and accumulate always</td>
</tr>
<tr>
<td>Ambiguity aversion</td>
<td>Prefer to take risks that can be quantified or analysed</td>
</tr>
<tr>
<td>Herding</td>
<td>Conforming to majority views</td>
</tr>
</tbody>
</table>
And if it all goes wrong…

Are you a winner or a loser?
Two Millennia of GDP growth

Growth of Global GDP from 1 AD onwards

Source: Camdor Global, Maddison Project
A long term perspective on individual wealth

GDP per capita for Western Europe (1 AD - 2012)

Source: Camdor Global, Maddison Project
The risks we never talk enough about: a) People

*As long as the music is playing, you gotta keep dancing.*

Chuck Prince

- The importance of **career risk**
- **Hedonic bias** and the illusion of movement
- **Tale risk** – we all love stories
- **The need to belong** – the Seattle Windshield epidemic
b) Debt

Source: Bob Swarup & Dario Perkins, *Till Debt Do Us Part*, Lombard Street Research, Camdor Global
c) Geopolitics. (it’s not just oil or Russia...)

- Geopolitics is not international relations and it is not cataloguing current events
- It is about people, the places they inhabit and the herds they create
- It is about their:
  - Compulsions – what moves us;
  - Constraints – what limits us;
  - Choices – what we do;
  - Consequences – what follows; and
  - Complexity – the system we create.
d) Inequality and disenfranchisment

Feelings about how the federal government is working

- Enthusiastic: 70%, Satisfied: 75%, Dissatisfied: 45%, Angry: 18%

Most View Eurosceptic Parties as Good Thing for the Country

The rise of nation-specific nontraditional parties is a...

- Spain: 25% Good thing, 70% Bad thing
- UK: 24% Good thing, 66% Bad thing
- Italy: 28% Good thing, 58% Bad thing
- Germany: 28% Good thing, 50% Bad thing
- Poland: 36% Good thing, 39% Bad thing
- France: 36% Good thing, 63% Bad thing

Note: Asked about UK Independence Party in UK, National Front in France, Alternative for Germany in Germany, Five Star Movement in Italy, Podemos in Spain and Congress of the New Right in Poland.


PEW RESEARCH CENTER

WHO DO EUROPE’S FAR-RIGHT PARTIES HATE THE MOST?

Far-right parties who have made statements against particular groups

- Jewish People: 6
- Muslims: 7
- Other Ethnic Minorities: 6
- Immigrants: 8
- Gay rights: 6
- Feminism: 2
- Global Capitalism: 6
- The EU: 9

Most common scapegoats
The evolution of complexity

Image courtesy of Barrett Lyon and the Opte Project
The Innovation Gap

Growing economic uncertainty, regulatory complexity, data etc.

Ability to distil, model, allocate, analyse etc.

Source: Camdor Global
The Moses Principle

• Why did the Jews spend forty years in the desert?
  • The land of ‘Milk and honey’?

• A metaphor for generational change
  • As the old died out, so did their memories of Egypt
  • Most Israelites would have been born in the desert

• Today, the Moses Principle lives on...
  • The world economy
  • Policymakers
  • Societies
A REMINDER: The environment is important

- *Ceteris paribus schmaribus*
- You cannot divorce economics from politics or society
- Left untended, a crisis of finance will always becomes one of society
- E.g. The Arab Spring, the French Revolution, etc.
- In other words, macro matters
The meme of globalisation

- An assumption we all take for granted
- But the underlying can change and flocks can move in new directions
- What is globalisation?
- Globalisation
  - The economic state where trade across nations (exports and imports) is growing faster than GDP
  - People interact more, transact more and create more wealth through their exchanges.
  - Also a growth in debt and inequality
- Deglobalisation?
  - By opposition, the alternate state where trade grows less than GDP
  - Countries become inward focused, international trade declines as a proportion of GDP and growth slows down as economic opportunities shrink
  - By implication, deleveraging and higher returns to labour
Today we are in Deglobalisation 2.0

- The fractures of globalisation and the rush to isolationism
The consequences of fear

- 50% increase between 2014 and 2015
- 80% of protectionist measures from G20 countries

Source: Global Trade Alert, Camdor Global
Globalisation grows debt markets

Total debt securities globally (all issuers, $bn)

Source: BIS, Camdor Global
The importance and pervasiveness of debt

Total Debt to GDP

- Greece
- Germany
- United States
- France
- Portugal
- Spain
- United Kingdom
- Japan
- Ireland

Source: McKinsey Global Institute
...and all bound up in a complex web

Source: Bob Swarup & Dario Perkins, *Till Debt Do Us Part*, Lombard Street Research, Camdor Global
The mis-coordination of monetary policy?

- Central banks are running out of options and reaching for ever more exotic solutions
- Japan on the cusp of direct monetisation
- What happened to politicians?
- Policymakers will in the bulk be driven by domestic priorities
Yields have cratered.
The wealth effect: hope is not a strategy

"I think you should be more explicit here in step two."
Meanwhile, regulation...

- Can you fight complexity with complexity?
- The problem with regulating Citigroup
- The allure of arbitrage
- The new problems of regulators
- Macroprudential policy
Balancing growth and financial stability?

Figure 1: The Trade-off Between Financial Stability and Growth

How do politicians lose touch?

- Policymakers respond to:
  - Voters
  - External markets
- The two are not always in unison
- Elections motivate them to respond to voters
- Economic interdependence motivates them to respond to markets

Source: Lawrence Ezrow
The traditional political spectrum

- An artefact from the French Revolution and another assumption
- From left to right...

Source: Bob Swarup
The real political spectrum is a Mobius ring

- There is no direction
- Only inward or outward
Globalisation creates disconnects

- Policymakers become less sensitive to their public and focused to their detriment on markets
- True also of urban ‘elites’

Figure 2. Effect of Economic Globalization on Political Party Responsiveness to Public Opinion

Source: Timothy Hellwig
Political and nationalist tensions...
The impact of debt and disenfranchisement

Source: Swarup & Perkins
1. Of capitalism and democracy

- Capitalism: Exploit resources to produce goods and sell them on for a profit
- Democracy: Share political power and focus on society being better off
- Deeply intertwined
  - Democracy implies ongoing redistribution of wealth, creating large markets of consumers with considerable aggregate savings (e.g. pension funds) and discretionary spending power
  - Capitalism creates a complex web of interconnected trades that weave together society
- A powerful symbiotic environment that nurtures innovation and growth
- BUT our institutions and natural hierarchies are still feudal
- The structural inequity of society
- The importance of social mobility
2. Debt forgiveness

- Growth and complexity need credit to survive and to grow
- The role of debt in wealth inequality
- Reboot the system: restructure debt and restore capacity
- Biblical jubilees and Brady bonds as examples
- Redistribution on the sly
3. The Fetish of GDP

- What is GDP?
- What is growth?
- The structure of demand
- Redefining the metrics of growth
Caveat societas

- The knee jerk answer is wealth redistribution
- Simple and populist
- But does it work?
- The lessons of Rome
  - Bread and circuses
  - 368AD: What would you do to avoid tax?
  - The birth of feudalism
Autarky vs Globalism

- Populations are left behind and without a voice
- In the absence of choices and the proliferation of uncertainty...
- The rise of populism
- We can demonise but we need to analyse and understand if we are to solve
- Recall our analytic framework:
  - Compulsions – what moves us;
  - Constraints – what limits us;
  - Choices – what we do;
  - Consequences – what follows; and
  - Complexity – the system we create.

Source: Timothy Hellwig
Focus on the bigger picture: People

Would you believe me if I told you A and B are the same colour?

We are all intendedly rational

Source: Edward H Adelson
Credit...

Source: The Pitts River Museum
...And complexity
Europe in 1913

Source: Swarup & Perkins
The Old Economic Order

Surpluses and Deficits in the good old days

Harvest colonial surplus, sell manufactured goods to colonies and collect interest on loans

Supply food and commodities

Great Britain

Sell goods and borrow money

Mainland Europe

Colonies
The Impact of the First World War

- A broken economic order in Europe
- Infrastructure and capital ravaged
- Huge social costs – 16mn dead and 20mn wounded
- No creditors – just debtors!
- Large deficits and borrowings by everyone
- Impaired economic competitiveness and strained sovereign balance sheets
The US emerged as the largest creditor globally

Source: Schwartz (1992); Swarup & Perkins (2012)
Initial camaraderie at Versailles...

- Wilson’s Fourteen Points
  - Reconciliation
  - Free trade
  - Disarmament
  - Self determination
- League of Nations
- Hopes of debt forgiveness
- Acceptance of some reparations by Germany and others
- Germany begins to reform tax code to increase revenues in preparation
- Wilson awarded Nobel Peace Prize in 1919 for his efforts
...soon turned bitter

- Economic self-interest dominates
  - US insistence on inter-allied debt repayment
  - British and French insistence on linking war loans to reparations
  - French insistence on extracting revenge for Franco-Prussian War of 1870-71
- US retreats into isolationism and rejects treaty
- Does not join League of Nations
- France dominates treaty negotiations
- A poor deal for Germany
The little matter of Reparations

- Set in 1921 at 132 billion gold Marks
- Made up of three tranches:

  - **C bonds totalling 82 billion gold marks** aimed at neutering Germany economically and satisfying nationalist sentiments
  - **B bonds totalling 38 billion gold marks** earmarked for repayment of inter-allied war debts owed by Britain and France to the US.
  - **A bonds totalling 12 billion gold marks** to compensate for direct war damage to the Allies.
The problem with paying reparations

### The burden of German reparations

<table>
<thead>
<tr>
<th></th>
<th>Gold marks (bn)</th>
<th>% of 1913 GNP</th>
</tr>
</thead>
<tbody>
<tr>
<td>GNP 1913</td>
<td>51</td>
<td></td>
</tr>
<tr>
<td>Public debt 1913</td>
<td>32.8</td>
<td>64%</td>
</tr>
<tr>
<td>Public debt 1920</td>
<td>25.2</td>
<td>49%</td>
</tr>
<tr>
<td>A bonds</td>
<td>12</td>
<td>24%</td>
</tr>
<tr>
<td>B bonds</td>
<td>38</td>
<td>75%</td>
</tr>
<tr>
<td>C bonds</td>
<td>82</td>
<td>161%</td>
</tr>
<tr>
<td>Total debt inc. reparations</td>
<td>157.2</td>
<td>308%</td>
</tr>
</tbody>
</table>

Source: Ritschl (2012)

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**German Public debt to GDP (post reparations)**

- C Bonds: 161%
- B Bonds: 75%
- A Bonds: 24%
- Public debt: 49%

% of 1913 GNP
The Psychological Impact

- Resentment and mood of national apathy in Germany
- Anger at political classes for ‘selling out’
- Communist and nationalist parties begin to emerge
  - 1921: Erzberger (former finance minister) assassinated
  - 1922: Rathenau (foreign minister) assassinated
- Inability to grow through exports leads to money printing to finance deficit
- Resulting inflation stokes European tensions and protectionist sentiments
- 1922: Germany declared in default
- 1923: France occupies Ruhr valley
  - Responsible for 80% of German production of coal, iron and steel
Obstinacy and Capitulation

- Policy of passive resistance undertaken
- Ruhr valley production falls by 2/3rds
- German government undertakes to bail out industries and provide benefits to unemployed workers
- The infamous Weimar hyperinflation episode
  - Jan 1921: 64 Marks to 1 US Dollar
  - Nov 1923: 4,200,000,000,000 Marks to 1 US Dollar
A New Solution: the Dawes Plan...

- US keen to protect its newly minted superpower status
- 1924: The Dawes Plan is unveiled
  - Begins to directly finance European government deficits
  - Currency stabilisation for Germany, restructuring of Reichsbank and new taxes to put Germany on a sustainable path
  - Annual reparations cut and extensive loans made to Germany to spur growth
  - But German currency reserves protected

- US banks begin to lend extravagantly to Germany as perceived risk diminishes
- Germany goes on a Keynesian spending binge
- Investment in industry, Infrastructure (first autobahn) etc
- Dawes get Nobel Peace Prize in 1925 for averting crisis
...leads to a new even more complicated debt triangle

Source: Swarup & Perkins
Meanwhile, gold is making a comeback...

- Rosy eyed view of pre-war 1913 economies
- Britain implements law to return to a full gold standard at the pre-war exchange rate of $4.86
- Hugely deflationary and coupled with a tight fiscal policy, leads to a stagnant 1920s
- Gold creates a fixed exchange rate system, now centred around the US
- Debt servicing costs mount and net debt remains stubbornly high
A Wave of Debt Restructurings begins...

- France negotiates 40 cents on the dollar in 1926 with the US
- Italy negotiates 26 cents on the dollar in 1926 with the US
- Germany begins to use US loans to fund reparations
- Short term debt for long-term liabilities!
- But buys time for Europe to stabilise and hopefully work out what to do with all the war debts
The Perils of Relying on Financial Markets

• 1928: US banks begin to grow worried about German credit rating
• Markets can absorb A bonds but not B bonds
• US adamant that no debt forgiveness
• 1920 Redux
• Germany unable to roll over debt in 1929
1929: Back to the Drawing Board…

- The Young Plan
- Cut German debt effectively in half
- Extend payments out even further to 1988
- More taxation
- ‘A bold plan’
- Young named TIME magazine’s Man of the Year
The Great Depression Hits

- American banks begin to withdraw credit
- European governments and private sector ill-prepared
- Protectionist sentiment surges again
- Fearful of Weimar like inflation, German government implements austerity
- May 1931: Creditanstalt bank collapses
- Leads to contagion and run on banks in Austria, Germany and elsewhere
Hugely Deflationary...

- German suffers one of the worst declines after US due to reliance on foreign debt

<table>
<thead>
<tr>
<th>Country</th>
<th>Decline</th>
</tr>
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<tbody>
<tr>
<td>United States</td>
<td>46.8 %</td>
</tr>
<tr>
<td>Great Britain</td>
<td>16.2 %</td>
</tr>
<tr>
<td>Germany</td>
<td>41.8 %</td>
</tr>
<tr>
<td>France</td>
<td>31.3 %</td>
</tr>
<tr>
<td>Canada</td>
<td>42.4 %</td>
</tr>
<tr>
<td>Czechoslovakia</td>
<td>40.4 %</td>
</tr>
<tr>
<td>Italy</td>
<td>33.0 %</td>
</tr>
<tr>
<td>Belgium</td>
<td>30.6 %</td>
</tr>
<tr>
<td>Netherlands</td>
<td>37.4 %</td>
</tr>
<tr>
<td>Sweden</td>
<td>10.3 %</td>
</tr>
<tr>
<td>Denmark</td>
<td>16.5 %</td>
</tr>
<tr>
<td>Poland</td>
<td>46.6 %</td>
</tr>
<tr>
<td>Argentina</td>
<td>17.0 %</td>
</tr>
<tr>
<td>Brazil</td>
<td>7.0 %</td>
</tr>
<tr>
<td>Japan</td>
<td>8.5 %</td>
</tr>
</tbody>
</table>

Source: Romer
Revenues and growth collapse...

- GDP collapses almost back to end-WWI levels
- German government pursues policy of strict austerity and hopes for growth
  - Govt revenue declines by 27% from 1929 to 1932, while spending declines by nearly 31%

Source: Swarup & Perkins
Social Tensions Mount

- Political paralysis means a minority government that tries to pass emergency laws by decree to enforce further austerity
- Extremist parties see a resurgence in support in the 1930 elections
- Blame now fixed squarely on current government, particularly in the aftermath of the late 20s boom
- 1930: France threatens to withhold last part of Young Plan loan till Germany makes reparation payment
- 1931: Germany threatens default
- Hoover negotiates a one year moratorium on all debts
Extremist parties become mainstream

- 1930: Communists and Nazis make strong gains
- 1932: Nazi Party more than doubles its seats and becomes the largest party

Source: Swarup & Perkins
A Final Futile Attempt

- 1932: The Lausanne conference
- Debt forgiveness back on the agenda – permanent elimination of all war debts and reparations in parallel
- Rejected again by the US
- 1932: Germany has three Chancellors in a single year as the political crisis mounts
- Jan 1933: Hindenburg invites Hitler to form government after he wins 33% of the popular vote
- Germany defaults on all its debts and begins to pursue a policy of autarky
- And the rest is history...
ABOUT MONEY MANIA

Twenty-five centuries of financial bubbles, investment manias and human folly explained, with rich historical detail and an insider’s financial acumen

“Unusually well-told, and expansive in scope. Similarities between different episodes are breath-taking... His framework provides interesting pointers.” - Financial Times

“[An] excellent new book, which looks at booms, panics and busts down the ages. ... Swarup's book comes out at an opportune moment.” - The Guardian

“[An] erudite history of financial speculation.” – The Economist

“[A] rigorously researched history packed with great stories and insights. Swarup takes the reader through a fascinating and thought provoking analysis of emotional biases, money, credit and social complexity.... The vexing question for every serious investor today is whether our uniquely complex modern society is at risk of another systemic crisis. Money Mania is a timely, well written reminder that this question should be given renewed priority.” – Paul Tudor Jones, Tudor Investment Corporation
PRINCIPAL BIO

**Dr Bob Swarup** is a respected international expert on macroeconomics, financial markets, investment strategy and alternatives. He is the author of the internationally acclaimed bestseller *Money Mania*, examining over two millennia of financial crises (Bloomsbury, 2014). Bob has also written extensively on diverse topics, with his work appearing in the Financial Times, Economist, Guardian, CNBC, Bloomberg, Boston Globe and others.

Outside writing, Bob is the founder of Camdor Global, an advisory firm that works with leading institutions, investors and policymakers around the world on strategic investment, risk management and business issues. He is also the co-founder of Alpha Governance Partners, a leading independent governance boutique with over $17bn in assets under governance.

Bob was formerly a partner at Pension Corporation, a leading UK-based pension buyout firm with $20bn in assets, where he ran alternative investments, was Chief Risk Officer and oversaw the thought leadership unit. Bob also served as Senior Investment Advisor to the UK Pensions Regulator; on the Advisory Board of Adveq, a leading Swiss PE firm; the Board of CatCo, a $2bn reinsurance hedge fund that he helped seed in 2011; and on numerous other boards and industry bodies.

Bob is a Fellow of the Institute of Economic Affairs and a Senior Visiting Fellow at Cass Business School. He holds a PhD in cosmology from Imperial College London and an MA (Hons) from the University of Cambridge.