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ASSET MANAGEMENT

market notes: Can't Happen? Don't Be So Sure.

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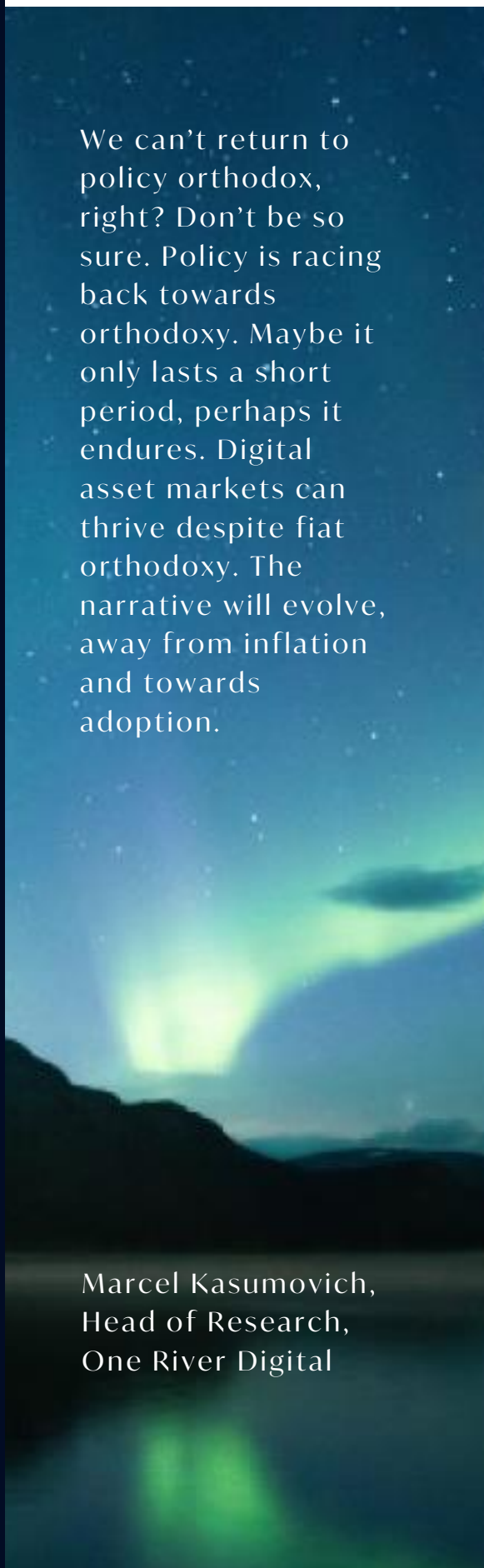

We can't return to policy orthodox, right? Don't be so sure. Policy is racing back towards orthodoxy. Maybe it only lasts a short period, perhaps it endures. Digital asset markets can thrive despite fiat orthodoxy. The narrative will evolve, away from inflation and towards adoption.

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1. The best lessons are realized with reflection. The value of wrinkles and grey hair – they are the scars of experience. Investing is no different. In a nondescript meeting with a living legend, I walked through comprehensive scenarios around a macro trade. "This one can't really happen," I observed casually, almost certain it could be safely discarded. The legendary volley that returned said, humbly, "don't be so sure."

2. The lesson in "don't be so sure" is that asset allocation is not about a clearer crystal ball or a higher rate of being right. Investing is about the preparation for what can happen. The conviction in any idea is more defined by understanding the risks of being wrong, rather than the chances of being right. And the 2008 financial crisis was punctuated by a rapid US dollar appreciation, counter to the trend and the opposite of conventional wisdom of the time.

3. We are living in times of unprecedented change. Inflation is the bright red button, mostly symbolic of the challenges ahead. Periods of low unemployment, low inflation, and low debt are being replaced by high inflation, high unemployment, and high debt. Current policy choices are defined by bad options, and digital asset markets are highly attentive to them. The conventional bullish case for digital assets rests with nominal illusion. Policy will be forced to accommodate high inflation as unemployment rises and asset markets decline. Quantitative easing is a permanent part of the policy architecture, and the thirst for nominal anchor takes you to assets like bitcoin.

4. But that's not where we are. An alternative is emerging – a surprisingly rapid return to orthodoxy. It seems implausible given the magnitude of government debt imbalance. But the "don't-be-so-sure" lesson applies. The United Kingdom is first in line. Policy is paying attention to market signals. The mix of low rates and prospects for an expansionary budget led to an immediate confidence run against UK assets. The sharp rise in bond yield and depreciation of the currency is usually reserved for emerging markets. Soon enough, a new budget proposal will emerge, and the Bank of England will be the ultimate arbiter on the speed of the return to orthodoxy with its November 3 rate decision.

5. Playbooks from the early 1990s are being dusted off. A more front-loaded macro policy tightening causes immediate economic pain but with the benefit of more balanced prospects ahead. UK fiscal policy will require immediate and outsized restraint. It isn't that UK policy will necessarily be followed by others. The choices are just becoming stark. It is also much easier for the Bank of England to execute than other countries – having been indemnified from losses, the Treasury must absorb any losses from the policy strategy. Even with calm policy responses, these losses accumulate to 3-5% of GDP in the next four years.

6. Already, policy is marching ahead with orthodoxy despite awkward realities. Federal Reserve Banks are accruing losses faster because of the increase in policy rates. Through October 13, the Federal Reserve's cumulative losses are $4 billion and will rise to the hundreds of billions through next year. This is a known policy choice – the Federal Reserve understands that a rise in the policy rate increases payments on reserves and repo operations that become greater than the average income earned on portfolio assets and lead to losses. It is the dark side of central bank balance sheet expansion – a sharp rise in short rates means that central bank losses transform past quantitative easing into fiscal tightening today.

7. Orthodoxy is more the historical norm than the exception. Figures 1 and 2 illustrate the deleveraging experience for highly indebted countries. There are outliers – hyperinflation in Germany (1918) and very high inflation in Greece (1931) were the mechanisms for reducing debt strains. But the norm is less pernicious. Governments run primary budgetary surpluses for very long periods, inflation is moderate, and a long period of interest rates being below nominal growth leads to a slow reduction of government debt. Orthodoxy can come in all shapes and sizes, but the macro contours must follow this simple roadmap.

8. Can digital asset markets survive a return to traditional orthodoxy? Most certainly, only with a very different narrative. What we also know about orthodoxy is that innovation is driven less by cheap capital and more by the value of executing solutions. The cost of playing in a meme coin is low when money is worthless. With an appropriate cost of capital, cash becomes a viable alternative, an ally to the patient. Innovation does not stop during orthodoxy. On the contrary, institutions must focus on improving their fundamental positions by running their business more efficiently. When capital is dear, there is far more scrutiny over investment.

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9. Blue-sky protocols will need to provide a solution to a problem, ideally with a focus on efficiency that can help improve margins. This is true of any cycle of orthodoxy – the manufacturing and agriculture shares of GDP declined materially in the 1900s alongside efficiency improvements. Now, think of a key problem that requires resolution as we move to a green electricity grid and increased automation – security. A self-driving car or helicopter to take you from A to B is inevitable. Having a single point of security failure is problematic. The digital ecosystem is working to solve that problem – these are the types of innovations that can be enduring.

10. Orthodoxy is the only option in digital asset markets without a lender of last resort. Protocols that did not survive the early-year downturn had bad luck or bad design – or both. Orthodoxy in traditional markets is more of a policy choice. Local currency sovereign debt has a special place in the financial system – regulators declare the probability of default to be zero. An obligation can be met, it just might be met with money that is worthless. A tenth-month adjustment may be preferred to a ten-year devaluation, after all. Survivors – digital or otherwise – must now sharpen their pencils. Costs matter. The value of a dollar is real again. It's not just a crypto winter, it is a world-wide winter.

Figure 1: Orthodoxy an Old Normal

1. Episodes with an Overall Reduction in Debt to GDP over 15 Years

Episodes					
Country	Start Year	Change in Debt to GDP (percent)	GDP Growth (percent)	Inflation (percent)	Primary Balance (percent of GDP)
Germany	1918	–129	1.2	1.4×10^{10}	. . .
Japan	1942	–96	0.7	91.4	3.8
Ireland	1986	–74	6.1	2.8	3.5
Italy	1942	–68	2.8	41.5	. . .
United States	1946	–68	1.4	3.0	1.7
Greece	1931	–57	–2.8	90.0	3.5
Belgium	1940	–55	2.2	3.1	0.7
Italy	1919	–43	0.1	2.7	2.0
Spain	1898	–27	1.1	0.3	3.9
Israel	1977	–22	2.2	. . .	. . .
Belgium	1921	–22	1.3	4.8	0.8
Canada	1995	–18	1.7	1.9	2.0
Netherlands	1887	–15	0.1	–0.2	1.3
France	1884	–13	1.7	–0.6	3.3
Italy	1992	–2	1.3	2.8	2.8
Average		–47	1.4	1.0×10^{9}	2.4
Average Excluding Hyperinflation (>40 percent)		–33	1.8	2.1	2.2

Source: International Monetary Fund.

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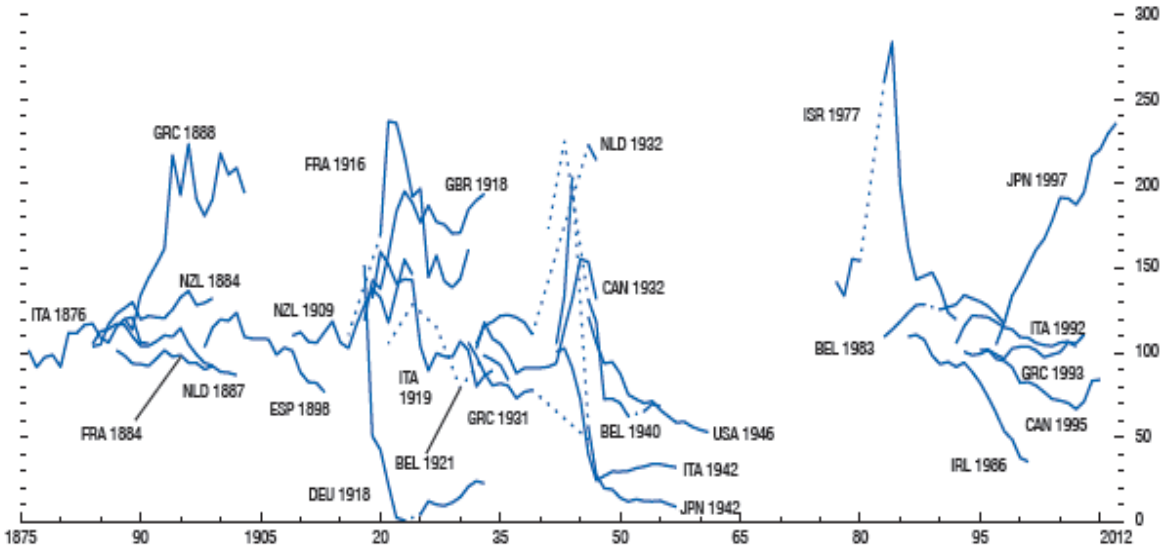
Figure 2: Debt Dynamics When Above 100% of GDP

Increases in public debt to above 100 percent are reasonably frequent, with very diverse dynamics of the debt-to-GDP ratios. These episodes are clustered around four major eras: the last quarter of the 19th century, the periods following the two world wars, and the last quarter of the 20th century.



Sources: Abbas and others (2010); and IMF staff calculations.
Note: BEL = Belgium; CAN = Canada; DEU = Germany; ESP = Spain; FRA = France; GBR = United Kingdom; GRC = Greece; IRL = Ireland; ISR = Israel; ITA = Italy; JPN = Japan; NLD = Netherlands; NZL = New Zealand; USA = United States. We consider all historical episodes when gross public debt rose above 100 percent of GDP and trace the evolution of the debt-to-GDP ratios for the subsequent 15 years. Where data are missing, dotted lines represent linear interpolations between available observations.

Source: International Monetary Fund.

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