Challenging Perceptions: Why We Need a Multi-Polar Monetary System

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I have got only a few notes. My perspective is really from having several decades as an asset manager and talking to not just policymakers but pension funds and asset allocators and reserve managers.

If we are thinking about this theme of moving towards a multipolar world, I suppose the first question in terms of international architecture is: Are we agreed on where we want to go? And we are probably not. But even if we were, I think how you get there is very problematic. And I think we are facing substantial risks at the moment of repeat crises. We do have problems of imbalances still in the global economy.

The way I see the build-up towards the problems in 2007/08 was one of a massive increase in savings flow from the emerging markets, and these net savers were basically pushing down yield curves in the developed world, and this was creating, together with, frankly, poor regulatory oversight, a massive leverage-induced frenzy based on unrealistic views of risk.

What I have tried to do in my new book – it has taken me a long time to write in part because I think some of the basic problems are very deep in the way we think about markets – is, (and I am with Milton Friedman on this) if a theory neither has realistic assumptions nor any predictive power, then it is frankly useless. But far too much of finance theory falls into that category. And what academia can say is, well, it doesn't matter because we've stated very clearly the assumptions. That is quite true, but the practitioners go and use it anyway. And the actual practice of asset allocation, I would say, has distorted global capital flows very substantially.

Whereas the norm, I suppose, is to think as economists and as regulators in terms of aggregates, I think what we need to do is think much more at a granular

1 Jerome Booth recently published his book: Emerging Markets in an Upside Down World: Challenging Perceptions in Asset Allocation and Investment.

level, about who owns what and why they behave as they do, and what their prejudices are as well.

We also have, I think, clearly a world which is much different to the one we had after the Second World War. We do not have a world dominated by the USA as 50% of GDP, and that is ever changing. We are going to see the emerging markets more and more dominant. They already have 85% of the world's population, and using purchasing power parity, already about 50% of GDP, and clearly the bulk of growth, clearly the bulk of reserves. They are also actually the world's net savers. We have got to stop thinking about them being the recipient of the behavior of Western investors.

There is a thing I called Core/Periphery disease, and I call it a disease because it is a meme, it is a deep-seated virus in our brains. It is very, very deep. And this Core/Periphery disease has been with us several hundred years. This is the idea that the Core, the developed world (or what I call the HIDCs, the Heavily Indebted Developed Countries, because their average debt to GDP – if you count private debt – is about 250%, ten times what is in the emerging markets) we assume, affects the Periphery, but we ignore the effect of the Periphery on the Core. I remember reading an IMF paper shortly after 2008 asking the question what would happen, if there was another major crisis in Europe, to emerging markets? And we have seen a bit of this questioning again in the last few months. People rush out of emerging markets. At that time they estimated that there might be USD 15 billion potentially leaving emerging markets in a future crisis. That sounds like an awful lot of money. Core-periphery disease is not asking the question the other way round – How much emerging market money might leave the developed world? Because when you ask the question the other way round you realize that central banks and sovereign wealth funds in emerging markets own USD 11 trillion of the supposedly liquid treasuries and European government bonds. Then you realize that actually that is the thing we should be worried about.

The fact that recently central banks in emerging markets have been complacent, and have not acted (and as a result some modest foreign exchange volatility has been observed), is not I think the guide to the really big risks in the future. If you have several hundred billion US dollars in reserves, frankly you can alter your exchange rate at will. If you find it inconvenient to bother intervening in the short term that does not mean that you are not going to do something if there is a more serious threat in the future. Foreign exchange volatility today may thus be a counter indicator of future major risks.

I think there are different versions also of history which reflect this Core/Periphery disease. Take the swap lines extended to the four emerging market countries shortly after the crisis. Were these mainly to help these countries out, or was it to persuade/prevent them from selling US Treasuries and causing a problem back home in the USA?

At the outbreak of World War I, which currencies rallied? Pound Sterling and the French franc did. The US dollar came off. Why was that? Well you can interpret the situation just as we can after 2008 when the dollar went up temporarily. This is perhaps because countries like the UK and France in 1914 – they had the problem - their investors who are invested abroad, brought money home in order to cover the hole at home. That's not a flight to quality or flight to safety. That's a flight to liabilities. So I think Core/Periphery disease, as I call it, affects, it perverts, it distorts our view of the world.

The world is also not easily categorized into risky and non-risky. The term "risk-free investment" – we use that term a lot in asset management – is an abuse of language. There is no such thing as a risk-free investment. If something is called risk-free, that means that the risk is not perceived. It does not mean there is not any risk. In Mr Li's presentation yesterday, he made an important point. If all the currencies in the world are going up and down at the same time and they are highly correlated, this sounds very worrying. Say not just in the emerging countries but also the developed countries, all currencies are going up and down pretty correlated against the US dollar. Are they all volatile and highly correlated, or is it actually the US dollar that is volatile? Thinking the US dollar stable and the rest of the world risky in such a scenario is a facet of Core/Periphery thinking.

And if I am standing on a mountain top and I have got some device to measure some flying object and I am measuring this all the time, in markets we might call the angle of view to the object a spread. As the spread moves we think this object is more risky, then less risky, more risky, etc. But then suddenly we have this revelation that we are not standing on a hill at all – we are actually on the deck of a ship. And we have been becalmed, but are now in a gale. It is us that is moving. So we have to rethink our view of the world. And when we do that, I think, we shall realise we have some major avoidable risks because pension funds and reserve assets are far too focused on developed economies.

I also think one of the reasons correlation has been very high particularly in 2007/08 is due to leverage, and that leverage has mainly been in the HIDCs as we know.

David Swensen's Yale model is taught in business schools all over the world and has massively improved the way we think about asset allocation. But for me we are, in using his more sophisticated ideas like the cavemen that discover fire: massive technological invention, but we are still troglodytes. The great innovations of the Yale model include that we should maybe do more than two asset classes, we can invest abroad and we can invest in stuff that is not liquid. But where is macroeconomics in asset allocation? Nowhere. Where is the idea of thinking strategically? Where is taking what we know about behavioral finance, behavioral biases and adjusting the way that we asset allocate? Where is our picture of our world? Why do we use indices to asset allocate at all? Just doesn't make any real sense – because indices are massively biased.

I have not got time here (though I do in the book) to go through some history of finance theory starting with Markowitz in 1959 and how his and others' simplifications have led us to this ridiculous position where we equate volatility with risk. Most people, if they are managing their own money, not other people's money, and they are not day traders, would probably care more about large permanent loss than volatility. And yet from the conventional way that assets are managed, this is simply not part of the equation. And likewise, I think regulators are falling into this trap as well because they think about volatilities equating to risk. Volatility is not risk, it is a part of it. It might in certain circumstances equate to risk, but not in all circumstances.

So I think we need to think about our assumptions and when these assumptions that we use are valid and when they might not be. Because we have a tendency, like small children, like infants: If they cannot see something, it does not exist. If we can't measure it, we just ignore it.

We have ignored uncertainty. We have denied uncertainty as opposed to risk, we have ignored all sorts of other aspects of reality, we have ignored macroeconomics, politics, a lot of things in the way that we asset allocate and regulate capital flows.

Because of this, I think we need to start mapping who owns what - at a micro-level. We cannot just budget this thing called risk (actually observed past volatility) and merely think about excess risk taking so defined. I would be thinking about who owns what and what their liabilities are and then, if you want to move one level further, I would try to map not just who owns what but what their prejudices are, what their world views are.

By the way prejudice is a fascinating thing in the sense that it tends to live with you until you die and you have to wait therefore for people to die for a new paradigm to become universal – Thomas Kuhn wrote about this. And there is often long-term arbitrage in markets affected by deep prejudice. But people can also change their minds at once. It does happen occasionally. We can get a group of homogenous investors, who do, if you like, all think that the emperor has got no clothes quite suddenly.

We need to redesign the international monetary system, precisely because we have a very skewed system overly based on the US dollar. Finance theory and misperceptions of risk have obscured our view on this issue, as with asset allocation more generally. We need to reduce likelihoods of crisis scenarios currently made uncomfortably possible by the dominant position of emerging market central bank reserve managers in the structure of the external US Treasury investor base. And we need to move towards a multi-polar reserve system. And how do we get there? Well, because we don't agree on the goals, it probably is not realistic to pin our hopes just on the G-20 and on coordination. I think we have to take unilateral action. And I think that starts with those excess reserves, with the big reserves. And that is emerging-market central banks. The message is to them: that they should start opening their eyes to the real risks of holding tons and tons of US Treasuries. The average 10-year yield on a US Treasury for the last six decades was around 6%. If yields go to 6% this could cause extensive Treasury portfolio losses. So that is hardly risk-free. And that is not including the currency losses that are likely.

If your trading pattern, like Brazil's, is only 10% with the United States, why would you have 80% of your reserves in US dollars? Ah, liquidity of course. But liquidity is also, I think, misunderstood. Future liquidity is very different to past liquidity. And I think there are three warning signals for liquidity suddenly drying up. One is a homogenous investor base, and I have a theory (in the book) of investor bases becoming homogenous due to perception changes. Also it should be noted that financial repression, by capturing domestic savings and forcing institutional investors into government bonds, and so artificially reducing yields can create greater homogeneity in an investor base. The second warning signal is a misperception of risk. Calling something risk-free for a start is a misperception of risk. And the third is leverage – a clear danger signal. If you look at the history of liquidity (Keynes writes about the fetish of liquidity) it is obviously not a God-given right. It is a function of supply and demand. And if all the demand is suddenly not there when a large homogenous group of holders changes its collective mind that's when you get a liquidity crisis. The world's reserves are frankly now too large for the U.S. Treasury market. And the euro is no alternative, I do not disagree with that. I am not saying there is an alternative. I am saying, we need to go to a multipolar system.

The Chinese central bank and other central banks are arguably already moving towards at least trade-weightings in their reserve holdings (and world trade has moved from maybe 10% South-South trade to now 30%). Further diversification is in effect coming through increased use of swaps. Also, as emerging currencies become more widely held as reserves they will become much more liquid and stable.

I also see currency wars as actually largely a "south-south phenomenon". For me, tapering is really like bad weather: emerging markets can complain about it, but they should just put on a Macintosh or have an umbrella and stop whining – the policy tools to mitigate the impact of the problem are in their hands.

This is in part because, of course, the liquidity created by quantitative easing is just going round a circle anyway. It has been designed to help the banks, not to stimulate the economy, which it has not done that well. And tapering is very different to raising interest rates.

Of great importance for emerging markets is that they do not want to appreciate six months before their export competitors. So we are all watching the Chinese. But once they start to appreciate against the dollar and diversify reserves more, I think you will see more and more acceleration of diversification of reserves by others, selling US dollars in order to buy each other's currencies. And that is a healthy gradual process which can reduce systemic risk in the whole system over time. And that is what I think we should be going towards.

My scare scenarios are just to give you a bit of drama. I do not know whether they are going to happen, and I hope not. But if they do not then it will be because we do focus on their possibility and move gradually away from the precipice; because the more gradual process of reserve diversification I have alluded to will happen. And it does not require coordination through the G-20.

Thank you very much.